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TAKING MISAPPROPRIATION SERIOUSLY: STATE COMMON LAW DISGORGEMENT ACTIONS FOR INSIDER TRADING

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I. INTRODUCTION

A. Background

In two recent cases, the U.S. Supreme Court substantially diminished the Securities and Exchange Commission's ("SEC") ability to deprive persons who violate the federal securities laws of their ill-gotten gains. In the 2017 case of *Kokesh v. SEC*,[1] a unanimous opinion penned by Justice Sonya Sotomayor held that disgorgement actions were subject to the five-year statute of limitations for penalties imposed by U.S.C. § 2462.[2] In a notorious

1. 137 S. Ct. 1635 (2017).

2. 28 U.S.C. § 2462 governs any "action, suit or proceeding for the enforcement of any civil fine, penalty, or forfeiture, pecuniary or otherwise." As Urska Velikonja points out, this is particularly significant since the five-year statute of limitations would almost certainly start to run from the time of the fraud, not the time of the SEC's discovery of the fraud. Urska Velikonja, *Public Enforcement After Kokesh: Evidence from SEC Actions*, 108 GEO. L.J. 389, 391 (2019). Her examination of 8,000 cases from 2010 (the year the SEC sued the defendant in *Kokesh*) to 2018 (the year *Kokesh* was decided) suggests that, depending on how courts interpret *Kokesh*, between 20% and 80% of SEC disgorgement actions might be at risk. *Id.* at 395.

One reason for this is that, unlike private litigants who file complaints before discovery, the SEC generally does not bring actions until its investigation is completed, which often take years. *Id.* at 398. One suspects that one of the effects of *Kokesh* might be that the SEC will change its practice and commence actions earlier. *Id.* at 431–32. Velikonja also suggests that the reduced statute of limitations might have a lesser effect on insider trader enforcement actions than for actions for other violations because they are easier to detect than large, on-going, frauds like Ponzi schemes. *Id.* at 411–13, 415–

footnote, the Court stated that it was leaving the question as to whether the SEC had the authority to seek disgorgement at all to another day,[3] implying that the writing was on the wall.

Three years later, in *Liu v. SEC*,[4] in an 8-1 opinion once again authored by Justice Sotomayor, the Court held that the SEC could continue to seek disgorgement in judicial actions as an equitable remedy adjunct to its statutory authority to seek injunctions under §21(d)[5] of the Securities Exchange Act of 1934 (the "Exchange Act"), but its practice had exceeded the bounds of equity.[6] Consequently, the Court imposed substantial limitations on disgorgement going forward.[7] Disgorgement orders must be limited to the defendant's net profits, after deducting legitimate expenses.[8] Rejecting a theory of joint and several liability, it ruled that in most cases a defendant can be forced to disgorge only his own profits, not those of third parties.[9]

Perhaps most important, the Supreme Court held that disgorged funds must be distributed to the victims of the defendant's fraud.[10] In the past, the SEC often turned disgorged funds over to the U.S. Treasury. In so holding, the Supreme Court rejected the SEC's argument that it is enough that the

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3. *Kokesh*, 137 S. Ct. at 1642 n.3.

4. 140 S. Ct. 1936 (2020).

5. 15 U.S.C. § 78u(d).

6. In fact, as the Restatement (Third) of Restitution and Unjust Enrichment (the "R3RUE") makes clear, the modern law of "restitution" (which includes what federal securities law calls disgorgement) does not easily fit into equity. Rather, it has grown to encompass a wide variety of legal and equitable doctrines including contract, tort, and most relevant to securities regulation, principal-agency and property principles. As such, courts impose both legal and equitable remedies in the name of restitution. Consequently, the R3RUE takes the position that it would not try to shoe-horn restitution into a legal/equitable dichotomy because most state common law courts today have both legal as well as well as equitable jurisdiction. Nevertheless, this distinction remains significant for federal purposes since the SEC does not have the express statutory authority to seek disgorgement, only the general authority to seek equitable remedies auxiliary to its statutory authority. The lingering significance of the distinction at the *state* level is whether the defendant has a Constitutional right to trial by jury when a plaintiff seeks restitution. Restatement (Third) of Restitution and Unjust Enrichment § 4 cmts. 1, b (AM. L. INST. 2011) [hereinafter R3RUE]; *see also* Douglas Laycock, *Restoring Restitution to the Canon*, 110 MICH. L. REV. 929, 930–31 (2012). However, in Delaware, restitution actions to recover profits from classic insider traders are implicitly considered equitable as they are adjudicated before chancellors without juries. *See infra* text at notes 68–70, 218–47.

7. 140 S. Ct. 1936 (2020).

8. *Id.* at 1940.

9. *Id.* at 1949. It did, however, note there might be exceptions in some cases, such as in the case of *Liu*, where the two defendants were spouses or where there is, in effect, a partnership. *See id.*

10. *Id.* at 1940.

enforcement action benefits the public generally.[11] Only subsequent cases will tell us under what circumstances and to what extent payments to the Treasury can be made if it is not feasible to distribute funds to victims.[12]

The holdings of *Liu* and *Kokesh* are in tension. Among the Court's rationales in *Kokesh* for finding that disgorgement was a penalty was that defendants were often required to disgorge profits earned by others (such as tippees in insider trading cases) and sometimes disgorged funds were paid to the U.S. Treasury.[13] But in *Liu*, the Court imposed limitations on the SEC's disgorgement powers because equitable remedies must not be punitive. This suggests that it was the SEC's improper wielding of its disgorgement powers that was punitive and perhaps implies that disgorgement *properly* applied would *not* be a penalty. This raises the question, assuming that the SEC follows the restrictions imposed by *Liu*, will the practice cease to be a penalty such that the five-year statute of limitations of 28 U.S.C. § 2462 will cease to apply? If so, *Kokesh* might retroactively become irrelevant — a curious historical footnote.

In the meanwhile, the Supreme Court has been developing a largely property-based theory of insider trading. Why is insider trading evil? Because material nonpublic information is property that the trader has fraudulently obtained and must not use for his own purposes.

In this Article I bring these thoughts together. I examine the restitutionary remedy of disgorgement and connect it to the specific context of insider trading. I argue that disgorgement can and should be sought in *private* rights of actions brought under *state* common law rather than by the SEC under the federal securities laws.[14] Delaware and New York already permit issuers to

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11. *Id.*

12. Velikonja estimated that "between 2004 and 2012, the SEC used fair funds to distribute more than 75% of all collected monetary penalties," including disgorgement. Urska Velikonja, *Public Compensation for Private Harm: Evidence from the SEC's Fair Funds Distributions*, 67 STAN. L. REV. 331, 334 (2015). Velikonja's data suggests that during the period from 2010 to 2018, disgorgement was obtained in approximately 96.6% of SEC insider trading actions (including those that are settled). Velikonja, *supra* note 2, at 425–26.

13. Kokesh v. SEC, 137 S. Ct. 1635, 1644 (2020).

14. As early as 1984, Robert Thompson suggested that, at least in some cases, restitution based on unjust enrichment policies might be the appropriate remedy for insider trading. Robert Thompson, *The Measure of Recovery Under Rule 10b-5: A Restitution Alternative to Tort Damages*, 37 VAND. L. REV. 349 (1984). One of two problems he identifies is that, following *Diamond v. Oreamuno*, 248 N.E.2d 910 (N.Y. 1969), the appropriate party to seek restitution in the case of what we now call classic insider trading would be the issuer of the securities but, as I will discuss (*see infra* text at notes 130–32) it will rarely have standing under federal law. *Id.* at 395.

Second, Thompson finds "it provides little deterrence to an insider. The defendant knows that if he is caught, he simply must hand back what he gained, and that if he is not caught, he will make a handsome profit." *Id.* at 396 (citations omitted). Of course, this assumes that the purpose of disgorgement is deterrence, not corrective do so in the context of what is known as classic insider trading. If one takes the Supreme Court's insider trading jurisprudence seriously, other owners of information should also be able to do so under the alternate misappropriation theory of insider trading. Such cases would not be subject to the limitations imposed by *Kokesh* and *Liu.* More importantly, they would avoid many of the doctrinal quandaries that have arisen under the notoriously problematic federal caselaw.

Private disgorgement actions under state law would be a supplement to, not a replacement of, SEC civil actions for injunctions and fines[15] or Department of Justice ("DOJ") criminal actions. Indeed, private actions will probably be largely parasitic on federal actions because insider trading is typically only revealed through government investigation.[16] And there are reasons to expect that relatively few state disgorgement actions will be brought, if for no other reason than the profits most insider traders make (or losses avoided) are typically quite modest.[17] Nevertheless, I argue that by the logic of the Supreme Court's jurisprudence, the owners of the material nonpublic information would be the appropriate parties to bring such litigation. Indeed, part of my impetus for writing this Article is to illustrate how the Supreme Court's approach which combines property, fiduciary duty, and fraud elements is inadequate for addressing the public policy issues regarding insider trading as a federal offense.

I will not offer a detailed analysis of the *Kokesh* and *Liu* decisions, merely noting in passing, that the Supreme Court's understanding of restitution is flawed. In her short opinion in *Kokesh*, Justice Sotomayor partly based her holding on the assertion that disgorgement was a penalty because in practice it was intended to deter wrongdoing rather than to compensate victims. As

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justice. *See infra* text at notes 25–31. Moreover, this is less an argument as to who should be the appropriate plaintiff in a private right of action as one suggesting that the state should be able to bring civil or criminal enforcement actions.

For others who have suggested that insider trading might be analyzed as a form of unjust enrichment under state law, see, e.g., James J. Park, *Rule 10b-5 and the Rise of the Unjust Enrichment Principle*, 60 DUKE L.J. 345 (2010); WILLIAM K.S. WANG & MARC I. STEINBERG, INSIDER TRADING § 3.5.2 (2d ed. 1996); Donald C. Langevoort, *Insider Trading and the Fiduciary Principle: A Post-Chiarella Restatement*, 70 CAL. L. REV. 1, 26 (1982); and Saikrishna Prakash, *Our Dysfunctional Insider Trading Regime*, 99 COLUM. L. REV. 1491, 1500 (1999).

15. Verity Winship's analysis of SEC actions for insider trading for fiscal years 2005 through 2015 might suggest that it has been over-reliant on disgorgement, as opposed to fines. Verity Winship, *Disgorgement in Insider Trading Cases: Fy2005-Fy2015*, 71 SMU L. REV. 999 (2018). Although the SEC has the authority to seek penalties of up to triple profits in addition to disgorgement, in fact, it has not typically sought the maximum it could. *Id.* at 1009–10.

16. *See infra* text at note 143.

17. *See infra* text at note 148.

such, she stated, it addresses a public rather than an individual harm.[18]

This presumes that law falls into a rigid punitive v. compensatory dichotomy. This is a category mistake, but confusion about restitution is common. Indeed, Andrew Kull, the Reporter on the Restatement (Third) of Restitution and Unjust Enrichment ("R3RUE") has asked rhetorically whether the "law of restitution in this country has been neglected so long that it is already past resuscitation."[19] I, like the drafters of the R3RUE and the American Law Institute, answer "no." It ought to be resuscitated.

The R3RUE insists that restitutionary remedies — which include disgorgement[20] — are neither compensatory nor punitive, but fall within a third category: unjust enrichment.[21] As Doug Rendleman, a member of the R3RUE advising committee explains "The . . . baseline guide to restitution is the defendant's gain, not the plaintiff's loss,"[22] a simple point that many courts do not internalize.[23]

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18. *Kokesh*, 137 S. Ct. at 1635, 1643.

19. Andrew Kull, *Three Restatements of Restitution*, 68 WASH. & LEE L. REV. 867 (2011). Professor Kull suggests that one reason why knowledge and scholarship of remedies generally, and restitution specifically, has languished in the United States, even as it has flourished in other common law jurisdictions, is that since the 1960s, U.S. law schools have become academies for the study of public law. *Id.* at 870 (citing John Langbein, *The Later History of Restitution*, *in* RESTITUTION: PAST, PRESENT, AND FUTURE 57, 61 (W.R. Cornish et al. eds., 1998). Even American private law scholarship tends to be focused on "'instrumental' or policy-based analysis," whereas restitution rarely extends beyond the relative rights of the litigants. *Id.* at 871. He notes that he once heard Ernest Weinrib refer to restitution as the "private parts of private law." *Id.*; *see also* Laycock, *supra* note 6, at 930.

Justice Sotomayor does not mention the R3RUE in *Kokesh* in which she makes this distinction, although she does discuss it in *Liu* to justify her limitations on disgorgement.

20. James Edelman limits the term "restitution" for remedies designed to return a transfer of property or its traceable proceeds to its owner, JAMES EDELMAN, GAIN-BASED DAMAGES: CONTRACT, TORT, EQUITY AND INTELLECTUAL PROPERTY 66 (2002), and disgorgement for remedies that seek to recover profits from a wrongdoer, whether or not a transfer has been made. *Id.* at 72. Nevertheless, as the R3RUE does not make this distinction, I will generally not do so either.

21. Brief of Remedies and Restitution Scholars as Amici Curiae in Support of Neither Side at 12, Liu v. SEC, 140 S. Ct. 1936 (2020) (No. 18-1501), https://www.supremecourt.gov/DocketPDF/18/18-1501/126519/20191223115738971_18-1501%20Liu%20v%20SEC%20Restitution%20Scholars%20Brief.pdf; *see also* Doug Rendleman, *Measurement of Restitution: Coordinating Restitution with Compensatory Damages and Punitive Damages*, 68 WASH. & LEE L. REV. 973, 975 (2011). Rendleman notes, however, that in practice although the policies favoring punitive damages and restitution "are not identical[,] . . . the policies are unclear and may overlap, leading an observer to remark or a defendant to argue that disgorgement has a punitive quality." *Id.* at 980.

22. Rendleman, *supra* note 21, at 975–76.

23. *Id.* at 977–79. However, as I discuss (*see infra* text at notes 184, 194–97, 215, 228, 237–43), some courts, reflecting the ignorance that Kull, Rendleman, and Laycock lament, have incorrectly refused to order disgorgement in private rights of actions for

Although, the R3RUE agrees with the Supreme Court that the goal of restitutionary remedies is to deter bad action, it denies the Supreme Court's assertion that restitution seeks to do this by punishing the defendant. Rather, restitution un-does the bad act.[24] That is, we are not *punishing* a thief when we make him give back stolen goods (or pay damages for the tort of conversion). We are recognizing the property rights of the owner of the goods and re-establishing the *status quo ante.* We penalize the thief when we prosecute him.

Accordingly, Ernest Weinrib argues that restitution should not be viewed through the instrumental lens of deterrence at all, but through a Kantian one of correlative rights and duties.[25] When a defendant interferes with certain rights of the plaintiff, corrective justice demands that we make the defendant reverse this interference by, in appropriate circumstances, ceding her profits earned (or losses avoided) to the plaintiff.[26]

While I am sympathetic with Weinrib's analysis, as a practical matter, the difference between a deterrence and a corrective justice rationale for remediating insider trading law might lie in the questions of who should bring a cause of action and who should receive the disgorged profits. If we are only concerned with deterrence, then it would be appropriate for the state to bring the cause of action because, as Justice Sotomayor suggested in *Kokesh* in finding that disgorgement is a penalty, it would be addressing a

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insider trading on the mistaken grounds that the issuer does not suffer harm.

24. Justice Sotomayor recognizes this in *Liu* when she insists that to come within the SEC's statutory authority to seek equitable remedies, disgorgement cannot be punitive. Liu v. SEC, 140 S. Ct. 1936, 1942 (2020). As mentioned, this is in tension with her opinion in *Kokesh* holding that it is a penalty.

25. Ernest Weinrib states:

> [R]ights and their correlative duties imply a conception of the parties as persons who interact with each other as free and equal agents, without the law's subordinating either of them to the other. Accordingly, as an instantiation of corrective justice, liability for unjust enrichment should exhibit the correlative structure of the parties' relationship, vindicate the plaintiff's rights as against the defendant, and affirm the parties' freedom and equality.

ERNEST J. WEINRIB, CORRECTIVE JUSTICE 188 (2012).

26. That is:

> Just as the owner's rights to set the terms on which property is used or transferred implies a correlative duty on others to abstain from using it . . . , so the owner's right to the profits from the use or transfer of the property imports a correlative duty on others to abstain from such profits. [] The gain is the continuing embodiment of this injustice, and the injustice is undone when the gain is restored to the owner of the object from which the gain accrued. Gain-based damages reverse the wrong by showing, through the return of the benefits, that the law considers the defendant's implicit assertion of ownership to be a nullity whose consequences are to be undone.

Id. at 126.

public, not an individual, harm.[27] Moreover, at least in those cases where the "victim" has not suffered out-of-pocket damages, it should not matter whether disgorged funds are distributed to the issuer, to investors, or kept by the state.[28] Nevertheless, despite finding in *Kokesh* that disgorgement is a penalty, Justice Sotomayor also insists in *Liu* that disgorged funds be distributed to victims, suggesting that the remedy is compensatory, not punitive.[29]

If, however, one adopts the corrective justice theory of restitution, then the person whose rights have been violated (i.e., the issuer in the case of classic insider trading or some other source of the information, in the case of the misappropriation theory) would be both the appropriate plaintiff and the recipient of the disgorged amount. This would seem to be consistent with Justice Sotomayor's rejection in *Liu*, of the SEC's argument that it is enough if enforcement actions benefit the public generally even if disgorged funds are not distributed to victims[30] — which, of course, is inconsistent with her previous holding in *Kokesh* that disgorgement, being deterrent in nature, serves a public, rather than a private, purpose. It is, however, consistent with Andrew Kull's assertion that restitution policy rarely extends beyond the relative rights of private litigants.[31]

This is the approach that Delaware has taken with respect to the classic theory of insider trading. I argue that if we were to take the Supreme Court's insider trading jurisprudence seriously, which is based both on breach of fiduciary-type duties and the conceptualization of material nonpublic information as property, then the owner of the information should have a private right of action for "disgorgement."[32] Moreover, based on basic principles of unjust enrichment the plaintiff should be entitled to the funds regardless of whether she suffered an out-of-pocket loss.[33]

Unfortunately, under the Supreme Court's standing requirements for

27. Kokesh v. SEC, 137 S. Ct. 1635, 1643 (2020).

28. This was the SEC's position prior to *Liu*. *See* Roberta S. Karmel, *Will Fifty Years of the SEC's Disgorgement Remedy Be Abolished?*, 71 SMU L. REV. 799, 806 (2018).

29. *See Liu*, 140 S. Ct. at 1945–46 (explaining the importance of distributing disgorged funds to victims).

30. *See supra* text at notes 10–12 .

31. *See supra* note 19.

32. Similarly, Andrew Marrero has argued that the Supreme Court's logic suggests that the SEC should disburse amounts disgorged by insider traders under the misappropriation theory to the defrauded source, not to investors. Andrew W. Marrero, *Insider Trading: Inside the Quagmire*, 17 BERKELEY BUS. L.J. 234, 290 (2020). I agree.

33. As Graham Virgo says in his treatise on restitution, its function is "to deprive the defendant of a gain rather than to compensate the claimant for loss suffered." GRAHAM VIRGO, THE PRINCIPLES OF THE LAW OF RESTITUTION 3 (2d ed. 2006) (citations omitted); *see also infra* text at notes 167–68, 320–23.

Exchange Act § 10(b)[34] and Rule 10b-5 promulgated under it,[35] it will usually be difficult if not impossible for the owner to have standing to seek disgorgement under the federal securities laws.[36] This is one of the many reasons I suggest that such actions should instead be brought under state law.

B. Advantages of Taking Appropriation Seriously

As I discuss in the last section of this Article,[37] taking the Supreme Court's insider trading jurisprudence seriously, applying the common principles of restitution, and bringing the action in state, rather than federal, court would go far towards solving some of the most vexing issues that have arisen in the law of insider trading. This is so for seven reasons.

First, one reason the federal law of insider trading law is so complex is that the Supreme Court requires not just that the defendant breach a fiduciary or similar duty and misappropriate material nonpublic information, but that, in doing so, she must *also* commit actual fraud. That is, although all fraud might be wrongful, not all wrongful acts are fraudulent. The confluence of these three necessary elements (fraud, fiduciary duty, and misappropriation of property) into one cause of action has become cacophonous. In contrast, under state law, although fraud can be grounds for restitution, breaches of fiduciary duty and misappropriation standing alone can each be an independent ground for restitution.[38]

Second, there is ample confusion over the requisite relationship between the information owner and the information trader as well as the latter's duties that would make trading based on the information actionable. There is also disagreement with whether this duty comes from state law or federal common law. This has resulted in inconsistent and ad hoc rulings.[39] It also raises significant *Erie* questions that are rarely addressed in the caselaw and are beyond the scope of this Article.[40] When presented with these actions, state courts would merely be applying their own common law of fiduciary duties, property, and fraud, and they have much experience in deciding these issues.

Third, it would simplify the rules as to when a tippee inherits the tipper's duty not to trade on material nonpublic information. Under the federal law

34. 15 U.S.C. § 78j(b).

35. 17 C.F.R. § 240.10b-5 (2021).

36. *See infra* text at notes 130–32, 292–93.

37. *See infra* text at notes 376–483.

38. *See infra* text at notes 331–75.

39. *See infra* text at notes 378–413.

40. In *Erie Railroad Co. v. Tompkins*, 304 U.S. 64 (1938), the Supreme Court held that in diversity jurisdiction cases federal courts are not entitled to create their own general common law for issues that properly fall within state law.

of tipping, the party bringing the cause of action has the burden of proving that the tippee knew, or had reasonable grounds to believe, that the tipper was violating a duty to the owner of the information exploited and that the tipper received a personal benefit from the tip.[41] In contrast, if we take seriously the Supreme Court's theory that material nonpublic information is *property* of the issuer or other source of the information, then under state common law of property, the *tippee* as transferee of misappropriated property should have the burden of showing that he was a good faith purchaser for value who *lacked* knowledge when he learned and used the information.

Fourth, it provides justification for one aspect of SEC disgorgement that most concerned the Supreme Court in *Koresh* and *Liu*. That is, in the past, tippers were made to disgorge an amount of money equal to the profits made by tippees even when the tipper did not share directly in that profit.[42] Justice Sotomayor viewed this as an impermissible imposition of joint and several liability.[43] However, if we take seriously the Supreme Court's tipping jurisprudence that passing information as a gift constitutes *value to the tipper*, then under the principles of unjust enrichment the tipper, who must account to the owner for his ill-gotten gains, should have to disgorge an amount equal to the value of the gift. This most reliable measure of the value of the gift, in turn, should be measured by the tippee's profits earned (or loss avoided) in trading on the information. This would be the direct, not the vicarious or joint and several, liability of the tipper.

Fifth, the law of restitution provides an appropriate measure of recovery in misappropriation cases. If we considered the market to be injured by insider trading so that all contemporaneous traders could recover out-of-pocket damages, then the potential liability for misappropriation would be disproportionate.[44] However, if we take the Supreme Court seriously that in misappropriation it is the owner of the information that is defrauded, then a disgorgement action by the owner would result in the more appropriate remedy of depriving the disloyal confidant of the fruits of his misdeeds.

Sixth, it would eliminate the embarrassment identified by the Second Circuit Court of Appeals in *SEC v. Dorozhko*,[45] which suggested that insider trading on the basis of *stolen* as opposed to fraudulently obtained material

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41. Dirks v. SEC, 463 U.S. 646, 661–62 (1983).

42. *See infra* text at notes 435–37.

43. Liu v. SEC, 140 S. Ct. 1936, 1949 (2020).

44. William K.S. Wang, *Measuring Insider Trading Damages for a Private Plaintiff*, 10 U. CAL. DAVIS BUS. L.J. 1, 3 (2009). This is why, of course, Section 20A caps damages at the defendant's profits earned or losses avoided. *See infra t*ext at notes 135–42.

45. 574 F.3d 42 (2d Cir. 2009).

nonpublic information does not violate the federal securities laws. However, if we conceptualize such information as property, then any non-permitted use should be grounds for restitution under state common law.

Finally, and following from the last point, eliminating the necessary element of fraud in insider trading law and looking to the broader law of restitution would do away with perhaps the most unsatisfying aspect of *United States v. O'Hagan*,[46] the case in which the Supreme Court adopted the misappropriation theory. This is the possibility that a so-called brazen misappropriator could get away with her ill-gotten gains.[47]

II. CURRENT LAW

A. Federal Insider Trading Jurisprudence

In this Article, I do not directly address the SEC's right to obtain disgorgement in civil actions. Rather, I argue that if one takes the Supreme Court's insider trading law jurisprudence seriously, then "disgorgement" should be available in private rights of action under state law.

I will also not purport to give a detailed account of federal case law for two reasons. First, in my experience, almost every academic article on insider trading does so and I probably would have little to add to this well-trodden field. I assume anyone who is reading this Article already has a passing knowledge of the law. Second, and more importantly, I am advocating an expansion of the state common law regime precisely to avoid the inadequacy of federal law.

i. Texas Gulf Sulphur

The *Liu* case should be read in the context of the Supreme Court's forty-five year attempt to curtail the expansion of the securities law which began in the 1960's when the SEC and the lower federal courts were in effect seeking to federalize what would today be considered the bailiwick of state corporate law.[48] Disgorgement of profits for securities fraud is generally considered to originate in the Second Circuit case *SEC v. Texas Gulf Sulphur*,[49] decided at the height of the expansionary era. Although *Texas Gulf Sulphur* heralded the modern era of insider trading enforcement and private rights of action against issuers,[50] the Supreme Court long rejected

46. 521 U.S. 642 (1997).

47. *See infra* text at notes 462–66.

48. For an argument that insider trading law could have been developed as state rather than federal law, see Larry E. Ribstein, *Federalism and Insider Trading*, 6 SUP. CT. ECON. REV. 123 (1998).

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

50. Although the case was an SEC enforcement action, it was the basis for the

many elements of the Second Circuit's analysis.[51] *Liu* is yet another bullet in this zombie case that will not die.

First, in *Santa Fe Industries Inc. v. Green*[52] the Supreme Court rejected the Second Circuit's holding that Rule 10b-5 encompasses constructive, as opposed to actual, fraud. Consequently, under modern securities law, breach of fiduciary duty *standing alone* is not supposed to constitute securities fraud, although (confusingly) it remains as an element in insider trading cases.[53]

Second, in *Chiarella v. United States*[54] the Supreme Court rejected the Second Circuit's holding that the federal securities laws mandate parity of information. Consequently, today the mere possession of material non-public information standing alone does not impose the so-called *Cady, Roberts*[55] duty to "disclose or abstain" before trading securities.[56] Reading

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explosion of private causes of action for securities fraud because it established that a plaintiff need not have privity with the issuer. *Id.* at 862; *see* Donald C. Langevoort, *From* Texas Gulf Sulphur *to* Chiarella*: A Tale of Two Duties*, 71 SMU L. REV. 835, 836–37 (2018) [hereinafter Langevoort, *Duties*]; A.C. Pritchard & Robert B. Thompson, Texas Gulf Sulphur *and the Genesis of Corporate Liability Under Rule 10b-5*, 71 SMU L. REV. 927 (2018).

51. James Cox says that he continues to teach *Texas Gulf Sulphur* even though little of it remains because "[w]hat truly sets *TGS* apart is its opacity on the core of the case: why insider trading is proscribed. Its vagueness naturally invites conjecture on how its carefully developed record overcomes that weakness to divine a solid foundation for regulating insider trading." James D. Cox, *Seeking an Objective for Regulating Insider Trading Through* Texas Gulf Sulphur, 71 SMU L. REV. 697, 700 (2018). Onnig Dombalagian argues that, although some of its specific elements have been overruled, *Texas Gulf Sulphur* continues to influence the SEC's decisions on how issuers make disclosure and its vision of parity of information still captures the popular imagination. Onnig H. Dombalagian, Texas Gulf Sulphur *and Information Disclosure Policy*, 71 SMU L. REV. 713 (2018). Marc Steinberg emphasizes that *Texas Gulf Sulphur* continues to influence insider trading law in other countries. Marc I. Steinberg, Texas Gulf Sulphur *at Fifty — A Contemporary and Historical Perspective*, 71 SMU L. REV. 625, 638–40 (2018).

52. 430 U.S. 462 (1977).

53. As I discuss (*see infra* text at notes 114–19) fiduciary or similar duties impose the duty to speak that will establish omission as an element of fraud.

54. 445 U.S. 222 (1980). Langevoort suggests that in application, the Second Circuit's egalitarian parity-of-information principle was "long gone by the time Justice Powell wrote the Court's opinion in *Chiarella.*" Langevoort, *Duties*, *supra* note 50, at 847.

55. Cady, Roberts & Co., Exchange Act Release No. 6668, 1961 WL 60638 (Nov. 8, 1961). As has been oft noted (*see, e.g.*, STEPHEN BAINBRIDGE & WILLIAM D. WARREN, INSIDER TRADING LAW AND POLICY 33–34 (Found. Press, 1st ed. 2014) [hereinafter BAINBRIDGE, INSIDER TRADING]), because the insider will rarely have the right to disclose the information, this is tantamount to an "abstain" rule.

56. As Stephen Bainbridge discusses in his essay on the silver anniversary of *TGS*, two of the problems of the Second Circuit's analysis are that it applied to *anyone* in possession of material nonpublic information (i.e., not just to traditional insiders or others having fiduciary or similar duties), and material nonpublic information was implicitly

Santa Fe Industries together with *Chiarella*, it also clear that, federal insider trading law rejects the *Cady, Roberts* notion that the federal law of insider trading is intended to prevent some vague notion of "unfairness" to investors.[57]

Third, in *TSC Industries, Inc. v. Northway, Inc.*,[58] the Court rejected the Second Circuit's definition of materiality as that which *might* reasonably affect an investment decision in favor of a *would* standard.[59]

Fourth, in *Ernst & Ernst v. Hochfelder*,[60] the Supreme Court rejected the Second Circuit's holding that one can negligently violate Rule 10b-5 in favor of a scienter standard. In light of this quadruple repudiation of the Second Circuit's overly expansive holdings in *Texas Gulf Sulphur*, perhaps what should be surprising is not that the Supreme Court also at least partially rejected its broad remedial provisions, but how they survived this long.

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defined to include market information not received from the issuer or from another person having a proprietary relationship to the information. Stephen M. Bainbridge, *Equal Access to Information: The Fraud at the Heart of* Texas Gulf Sulphur, 71 SMU L. REV. 643 (2018). As Justice Powell was concerned in *Dirks v. SEC*, 463 U.S. 646, 658–59 (1983), such an expansive rule would actually discourage market analysis. *See* A.C. Pritchard, *Justice Lewis F. Powell, Jr., and the Counterrevolution in the Federal Securities Law*, 52 DUKE L.J. 841, 931 (2003). Bainbridge is particularly scathing in his review of the *TGS* court's mischaracterization of precedent and legislative history. *See* Bainbridge, *supra* note 56, at 648–52.

57. *Cady, Roberts & Co.*, Exchange Act Release No. 6668, at 912.

58. 426 U.S. 438 (1976), *rev'g* 512 F.2d 324 (1985).

59. In *TSC Industries* the Supreme Court stated, "[a]n omitted fact is material if there is a substantial likelihood that a reasonable shareholder *would* consider it important in [making an investment decision] . . . ." 426 U.S. at 449. However, the Supreme Court would eventually adopt the *Texas Gulf Sulphur* magnitude versus probability test for the materiality of contingent events in *Basic Inc. v. Levinson*, 485 U.S. 224 (1988).

60. 425 U.S. 185 (1976).

ii. The Common Law of Insider Trading

It is almost *de rigeur* in academic literature to bemoan the sorry state of insider trading law.[61] In Donald Langevoort's term, it is a "crazy-quilt."[62] One reason for this is that no statutory provision defines it. Even in 1988, when Congress amended the Exchange Act to add §§ 20A[63] and 21A[64] authorizing private rights of action for contemporaneous traders and SEC actions for penalties, respectively, against "[a]ny person who violates any provision of this chapter or the rules or regulations thereunder by purchasing or selling a security while in possession of material, nonpublic information,"[65] it notoriously did not define *when* or *how* such purchasing and selling violates the law. Consequently, except for insider trading in the context of a tender offer, which is governed by the prophylactic provisions of Rule 14e-3,[66] to be unlawful, insider trading must contravene the anti-

61. For an introduction to the voluminous literature bewailing the chaotic "quagmire" of insider trading law, see DONALD C. LANGEVOORT, 18 INSIDER TRADING: REGULATION, ENFORCEMENT, & PREVENTION § 1.6, Westlaw (May 2021 update); *see also* Marrero, *supra* note 32, at 250–01.

As always, there are exceptions. Relying on Michal Shur-Ofry and Ofer Tur-Sinai's concept of "constructive ambiguity," Jill Fisch argues that what others, such as myself, see as incoherent insider trading jurisprudence in fact has the advantage of allowing judicial lawmaking to be "flexible and incremental." Jill E. Fisch, *Constructive Ambiguity and Judicial Development of Insider Trading*, 71 SMU L. REV. 749, 757, 764 (2018).

As a former transactional attorney, I agree that constructive ambiguity is often both intentional and beneficial in contract drafting. *See* Jeanne L. Schroeder, *Sense, Sensibility and Smart Contracts: A View From a Contract Lawyer*, 49 U.C.C. L.J. 251 (2020). However, although Professor Frisch mentions it in passing, Fisch, *supra* note 61, at 770, I do not think she gives sufficient concern to the fact that there is criminal as well as civil liability for insider trading. Indeed, Langevoort suggests that courts often apply the law too narrowly in civil cases precisely because of the concern of a broad interpretation in criminal cases. Donald C. Langevoort, *Watching Insider Trading Law Wobble: Obus, Newman, Salman, Two Martomas, and a Blasczcak*, 89 FORD. L. REV. 507, 526–27 (2020) [hereinafter Langevoort, *Wobble*]. For a recent critique of the common law aspect of criminal insider trading law and argument for an insider trading criminal statute, see Miriam H. Baer, *Insider Trading's Legality Problem*, 127 YALE L.J.F. 129 (2017), http://www.yalelawjournal.org/forum/insider-tradings-legality-problem.

62. Donald C. Langevoort, *What Were They Thinking? Insider Trading and the Scienter Requirement* [hereinafter Langevoort, *What Were They Thinking*], *in* RESEARCH HANDBOOK ON INSIDER TRADING 52 (Stephen M. Bainbridge ed., 2013) [hereinafter, HANDBOOK].

63. 15 U.S.C. § 78t-1.

64. *Id.* § 78u-1.

65. *Id.* § 78t-1(a).

66. 17 C.F.R. § 240.14e-3 (2021). In *United States v. O'Hagan*, 521 U.S. 642 (1997), the Supreme Court confirmed that prophylactic rules were permitted under Exchange Act § 14(e), 15 U.S.C. § 78n(3), because its language is broader than that of § 10(b) which is limited to actual fraud. *See id.* 672–73.

fraud provision of Exchange Act § 10(b) as developed in caselaw. However, as Justice Powell stated in *Chiarella*, "Section 10(b) is aptly described as a catchall provision, but what it catches must be fraud."[67]

iii. Purpose Of Restricting Insider Trading

Another reason for the chaotic state of insider trading law is that there is little consensus as to what, if anything, is wrong about insider trading and how this relates to federal securities law policy.[68] The commentary on this issue is voluminous. Many who argue insider trading should be unlawful tend to do so on the grounds that it is unfair.[69] Another rationale for a ban is

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67. Chiarella v. United States, 445 U.S. 222, 234–35 (1980).

68. Fisch identifies the problem of seeking a statutory solution to the inconsistency in the caselaw, reflecting the fact that there is no consensus on the purpose of the ban on insider trading. Fisch, *supra* note 61, at 751. One commentator has noted:

> Manifesting the extent to which even authorities on the subject are unable to articulate a compelling legal theory of what insider trading is and why the conduct it encompasses should be declared unlawful, a large body of case law and commentary, for instance, variously portrays insider trading doctrine as based on principles drawn from or analogous to the law of fraud, breach of fiduciary duty, agency, theft, conversion, embezzlement, trusts, property, contracts, corporations, confidential relationships, unjust enrichment, lying, trade secrets, and corruption.

Marrero, *supra* note 32, at 254–55 (citations omitted). This is somewhat of an overstatement since many of these categories (for example, fiduciary duty and agency) substantially overlap. Nevertheless, he is correct that overall, the law is a quagmire and the jurisprudence that requires us to combine both fiduciary and property concepts to produce fraud is unsatisfying.

Bainbridge, writing in 1995, identifies three rationales in the academic literature. Stephen M. Bainbridge, *Incorporating State Law Fiduciary Duties into the Federal Insider Trading Prohibition*, 52 WASH. & LEE L. REV. 1189, 1228–41 (1995) [hereinafter Bainbridge, *Incorporating*]. First, it is an adjunct to the mandatory disclosure system. *Id.* Second, it protects investors. *Id.* Third, it is necessary for confidence in the markets. *Id.* Richard W. Painter, Kimberly D. Kwawiec & Cynthia A. Williams list among the various purposes attributed to insider trading regulation objectives of promoting information symmetries, market confidence, disclosure, fraud prevention, protection of proprietary material, and enforcement of fiduciary obligations. Richard W. Painter et al., *Don't Ask, Just Tell: Insider Trading After* United States v. O'Hagan, 84 VA. L. REV. 153 (1998). For another good introduction to the policy debate pro and con regulation, see Steven M. Bainbridge, *An Overview of Insider Trading Law and Policy: An Introduction to the Research Handbook on Insider Trading*, *in* HANDBOOK, *supra* note 62, 1, 19–30 [hereinafter, Bainbridge, *Overview*].

69. This is best expressed by the title of Kim Scheppele's classic article *"It's Just Not Right": The Ethics of Insider Trading*, 56 L. & CONTEMP. PROBS. 123 (1993). See also the dyspeptic comments of Judge Richard Howell when sentencing Raj Rajaratnam for insider trading that "insider trading is an assault on the free markets . . . his crimes reflect a virus in our business culture that needs to be eradicated." quoted in Alexandre Padilla, *Insider Trading: What is Seen and What is Not Seen*, *in* HANDBOOK, *supra* note 62, at 251 [hereinafter Padilla, *Insider Trading*]. This begs the question that our free-market system allows the buying and selling of property on the basis of material nonpublic information in almost every context other than the securities markets. *See*

that insider trading makes markets less efficient because the market does not have full information relevant to the correct pricing of securities.[70] However, there are others who argue the opposite and believe that it should be permitted as it enhances market efficiency.[71] That is, trading by insiders puts the market on notice of nonpublic information and is a substitute for affirmative disclosure of the substance of that information.[72] Richard Epstein takes both sides, arguing that sometimes insider trading is efficient and sometimes it isn't.[73] Consequently, he would prefer that restrictions be left to the private ordering of contract.[74]

Related to both the fairness and efficiency arguments is the assertion that permitting insider trading would negatively affect the securities markets. For example, in *O'Hagan*, the case in which the U.S. Supreme Court adopted the misappropriation theory of insider trading, Justice Ruth Bader Ginsberg included investor confidence as one of her rationales for adopting the misappropriation theory.[75] Tamar Frankel suggests that, based on 1929 and "to some extent" 2008, "when trust is undermined, the securities markets

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infra text at notes 89–94. In a relatively early article written before the Supreme Court adopted the misappropriation theory, James Cox notes that "American jurisprudence abhors insider trading with a fervor reserved for those who scoff at motherhood, apple pie, and baseball." James D. Cox, *Insider Trading and Contracting: A Critical Response to the "Chicago School"*, 1986 DUKE L.J. 628, 628 [hereinafter Cox, *Insider Trading*]. He raises questions about the usual rationales including fairness, "arguments explaining how insider trading impacts the corporation's operation, investor behavior, and the allocational efficiency of capital, markets," *id.* at 628–29, as well as the Supreme Court's fiduciary principal.

Peter Molk suggests that some:

> Justify [the ban on insider trading] as protecting the capital markets, safeguarding ordinary investors and their companies from opportunism. Others characterize insider trading restrictions as preventing the "inherent unfairness" that would result from insiders systematically trading with superior information. Still others focus on preventing share price distortions that could arise from legalized insider trading.

Peter Molk, *Uncorporate Insider Trading*, 104 MINN. L. REV. 1693, 1693 (2020) (citations omitted).

70. *See, e.g.*, Cox, *Insider Trading*, *supra* note 69, at 630.

71. *See, e.g.*, *id.* at 635–37.

72. For a quick survey of the economic arguments for and against insider trading, see Matthew Barbabella et al., *Insider Trading in Congress: The Need for Regulation*, 9 J. BUS. & SEC. L. 199, 227–37 (2008) and BAINBRIDGE, INSIDER TRADING *supra* note 55, at 175–86.

73. Richard A. Epstein, *Returning to Common-Law Principles of Insider Trading After* United States v. Newman, 125 YALE L.J. 1482, 1491–94 (2016).

74. *Id.*

75. United States v. O'Hagan, 521 U.S. 643, 658–59 (1997). In doing so she cited the classic article for this proposition, Victor Brudney, *Insiders, Outsiders, and Informational Advantages Under the Federal Securities Laws*, 93 HARV. L. REV. 322, 356 (1979).

will dry up."[76] One commentator has gone so far as to suggest that if insider trading were legalized "[s]tock markets would drastically shrink if not disappear."[77]

These are empirical assertions that have been challenged since the 1960's.[78] Henry Manne argues that there is an easy way to test which side is correct in the case of classic insider trading.[79] That is, we could allow a publicly traded company to give its management and employees permission to engage in classic insider trading so long as the company publicly disclosed this policy.[80] If investors react by "dumping" said company's stock, we have evidence that the net effect of allowing insider trading does hurt market confidence and that Congress should consider banning this practice. However, arguably this might not be necessary because if such a policy does depress stock prices, one would expect management would not adopt it or face stockholder ire. If they don't, it would suggest that the current ban is unnecessary and perhaps inefficient.[81] Moreover, at least some studies have indicated that the "general public [is] fully aware that insider trading laws are ineffective in discouraging insider trading, but they are still investing despite knowing that they are at risk of trading with insiders."[82]

Underlying many of these arguments is the belief that, despite the Supreme Court's holdings to the contrary, the federal securities laws should

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76. Tamar Frankel, *Insider Trading*, 71 SMU L. REV. 783, 789 (2018).

77. George W. Dent, Jr., *Why Legalized Insider Trading Would Be a Disaster*, 38 DEL. J. CORP. L. 247, 248 (2013).

78. *See, e.g.*, Henry G. Manne, INSIDER TRADING AND THE STOCK MARKET (1966).

79. Henry G. Manne, *Insider Trading and the Law Professors*, 23 VAND. L. REV. 547, 555–57 (1970).

80. *Id.*

81. *Id.* For two recent discussions suggestions that insider trading has negative effects on markets, see Michael A. Perino, *The Lost History of Insider Trading*, 2019 U. ILL. L. REV. 951 (2019) and David Rosenfeld, *The Impact of Insider Trading on the Market Price of Securities: Some Evidence from Recent Cases of Unlawful Trading*, 44 J. CORP. L. 65 (2018). For a recent article questioning the market-confidence argument, see John P. Anderson, *Insider Trading and the Myth of Market Confidence*, 56 WASH. U. J.L. & POL'Y 1 (2018). For a cogent overview of the debate and how it ignores modern high-frequency trading practices, see Yesha Yadav, *Insider Trading and Market Structure*, 63 UCLA L. REV. 968 (2016) [hereinafter Yadav, *Market Structure*]. For a more recent skeptical view of the market-confidence argument, see John P. Anderson, *Insider Trading and the Myth of Market Confidence*, 56 WASH. U. J.L. & POL'Y 1 (2018).

Epstein makes a more subtle form of this argument. He does not think that we can conclude that insider trading is always either efficient or inefficient. Rather, some forms of insider trading might be efficient, while others might be detrimental to a corporation and its shareholders. Accordingly, rather than adopting a blanket rule by regulation or case law, we should apply classic insider trading policy to an issuer's board of directors so long as it discloses its decision and reasoning to the stockholders. Epstein, *supra* note 73, at 1493–94.

82. Padilla, *supra* note 69, at 251, 257.

favor parity of information among market participants, the policy behind *Cady, Roberts,* and *Texas Gulf Sulphur*.[83] The classic argument for parity of information (published one year before *Chiarella*) is Victor Brudney's suggestion that prohibitions on trading based on nonpublic information should depend on whether the trader's informational advantages are erodable (such that others could theoretically obtain the information) or uneroadable.[84] Others have argued that this distinction is unworkable either in practice or theory.[85] As Jonathan Glater notes, informational asymmetries are just one of the many inequalities that exist between and among market participants.[86]

Yesha Yadav has noted that high-speed traders have strong structural advantages in obtaining and trading on non-fully market information over other traders.[87] She suggests that regulators should consider "what counts as a harmful and unfair allocation of informational privileges — in other words, clarifying what should fall within the prohibition against insider trading and why."[88] It is not clear why informational advantages are more unfair than

83. *See, e.g.*, SEC v. Texas Gulf Sulphur Co., 446 F.2d 1301, 1308 (2d Cir. 1971) ("Either the transactions so traded could be concluded by a relative or an acquaintance of the insider.").

84. Brudney, *supra* note 75, at 361–67. More recently, Bruce Klaw argues for a statutory ban on insider trading based on an equality of access of information principle that he derives from the ethical theories of John Rawls and Immanuel Kant. Bruce W. Klaw, *Why Now Is the Time to Statutorily Ban Insider Trading Under the Equality of Access Theory*, 7 WM. & MARY BUS. L. REV. 275, 298, 313 (2016). In doing so, however, he does not address why what he sees as a universal ethical principle does not apply generally to economic behavior and relies largely on arguments based on negative effects on securities markets.

85. For three very different critiques of this distinction, see Ian Ayres & Stephen Choi, *Internalizing Outsider Trading*, 101 MICH. L. REV. 313 (2002); Kimberly D. Krawiec, *Fairness, Efficiency, and Insider Trading: Deconstructing the Coin of the Realm in the Information Age*, 95 NW. U. L. REV. 443 (2001); Frank H. Easterbrook, *Insider Trading, Secret Agents, Evidentiary Privileges, and the Production of Information*, 1981 SUP. CT. REV. 309.

86. He states:

> Some have more experience, some have more wealth, which enables the purchase of advice from others with more experience or with better information. Given the cost of compensating for such diversity and the dubious normative case for trying to, there is a strong argument that capital market regulation should strive for allocative efficiency. Yet this is conspicuously not the approach taken by securities regulation.

Jonathan D. Glater, *Insiders, Outsiders, & Fair Access: Identifying Culpable Insider Trading*, 83 BROOK. L. REV. 1393, 1394–95 (2018).

87. Yesha Yadav, *Insider Information and the Limits of Insider Trading*, 56 WASH. U. J.L. & POL'Y 135 (2018).

88. *Id.* at 137 (continuing "[s]hould confidential, corporate information merit different legal treatment than data from exchanges and trading venues that is not-fully-public? If confidential corporate information is different, then why?"); *see also* Yadav,

these and other structural inequalities inherent in our capitalist economy — including, without limitations, educational, wealth, and social conditions.

Moreover, one may legally buy and sell almost any other type of property based on informational advantages, as the Second Circuit Court of Appeals noted without irony in *Texas Gulf Sulphur*.[89] In that case, the nonpublic information concerned a valuable mineral strike on the issuer's land.[90] The Second Circuit noted that the issuer had a "legitimate corporate objective" in concealing this information — i.e., it wanted to surreptitiously buy adjoining land from neighboring property owners.[91] In other words, parity of information counts for nothing in the commercial real estate market. And yet it found that it was unlawful for insiders to buy securities based on the same information because of a lack of parity of information between the insiders and the sellers.[92] As Andrew Verstein notes, if instead of buying stock based on the material nonpublic information concerning Texas Gulf Sulphur's mineral strike, the insiders had

> [S]hort[ed] copper and zinc futures, [they] could have reaped similar fortunes, but without the legal problems. For while insider trading in securities has long been illegal, the same behavior has been entirely legal in the commodities and futures markets.[93]

In the words of Jamie Boyle, why do we have this enigmatic "island of egalitarianism" in the otherwise individualistic ocean that is capitalism?[94] Indeed, the misappropriation theory of insider trading is based on the proposition that the source of information has a property interest in it with the right to exploit it for its own financial advantages.

Of course, the difference between the two fact patterns in *Texas Gulf Sulphur* is the identity of the persons exploiting material nonpublic information and their relationship to the source of the information. If the issuer's insiders bought the land, instead of stock, without the prior approval of the issuer's disinterested directors after full disclosure this, no doubt, would have been an improper taking of a corporate opportunity from the issuer. That is, if the hypothetical purchase of the land by the insiders on inside information would have been wrongful, it is not because the lack of parity of information between the sellers and the buyers was *unfair to the*

Market Structure, *supra* note 81.

89. 401 F.2d 833, 848–49 (2d Cir. 1968).

90. *Id.* at 839–42.

91. *Id.* at 848.

92. *See id.* at 849–50.

93. Andrew Verstein, *Insider Trading in Commodities Markets*, 102 VA. L. REV. 447, 448 (2016) (citations omitted). Verstein calls for more coordination between the two legal regimes. *Id.* at 450.

94. James Boyle, *A Theory of Law and Information: Copyright, Spleens, Blackmail, and Insider Trading*, 80 CAL. L. REV. 1413, 1491 (1992).

sellers (who would have no cause of action against the buyers). The wrongfulness would be the insiders' breach of their fiduciary duty of loyalty to the issuer. As such, it is the issuer who should have a cause of action against the insiders, not the sellers of the land. As I discuss, this is the position that Delaware has taken in finding that there is a derivative action on behalf of an issuer to sue insiders for disgorgement of profits for insider trading.[95]

Nevertheless, the biggest *doctrinal* problem for those who favor a parity-of-information rationale for a ban on insider trading is that, as discussed below,[96] the Supreme Court expressly rejected such reasoning in *Chiarella.*[97] Moreover, whatever goals one thinks insider trading law should serve, the Supreme Court reads the language of Exchange Act Sec. 10(b) and Rule 10b-5 as being limited to *actual* fraud.[98] This causes a mismatch because, as Langevoort has correctly stated, "relatively little" about insider trading "can fairly be considered deceptive."[99]

To complicate things even more, the Supreme Court has found that violations of fiduciary duties are not fraudulent *per se*.[100] Nevertheless, breaches of duty are necessary to establish when insider trading is fraudulent. The SEC and the courts have twisted themselves into pretzels trying to fit their policy concerns into the Supreme Court's Procrustean doctrinal bed. Consequently, it is both refreshing and distressing that Langevoort asserts "[t]he robust persistence of insider trading enforcement (criminal and civil) is based as much on politics as coherent policy."[101] More cynically, some

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95. *See infra* text at notes 166–68, 229–46.

96. *See supra* note 54 and *infra* text at notes 107–18.

97. 445 U.S. 222 (1980).

98. In the early retrenchment case of *Ernst & Ernst v. Hochfelder*, the Supreme Court stated that "despite the broad view of [Rule 10b-5] advanced by the Commission . . . its scope cannot exceed the power granted the Commission by Congress under § 10(b)." 425 U.S. 185, 212–14 (1976). Since the Supreme Court previously found that § 10(b) is limited to actual fraud — an intentional tort — scienter is an element of a private right of action under Rule 10b-5. *Id.*; *see also* United States v. O'Hagan, 521 U.S. 642, 651 (1997) (stating that "precedent indicates [that liability under Rule 10b-5] does not extend beyond conduct encompassed by § 10(b)'s prohibition").

99. Langevoort, *What Were They Thinking*, *supra* note 62, at 52.

100. *See* Santa Fe Indus. Inc. v. Green, 430 U.S. 462, 480 (1977) ("We thus adhere to the position that 'Congress by § 10(b) did not seek to regulate transactions which constitute no more than internal corporate mismanagement.'").

101. Unfortunately, this language which appeared in an earlier version of Langevoort, *Wobble*, *supra* note 61, did not make it to the final published version. *See* Donald C. Langevoort, *Watching Insider Trading Law Wobble: Obus, Newman, Salman, Two Matromas and a Blaszczak*, (Jan. 8, 2019) (unpublished draft) https://ssrn.com/abstract=3490636 at 8 [hereinafter, Langevoort, *Wobble (draft)*]. In the earlier version he continued:

> Insider trading enforcement has become a recognizable brand symbol for American-style securities regulation, touching on some deep-seated public

suggest that, during the great recession, regulators and politically ambitious prosecutors wanted to be seen doing something by bringing civil and criminal actions against easy targets rather than the more difficult or impossible task of pursuing the structural causes of the crisis.[102]

I do not attempt to solve the problem of the *federal* insider trading policy, other than to note that there does seem to be strong revulsion against insider trading by the public generally.[103] Moreover, Congress has expressed its displeasure with insider trading by enacting legislation providing for private rights of action as well as penalties for it, without defining what it is.[104] So it would seem to be appropriate for Congress to take the next step and enact legislation to clarify its contours.[105]

> fascination, envy and distaste for the arrogance of economic elites and others who exploit some undeserved edge in the stock markets. [] The campaign against abusive trading generates public support for the complex mission of investor protection more generally, which is consequential whether or not we have a coherent theory of how and why it constitutes securities fraud.

Id. at 8 (citations omitted). I have similarly, but not as graciously, suggested that envy plays a large part in the public distaste for insider trading. Jeanne L. Schroeder, *Envy and Outsider Trading: The Case of Martha Stewart*, 26 CARDOZO L. REV. 2023 (2005) [hereinafter, Schroeder, *Envy*].

102. A.C. Pritchard, *Insider Trading Law and the Ambiguous Quest for Edge*, 116 MICH. L. REV. 945, 951 (2018) [hereinafter, Pritchard, *Edge*]. Roberta Karmel, a former SEC commissioner, alleges that "blockbuster cases are used to prop up the SEC's image as a tough cop on Wall Street," that the "number and types of insider trading cases currently being brought" are a "misallocation of enforcement resources," and is concerned that "it is wrong for a person to be jailed for an undefined crime." Roberta S. Karmel, *The Law on Insider Trading Lacks Needed Definition*, 68 SMU L. REV. 757, 758 (2015) [hereinafter, Karmel, *Definition*]. Nevertheless, Karmel believes that "a ban on insider trading is necessary to the SEC's disclosure system." *Id.* at 768 (citations omitted).

Another variation on this is the "public choice" theory that insider trading regulation is an attempt by the SEC "to enlarge its jurisdiction and enhance its prestige" as well as to "maximize [administrators'] salaries, power and reputation by maximizing the size of their agency's budget." Bainbridge, *Overview*, *supra* note 68, at 27; *see also* M. Todd Henderson, *The Changing Demand for Insider Trading Regulation*, *in* HANDBOOK, *supra* note 62, at 230. The public choice theory of regulation (based on agency capture) is probably most closely, but not exclusively, associated with Jonathan Macey. JONATHAN MACEY, INSIDER TRADING: ECONOMICS, POLITICS, AND POLICY (1991).

103. One study indicates that the public is equally confused about the rationale for a ban. They don't like insider trading, but they are not sure why. Stuart P. Green & Matthew B. Kugler, *When is it Wrong to Trade Stocks on the Basis of Non-Public Information?: Public Views of the Morality of Insider Trading*, 39 FORDHAM URB. L.J. 445, 484 (2011).

104. *See infra* text at notes 63–65.

105. One relatively recent, and in my mind, unsuccessful attempt by Congress to clarify insider trading was the Stop Trading on Congressional Knowledge Act of 2012 (STOCK Act), Pub. L. No. 112-105, 126 Stat. 291. This was supposed to eliminate a non-existent loophole that supposedly exempted Representatives and Senators from

Rather, I am taking the Supreme Court's insider trading jurisprudence seriously that, whether it constitutes fraud for the purpose of the federal securities laws, it does constitute violation of fiduciary duties and misappropriation of information. If so, under basic restitutionary principles of common law it is the person to whom the duty is owed or the owner of the information who should have a cause of action against the trader for disgorgement and that right of action does not require a proof that the plaintiff was defrauded or that it suffered economic harm.

iv. Classic Insider Trading

"Classic insider trading" involves the purchase or sale of equity securities (or options on equity securities) by traditional insiders owing a fiduciary duty to the issuer — directors, officers and perhaps employees and major stockholders — based on material nonpublic information learned from the issuer.[106] Classic insider trading has also been extended to so-called temporary or constructive insiders such as outside counsel who take on fiduciary or equivalent duties in the context of specific transactions.[107] Consequently, in *Chiarella*,[108] the Supreme Court found that the defendant, who bought shares in the targets of unannounced tender offers based on information he learned at his job working at a financial printing house

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insider trading liability. Of course, there never was such a loophole, legislators were subject to the same rules as everyone else. What was true was that it was unclear how to apply the misappropriation theory of insider trading to legislators with respect to material nonpublic information they learned in performing their official duties. However, the operative portion of the STOCK Act merely states:

> [S]olely for the purposes of the insider trading prohibitions arising under this Act, . . . each Member of Congress or employee of Congress owes a duty arising from a relationship of trust and confidence to the Congress, the solely United States Government, and the citizens of the United States with respect to material, nonpublic information derived from such person's position as a Member of Congress or employee of Congress or gained from the performance of such person's official responsibilities.

Id. § 4(b)(g)(1). As I have shown elsewhere, this language does not address the many other ambiguities of the law. Jeanne L. Schroder, *Taking Stock: Insider and Outsider Trading by Congress*, 5 WM. & MARY BUS. L. REV. 159 (2014) [hereinafter, Schroeder, *Taking Stock*]. As confusion as to whether certain senators who traded in securities after a private briefing on the dangers of the Coronavirus early in the outbreak shows, the STOCK Act seems to have done little to clarify the law. *See, e.g.*, Rachel Sandler, *Senate Ethics Panel Drops Insider Trading Probe Into Kelly Loeffler*, FORBES (June 16, 2020, 8:13 PM), https://www.forbes.com/sites/rachelsandler/2020/06/16/senate-ethics-panel-drops-insider-trading-probe-into-kelly-loeffler/?sh=2bd20363416c.

106. *See* Zachary Gubler, *A Unified Theory of Insider Trading Law*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Sept. 30, 2016), https://corpgov.law.harvard.edu/2016/09/30/a-unified-theory-of-insider-trading-law/.

107. United States v. O'Hagan, 521 U.S. 642, 652 (1997); Dirks v. SEC, 463 U.S. 646, 655 n.14 (1983); *see* Bainbridge, *Overview*, *supra* note 68, at 11–12.

108. *See* 445 U.S. 222, 231–37 (1980).

producing documentation for the bidder, did *not* violate the law because he had no fiduciary duty to the *target* or its stockholders.

The Supreme Court has never expressly set forth every step in its reasoning in *Chiarella*, perhaps because it is largely written in the negative — finding that Chiarella did *not* violate the law because he had no fiduciary or similar duty rather than explaining *when and why* such a duty would have made his trading fraudulent.[109] Justice Powell seems implicitly to be relying on the common law doctrine that self-dealing — a fiduciary's use of the assets of the beneficiary for the fiduciary's own benefit — is a breach of fiduciary duty.[110] Moreover, material non-public information is implicitly conceptualized as property of the issuer, a conception made express in *Carpenter v. United States*[111] and *O'Hagan.*[112] However, as discussed,[113] the Court had previously found that mere breach of fiduciary duty standing alone does not constitute securities fraud. Fraud requires either the misstatement of a material fact or the omission to state a material fact when under a duty to disclose.[114] Insider trading cases are almost always omission cases. But silence can only be fraudulent if there is a duty to speak. Justice Powell noted that the common law imposes duties on fiduciaries to speak to their beneficiaries.[115] Accordingly, in *Chiarella*, (and subsequently in *Dirks v. SEC*)[116] the Supreme Court held that this implies that the possession of material nonpublic information by a person who does not have a fiduciary or similar duty to the issuer does *not* impose the *Cady, Roberts* duty to disclose or abstain from trading.[117]

Justice Powell also assumed that the classic insider's duty to disclose or abstain runs not just to the corporation, but directly to its stockholders as well.[118] He also suggested that this fiduciary duty runs not merely to existing shareholders (in which case only purchases of securities would also be unlawful) but also to future shareholders (so that sales of securities can also

109. Marrero asserts that insider trading law is based on five fictions: fiction of the insider, fiction of fiduciary duty, fiction of disclosure, fiction of personal benefit, and fiction of deception. Marrero, *supra* note 32, at 262. I agree that the last one (deception) is fictional. I think that it is more accurate to say with respect to the others that sometimes courts stretch them to near their breaking points.

110. RESTATEMENT (THIRD) OF AGENCY §§ 8.02, 8.05 (AM. L. INST. 2006).

111. 484 U.S. 19, 25–26 (1987).

112. *O'Hagan*, 521 U.S. at 653–54.

113. *See supra* text at notes 53 and 100.

114. Interestingly, the Supreme Court has held that material misstatements or omissions are not necessary elements for fraud under bankruptcy law. Husky Int'l Elec. v. Ritz, 136 S. Ct. 1581, 1586 (2016).

115. Chiarella v. United States, 445 U.S. 222, 228–29 (1980).

116. *See infra* text at notes 160 and 374.

117. *Chiarella*, 445 U.S. at 230–32.

118. *Id.* at 228–30.

be unlawful).[119] This means that the *Cady, Roberts* duty is to disclose information to the market generally.

Finally, there is an assumption that the information that must be disclosed under the *classic* theory (in contradistinction to the misappropriation theory) is the material information itself rather than the insider's intent to trade. As others have noted, this was not, in fact, the state corporate law of fiduciary duties with respect to insider trading at the time *Chiarella* was decided.[120] Despite the doctrinal issues with this analysis, however, the boundaries of classic trading are fairly clear.[121] This cannot be said about the misappropriation theory and the extension of liability to tippees.

B. Misappropriation

The Supreme Court adopted the misappropriation theory of insider, or more accurately outsider, trading in *O'Hagan*.[122] Under this theory, the

119. In a footnote, Justice Powell cites with approval an opinion by Judge Learned Hand that it would be a "sorry distinction" to find that a director or officer did not have a fiduciary duty to a future shareholder who purchased stock sold by that person, when he had a duty to the present shareholder from whom he purchased stock. *Id.* at 227 n.8 (quoting *Cady, Roberts*, 40 SEC at 914 n.23).

As sorry as this distinction might seem to Justice Powell and Judge Hand, state corporation law makes a sharp distinction between current and potential stockholders. For example, derivative actions can only be maintained by persons who are stockholders of the nominal plaintiff at the time of the alleged wrong and throughout the pendency of the case. Kahn v. Kohlberg, Kravis, Roberts & Co., 63 A.3d 831, 836 (Del. 2011).

120. For discussions of how *Chiarella* differs from state precedent, see Zachary J. Gubler, *A Unified Theory of Insider Trading Law*, 105 GEO. L.J. 1225 (2017); Adam C. Pritchard, *United States v. O'Hagan: Agency Law and Justice Powell's Legacy for the Law of Insider Trading*, 78 B.U. L. REV. 13, 22–26 (1998); Harry S. Gerla, *Confidentiality Agreements and the Misappropriation Theory of Insider Trading: Avoiding the Fiduciary Duty Fetish*, 39 U. DAYTON L. REV. 331, 333–34 (2015); Bainbridge, *Overview*, *supra* note 68, at 9–10. Bainbridge correctly points out that there is a tension in Powell's holdings in *Chiarella* and *Dirks* that insider trading involves breaches of fiduciary duties with the Supreme Court's holding in *Santa Fe Industries* that breaches of fiduciary duty standing alone do not constitute fraud under Rule 10b-5. Bainbridge, *Overview*, *supra* note 68, at 9–10; *see also* Stephen M. Bainbridge, *Regulating Insider Trading in the Post-Fiduciary Duty Era: Equal Access or Property Rights*, *in* HANDBOOK, *supra* note 62, at 80, 81–83 [hereinafter, Bainbridge, *Post-Fiduciary Duty*].

121. In an interesting recent article, Peter Molk considers the implications for insider trading law of the fact that increasingly businesses, including publicly traded ones, are not being organized as corporations or limited partnerships, but as limited liability companies, which are permitted to eliminate management fiduciary duties in their organizational charters. Does this imply that classic insider trading by L.L.C. managers might be permitted under federal law? *See* Molk, *supra* note 69.

122. United States v. O'Hagan, 521 U.S. 642 (1997). In Carpenter v. United States, 484 U.S. 19 (1987), the Supreme Court previously adopted the misappropriation theory in the context of wire and mail fraud, but split 4-4 on its application to securities fraud, leaving in place the Second Circuit's opinion adopting a version of the misappropriation theory. *See infra* text at notes 275–93.

source of the information does not have to be the issuer of the securities being traded. Moreover, the trader need not be a traditional insider of the source, but can be anyone who has, to quote Justice Ginsberg in *O'Hagan*, a "*fiduciary* or similar duty of trust *and* confidence" to the source[123] which, as I discuss below,[124] the SEC has by regulation tried to vitiate as a "duty of trust *or* confidence." As Donna Nagy has accurately and powerfully argued, the actions by the SEC and certain courts should be seen as a surreptitious attempt to repudiate the Supreme Court's fiduciary principle and to reinstate the parity of information standard.[125]

The theory is that material nonpublic information is property of the source

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123. *O'Hagan*, 521 U.S. at 670 (emphasis added). At a number of points in *O'Hagan*, Justice Ginsburg describes the deception required for misappropriation in terms of a violation of a duty of "trust and confidence." *See, e.g.*, *id.* at 643, 645, 652. However, most of her discussion refers to the duties of fiduciaries. *See, e.g.*, *id.* at 652 (emphasis added) ("[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."); s*ee also id.* (emphasis added) ("[T]he misappropriation theory premises liability on a *fiduciary-turned-trader's* deception of those who entrusted him with access to confidential information."). Justice Thomas, in his dissent, agrees with Justice Ginsburg's characterization that misappropriation involves a breach of a fiduciary duty. *Id.* at 680–81 (Thomas, J., dissenting) (emphasis added) ("I do not take issue with the majority's determination that the undisclosed misappropriation of confidential information by a *fiduciary* can constitute a 'deceptive device' . . . ."). Elsewhere, Justice Ginsburg quotes the government's brief with approval, which describes the theory as being based on the "common law rule that a trustee may not use the property that [has] been entrusted [to] him." *Id.* at 654. Moreover, the two examples she gives of persons who have the type of duties necessary for insider-trading liability are traditional fiduciaries — i.e., officers and directors of corporations under the classic theory, and O'Hagan himself who, as an attorney, has a fiduciary duty to his firm and client. *Id.* at 644.

Similarly, in *Carpenter*, in which the Supreme Court adopted a misappropriation theory in the context of wire and mail fraud, Justice White, applying New York law, found that R. Foster Winans violated his *fiduciary* duty to his employer — *The Wall Street Journal* — when he used its confidential, proprietary information for his own purposes, without disclosing this intention. Justice White stated:

> [In an earlier case] we noted the similar prohibitions of the common law, that "even in the absence of a written contract, an employee has a *fiduciary* obligation to protect confidential information obtained during the course of his employment." As the New York courts have recognized: "It is well established, as a general proposition, that a person who acquires special knowledge or information by virtue of a confidential or *fiduciary* relationship with another is not free to exploit that knowledge or information for his own personal benefit but must account to his principal for any profits derived therefrom.

Carpenter v. United States, 484 U.S. 19, 27–28 (1987) (emphasis added) (citing Diamond v. Oreamuno, 248 N.E.2d 910, 912 (1969); RESTATEMENT (SECOND) OF AGENCY §§ 388 cmt. c, 396(c) (AM. L. INST. 1958)).

124. *See infra* text at notes 360–63.

125. Donna M. Nagy, *Insider Trading and the Gradual Demise of Fiduciary Principles*, 94 IOWA L. REV. 1315 (2009); *see also* Bainbridge, *Post-Fiduciary Duty*, *supra* note 120, at 83–88.

of the information. When the source discloses the information to a confidant having the requisite duty, the confidant makes an implied representation of loyalty she will not engage in self-dealing by using the information for her own profit. If she does so, she is defrauding the source out of its possessory right in the property understood as the exclusive control of its use.[126] Misappropriation of information is akin to the embezzlement of money.[127] This fraud is "consummated" as *securities* fraud when the disloyal confidant uses the information to purchase or sell securities.[128] Although *O'Hagan* involved a defendant who was a lawyer with fiduciary duties to his partners and a former client by virtue of partnership law and legal ethics, there is no logical or doctrinal reason why confidants should not be able to accept similar duties by contract or why misrepresentations of fidelity could not be express, rather than implied. Consequently, the caselaw leaves the scope of the misappropriation theory unclear.[129]

It is also unclear who, other than the SEC and the DOJ, can bring a cause of action for misappropriation insider trading under § 10(b) and Rule 10b-5. In *Blue Chip Stamps v. Manor Drug Stores*,[130] the Supreme Court held that, to have standing to bring a private right of action under Rule 10b-5, the plaintiff must itself purchase or sell securities. This means that, even though the source is deemed defrauded under the misappropriation theory, in most cases the source will be precluded from bringing a cause of action against the inside trader in federal court.[131] Accordingly, state common law might be able to remediate some of the well-known paradoxes and analytical problems of the Supreme Court's analysis of the misappropriation theory of insider trading.

It is generally thought that persons who buy or sell securities during the period that *classic* insider trading occurs should have a cause of action for

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126. *See O'Hagan*, 521 U.S. at 651.

127. *Id.* at 654.

128. *Id.* at 655–56.

129. The federal courts in general are surprisingly lax in their discussions of the law of the requisite duty, typically merely stating that duty either does or does not exist. *See infra* text at notes 379–412. Although I, like Bainbridge, Bainbridge, *Incorporating*, *supra* note 68, prefer incorporating state law on federalism grounds, the resolution of this issue is beyond the scope of this Article.

130. 421 U.S. 723 (1975).

131. For example, in *Davidge v. White*, 377 F. Supp. 1084, 1088–90 (S.D.N.Y. 1974), the District Court for the Southern District of New York dismissed a derivative Rule 10b-5 action for insider trading against a former director on the grounds that the company did not itself purchase or sell securities. It allowed a claim brought under Delaware law to proceed. Similarly, over 35 years ago Robert Thompson, citing *Diamond* as well as some largely pre-*Blue Chip Stamps* scholarship, suggested that the issuer (in the case of classic insider trading) might be the more appropriate plaintiff in insider trading litigation, based on an unjust enrichment theory but for the standing requirement of federal law. Thompson, *supra* note 14, at 395.

fraud, although there are questions as to how to prove causation and the measure of damages. In a securities fraud cause of action, a plaintiff must prove both transaction causation (roughly, but-for causation) through reliance on the misstatement or omission,[132] as well as loss causation (similar to proximate causation).[133] Since insider trading cases usually involve omissions, not misstatements, the plaintiffs can probably invoke the presumption of reliance and transaction causation established in *Affiliated Ute Citizens of Utah v. United States*.[134]

However, with respect to loss causation there is an argument that the plaintiff's loss is not caused by defendant's *trade*, but the non-disclosure of the material nonpublic information.[135] Indeed, if the insider observed the *Cady, Roberts* "disclose or abstain" rule by *abstaining* from trading, the plaintiff would have incurred the same loss when the issuer subsequently disclosed the information.[136] Alternately, if the insider fulfilled the rule by disclosing the information immediately before trading, most traders would have suffered the same loss a little earlier than they did. Moreover, for every investor who, for example, "lost" money by selling at a low price before positive information was released, there will be another investor who fortuitously gained by buying before the release. Nevertheless, it is generally assumed that the measure of damages for private rights of action under Rule 10b-5 is out-of-pocket losses.[137] This could, however, result in aggregate damages to a plaintiff class disproportionate to the defendant's wrongdoing.

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132. Halliburton Co. v. Erica P. John Fund, Inc., 573 U.S. 258, 267 (2014).

133. Dura Pharmaceuticals, Inc. v. Broudo, 544 U.S. 336, 342 (2005).

134. 406 U.S. 128 (1972).

135. *See* Bainbridge, *Overview*, *supra* note 68, at 23–24. This assumption that a contemporaneous trader is hurt by the insider's trading seems to be based on a "day trader" mentality where investors are trying to beat the market. For long term investors like myself (and Warren Buffett to whom I unfairly compare myself), I invest on what I think the future financial results of issues will be. Long-term traders do not view trading as a zero-sum game where some investors do better than others by making short-term bets.

136. As Robert Thompson has noted (in arguing, as I do, for a restitutionary approach to insider trading):

> Those traders on the other side of the transaction from the insider may have sustained losses, but given the anonymous nature of the market few, if any, can show that their trading was induced by defendant's fraudulent conduct. In almost all cases plaintiffs made decisions to trade that were independent of the defendant; these plaintiffs would have suffered the same losses had the defendant simply not traded and not disclosed- action that would not have been a breach of defendant's rule 10b-5 duty.

Robert Thompson, *The Measure of Recovery Under Rule 10b-5: A Restitution Alternative to Tort Damages*, 37 VAND. L. REV. 349, 391 (1984) (citations omitted); *see also,* Cox, *Insider Trading*, *supra* note 69, at 635.

137. *See* Wang, *supra* note 44.

Moreover, the logic of *O'Hagan* suggests that such investors would not have a cause of action for securities *fraud* under the misappropriation theory because the duty to speak runs to the source of the information, not the investment public.[138]

In 1988 Congress addressed these concerns by enacting Exchange Act Section 20A giving contemporaneous traders a statutory cause of action against "any person who violates any provision of [the Exchange Act] . . . by purchasing or selling a security while in possession of material, nonpublic information."[139] Unfortunately, this section does not specify when such trading violates the Exchange Act.

It is sometimes said that Section 20A is an action for disgorgement of profits.[140] This is not technically correct. The rule merely establishes a cause of action but does not set forth the measure of recovery. It does, however, *limit* the maximum recovery in two ways. First, Section 20A(b)(1) provides that "[t]he total amount of damages imposed . . . shall not exceed the profit gained or loss avoided in the transaction or transactions that are subject of the violation."[141] That is, disgorgement is the ceiling, not the measure, of damages. Second, Section 20A(b)(2) provides "the total amount of damages imposed against any person under [this section] shall be diminished by the amounts if any, that such person may be required to disgorge, pursuant to a court order obtained at the instance of the [SEC] . . . relating to the same transaction or transactions."[142]

It is not clear how helpful Section 20A actually is to contemporaneous traders. As an empirical matter, a contemporaneous trader will probably only learn of the insider trading because the SEC has already brought an action seeking disgorgement,[143] in which case it might be too late for the plaintiff to obtain meaningful damages.[144] The Supreme Court's holding in *Liu* that, in most cases, disgorgement is proper only if the SEC uses it to compensate victims may or may not change this.

Another reason might be that recovery under Section 20A is limited by the

138. *See* Moss v. Morgan Stanley, 719 F.2d 5, 10–12, 15 (2d Cir. 1982).

139. 15 U.S.C. §78t-1(a).

140. *See, e.g.*, STEPHEN J. CHOI & A.C. PRITCHARD, SECURITIES REGULATION CASES AND ANALYSIS 469–70 (5th ed. 2019).

141. 15 U.S.C. § 78t-1(b)(1).

142. *Id.* §78t-1(b)(2).

143. Bainbridge notes that "[v]irtually all private party insider trading lawsuits are parasitic on SEC enforcement efforts, which is to say that the private party suit was brought only after the SEC's proceeding became publicly known." Bainbridge, *Incorporating*, *supra* note 68, at 1263 (citations omitted).

144. Where the SEC has obtained disgorgement in a settlement, however, courts have permitted plaintiffs to try to prove that the actual profits reaped by the defendant exceeded the settled amount. *See, e.g.*, Kaplan v. S.A.C. Cap. Advisors, L.P., 40 F. Supp. 3d 332, 338 (S.D.N.Y. 2017).

defendant's gains or avoided losses.[145] This is in contrast to a private class action under Sec 10(b) where the presumed damages are the aggregate out-of-pocket losses of the entire plaintiff class.[146] Except for a few high profile cases, the amount of profits disgorged in insider trading actions tends to be relatively moderate and probably would not support the legal fees of complex securities litigation if recovery must be shared among a plaintiff class.[147] Consequently, trading by insiders is commonly raised as evidence of the *issuer's* scienter in class actions for fraud under Rule 10b-5 where the plaintiff class can seek out-of-pocket damages (that is, the traditional insiders' guilty state of mind as evidenced by their trading on material nonpublic information will be attributed to the corporation in an allegation that the corporation's failure to disclose constitutes securities fraud).[148]

The interrelationship between breach of fiduciary or other duties on the one hand and the fraud requirement for Rule 10b-5 liability is strained. Both the classic and misappropriation theories conceptualize material nonpublic information as property — implicitly, of the issuer under the classic theory and expressly of the source under the misappropriation theory. Classic insider trading is analogous to self-dealing by a fiduciary. Misappropriation is akin to embezzlement by an unfaithful confidant.[149] However, neither self-

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145. *See* William K.S. Wang, *ITSFEA's Effect on Either an Implied Cause of Action for Damages by Contemporaneous Traders or an Action for Damages or Rescission by the Party in Privity with the Inside Trader*, 16 J. CORP. L. 445, 454 (1991).

146. *Id.*

147. The SAC Capital Advisor's insider trading settlement where the defendant paid fines and disgorgement in over a billion dollars is the exception. *See* Nate Raymond & Emily Flitter, *SAC Capital Agrees To Pay $1.8 Billion In Largest Insider Trading Settlement In History*, BUS. INSIDER (Apr. 10, 2014, 10:24 PM), https://www.businessinsider.com/sac-capital-settlement-2014-4.

Verity Winship's analysis of SEC insider trading actions from fiscal years 2005–2015 indicate that, although disgorgement was ordered in 93% of the cases:

> [T]he median disgorgement amount was $62,756, which is indicative of the concentration of awards at the low end of the range. Although the overall average disgorgement ordered was $1,567,232, more than half of the awards were under $100,000 and only 12% were $1 million or above. Moreover, the range was enormous: from $1 to approximately $275 million.

Winship, *supra* note 15, at 1008 (citations omitted).

148. One report written in 1999 showed that a significant majority of cases brought after the adoption of the enhanced scienter pleadings standards of the Private Securities Litigation Reform Act four years earlier alleged insider trading as evidence of senior management's knowledge of material nonpublic information compared to just over 1/5 before the passage of the Act. Bainbridge, *Post-Fiduciary Duty*, *supra* note 120, at 94 (citing John L. Latham & Todd R. David, *Compliance Programs Risk of Insider Trading*, NAT'L L.J. June 28, 1999, B8).

149. In the words of Judge Rakoff of the Southern District of New York who has decided many noted insider trading cases (including the lower court opinion in *Salman*, discussed *infra* in text at notes 448–49):

> Essentially, insider trading is a variation of the species of fraud known as

dealing nor embezzlement standing alone constitutes fraud. Consequently, the Supreme Court must add the additional step of arguing that the duties under both theories of insider trading create implied representations so that silence constitutes securities fraud.

This has led Bainbridge to argue that insider trading law can more coherently be read as a de facto federal common law of property rights in information.[150] Consequently, we could simplify the caselaw as applied if we just admit this and drop the extra step of a fraud analysis entirely.

There is great merit with Bainbridge's argument from a practical and policy matter. However, even ignoring the *Erie* question of the propriety of a federal common law of property, unless the Supreme Court were to overrule its own precedents construing the language of Section 10(b) as being limited to actual fraud or Congress amends the law, Bainbridge's suggestion is highly unlikely in the foreseeable future.[151] This is why I argue that if we take the misappropriation theory seriously, we should look to state law under which fraud, breaches of fiduciary duty, and violations of property rights are independent grounds for restitutionary remedies.

> embezzlement, which is defined in Black's Law Dictionary as "[t]he fraudulent taking of personal property with which one has been entrusted, especially as a fiduciary." [] If the embezzler, instead of trading on the information himself passes on the information to someone who knows it is misappropriated information but still intends to use it in connection with the purchase or sale of securities, that "tippee" is likewise liable, just as any knowing receiver of stolen goods would be.

United States v. Pinto Thomaz, 352 F. Supp. 3d 287, 295–96 (S.D.N.Y. 2018). However, he also believes that "[t]he crime of insider trading is a straightforward concept that some courts have somehow managed to complicate." *Id.*

Judge Rakoff, despite his criticism of other judges in fact, misstates the law of property. A good faith recipient of *stolen* goods is not entitled to retain the goods and must disgorge profits. However, embezzled property is obtained by fraud not theft; a thief has void title, while an embezzler has voidable title. A good faith purchaser of value can take fraudulently obtained property free of the true owner's adverse claim. A recipient of stolen property, however, always takes subject to the adverse claim regardless of his knowledge lack thereof. *See infra* text at notes 266–68, 271–74.

150. Bainbridge, *Post-Fiduciary Duty*, *supra* note 120, at 91–98; Stephen M. Bainbridge, *Insider Trading Regulation: The Path Dependent Choice Between Property Rights and Securities Fraud*, 52 SMU L. REV. 1589, 1644 (1999) [hereinafter, Bainbridge, *Path Dependent*]. He states "[t]he Court should again explicitly acknowledge that it is making common law. The rules it announces should be based on the protection of property rights, not on inapt securities fraud concepts." *Id.* at 1651.

151. As Karmel states, "[t]he trouble with [the misappropriation] theory is that the federal securities laws are concerned with fairness and the protection of investors, not the protection of business property rights in information." Karmel, *Definition*, *supra* note 102, at 768. She is, of course, ignoring the Supreme Court's holdings to the contrary.

C. Tipper-Tippee Liability

The third form of liability for insider trading is for tippers and tippees. This rule is articulated by the Supreme Court in *Dirks*.[152] Although the tipper in *Dirks* was a classic insider, the rule of *Dirks* seems also to apply to misappropriators.[153]

In *Dirks*, Ronald Secrist, a former officer of a publicly traded insurance company, contacted the defendant, Raymond Dirks, a broker-dealer who specialized in the insurance industry after failing to get regulators to investigate his allegation that the company was engaged in fraudulent practices that inflated its earnings.[154] After investigation, Dirks determined that the tipper's allegations were true and tried to spread word of the fraud by contacting, among others, *The Wall Street Journal*, which initially refused to publish this information.[155] Although he and his firm did not trade in the issuer's securities, Dirks did disclose the information to some of his clients who sold their stock in the company.[156] When the market learned of the fraud, largely because of Dirks's activities, the price dropped, the New York Stock Exchange suspended trading, and the California insurance regulator started an investigation.[157] Only then did the SEC deign to investigate the company. Rather than thanking Dirks for his service in helping to bring the fraud to light, it brought an enforcement action against him for insider trading.[158] The SEC argued that when "'tippees' — regardless of their motivation or occupation — come into possession of material 'information that they know is confidential and know or should know came from a

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152. 463 U.S. 646 (1983).

153. The Second Circuit Court of Appeals once suggested that the *Dirks* analysis did not apply in misappropriation cases. *See* United States v. Falcone, 257 F.3d 226, 230–31 (2d Cir. 2001). As its opinions in *Newman* and *Martoma II*, discussed *infra* in text at notes 417–21 show, it no longer takes this position. I will argue that one of the advantages of seeking disgorgement under state law is that it does not require the *Dirks* test for tippees.

As Langevoort notes, however, in the more recent case of United States v. Blaszczak, 947 F.3d 19, 19 (2d Cir. 2019), the Second Circuit found that *Dirks* does not apply to wire fraud or the criminal securities fraud action added as part of Sarbannes-Oxley (18 U.S.C. § 1348). Langevoort, *Wobble*, *supra* note 61, at 525–26. Karen Woody accurately argues that this interpretation of § 1348 results in "an inversion of civil and criminal standards as related to insider trading," in which the standards for prosecuting a criminal case against an alleged trader is lower than those for an SEC civil action. Karen E. Woody, *The New Insider Trading*, 52 ARIZ. S. L. REV. 594, 644 (2020).

154. *Dirks*, 463 U.S. at 649.

155. *Id.* at 649–50.

156. *Id.* at 649.

157. *Id.* at 650.

158. *Id.*

corporate insider,' they must either publicly disclose that information or refrain from trading."[159]

Justice Powell, the author of the majority opinion in *Chiarella*, reconfirmed its holding that mere possession of material nonpublic information does not impose liability absent a breach of fiduciary duty.[160] A tippee could, however, in certain cases inherit her tipper's duties. But to do this, not only must the tipper violate a duty to the issuer or other source when he made the tip, but the tippee must know or should have known of the tipper's violation.[161] Moreover, for a tipper to violate his duty to the issuer or other source, he must make the tip with the intent of obtaining a financial benefit.[162] This benefit can take the form of an expectation of receiving a quid pro quo from the tippee.[163] But the tipper is also deemed to receive a benefit if he intended to make a gift to the tippee.[164] As I discuss below,[165] this will provide a state law theory as to why a tipper may have to disgorge an amount equal to the profits earned (or losses avoided) by his tippee that does not invoke joint and several liability.

159. *Id.* at 651.

160. *Id.* at 654–55.

161. *Id.* at 660.

162. *Id.* at 662. This part of the *Dirks* test is odd because, as I emphasize throughout this Article, personal benefit by a beneficiary is not a necessary element of self-dealing as Justice Powell, a former corporate lawyer, must have known. As Langevoort discusses, A.C. Pritchard's examination of Powell's notes show that the language of the case was the result of a compromise between Justice Powell and Justice O'Connor. This helps explain why it is so confusing. Langevoort, *Wobble*, *supra* note 61, at 512–13; *see* A.C. Pritchard, Dirks *and the Genesis of Personal Benefit*, 68 SMU L. REV. 857 (2015).

Consequently, Merritt Fox and George Tepe agree with me that the personal benefit test, which was developed in the context of the classical theory and fiduciary type duties owed to the issuer and its shareholders, has no place in tipping of misappropriated material nonpublic information. Merritt B. Fox & George N. Tepe, *Personal Benefit Has No Place in Misappropriation Tipping Cases*, 71 SMU L. Rev. 767, 770–71 (2018). They believe, however, that it has a role to play in classic insider trading under the rationale suggested by Justice Powell in *O'Hagan* — we don't want to "chill" legitimate research including interviews with analysts. *Id.* at 778–79.

Jonathan Macey defends the personal benefits test at least in the context of classic insider trading as consistent with the property theory of information on efficiency grounds. Jonathan Macey, *Martoma and Newman: Valid Corporate Purpose and the Personal Benefit Test*, 71 SMU L. REV. 869 (2018) [hereinafter Macey, *Martoma II*]. To simplify, if information is property of an issuer, then its management should be able to use it as it sees fit to further valid corporate purposes. *Id.* at 873–77. This means that tipping should be permitted if it serves valid corporate purposes, such as making the market for an issuer's securities by giving information to professional securities analysts and others. *Id.* If the insider obtains a personal benefit from the tip, this is evidence that he was not using the information for a corporate purpose. *Id.*

163. *Dirks*, 463 U.S. at 663–64.

164. *Id.* at 664.

165. *See infra* text at notes 445–51.

III. THE STATE LAW DISGORGEMENT AND BREACH OF FIDUCIARY DUTY

In this section, I introduce the state law that has recognized that a corporation has the right to sue a traditional insider for trading on the basis of material insider information about the corporation learned through her position, i.e., classic insider trading. I then explore the basic rules of property law which suggests that, if we take the Supreme Court's misappropriation theory seriously, there should also be a state common law cause of action for the source of information to sue for trading on the basis of its material non-public information. I then turn to the R3RUE to examine the common law support for my proposal. I end with a discussion as to how such an approach would simplify and rationalize insider trading law.

A. Origins

In the 1949 case of *Brophy v. Cities Services Co.*,[166] the Delaware chancery recognized that a corporation has a restitutionary claim to recover the profits in what we would today call classic insider trading — that is trading by officers and directors of a corporation in securities issued by the corporation based on material non-public information belonging to the corporation.[167] In *Brophy*, Chancellor Harrington recognized that the concern of unjust enrichment is not loss to the plaintiff, but gain by the defendant, stating:

> In equity, when the breach of confidential relation by an employee is relied on and an accounting for any resulting profit is sought, loss to the corporation need not be charged in the complaint. [] Public policy will not permit an employee occupying a position of trust and confidence toward his employer to abuse that relation to his own profit, regardless of whether his employer suffers a loss.[168]

New York followed suit 30 years later in *Diamond v. Oreamuno*.[169] This was also a derivative action against certain officers and directors for an accounting of profits received from the sale of corporate stock allegedly on the basis of material nonpublic information.[170] The defendant argued that the case should be dismissed because the harm of insider trading was unfairness to shareholders, but there was no damage to the corporation itself.[171] Like the Delaware Supreme Court, the New York Court of Appeals ruled that the purpose behind a suit for breach of fiduciary duty is not

166. 70 A.2d 5 (Del. Ch. 1949).

167. *Id.* at 7–8.

168. *Id.* at 8. (citing Loft, Inc. v. Guth, 2 A.2d 225 (Del. Ch. 1939), *aff'd* 5 A.2d 503 (Del. 1939); Lutherland, Inc. v. Dahlen, 53 A.2d 143 (Pa. 1947)).

169. 248 N.E.2d 910 (N.Y. 1969).

170. *Id.* at 911.

171. *Id.* at 912.

compensation, but the recovery of ill-gotten profits, i.e., unjust enrichment.[172]

As a *secondary* grounds for finding a cause of action, the Court of Appeals noted that, although the defendants' actions almost certainly violated Exchange Act §10(b) and Rule 10b-5, at that time the federal remedies were inadequate — being basically limited to the SEC's ability to obtain injunctive relief.[173] The Court of Appeals stated that a "class action under the federal rule might be a more effective remedy but the mechanics of such an action have, as far as we have been able to ascertain, not yet been worked out by the federal courts and several questions relating thereto have never been resolved."[174] Some later courts would rely on this secondary rationale, coupled with subsequent developments in federal caselaw and amendments to the Exchange Act, as a reason to reject the *Brophy/Diamond* rule on the grounds that it was outdated.[175]

B. Reception

Since then, the reception in other states has been patchy. It is frequently said[176] that Florida rejected the *Diamond* rule in *Schein v. Chasen*.[177] This is not quite correct because that case does not even consider the applicability of this rule to classic *insiders*.

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172. It stated:

> Just as a trustee has no right to retain for himself the profits yielded by property placed in his possession but must account to his beneficiaries, a corporate fiduciary, who is entrusted with potentially valuable information, may not appropriate that asset for his own use even though, in so doing, he causes no injury to the corporation. The primary concern, in a case such as this, is not to determine whether the corporation has been damaged but to decide, as between the corporation and the defendants, who has a higher claim to the proceeds derived from the exploitation of the information. In our opinion, there can be no justification for permitting officers and directors, such as the defendants, to retain for themselves profits which, it is alleged, they derived solely from exploiting information gained by virtue of their inside position as corporate officials.

Id. at 912. The court did, however, entertain the possibility that a corporation might suffer reputational damage if the public learned that its insiders were trading on non-public information. *Id.* at 912.

The court also rejected the defendant's arguments that the short-swing profit rule of Exchange Act Section 16(b), 15 U.S.C. § 78p(b), was exclusive and that permitting a state cause of action might result in double liability. *Id.* at 914.

173. *Id.* at 914–15.

174. *Id.*

175. *See infra* text at notes 212–15, 218–19.

176. For example, it is cited for this proposition in the influential case of *Freeman v. Decio*, 584 F.2d 186, 189 (7th Cir.1978), discussed *infra* text at notes 203–13.

177. 313 So. 2d 739 (Fla. 1975); *see, e.g.*, Thompson, *supra* note 14, at 395.

In *Schein*, the Florida Supreme Court considered an issue of Florida law certified by the Second Circuit Court of Appeals.[178] Unlike in *Brophy* and *Diamond*, the defendants were *not* insiders of the titular corporate plaintiff because they had not been validly served under New York law.[179] Rather, the defendants were alleged direct and remote tippees of the corporation's president.[180] In this pre-*Dirks* case, the Florida Supreme Court found that the plaintiff failed to plead a cause of action under Florida law. In doing so it rejected three theories: 1) that possession of material insider information imposes a fiduciary duty on a tippee, 2) that a tippee has joint and several liability with his tipper because tippers and tippees are involved in a common enterprise, and 3) that tippees are aiders and abettors of tippers.[181] In other words, the Florida Supreme Court did not even consider, let alone reject, the *Brophy/Diamond* rule that issuers can sue *insiders* who commit classic insider trading. Rather, it rejected the plaintiff's allegation that the tippees' activity was unlawful. Indeed, in doing so, the *Schein* court anticipated some aspects of federal jurisprudence of tippee liability. As discussed,[182] in *Dirks*, the Supreme Court rejected the SEC's position that mere possession of material nonpublic information imposes fiduciary duties on tippees. Moreover, in *Liu*, the U.S. Supreme Court expressly rejected the concept of joint and several liability of tippers and tippees in most cases.[183] The Florida Supreme Court did, however note, in addition to its primary argument that a

178. *Schein*, 313 So. 2d at 739.

179. *Id.* at 741.

180. *Id.* at 740–41.

181. The District Court for the Southern District of New York originally granted the defendant's motion to dismiss on the grounds that Florida law requires damage to the corporation. In this opinion, however, the District Court went on to say that derivative actions were designed to enforce proper behavior of corporate officials and cannot be extended "to cover outside individuals, corporations, or institutions." *Id.* at 742. It also held that the issue as to whether Florida would adopt *Diamond* with respect to the insider was not before the court. *Id.*

This holding was reversed by a two to one Second Circuit Court of Appeals decision. Schein v. Chasen, 478 F.2d 817 (2d Cir. 1973). That was, in turn, vacated by the Supreme Court of the United States on April 29, 1974, in an opinion reported at *Schein v. Chasen*, 416 U.S. 386 (1974), leading to the certification of the question by the Second Circuit.

In its opinion the Florida Supreme Court quoted at length the dissent of Judge Kaufman in the earlier Second Circuit case to the extent that outside tippees are not fiduciaries with liability for trading on the basis of material nonpublic information. *Schein*, 313 So. 2d at 743–46. The Florida Supreme Court explained that it "quote[d] the dissent of Judge Kaufman and [held] it to be responsive and to be dispositive of the certified questions." *Id.* at 746.

182. *See supra* text at notes 160–64.

183. *See supra* text at note 9. As I discuss below, *see infra* text at notes 445–61, I argue that under some circumstances, tippers should have to disgorge an amount measured by her tippee's profits, but under a different theory of direct liability.

tippee has no duty not to trade, that it was adhering to Florida precedent "that actual damage to the corporation must be alleged . . . to substantiate a stockholders' derivative action."[184] This is consistent with the proposition that, if the issue were raised in the future, it might also require a showing of harm in a *Brophy/Diamond* derivative action against an insider.

Most other cases finding that states either do or do not adopt the *Brophy/Diamond* rule are, in fact, federal court decisions making "*Erie* guesses" as to what a state court would do. A number of federal decisions have concluded that New Jersey would follow *Brophy*.[185] Conversely, two other federal courts suggested that absent controlling state law, Connecticut[186] and Nevada[187] would look to Delaware for guidance and adopt the *Brophy* rule.

The federal courts in Ohio have been inconsistent. In 2007, in *In re Goodyear Tire & Rubber Co. Derivative Litig.*[188] the district court for the Northern District of Ohio expressed skepticism as to whether *Brophy* was the rule in Ohio, noting that some Delaware lower courts questioned its continued applicability. Nevertheless, it decided that the defendants would, in any event, not be liable under a *Brophy* analysis.[189] However, in 2014, in *In re Gas Natural, Inc.*,[190] the federal court for the Northern District of Ohio noted that some federal courts had held that, in the absence of any Ohio precedent on point, Ohio state courts would probably look to Delaware for guidance. Consequently, the court ruled that *Brophy* was the Ohio rule.[191] As I will discuss,[192] in the interim, in *Kahn v. Kohlberg, Kravis and Roberts L.P.*,[193] the Delaware Supreme Court dismissed the qualms of some Delaware chancellors relied on by the *Gas Natural* court and clarified that *Brophy* is alive and well.

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184. *Schein*, 313 So. 2d at 746.

185. Nat'l Westminster Bancorp v. Leone, 702 F. Supp. 1132 (D.N.J. 1988); *see also In re* ORFA Sec. Litig., 654 F. Supp. 1449 (D.N.J. 1987) (holding that New Jersey would adopt the *Brophy/Diamond* rule); Frankel v. Slotkin, 984 F.2d 1328, 1336–37 (2d Cir. 1993) (applying New Jersey law); *In re* Cendant Corp. Derivative Action Litig., 189 F.R.D. 117, 130 (D.N.J. 1999) (holding that there was no conflict of law between New Jersey and Delaware, although the court seemed to assume that harm to the issuer was an element in a *Brophy* cause of action).

186. *In re* Coleco Secs. Litig., 591 F. Supp. 1488, 1495 (S.D.N.Y. 1984). The court also thought that a Connecticut court would look to *Diamond* for guidance.

187. *In re* Jackpot Enterprises Sec. Litig., No. CV-S-89-805, 1991 U.S. Dist. LEXIS 16287, at *7 (D. Nev. Mar. 28, 1991).

188. No. 5:03CV2180, 2007 U.S. Dist. LEXIS 1233 (N.D. Ohio Jan. 5, 2007).

189. *Id.* at *25–26.

190. No. 1:13-CV-02805, 2014 U.S. Dist. LEXIS 184046 (N.D. Ohio Sept. 24, 2014).

191. *Id.* at *68.

192. *See infra* text at notes 229–46.

193. Kahn v. Kohlberg Kravis Roberts & Co., 23 A.3d 831 (Del. 2011).

Nevertheless, one year after *Gas Natural* (and four years after *Kahn*), in *Brosz v. Fishman*,[194] the district court for the Southern District of Ohio, without citing *Brophy*, *Natural Gas*, or *Kahn*, dismissed a derivative action brought on behalf of a corporation against a classic insider trader on the grounds that Ohio law requires that the plaintiff show harm to the nominal corporate plaintiff.[195] The court expressly found that there were no grounds for an unjust enrichment claim against the officers who traded on material nonpublic information: holding that "the profit generated by the alleged insider trading of the individual Defendants cannot be considered a benefit conferred on them by" the corporate plaintiff.[196] As I will show,[197] this ignores the Delaware Supreme Court holding in *Kahn* and reveals that the district court fundamentally misunderstands common law principles of restitution.

Probably the most influential anti-*Brophy* opinion is another *Erie* guess of state common law by a federal court. In the 1978 case of *Freeman v. Decio*,[198] the Seventh Circuit Court of Appeals decided, in the absence of relevant Indiana precedent, Indiana courts were *unlikely* to adopt the *Brophy/Diamond* rule. Despite its influence, the reasoning in *Freeman* is in many ways out of step with both state common law and subsequent federal securities law. As G.W.F. Hegel said of Immanuel Kant's theory of the four antinomies, it is "a whole nest . . . of faulty procedure."[199]

Citing *Cady, Roberts*, the Seventh Circuit noted that the harm of insider trading is not to the corporate source of information but unfairness to stockholders.[200] This is, of course, inconsistent with subsequent Supreme Court jurisprudence which would reject the fairness justification for insider trading liability in favor of an actual fraud theory involving a breach of a fiduciary or similar duty to the issuer and its shareholders (under the classic theory) or the source of the information (under the misappropriation theory).[201]

The Seventh Circuit noted, and rejected, *Diamond*:

> [T]he New York Court of Appeals in *Diamond* . . . engineer[ed] an innovative extension of the law governing the relation between a corporation and its officers and directors. The court held that corporate officials who deal in their corporation's securities on the basis of non-

194. 99 F. Supp. 3d 776 (E.D. Ohio 2015).
195. *Id.* at 787–88.
196. *Id.* at 788.
197. *See infra* text at notes 229–46.
198. 584 F.2d 186 (7th Cir. 1978).
199. G.W.F. HEGEL, HEGEL'S SCIENCE OF LOGIC 195 (A.V. Miller trans. 1969).
200. *Freeman*, 584 F.2d at 189.
201. *See supra* text at notes 54–57, 106–29.

> public information gained by virtue of their inside position commit a breach of their fiduciary duties to the corporation. *This holding represents a departure from the traditional common law approach, which was that a corporate insider did not ordinarily violate his fiduciary duty to the corporation by dealing in the corporation's stock, unless the corporation was thereby harmed.*[202]

The Seventh Circuit also dismissed *Brophy* as a "significant departure from the traditional common law."[203] To say that *Brophy* was a deviation from traditional common law is, of course, absurd since by the time that *Freeman* was written, thirty-year-old *Brophy* was the traditional common law of fiduciary duty of the most significant state governing corporate law.[204] It also reflects the traditional rule of principal-agency law that an agent must account to her principal for profits earned from the abuse of her position even if the principal is not harmed.[205] The R3RUE of Restitution agrees.[206]

The Seventh Circuit also rejected the New York Court of Appeals finding in *Diamond* that inside information is a corporate asset, asserting that this position is inconsistent with the law of corporate opportunity.[207] In doing so, it ignored the fact that the highest courts in New York and Delaware determined that this was their common law of fiduciary duty, although as the Delaware Court would clarify, *Brophy* is not grounded in corporate opportunity.[208] The Seventh Circuit also did not anticipate that the Supreme Court would later cite with approval *Diamond*'s holding that material nonpublic information is property of the issuer in finding that insider trading constituted wire and mail fraud.[209] The Supreme Court subsequently

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202. *Freeman*, 584 F.2d at 191–92 (emphasis added).

203. *Id.* at 192.

204. In 2011, before *Kahn*, in which the Delaware Supreme Court confirmed that *Brophy* was still controlling, the Alabama Supreme Court, applying Delaware law, upheld a $147,450,000 judgment against Richard Scrushy in a derivative action for insider trading in the stock of HealthSouth Corporation expressly rejecting the argument that *Brophy* was no longer valid law because it was anachronistic and/or had been pre-empted by changes in federal law. Scrushy v. Tucker, 70 So. 3d 289 (Ala. 2011). The court cited Vice Chancellor Laster's opinion in *Pfeiffer* (*see infra* text at notes 224–27) that its continued existence was the cornerstone of federal insider trading law, and stated that "*Brophy* has been a part of the warp and woof of Delaware securities laws for more than 60 years." *Id.* at 309.

205. RESTATEMENT (SECOND) OF AGENCY § 388 cmt. c (AM. L. INST. 1958). Many law students are familiar with this principle from the British case of *Reading v. Regem*, 2 KB 268 (1948), often included in business associations and agency casebooks because of its colorful yet easy to understand facts reminiscent of *Masterpiece Theater Series* of shows such as *The Jewel in the Crown.*

206. *See infra* text at notes 362–72.

207. *Freeman*, 584 F.2d at 193–94.

208. Kahn v. Kolberg Kravis Roberts & Co., 23 A.3d 831, 840 (Del. 2011).

209. Carpenter v. United States, 484 U.S. 19, 27–28 (1987).

extended this principle to securities fraud as well.[210] That is, *Freeman* is inconsistent with the shift in insider trading law from a fairness rationale to one based on breaches of duty and violations of proprietary rights in material nonpublic information.

The Seventh Circuit was also wrong about state common law of insider trading. The early 20th century rule was that in the absence of special facts, *shareholders* had no *direct* private right of action against insiders for insider trading on impersonal public markets (as opposed to face-to-face transactions) — a principle that Justice Powell notoriously misstated in *Chiarella* when he asserted that an insider's fiduciary duties with respect to insider trading ran directly to the issuer's current and potential future stockholders.[211] This is, however, irrelevant to the question of whether in classic insider trading cases, the *issuer* of the securities (to whom insiders *do* owe a direct duty of loyalty) or the *source* of the information, in the case of the misappropriation, has a cause of action.

Most important, the Seventh Circuit seized on the New York Court of Appeals *secondary* justification for its opinion in *Diamond*, namely the inadequacy of remedies for insider trading under federal law.[212] It held, by negative pregnant, that since federal remedies had improved, there was no longer a rationale for a state law remedy.[213]

Nevertheless, despite its many doctrinal errors of state common law, its failure to anticipate the trend in federal law, and the fact that since the late 1970's when *Freeman* was decided, both federal case and statutory law have significantly cut back on private class actions for securities fraud, some federal courts have continued to adopt the *Freeman* rationale for

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210. *See supra* text at notes 109–17, 126–28, 149–50.

211. *See* Manning G. Warren III, *A Birthday Toast to Texas Gulf Sulphur*, 71 SMU L. REV. 987, 988 (2018); Gubler, *supra* note 120, at 1228, 1241–42; CHOI & PRITCHARD, *supra* note 140, at 411.

212. *See Freeman*, 584 F.2d at 191–92.

213. It stated:

> Since the *Diamond* court's action was motivated in large part by its perception of the inadequacy of existing remedies for insider trading, it is noteworthy that over the decade since *Diamond* was decided, the 10b-5 class action has made substantial advances toward becoming the kind of effective remedy for insider trading that the court of appeals hoped that it might become. Most importantly, recovery of damages from insiders has been allowed by, or on the behalf of, market investors even when the insiders dealt only through impersonal stock exchanges, although this is not yet a well-settled area of the law. In spite of other recent developments indicating that such class actions will not become as easy to maintain as some plaintiffs had perhaps hoped, it is clear that the remedies for insider trading under the federal securities laws now constitute a more effective deterrent than they did when *Diamond* was decided.

Id. at 195–96.

Erie guessing that state courts would reject *Brophy*. In *Daisy Systems Corp. v. Finegold*,[214] the federal court for the Northern District of California dismissed a cause of action by guessing that a California court would not follow *Brophy/Diamond* on a *Freeman* analysis. In *In re Cray Inc. Derivative Litig.*,[215] the district court for the Western District of Washington, relying heavily on *Freeman's* reasoning that *Brophy* may no longer be good law, guessed that Washington State would require a showing of damage to the corporation for a derivative action for insider trading. Although, this might be dictum since the court dismissed the case on the grounds that the plaintiff did not show that the defendants traded on the basis of material nonpublic information.

However, in *Arlia v. Blankenship*,[216] the federal court for the Southern District of West Virginia, while acknowledging the *Freeman* line of precedents, without clear, on point state precedent was not willing to find that West Virginia courts would reject *Brophy* or that a *Brophy* claim must be removed to federal court under SLUSA. Even some federal courts prior to *Kahn* applying New York law questioned, on *Freeman* grounds, whether they should consider the continued validity of *Diamond*.[217]

C. Temporary Doubts About the Continued Relevance of Brophy in Delaware

The Delaware chancery was not immune from doubt about the propriety of disgorgement for insider trading. Notably, in *In re Oracle Corp. Derivative Litig.*,[218] then Vice Chancellor Strine seemed open to the argument that *Brophy* should no longer be part of Delaware common law given subsequent developments in federal securities laws. However, because he found that the plaintiff failed to prove two elements of a *Brophy* action — namely that the defendants sold securities while in possession of material non-public information and did so with scienter — he

> [D]ecline[d] their invitation . . . to conclude that *Brophy* is an outdated precedent that ought to be abandoned. The important policy question the defendants have raised can be left to a later case in which the answer to

214. No. C 86-20719, 1988 U.S. Dist. LEXIS 16765, at *14–15 (N.D. Cal. Sept. 20, 1988).

215. 431 F. Supp. 2d 1114, 1132–33 (W.D. Wash. 2006).

216. 234 F. Supp. 2d 606, 611 (S.D.W. Va. 2002).

217. *See, e.g.*, *In re* Symbol Tech. Sec. Litig., 762 F. Supp. 510, 517–18 (E.D.N.Y. 1991) (noting how in the time since *Diamond* was decided, the Rule 10b-5 class action has become the sort of federal remedy the court in *Freeman* envisioned); Frankel v. Slotkin, 795 F. Supp. 76, 81 (E.D.N.Y.1992) ("Under these circumstances a common law claim to recover profits from insiders presents an actual, and needless, risk of double liability.").

218. *See* 867 A.2d 904, 930 (Del. Ch. 2004) (hesitating to strengthen *Brophy*).

> that question is outcome-determinative. Because the defendants prevail under a reasoned application of *Brophy*, it is unnecessary to make a broad ruling with sweeping effect.[219]

Doubts about *Brophy* started changing in 2010 with *Pfeiffer v. Toll*.[220] Vice Chancellor Travis Laster refused to grant a Special Litigation Committee's ("SLC") motion to dismiss a *Brophy* derivative claim against a corporation's directors for allegedly selling their stock on the basis of material non-public information concerning the company's business.[221] He expressly rejected the defendants' argument that *Brophy* is "a persistent anachronism from a time before the current federal insider trading regime, when this Court felt compelled to address insider trading because of the absence of any other remedy."[222] Rather, *Brophy* is firmly located in Delaware duty-of-loyalty jurisprudence. That is, *Pfeiffer* is a rebuke to the *Freeman* misunderstanding that *Brophy* is a deviation from the common law. Rather, it *is* Delaware's common law.[223]

Moreover, far from being redundant to, or in conflict with, federal law, it is not merely complementary, but necessary, to federal law. That is, the *classic* theory of insider trading requires that a trader violate a fiduciary or similar duty of trust and confidence to the issuer of the securities, and by extension its stockholders.[224] As Bainbridge persuasively argues, although the federal courts have been unfortunately unclear about the source of this duty (at least in the case of misappropriation), the better view is that they should incorporate state common law.[225] This would seem to be the case for the classic theory which is based on duties that insiders owe to issuers and their shareholders. Consequently, for Delaware to overturn *Brophy*, it would indirectly destroy the federal cause of action as well in the case of classic insider trading of the securities of Delaware corporations. Chancellor Laster

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219. *Id.* at 929.

220. 989 A.2d 683 (Del. Ch. 2010).

221. *Id.* at 685.

222. *Id.* at 695.

223. Or, Laster states:

> If an officer or director of a corporation, in violation of his duty as such, acquires gain or advantage for himself, the law charges the interest so acquired with a trust for the benefit of the corporation, at its election, while it denies to the betrayer all benefit and profit. The rule, inveterate and uncompromising in its rigidity, does not rest upon the narrow ground of injury or damage to the corporation resulting from a betrayal of confidence, but upon a broader foundation of a wise public policy that, for the purpose of removing all temptation, extinguishes all possibility of profit flowing from a breach of the confidence imposed by the fiduciary relation.

Id.

224. *See supra* text at notes 118–19.

225. *See supra* note 129.

states:

> [T]he federal approach to insider trading . . . depends on the existence of a fiduciary relationship or similar relationship of trust and confidence. Federal law does not give rise to or establish the fiduciary duties of directors or officers. Those matters are governed by state law. Thus the federal insider trading regime as currently structured rests on a foundation of state law fiduciary duties. If Delaware were to hold that the fiduciary duties of directors and officers did not limit their insider trading, the cornerstone of the federal system would be removed.[226]

He continues:

> I cannot foresee what might happen were a Delaware court to hold, as the defendants ask, that insiders do not breach any fiduciary duty to the corporation they owe by engaging in insider trading. Such a holding would take [classic] insider trading outside the fiduciary relationship of trust and confidence that has formed the basis for the federal approach since *Chiarella*. Arguably the private right of action for [classic] insider trading under Rule 10b-5, which depends on a breach of fiduciary duty, would no longer function.[227]

Nevertheless, he did not order disgorgement but declared that the plaintiff's recovery would be limited to actual damages to the corporate plaintiff[228] — a position that seems at odds with his analysis that he is following *Brophy.*

D. Revival

In *Kahn*[229] the Delaware Supreme Court, in reaction against Vice Chancellor Laster's confusion about damages in *Pfeiffer*, confirmed that the traditional understanding of *Brophy* is alive and well. In *Kahn*, Primedia Inc, the nominal plaintiff, sought the disgorgement of profits made by its controlling shareholder when it purchased preferred stock allegedly on the basis of material nonpublic information it obtained from the plaintiff corporation.[230] Primedia's board members (who were also defendants) appointed an SLC which decided the action should be dismissed.[231] In the lower court's opinion, then Chancellor (later Chief Justice) Strine granted the SLC's motion applying the two part test of *Zapata v. Maldonado*.[232] The Delaware Supreme Court took the plaintiff's appeal because of the

226. *Pfeiffer*, 989 A.2d at 704.
227. *Id.* at 706.
228. *Id.* at 699–700.
229. 23 A.3d 831 (Del. 2011).
230. *Id.* at 835.
231. *Id.* at 834–35.
232. *Id.* at 835; *see also* Zapata Corp. v. Maldonado, 430 A.2d 779 (Del.1981).

significance of the issue despite its potential mootness,[233] precisely to clarify the continued viability of *Brophy*.[234]

The appeal concerned the application of the second prong of *Zapata*.[235] That is, if a chancellor finds that an SLC met its burden of the first prong — i.e., that the SLC made a fair and thorough investigation in deciding to dismiss the case — the chancellor must then apply his own business judgment to the decision to dismiss.[236] Vice Chancellor Strine's decision was reversed and remanded because he followed Vice Chancellor Laster's incorrect holding in *Pfeiffer* that the plaintiff must show harm to the corporate plaintiff to maintain a *Brophy* action.[237]

The Delaware Supreme Court emphasized that the *Brophy* court correctly applied the common law of restitution, citing the First Restatement of Restitution:[238]

> [F]or the proposition that a fiduciary cannot use confidential corporate information for his own benefit. As the court recognized in *Brophy*, it is inequitable to permit the fiduciary to profit from using confidential corporate information. Even if the corporation did not suffer actual harm, equity requires disgorgement of that profit.[239]

Although it praised Vice Chancellor Laster's analysis as "thoughtful,"[240] the Delaware Supreme Court rejected his holding that a *Brophy* claim requires harm to the corporation in most cases.[241] The Vice Chancellor was

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233. A derivative action can only be brought by a person who is stockholder of the nominal plaintiff corporation throughout the course of the litigation. Because of a pending cash-out merger, the individual bringing the derivative action would soon cease to be a stockholder and would no longer have standing.

234. It stated:

> This Court may, however, invoke the exception to mootness doctrine for matters of public importance that are capable of repetition yet may evade review. We find that this case falls within the public importance exception because other litigants have raised the *Brophy* issue in actions now pending before the Court of Chancery. For that reason, we will resolve the legal issue concerning available disgorgement remedies for a *Brophy* claim.

Kahn, 23 A.3d at 836 (citations omitted).

235. *Id.*

236. *Id.* at 836–37.

237. *See id.* at 837 (holding that *Pfeiffer* cannot be considered Delaware law).

238. The R3RUE was not published until later in the year in which *Khan* was decided. Oddly, there is no Second Restatement of Restitution. *See infra* note 344.

239. *Kahn*, 23 A.3d at 837–38 (citing RESTATEMENT OF THE LAW OF RESTITUTION § 200, cmt. a (AM. L. INST. 1937)).

240. *Id.* at 840.

241. That is

> To that end, the Vice Chancellor concluded that in the context of a *Brophy* claim, disgorgement is "theoretically available" in two circumstances: (1) "when a fiduciary engages directly in actual fraud and benefits from trading

incorrect because a *Brophy* action is restitutionary. As such, it is not designed to remedy harm to the corporate plaintiff but to prevent unjust enrichment of a disloyal fiduciary:

> We decline to adopt *Pfeiffer*'s interpretation that would limit the disgorgement remedy to a usurpation of corporate opportunity or cases where the insider used confidential corporate information to compete directly with the corporation. *Brophy* was not premised on either of those rationales. Rather, *Brophy* focused on the public policy of preventing unjust enrichment based on the misuse of confidential corporate information.[242]

A Delaware corporation has a right to recover profits earned by officers, directors and controlling stockholders who trade on its securities on the basis of inside information. Since this right sounds in unjust enrichment, it is not necessary for the plaintiff to show it was harmed.[243] Note, the *Kahn* court never expressly refers to information as property, but its statement that trading by the insider was a "misuse of confidential corporate information"[244] implies that it is.

The problems of derivative actions are well known. Since the corporation whose securities are being traded is the nominal plaintiff, recovery is in most cases paid to the corporation rather than the stockholder bringing the case in the corporation's name. Moreover, the requirement that the stockholder make demand on the corporate board to sue its fellow directors or officers, or show that demand would have been futile (the subject of much post-*Kahn*

> on the basis of the fraudulent information;" and (2) "if the insider used confidential corporate information to compete directly with the corporation." *Brophy*, in the Vice Chancellor's view, was an example of the second circumstance where disgorgement is an appropriate remedy. But, in most circumstances a corporation would only be able to recover for "actual harm causally related (in both the actual and proximate sense) to the breach of the duty of loyalty" — for example "costs and expenses for regulatory proceedings and internal investigations, fees paid to counsel and other professionals, fines paid to regulators, and judgments in litigation.

Id. at 839–40 (citations omitted).

242. *Id.* at 840 (citations omitted).

243. *Id.* The transaction leading to the *Kahn* opinion, eventually resulted in a settlement of $39 million payable to the former stockholders of Primedia, but not directly on the *Brophy* claim. *KKR Gets Approval to Pay $39M to End Class Action Over Primedia-TPG Merger*, BLOOMBERG L. (May 28, 2015, 12:00 AM), https://www.bloomberglaw.com/document/X5OTPDS000000?bna_news_filter=class-action&jcsearch=BNA%2520000001607239dc0fa5f0f239060f0000#jcite. Rather, the plaintiffs argued in a related class action that one of the reasons why the compensation paid to the stockholders in the cash-out merger (i.e., that should have rendered the *Kahn* opinion moot) was that the board did not consider the value of the *Brophy* claim against KKR when valuing the corporation. *In re* Primedia, Inc. S'holder Litig., 67 A.3d 455, 484 (Del. Ch. 2013).

244. *Kahn*, 23 A.3d at 840.

litigation), can be prohibitive.[245] Finally, the ability of the board of directors' of the formal plaintiff corporation to appoint an SLC that is likely to decide to dismiss an action against its fellow directors — the issue in *Kahn* — may make *Brophy* litigation unattractive. Moreover, as discussed, with a few notable exceptions, the profits gained, or losses avoided in typical insider

245. Nevertheless, numerous *Brophy* suits have been attempted in the context of classic insider trading since *Kahn*. *See, e.g.*, Sandys v. Pincus, No. 9512, 2016 Del. Ch. LEXIS 43 (Del. Ch. Feb. 29, 2016) (finding demand not futile in a *Brophy* action because there are directors who are not defendants); Silverberg v. Gold, No. 7646, 2013 Del. Ch. LEXIS 312 (Del. Ch. Dec. 31, 2013) (finding demand would be futile); Tilden v. Cunningham, No. 2017-0837, 2018 Del. Ch. LEXIS 510 (Del. Ch. Oct. 26, 2018) (stating failure to plead demand futility with particularity); *In re* Facebook, Inc., 922 F. Supp. 2d 445, 466, 469, 474–75 (S.D.N.Y. 2013) (finding failure to plead demand futility with particularity, derivative plaintiffs did not have standing to bring derivative action because they did not own stock on the day of the alleged wrong; claims not ripe); Davis v. Gutierrez, No. 17-cv-147, 2018 U.S. Dist. LEXIS 50135, at *47–48 (D.N.H. Mar. 27, 2018) (concluding the *Brophy* claim was adequately pleaded); Heartland Payment Sys., LLC v. Carr, No. 3:18-cv-9764, 2020 U.S. Dist. LEXIS 15302 (D.N.J. Jan. 27, 2020) (concluding the claim that tippee aided and abetted a *Brophy* claim was properly pleaded; disgorgement of profits to SEC does not preclude *Brophy* action); Scrushy v. Tucker, 70 So. 3d 289, 307 (Ala. 2011) (affirming that *Brophy* is still a valid claim under Delaware law); Dollens v. Zionts, No. 01 C 2826, 2002 U.S. Dist. LEXIS 13511 (N.D. Ill. July 22, 2002) (finding demand would be futile); *In re* Fossil, Inc., 713 F. Supp. 2d 644, 656 (N.D. Tex. 2010) (*Brophy* claim asserted with particularity); *In re* Symbol Tech. Sec. Litig., 762 F. Supp. 510, 517 (E.D.N.Y. 1991) (applying Delaware law, the plaintiff did not adequately plead demand futility, but is permitted to replead; the fact that there might be a private or SEC action under Rule 10b-5 does not preclude *Brophy* claim, but there should not be double recovery; damages awarded to the extent actual injury to the issuer is not proven, will be held in trust pending the resolution of federal proceedings); *In re* Taser Int'l S'holder Derivative Litig., No. CV-05-123, 2006 U.S. Dist. LEXIS 11554, at *48 (D. Ariz. Mar. 17, 2006) (*Brophy* claim sufficiently pleaded); Rosky v. Farha, No. 07-cv-1952-T-26MAP, 2009 U.S. Dist. LEXIS 107531, at *27 (M.D. Fla. Mar. 30, 2009) (*Brophy* claim sufficiently pleaded); Spiegel v. Buntrock, No. 8936, 1988 Del. Ch. LEXIS 149, at *12 (Del. Ch. Nov. 17, 1988) (demand not excused); *In re* Wells Fargo & Co. Auto Ins. Derivative Litig., 2018 Cal. Super. LEXIS 2388, at *30 (Cal. Super. Ct., S.F. Cnty. May 8, 2018) (applying Delaware law, found that demand futility not pleaded with particularity).

In addition, a number of derivative cases have recently been brought seeking, among other things, disgorgement in connection insider trading, (although not all of the complaints cite *Brophy*. *See* Rhodes v. Milton, No. 2022-0023 (Del. Ch. Jan. 7, 2022); Reiter v. Fairbank, No. 2021-1117 (Del. Ch. Dec. 29, 2021); Compl. at 96, Atchison v. Hernandez, Docket No. 2020-0655-JTL (Del. Ch. filed Aug. 12, 2020), https://www.bloomberglaw.com/document/X6EK9NA60058IIRLFCSU7LV2UU9?fmt=pdf; Cambridge Ret. Sys. v. McBride, Docket No. 2019-0658-AGB (Del. Ch. filed Aug 22, 2019), https://www.bloomberglaw.com/product/blaw/document/X4NBD3ULB5K9UR9TVNGATG2DB9S?fmt=pdf; Compl. at 51, Equity-League Pension Tr. Fund v. Great Hill Partners, L.P., Docket No. 2020-0992-SG (Del. Ch. filed Nov. 23, 2020), https://www.bloomberglaw.com/document/X71T4JR3TKA85BP517UHB7VDJ20?fmt=pdf).

trading tend to be modest and may not justify the expense of complex litigation.[246]

Nevertheless, expanding *Brophy* to its logical extreme under the U.S. Supreme Court's misappropriation theory of information as property, could breathe life into it precisely because the defendants would not be officers and directors of the source. For example, in *Carpenter*, the *Wall Street Journal* might well have been willing to sue Winans and seek disgorgement because of the damage he and his co-conspirators might have done to its journalistic reputation.[247] As such, it is more likely that state law misappropriation cases might be more attractive, in that the plaintiff — the source of the information — may be more inclined to want to sue a disloyal confidant even though the amount of recovery might be relatively small.

IV. RESTITUTION AND PROPERTY

Let us now consider the law of restitution, generally, in connection with the interference with property rights generally, before turning to the R3RUE's treatment, specifically. It should become clear that restitution is in many cases just a definition of the positive law of possessory interests in an object.

A. Common Law of Property

I reject the familiar "bundle of sticks" metaphor of property because it is analytically useful to group property rights into the three, traditional categories of possession, use, and alienation very broadly defined.[248] I also reject the proposition, associated most closely with Wesley Newcomb Hohfeld, that property does not necessarily require an object.[249] Of course, being a legal category, property rights are always relationships between and among legal subjects. However, in the case of property, these relationships always revolve around the control and use of an object. For this purpose, the term "object" is not necessarily a tangible thing, but can be anything external to the subjects claiming a property right. The primary property right — i.e., the one necessary for all other rights — is "possession." I am using this term not as the *fact* of physical possession of a tangible thing, but the exclusive

246. See *infra* text at notes 275–78, 468–69 for the facts of this case.

247. *See* Carpenter v. United States, 484 U.S. 19, 25 (1987) (describing how the Journal was "defrauded" by Winan's actions and that the intangible nature of its confidential business information constituted it as "property" protectable by the mail and wire fraud statutes).

248. The second chapter in my first book is an extended critique of this metaphor. *See* JEANNE LORRAINE SCHROEDER, THE VESTAL AND THE FASCES: HEGEL, LACAN, PROPERTY AND THE FEMININE 107–225 (1998).

249. WESLEY NEWCOMB HOHFELD, FUNDAMENTAL LEGAL CONCEPTIONS AS APPLIED IN LEGAL REASONING 85 (W. Cook. ed. 1919).

right to exclude others, which means to control access to and use of an object.[250] This is how the Supreme Court uses the term with respect to possession of information in its misappropriation cases, *Carpenter*[251] and *O'Hagan*.[252]

Eminent scholars such as Richard Posner have suggested that rights in information can at best only be "quasi property" because more than one person can "possess" the same information — in the sense of having access to it — at the same time.[253] But, this conflates the *empirical fact* of use with the *legal right* of possession. I am not arguing that we, as a society, *must* recognize property rights in material, nonpublic information — in fact, I am skeptical of the wisdom of the Supreme Court's decision to do so in *Carpenter*, which in effect *criminalized* certain breaches of employment agreements that might be better addressed as matters of private law.[254]

However, I am arguing that *if* we were to decide to do so, it is coherent to analyze information as *true* property. Moreover, certain legal results flow from that decision. For example, as the Supreme Court ruled in *Carpenter* and *O'Hagan*,[255] under some circumstances if a confidant uses nonpublic information for her own purposes without the permission of the source of the information, she is interfering with the source's possessory rights to control its use. That is, she is misappropriating it and the source should have whatever legal and equitable property remedies that an owner would have with respect to any other object of property.

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250. This is how Hegel defines possession in his *Philosophy of Right*. G.W.F. HEGEL, ELEMENTS OF THE PHILOSOPHY OF RIGHT 84–88 (W. Wood ed. & H. B. Nisbet trans. 1991); *see also* SCHROEDER, *supra* note 248, at 42; Jeanne L. Schroeder, *Unnatural Rights: Hegel and Intellectual Property*, 60 U. MIA. L. REV 453, 469–70 (2006) [hereinafter, Schroeder, *Unnatural Rights*].

Unfortunately, although the U.C.C. ostensibly claims not to define the term "possession" despite the fact that it uses it over one hundred times, in context it is clear that it means not the *right* of possession but the *fact* of *physical* custody of *tangible* things. *See* Jeanne L. Schroeder, *Bitcoin and the Uniform Commercial Code*, 24 U. MIA. BUS. L. REV. 1, 23–27 (2016) [hereinafter Schroeder, *Bitcoin*].

251. 484 U.S. at 25–26 ("Confidential business information has long been recognized as property.").

252. 521 U.S. 642, 681–82 (1997) (Thomas, J., concurring in part) ("The majority correctly notes that confidential information 'qualifies as property to which the company has a right of exclusive use.'").

253. David D. Friedman et al., *Some Economics of Trade Secret Law*, 5 J. ECON. PERSP. 61, 61–62 (1991); *see also*, Schroeder, *Unnatural Rights*, *supra* note 250, at 453 n.2.

254. Similarly, although Epstein agrees with the analysis that the source of the information might have a state common law cause of action against the defendants in *Carpenter*, he believes that it was probably not appropriate to bring a federal criminal action. *See* Epstein, *supra* note 73, at 1501.

255. *See infra* text at note 283; *supra* notes 252, 406.

i. Theft

To illustrate, let us look to the law of theft of goods. The advantage of starting with an analysis of tangible property is that it is more intuitive than intangibles.[256] The disadvantage is that this intuitive attractiveness can lead to the wrong-headed Posnerian assumption that true property involves tangible rights and that rights with respect to other objects — such as intellectual property — are merely quasi-property and that rights of possession relate to the physical custody of tangible things. I agree with Hegel that intangibles are, in fact, the characteristic object of property and that tangibles are merely a special example.[257] Nonetheless, I take the plunge and start with goods since the rules are generally familiar, even to lay persons.

Assume that A owns a valuable object, a gold brick, that she keeps locked in a safe in her home. B breaks in and steals the gold brick. B obtains neither legal nor equitable title in the gold brick.[258] If A discovers the gold brick is in B's possession, she has the right to get her gold brick back.[259] If she does so, she is neither compensating herself nor penalizing B. As is so often the case, however, self-help may not be practicable, and she will have to seek redress in the courts. If B is still in possession of the gold brick, A can choose her remedies. On the one hand, she can sue under the tort of conversion. This is, in effect, a forced sale — the court will declare that when B took the owner's property, he bought it on that day and must pay the owner the fair market value. If, and only if, A chooses conversion will title in the gold brick pass to B.[260]

256. As Hegel argued in his theory of property in his *Philosophy of Right*, on which I base my property jurisprudence. I set forth this argument in detail in Schroeder, *Unnatural Rights*, *supra* note 250.

257. HEGEL, *supra* note 250, at 74–75; Schroeder, *Unnatural Rights*, *supra* note 250, at 464–65.

258. Laycock bemoans the fact that, despite the R3RUE's laudable decision not to try to pigeonhole restitution into a legal/equitable dichotomy, when it speaks of restitution of property it continues to use the traditional language of legal and equitable interests. Laycock, *supra* note 6, at 931–32. Nevertheless, I agree with the drafters of the R3RUE that this distinction is analytically useful when discussing the relative rights and obligations of the original owner of an object, a wrongful transferee, and third parties. It is a distinction regularly made in debtor-creditor law. Moreover, it maps onto the U.C.C.'s concept of voidable title — i.e., when a transferee has legal, but not equitable, title.

259. JOHN O. HONNOLD ET AL., THE LAW OF SALES AND SECURED FINANCING: CASES PROBLEMS AND MATERIALS 40–42 (7th ed. 2002). Notoriously, the U.C.C. does not set forth this common law rule. *Id.* The issue of when and under what circumstances the owner can use self-help is beyond the scope of this Article.

260. *See, e.g.*, Pierpoint v. Hoyt, 182 N.E.2d 235, 236 (N.Y. 1932). The tort of conversion is defined in the Restatement (2d) Torts Section 222A:

> (1) Conversion is an intentional exercise of dominion or control over a

Alternately, she can bring an action in replevin in which the court will order B to give A back her gold brick — i.e., restitution.[261] This is not *compensating* A for the loss. Nor is it *penalizing* B for theft. From a property perspective, B received nothing in the theft, so we are not taking anything from him.

What if B sells the gold brick before A can bring her replevy action? Because A owns the gold brick, the common law imposes a constructive trust on any proceeds B may receive on the sale — i.e., B in effect sold the gold brick for A's account.[262] However, for a constructive trust to be imposed, the plaintiff must be able to trace the proceeds from the sale.[263] The advantage of the remedies of restitution and constructive trust is that they are *in rem*. This means that if the thief were to become insolvent the stolen goods or their traceable proceeds would not be property of his estate and the owner would not be a general creditor of the thief so that she would be entitled to receive her property prior to distributions to general creditors.[264] If the proceeds cannot be traced, however, then the owner has an *in personam* claim for an amount equal to the thief's profits.[265] This is what securities law calls disgorgement. Of course, the owner would be a general creditor in the thief's bankruptcy, and this means she would be unlikely to recover her entire claim.

> chattel which so seriously interferes with the right of another to control it that the actor may justly be required to pay the other the full value of the chattel.
>
> (2) In determining the seriousness of the interference and the justice of requiring the actor to pay the full value, the following factors are important:
>
> (a) the extent and duration of the actor's exercise of dominion or control;
> (b) the actor's intent to assert a right in fact inconsistent with the other's right of control;
> (c) the actor's good faith;
> (d) the extent and duration of the resulting interference with the other's right of control;
> (e) the harm done to the chattel;
> (f) the inconvenience and expense caused to the other.

RESTATEMENT (SECOND) OF TORTS § 222A (AM. L. INST. 1965).

261. Note, this isn't technically rescission because, in theft, no title passes to the thief so there is no transfer to rescind.

262. The R3RUE defines proceeds as "assets received as the direct product of an asset for which the defendant is liable in restitution to the claimant." R3RUE § 53(2).

263. *See id.* § 58, cmt. i.

264. *See id.* § 13, cmt. h.

265. *See id.* § 1, cmt. a.

Suppose that B cannot be found or is insolvent so that neither restitution nor disgorgement from B is possible as an *empirical* matter, but A finds that B transferred the gold brick to C. The basic rule of property is derivation — that is, a transferor can only obtain the title she has so that a transferee's title derives from that of his transferor — unless an exception applies.[266] In the case of the *stolen* gold brick, since B had no title in the gold brick (sometimes referred to as "void title"), C only obtains void title in the gold brick. Under American law, there is no exception to this rule with respect to stolen *goods* (although, there are some exceptions for other categories of property).[267] This means that A can replevy the gold brick from C no matter how innocent C is. When A asks the court to make C give the gold brick back, she is neither asking to be compensated for a loss — she is reversing the loss — nor is she penalizing C since, *vis a vis* A, C had no interest in the gold brick. Of course, if C had paid B for the gold brick, then *C* suffered a loss. But it is up to C to find the elusive and/or judgment proof B to (probably unsuccessfully) seek recourse for breach of implied warranty of good title.[268]

ii. Fraud

For insider trading to violate *federal* securities law it must involve fraud, not theft. Indeed, although the term "misappropriation theory" might misleadingly imply that it covers outright theft of information, it is in fact used to explain when the use of information in violation of a fiduciary or similar duty constitutes fraud on the source. Once again, let us first consider the more intuitive law of goods.

B fraudulently induces A to sell him the gold brick. In this case, B obtains *legal*, but not *equitable* title, in the gold brick — what the UCC refers to as voidable title.[269] To simplify, B's title in the goods is good against the world except for A, but A needs to apply to a court to declare this the case. If she does so, A can choose to either sue under the tort of conversion or seek to replevy the gold brick — i.e., obtain restitution.[270] As is the case with stolen goods, if B no longer owns the gold brick, A can seek to impose a constructive trust on traceable proceeds.[271] If the proceeds cannot be traced,

266. With respect to goods, this is located in U.C.C. § 2-403(1) (first sentence). With respect to information, this would be governed by common law. Sometimes this is known by the Latin "*nemo potest dare quod non habet*" (i.e., no one can give what he does not have). VIRGO, *supra* note 33, at 656.

267. HONNOLD ET AL., *supra* note 259, at 40–42.

268. *See* U.C.C. § 2-213 (AM. L. INST. & UNIF. L. COMM'N 1951).

269. U.C.C. § 2-403(1) (second and third sentences). The U.C.C. leaves to extra-code law the determination of when a transferee's title might be voidable, although it lists four examples (e.g., paying for a good with a check that is subsequently dishonored).

270. HONNOLD ET AL., *supra* note 259, at 40–42.

271. R3RUE § 55.

A can choose between bringing an action for equitable accounting (i.e., disgorgement of an amount equal to the fraudster's profits) or suing for conversion.

The major difference between theft and fraud (void title versus voidable title) involves A's right against third party transferees. Once again, the background rule is derivation — if B has title voidable *vis a vis* A, the default rule is that C's title in the gold brick is also voidable by A. In the case of voidable title, however, there are exceptions to protect innocent parties. With respect to goods, if C can prove he is a good faith purchaser for value he will take free of A's property claim.[272] Analogous rules apply to other types of property. For example, a holder in due course takes free of adverse claims by previous owners of negotiable instruments.[273] It is important to note that it is the transferee who has the burden to show that he is entitled to keep the misappropriated property, not the original owner. This will become significant when we reconsider the *Dirks* rule for tippees under the misappropriation theory.[274]

Now that we have considered the classic rule of property with respect to goods obtained by fraud, we can move on to the misappropriation theory of insider trading.

B. The Supreme Court's Misappropriation Analysis

Let us start with the *ur-misappropriation* case, *Carpenter.*[275] The Supreme Court accepted that, at least for the purposes of federal mail and wire fraud, material non-public information is property of the source of such information.[276] The primary defendant was R. Foster Winans, a *Wall Street Journal* columnist who knew that the securities market predictably moved the morning his *Heard on the Street* column ran.[277] He and his co-conspirators timed their securities trading based on his knowledge of the *Journal's* production schedule.[278] The Second Circuit Court of Appeals found that Winans and his conspirators committed both wire and securities fraud, adopting a variation of what would become known as the

272. U.C.C. § 2-403(1) (AM. L. INST. & UNIF. L. COMM'N 1951) ("A person with a voidable title has power to transfer good title to a good faith purchaser for value.").

273. *Id.* § 3-305. In contrast to the law of goods, a holder in good faith of stolen *bearer* instruments takes free of the adverse property claims of the owner.

274. *See infra* text at notes 416–44.

275. 484 U.S. 19 (1987).

276. *Id.* at 24.

277. *Id.* at 23.

278. *Id.* at 22–24. The production schedule (not the content of the articles, which was based on market rumors and other public information) was the information owned by the *Journal*.

misappropriation theory.[279]

The Supreme Court found that this was mail and wire fraud but split 4-4 on whether it was also securities fraud, leaving the Second Circuit's misappropriation holding on securities fraud in effect for the defendants without approving it.[280] Mail and wire fraud are defined as "scheme or artifice to defraud, or for obtaining money or property by means of false or fraudulent pretenses, representations, or promises"[281] involving the jurisdictional hook of the use of the mail or wires. The Supreme Court found that material nonpublic information – in this case the production schedule — was property of the *Journal.*[282]

Winan's use of the information for his purposes deprived the *Journal* of its possession of such information understood as its exclusive right to control its use.[283] It is akin to embezzlement, even though there are no monetary damages.[284] I would note here that Justice White cites with approval the holding of *Diamond*:

> It is well established, as a general proposition, that a person who acquires special knowledge or information by virtue of a confidential or fiduciary relationship with another is not free to exploit that knowledge or information for his own personal benefit but must account to his principal for any profits derived therefrom.[285]

Here, unfortunately, the reasoning of the case becomes torturous because the Federal mail and wire fraud laws do not prohibit the *theft*, but only the *fraudulent acquisition*, of property.[286] Nevertheless, the Supreme Court found that Winans defrauded the *Journal* because its company policy, as set forth in the employee manual, made it clear that employees could not use company information.[287] It was also clear that Winans knew of the policy since he had twice reported leaks by others.[288] His deceit was that "he played the role of a loyal employee."[289]

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279. *Id.* at 23–24.

280. *Id.* at 24

281. 18 U.S.C. §§ 1341, 1343.

282. *Carpenter*, 484 U.S. at 25–26.

283. *Id.* at 26–27.

284. *See id.* at 26.

285. *Id.* at 27–28 (quoting Diamond v. Oreamuno, 248 N.E.2d 910, 912 (N.Y. 1969)) (citing RESTATEMENT (SECOND) OF AGENCY §§ 388, cmt. c, 396(c) (AM. L. INST. 1958)).

286. *Id.* at 27 (noting that the mail fraud statutes "reach any scheme to deprive another of money or property by means of false or fraudulent pretenses, presentations, or promises").

287. *Id.* at 27–28.

288. *Id.* at 28.

289. *Id.* at 28. Because electronic communication and the mails were necessary to deliver the newspaper supplying the jurisdictional hook of the statutes. *Id.*

As I discuss below,[290] one of the oddities of the misappropriation theory is that, because the *Journal* owned the material nonpublic information at issue, it could trade on the information without committing securities fraud. Moreover, there is no private right of action for mail or wire fraud.[291] And, as discussed,[292] under the *Blue Chip Stamps* rule, the *Journal* did not have standing to sue Winans for federal securities fraud because it did not itself trade securities. However, by his citation of *Diamond*, Justice White assumed that the *Journal* would have a *state* common law cause of action for disgorgement consistent with my thesis that the *Brophy/Diamond* principal should not be limited to classic insider trading.[293]

In the years following *Carpenter*, the Circuit Courts split as to whether or under what circumstances misappropriation might also constitute securities fraud, leading to the Supreme Court's granting *certiorari* to *O'Hagan*, in which the Eighth Circuit Court of Appeals rejected the misappropriation theory of insider trading.[294] The Supreme Court reconfirmed its holding in *Carpenter*, that material nonpublic information could be property of the source and that the unauthorized use of that property could in some circumstances be viewed as a misappropriation of property.[295] In this case the material nonpublic information was Grand Metropolitan PLC's ("GrandMet") intent to commence a hostile tender offer for Pillsbury Company.[296] The defendant, James O'Hagan, learned of this in his capacity as a partner in a law firm that represented GrandMet.[297] He used this information to acquire call options on Pillsbury stock in violation of his fiduciary duties to his former client and/or his law firm.[298]

There is no question that O'Hagan was a bad person. Although "a pillar

290. *See infra* text at notes 468–72.

291. Violation of the mail and wire fraud acts can, however, be predicate acts for liability to private plaintiffs under the Racketeer Influenced and Corrupt Organizations ("RICO") Act. 18 U.S.C. §1961(1).

292. *See supra* text at note 130.

293. *See Carpenter*, 484 U.S. at 27–28 (citing Diamond v. Oreamuno, 248 N.E.2d 910, 912 (N.Y. 1969)).

294. Notoriously, when the Supreme Court initially denied *certiorari* on *Carpenter*, Justice Powell, the author of the majority opinions in *Chiarella* and *Dirks*, drafted a dissent in which he argued that the misappropriation theory was inconsistent with the holdings of those earlier cases. By the time the Supreme Court reversed itself and heard *Carpenter*, Justice Powell had retired. If he had been on the Court, presumably he would have broken the split and the misappropriation theory would not have become law. CHOI & PRITCHARD, *supra* note 140, at 450–51.

295. *See* United States v. O'Hagan, 521 U.S. 642, 654 (1997) (citing *Carpenter*, 484 U.S. at 25–27).

296. *Id.* at 647.

297. *Id.*

298. *Id.* at 648.

of the Minneapolis business establishment [and] a star partner at Minnesota's largest and most prestigious law firm"[299] he betrayed the trust of his client and his partners. Indeed, the reason why he engaged in the trade was that he previously embezzled cash from a number of his law firm's clients, including the Mayo Clinic (of which he was a trustee), and apparently wanted to surreptitiously replace the funds.[300] The majority, no doubt, harbored a strong intuition that he should be punished. However, this trade clearly violated the prophylactic provisions of Rule 14e-3 governing tender offers, which was adopted in response to *Chiarella.*[301] The question was whether this trading also qualified as *actual* fraud in violation of Sec. 10(b) and Rule 10b-5 so that additional time could be added to O'Hagan's sentencing.

The *O'Hagan* holding raises several problems. As I discuss below,[302] although the source of the duty in classic insider trading derives from corporate law principles, courts have struggled with the question as to what constitutes the "fiduciary or similar duty of trust and confidence" necessary to make a misappropriation based on silence fraudulent. A second problematic aspect of *O'Hagan* is how does the fraud on the source, who does not necessarily purchase and sell securities, become fraud "in connection with the purchase and sale of securities" under section 10(b). After all, even DOJ prosecutors agreed that it would not be *securities* fraud if a disloyal fiduciary engaged in embezzlement of money (as O'Hagan did with respect to other clients) and used the funds to purchase or sell securities.[303]

Justice Ginsberg declared that the misappropriated information must be "of a sort that misappropriators ordinarily capitalize upon to gain no-risk profits through the purchase or sale of securities."[304] Justice Thomas in his dissent objected, on the grounds that even though he agreed that *O'Hagan* did misappropriate property, Justice Ginsberg's standard is hardly a model

299. Eben Shapiro, *A Leading Lawyer's Fall is a Jolt to Minneapolis*, N.Y. TIMES (Jan. 20, 1990), https://www.nytimes.com/1990/01/20/business/a-leading-lawyer-s-fall-is-a-jolt-to-minneapolis.html.

300. *Id.*

301. This prophylactic rule prohibits trading, after a person has taken "substantial steps" towards the commencement of a tender offer in the securities of a person, in possession of material information that he knew, or had reason to know was nonpublic and came directly or indirectly from the bidder, the target, or their insiders. 17 C.F.R. §240.14e-3(a) (2021). In *O'Hagan* the Supreme Court confirmed that because the language of Exchange Act Section 14(e) is broader than that of Section 10(b), it is not limited to actual fraud, so that the broad prophylactic provisions of Rule 14e-3 are permitted. *O'Hagan*, 521 U.S. at 667–70.

302. *See infra* text at notes 377–412.

303. *See O'Hagan*, 521 U.S. at 656–57.

304. *Id.* at 656.

of clarity.[305] I have discussed the "in connection with" element elsewhere and shall not expand on it in this Article.[306]

The third objection is more on point to my Article. Property law is usually thought to be the bailiwick of state common law. *O'Hagan*, following *Carpenter*, holds that the use of confidential information constitutes the misappropriation of property "akin to embezzlement."[307] In fact, although state law does protect rights in nonpublic information, it is not clear whether even information that is a trade secret should be analyzed in terms of property, contract, tort, or as a *sui generis* right.[308] Nevertheless, according to the R3RUE, state courts have imposed restitution in the case of misappropriated information even in cases where it does not constitute trade secrets, suggesting that they might be implicitly reflecting a property or quasi-property analysis of information.

Consequently, as mentioned,[309] Bainbridge has suggested that insider trading law would be simpler and clearer if it was conceptualized as the de facto federal law of property in information. Unfortunately, this would be inconsistent with the Supreme Court's holding that federal statute by its terms is limited to fraud, which is why I argue for a state common law analysis.[310]

C. The Logic of Misappropriation

As I discuss in the next section,[311] a property-based theory of disgorgement of insider trading profits is consistent with the R3RUE. If information is property, then the source of the information should theoretically have a right of restitution of possession of the information against the fraudster to return the property. Of course, since possession of information consists of the control of its use, once the misappropriator has

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305. *Id.* at 681–84 (Thomas, J., dissenting in part).

306. Schroeder, *Taking Stock*, *supra* note 105, at 211–20. One of my conclusions is that, although I believe that Justice Ginsberg's "in connection" test is incoherent, the SEC and DOJ have not tested it to extremes, but rather have only brought misappropriation cases in a number of relatively uncontroversial fact patterns, such as trading on unannounced financial information or planned mergers or acquisitions, drug trials and approvals, and pre-publication journalism.

307. *O'Hagan*, 521 U.S. at 654.

308. Schroeder, *Envy*, *supra* note 101, at 2061 n.163.

309. *See supra* text at notes 150–51.

310. For a brief account of the academic debate as to whether the duty imposing insider trading liability should be federal or state law, see Molk, *supra* note 69, at 1741–45. Epstein, like me, argues that, although in cases such as *O'Hagan*, where there is a clear misappropriation of information through breach of a fiduciary duty, this should be a matter between the source and the misappropriator, and it is unclear why the SEC should be involved at all. Epstein, *supra* note 73, at 1499–1501.

311. *See infra* text at notes 331–59.

traded on it, it is impossible to return the source to the status quo. Consequently, the source should, instead, have a constructive trust on the proceeds received by the fraudster. If the proceeds are not traceable, then the source should instead have an *in personam* cause of action for an accounting of profits — which is known in securities law as disgorgement.[312] Taking the Supreme Court's property theory of misappropriation seriously would also bring some logic to the Supreme Court's tortious analysis of tipper/tippee liability. I will now turn to the state law of restitution generally, and Delaware law specifically.

V. THE RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT

A. Introduction

The R3RUE, promulgated by the American Law Institute in 2011,[313] identifies restitution as the law of unjust enrichment. This, standing alone, says little.[314] It is like asserting that the reason why opium puts one to sleep is because it has a dormitive virtue.[315] The drafters were concerned that if they were to give a judge the power to order restitution on intuition that the defendant acted "unjustly," the law would have no bounds — i.e., it would not be law-like.[316] This was arguably the problem of the federal courts' pre-*Liu*'s imposition of disgorgement in securities law cases. The R3RUE insists that restitution is, in fact, not a matter of free-floating moral intuition but is

312. *O'Hagan* might be one of the rare cases where the source might have had standing to sue because GrandMet, the source, did eventually commence a successful tender offer for Pillsbury and, therefore, might have met the *Blue Chip Stamps* test.

313. Oddly enough, although there is a First Restatement of Restitution there is not, as the name Restatement (Third) might seem to imply, a Second Restatement of Restitution. Kull, the Reporter of the R3RUE, gives an account of the tumultuous and ultimately doomed attempt to draft a Second Restatement in Kull, *supra* note 19.

314. "Saying that liability in restitution is imposed to avoid unjust enrichment effectively postpones the real work of definition, leaving to a separate inquiry the question whether a particular transaction is productive of unjust enrichment or not." R3RUE §1, cmt. b.

315. *The Imaginary Invalid* (Moliere 1673).

316. As Ernest Weinrib, a strong defender of the coherence of unjust enrichment law, properly understood, states "[f]or many years the development of unjust enrichment was impeded by the suspicion that, once recognized as a category of liability, it would direct judges away from traditional legal reasoning to the amorphous exercise of legal discretion on unspecified grounds that vary according to one's personal sense of justice." WEINRIB, *supra* note 25, at 186 (citations omitted). James Steven Rogers, similarly, defends unjust enrichment from the common criticism that it is particularly indeterminate when compared to other areas of law. James Steven Rogers, *Indeterminacy and the Law of Restitution*, 68 WASH & LEE L. REV. 1377, 1388 (2011); *see also* Laycock, *supra* note 6, at 932.

governed by identifiable legal rules.[317] Consequently, although the R3RUE continues to use the traditional nomenclature of "unjust enrichment" a more accurate terminology would be "unjust*ified* enrichment" — i.e., gains that cannot be justified by recognized legal principles.

The R3RUE characterizes restitution as "the law of nonconsensual and nonbargained benefits in contrast to torts which is the law of nonconsensual and nonlicensed harms."[318] Ernest Weinrib refers to unjust enrichment as "the law of non-gifts."[319] Once again, as the drafters are aware, these formulations restate, but do not answer the issue of the content and bounds of the law. What is significant, however, is that in stark contrast to torts, harm to the plaintiff, is not an element in restitution. Restitution is, instead, based on benefit to the defendant.[320] "The general principle . . . is the one underlying the 'disgorgement' remedies in restitution, whereby a claimant potentially recovers more than a provable loss so that the defendant may be stripped of a wrongful gain."[321] Indeed, "[r]estitution [is] *an alternative* to damages . . . for injury."[322] Consequently, the Seventh Circuit in *Freeman* incorrectly stated the common law when it guessed that Indiana would not recognize a *Brophy/Diamond* cause of action for insider trading on the grounds that the plaintiff/source of the information did not suffer out-of-pocket damages.[323]

As discussed,[324] the Supreme Court has consistently insisted since the mid 1970's that Exchange Act Sec. 10(b) and Rule 10b-5 are limited to *actual fraud* which means intentional wrongdoing by the fraudster and misappropriation of information understood as property.[325] That is,

317. R3RUE § 1 cmt. c.; Laycock, *supra* note 6, at 932.

318. R3RUE §1 cmt. d.

319. WEINRIB, *supra* note 25, at 218 (citing Abraham Drassinower, *Unrequested Benefits in the Law of Unjust Enrichment,* 48 U. TORONTO L.J. 459, 478 (1998)).

320. R3RUE § 3 cmt. b.

321. R3RUE § 3 cmt. a.

322. R3RUE § 3 cmt. b. (emphasis added).

323. *See supra* text at notes 202–06. Of course, there can be overlap between tort and restitution in that an act that injures a tort victim *may* also benefit the tortfeasor. In such a case, the victim can elect whether to sue for damages or restitution. Consequently, restitution has sometimes been referred to as waiver of tort particularly, in the United Kingdom. As Daniel Friedmann correctly suggests, this concept is "useful, if limited," as many wrongs that give rise to restitutionary remedies are not tortious. Daniel Friedmann, *Restitution of Benefits Obtained Through the Appropriation of Property or the Commission of a Wrong*, 80 COLUM. L. REV. 504, 504–05 (1980).

324. *See supra* text at notes 52–57, 96–102.

325. There are a number or ways in which the R3RUE's understanding of fraud/disgorgement differs from federal law that are beyond the scope of this Article. For example, in contrast to the federal law of insider trading where scienter is always an element in an action, conscious wrongdoing is usually, but *not always*, necessary for common law restitution, just as scienter is not an element of violations of property rights

misrepresentations made with scienter do not need to be material, and one can get restitution from a transferee who did not act with scienter, but only if the representations are material. As I shall discuss,[326] state common law restitution, in contrast, is a cause of action for unjust enrichment predicated on violations of numerous independent grounds, including misappropriation of property, interference with intellectual property, and violation of fiduciary duty.

Indeed, as we have seen,[327] one of the reasons why federal law is so complex (as Chancellor Laster alluded to in *Pfeiffer*[328]) is that, although it does not make violations of fiduciary duties or misappropriations of property directly unlawful (because they are not necessarily fraudulent), a fiduciary-type relationship of trust and confidence creates the duty to speak that makes silence fraudulent. That is, the existence of state law is necessary to the continued viability of the federal law of insider trading under the classic theory and, perhaps, the misappropriation theory as well. I argue the mirror image should be true as well. The existence of the federal law of *property* in material nonpublic information, fosters a state claim for a private action for restitution for insider trading.[329]

The R3RUE discusses restitution in many diverse contexts such as payment by mistake and breach of contract.[330] I will only discuss those directly relevant to the Supreme Court's insider trading jurisprudence, namely breaches of fiduciary duty, fraud, and interferences in rights in property generally, and intellectual property specifically.

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generally. That is, the "degree of culpable awareness necessary to establish a liability to disgorge profits varies with the context. [For example,] trustees and other fiduciaries may be liable for profits realized as the result of even an unintentional breach of fiduciary duty. Disgorgement in such instances serves a prophylactic function." R3RUE § 3 cmt. a.

Another significant difference from federal securities fraud concerns the relationship between materiality and scienter. Under federal law, misrepresentations and omissions must always be of a material fact. Materiality is an objective test — a *reasonable* investor would have considered the fact in making an investment decision. TSC Indus., Inc. v. Northway, 426 U.S. 438, 445 (1976). Moreover, a plaintiff must also prove that the defendant acted with scienter. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 (1976). Instead, under state law, the materiality depends on the defendant's state of mind.

326. *See infra* text at notes 331–75.

327. *See supra* text at notes 37–38, 52–53, 105–29.

328. *See supra* text at notes 220–27.

329. Laycock, *supra* note 6, at 922.

330. *See* R3RUE § 3 cmt. a.

B. Restitution and Misappropriation of Property (Generally)

One of the main advantages of looking at the state law of restitution is that it would greatly simplify and clarify the law of insider trading in many ways. The first way is that it would do away with the Supreme Court's logic that to fall within Rule 10b-5, insider trading must involve fraud *in addition* to either breaches of fiduciary type duties or interferences with property rights in information. Under state common law, however, fraud, breach of duty, and misappropriation of property are each independent harms that can justify disgorgement. In this section, I shall set forth the R3RUE's understanding of when restitution is appropriate. In the following section,[331] I will apply these rules to insider trading taking seriously the Supreme Court's holding that material nonpublic information is property of the source.

One of the classic situations where restitution is ordered is when one party obtains the property of another through fraud. According to R3RUE § 13 entitled *Fraud and Misrepresentation*:

> (1) A transfer induced by fraud or material misrepresentation is subject to rescission and restitution. The transferee is liable in restitution as necessary to avoid unjust enrichment.
> (2) A transfer induced by fraud is void if the transferor had neither knowledge or, nor reasonable opportunity to learn, the character of the resulting transfer or its essential terms. Otherwise the transferee obtains voidable title.[332]

I have already mentioned the example of voidable title in goods.[333] The R3RUE makes clear that this can apply to intellectual property as well, even if it does not qualify as "trade secrets" within the meaning of state law.[334]

331. *See infra* text at notes 376–466.

332. R3RUE § 13.

333. *See supra* text at note 269–74.

334. Friedmann suggests two principles of restitution:

> First . . . restitution may be justified on the general principle that a person who obtains — though not necessarily tortiously — a benefit . . . through appropriation of a property or quasi-property interest held by [another] person is unjustly enriched and should be liable to the other for any benefit attributable to the appropriation.

Friedmann, *supra* note 323, at 509. For this purpose, he believes property should be interpreted very broadly to include "ideas, information, trade secrets, and opportunity," which he deems quasi-property "since they lack the element of exclusiveness — the right to exclude all others from enjoying it." *Id.* As discussed (*see supra* text at notes 111–12, 250–55, 275–76, 294–95), I and the Supreme Court would consider them to be property, not quasi-property, because we disagree with Friedmann's characterization of possession and exclusivity. Friedmann confuses the *empirical fact* that more than one person can enjoy information, etc. at the same time with the *legal right* to do so.

Friedmann suggests that the Florida Supreme Court decision in *Schein v. Chasen* (*see supra* text at note 177–84) denying restitution in derivative action seeking to obtain the profits of a tippee who traded on inside information might be justified on the grounds

This is consistent with the Supreme Court's analysis in federal securities, mail and wire fraud law that implicitly creates a federal common law of property in material nonpublic information.

According to the R3RUE, a transferor must show that the transferee's misstatements must have "induced the fraud."[335] This is parallel to the federal securities fraud requirement of transaction causation.[336] But there are significant differences from the federal claim. In addition to transaction causation, the plaintiff in a private securities fraud cause of action must also prove loss causation. That is:

> Rescission of a transfer induced by fraud or material misrepresentation requires no showing either that the transferor has suffered economic injury (the requirement in tort) or that the transferee has realized a benefit *at the transferor's expense* (the standard condition of unjust enrichment).[337]

Finally, the transferor can also obtain rescission from a transferee, unless she is a good faith purchaser for value. According to the R3RUE, "rescission is available against the third party who did not make the misrepresentation, rescission of a transfer induced by the fraud of a third party is not available against an immediate transferee who takes the property for value, without notice of the fraud."[338] This is the reverse of the Supreme Court's *Dirks* rule for tippee liability. Under *Dirks* one can only hold a tippee liable for trading on material nonpublic information under the federal securities law if the plaintiff, the SEC, or DOJ can prove that the tippee knew, or had reason to know, that the tipper had violated her duty to her source.[339]

However, by the logic of the Supreme Court's analysis of nonpublic information as *property*, under the basic derivation principle of state common law (as recognized by the R3RUE), a tippee, as recipient of misappropriated property would only obtain the transferor's voidable title in the information. As such the tippee should be subject to the same limitations

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that the inside information might not constitute property or quasi-property "because the tippee could not have been exploited by the corporation itself." *Id.* at 547–48. However, he also notes that the mere possibility that the corporation could have been damaged by the appropriation of the information should be sufficient to establish a right of restitution whether or not damages occurred. As discussed, the Supreme Court has determined that information is property that can be misappropriated by trading on it, and the Delaware Supreme Court has held that an insider trader is liable for restitution. Moreover, as discussed, the Florida Supreme Court did not deny restitution in the case of unlawful insider trading, it just found that plaintiff did not prove that the tippers' trading was unlawful.

335. R3RUE § 13 cmt. c.

336. Jill E. Fisch, *Cause for Concern: Causation and Federal Securities Fraud*, 94 IOWA L. REV. 811 (2009) (discussing induced fraud).

337. R3RUE § 13 cmt. c. (emphasis added).

338. *Id.* § 13 cmt. g.

339. *See supra* text at notes 160–61.

on its use as the tipper unless the *tippee* can show that he is entitled to an exception as a good faith purchase for value.[340] That is, in a private right of action under state common law the burden should be on the tippee to show that she is entitled to use the source's property. I will return to this.[341]

One potential advantage of seeking restitution over suing for damages (in addition to the obvious one of not having to show harm), is that *if* proceeds received upon the use of property can be traced, a constructive trust can be imposed on the proceeds which should have priority over creditors of the transferee.[342]

As Weinrib states:

> As has often been noted, the misappropriation of another's property is the paradigmatic example of an event that gives rise to gain-based damages. Because property rights give proprietors the exclusive right to deal with the thing owned, including the right to profit from such dealings, gains resulting from the misappropriation of property are necessarily subject to restitution. Gains from dealings in property are as much within the entitlement of the proprietor as the property itself.[343]

These basic rules of *in rem* remedies will probably have little or no *direct* application to my analysis of insider trading, however. That is because rescission actions seek to *re*possess the misappropriated property. However, when the property is information, the owner irrevocably loses its possession — defined as its exclusive control over its use and alienation — the moment the transferee (or her tippee) trades on the information. This is reflected in Justice Ginsberg's requirement in *O'Hagan* that misappropriation of non-public information is consummated as securities fraud when a trade

340. Epstein makes a similar point, arguing that under state common law principles, misappropriated information should be subject to a constructive trust in favor of the source which follows the transfer to the tippee who is not a good faith purchaser for value. Epstein, *supra* note 73, at 1505–07. In his brief discussion, however, he can be read as misstating the good faith purchaser law in that he seems to be suggest that the source suing the tippee might have the burden of showing that either she is in bad faith or did not give value.

341. *See infra* text at notes 427–44.

342. The R3RUE states

> Relief of this kind is most often achieved through the device of constructive trust. In particular circumstances, the appropriate remedy may be described in terms of equitable lien or subrogation. If the property itself is no longer available, the constructive trust should attach to any proceeds obtained by the transferee through the disposition of the property. Accordingly, in the case of insider trading, the source of the information should be able to recover the profits realized by the trader when she used the information obtained by fraud.

R3RUE § 13 cmt. h.

343. WEINRIB, *supra* note 25, at 125.

occurs.[344] I am also assuming, for simplicity, that the proceeds of insider trading will rarely be traceable so that the plaintiff will not be able to get a constructive trust over them.[345]

Nevertheless, these basic rules are necessary for understanding the transferor's remedies when it is not possible to replevy the original transferred property or to place a constructive trust on traceable proceeds — i.e., the *in personam* remedy that is known in securities law as disgorgement.[346]

C. Restitution and Property in Information (Specifically)

In addition to these rules with respect to property generally, the law of restitution has specific rules with respect to interference with intellectual property. The R3RUE does not itself, however, identify what intellectual property rights are, leaving this to other law.[347] As we have seen,[348] Delaware, New York, and a few other states following the rule of *Brophy/Diamond* have implicitly or expressly found that material non-public information obtained from a corporation is property of that corporation and that insider trading by traditional insiders constitutes an actionable interference in the corporation's rights. In *Carpenter* and *O'Hagan*, the Supreme Court cited *Diamond* with favor for the proposition that a source has a property interest in its material nonpublic information although it is not absolutely clear whether it thought it was applying state law or formulating a federal common law of information.[349]

The R3RUE does not limit this rule to trade secrets. Moreover, the types of information that have formed the basis of many successful insider trading actions[350] — such as the intent of a bidder to commence a tender offer

344. United States v. O'Hagan, 521 U.S. 642, 647 (1997).

345. Some commentators have criticized the logic and fairness of tracing to establish a property claim in proceeds of misappropriated property. *See, e.g.*, Dale A. Oesterle, *Deficiencies of the Restitutionary Right to Trace Misappropriated Property in Equity and in UCC § 9-306*, 68 CORNELL L. REV. 172 (1983); Rogers, *supra* note 316, at 1399–1404. Rogers states that it springs from a "primitive" concept of property. Rogers, *supra* note 316, at 1402. While I, the drafters of the R3RUE, as well as Article 9 of the U.C.C. disagree with this analysis, this debate is beyond the scope of this Article, as I am assuming that tracing will rarely be available in *Brophy* cases as an empirical matter.

346. As I mentioned earlier (*see supra* note 20), the terminology of the R3RUE (and the federal caselaw) is arguably not a precise as it could be. Historically, the word rescission and restitution may have been applied to replevin and constructive trust. The R3RUE is more flexible using it to also "describe[] cases in which the claimant may be restored to the status quo ante by obtaining the *fungible equivalent* of personal property previously transferred to the other party." R3RUE § 54 cmt. f.

347. *Id.* § 42 cmt. 1.

348. *See supra* text at notes 166–75, 190–92, 216–17.

349. Carpenter v. United States, 484 U.S. 19, 27–28 (1987).

350. See Schroeder, *Taking Stock*, *supra* note 105, at 211–20 for a discussion of the

(*O'Hagan*),[351] a valuable mineral strike (*Texas Gulf Sulphur*),[352] unpublished financial results (*United States v. Newman*),[353] and unannounced information concerning pharmaceuticals (*United States v. Martoma II*),[354] do not fall within the definition of trade secrets.[355] This is why the U.S. Supreme Court's recognition that material non-public information can be property (either under state law or federal common law) is so significant. Consequently, the law of restitution should give a right of action not only for corporations against insiders, but for any source if the disloyal confidant trades on the information under the misappropriation theory. Indeed, in *Carpenter*, Justice White assumed that the *Diamond* rule adopted by New York in a case of classic insider trading would also apply to misappropriation.[356]

The R3RUE's definition of an infringement of an intellectual property right is essentially the same as the Supreme Court's definition of misappropriation. It states, "[t]here is no unjust enrichment . . . unless the defendant has obtained a benefit in violation of the claimant's *right to exclude others* from the interests in question."[357]

As I have just stated,[358] under this definition, literal rescission — in the sense of the defendant returning possession of the property to the plaintiff — is impossible and I am assuming (for simplicity) that tracing of proceeds will

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typical fact patterns underlying reported insider trading cases.

351. 521 U.S. 642 (1997). Indeed, one study indicates that most insider trading enforcement investigations are initiated after the observation of unusual trading activity before the announcement of a merger or acquisition. Michael A. Perino, *Real Insider Trading*, ST. JOHN'S SCH. L. LEGAL STUD. RES. PAPER SERIES 30, 47 (St. John's School Legal Stud. Research Paper No. 19-0005, 2019), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3338536 (showing 67% of prosecutions involve announcements of M&A activity).

352. 401 F.2d 933 (2d Cir. 1968).

353. 773 F.3d 438 (2d Cir. 2014).

354. 894 F.3d 64 (2d Cir. 2018).

355. The Uniform Trade Secrets Act, which has been adopted in some form by every state other than New York, defines a trade secret as

> [I]nformation, including a formula, pattern, compilation, program, device, method, technique, or process, that:
> (i) derives independent economic value, actual or potential, from not being generally known to, and not being readily ascertainable by proper means by, other persons who can obtain economic value from its disclosure or use, and
> (ii) is the subject of efforts that are reasonable under the circumstances to maintain its secrecy.

UNIF. TRADE SECRETS ACT §1(4) (UNIF. L. CMM'N 1985). The federal Defend Trade Secrets Act of 2016 has a similar, but not identical definition. 18 U.S.C. § 1836. The differences between the two provisions are not relevant to this Article.

356. Carpenter v. United States, 484 U.S. 19, 27–28 (1987).

357. R3RUE § 42 cmt. b.

358. *See supra* text at note 312.

rarely, if ever, be practicable. Consequently, the restitutional cause of action can be expected to be *in personam.* That is

> As in every other case of profitable wrongdoing, restitution . . . allows the claimant to recover the benefits derived by the defendant from interference with the claimant's rights. Because a claimant entitled to disgorgement would also be entitled to damages, the practical result is that the claimant may recover either damages or profits, whichever is greater.[359]

D. Fiduciary and Similar Duties

As already introduced,[360] although the Supreme Court usually, but not always, describes the relationship that imposes liability of insider trading as a "*fiduciary or similar* duty of trust *and* confidentiality," the SEC has tried to vitiate this by using the language "duty of trust *or* confidence" in its questionable Rules 10b5-1 and 2.[361] Courts have struggled to identify how such duties are created.

The R3RUE, obviously channeling federal caselaw, states the rule as:

> A person who obtains a benefit
> (a) in breach of a fiduciary duty,
> (b) in breach of an equivalent duty imposed by a relation of trust and confidence, or
> (c) in consequence of another's breach of such a duty,
> is liable in restitution to the person to whom the duty is owed.[362]

It notes that:

> Courts in some jurisdictions distinguish fiduciary obligations in a strict sense (such as those existing between trustee and beneficiary, agent and principal, attorney and client, guardian and ward) from analogous obligations owed by persons not technically fiduciaries, who nevertheless occupy toward others a 'relation of trust and confidence' as regards the transaction in question. The distinction is irrelevant to the rule of this section . . . .[363]

The question as to the nature of the duty and how it arises is left to other

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359. R3RUE § 42 cmt. d. Once again state and federal law differ on the issue of scienter. Under federal law, scienter is always required. Under state law, scienter is relevant to the remedy. According to the R3RUE "[b]ecause a liability limited to the use value of the claimant's property would provide inadequate incentive to bargain over the rights at issue, restitution authorizes the disgorgement of profits in all cases of *conscious* wrongdoing." R3RUE § 42 cmt. g.

360. *See supra* text at notes 123–24.

361. *See* Schroeder, *Taking Stock*, *supra* note 105, at 199–200.

362. R3RUE § 43.

363. *Id.* § 43 cmt. a. Friedmann's second principle of restitution, where "the property approach does not apply [is] deterrence . . . . This principle justifies, for example, the reward of restitution in cases involving breach of fiduciary duty." Friedmann, *supra* note 323, at 509–10 (citations omitted).

law. Delaware has recognized misappropriation in the traditional context of officers and directors to a corporation.[364] In *O'Hagan* the Supreme Court recognized it in the traditional context of a lawyer's fiduciary duty to his client and/or his law firm partners.[365] Consequently, a state common law cause of action for a source seeking to sue a faithless confidant for trading on its material nonpublic information will continue to struggle with these line-drawing problems.

The R3RUE discusses the issue of what duties might render a confidant actionable for use of nonpublic information.[366] Traditional fiduciaries are subject to close strict liability, whereas other confidants, must be considered on a case by case basis.[367] That is as "a practical matter, the confidential character of a relationship normally described as 'fiduciary' . . . will be presumed; while the confidential character of a relation outside the standard fiduciary models must be proved as a matter of fact in a particular case."[368]

According to the R3RUE:

> If restitution takes the form of a liability to disgorge profits, a disloyal fiduciary — without regard to notice or fault — is treated as a conscious wrongdoer . . . though a defendant who obtains a benefit in consequence of another's breach of duty . . . might be treated for restitution purposes as an innocent recipient . . . . Restitutionary remedies (such as constructive trust) that give the claimant rights in identifiable property were originally devised to deal with disloyal fiduciaries . . . .[369]

It continues:

> The basic determination that opens the way to restitution within the rule of this section is always the same: that there has been trust and confidence justifiably reposed on one side, and an advantage improperly gained on the other, either in violation of fiduciary duty or in circumstances posing so great a risk of violation that violation is presumed as a matter of law. Any such advantage must be given up to the beneficiary.[370]

The R3RUE also deals with the misappropriation of nonpublic information, specifically. It states:

> Some notable instances of liability . . . respond to the misappropriation by a fiduciary of confidential information, whether or not the information in question is characterized under local law as a trade secret . . . . Restitution

364. Lyman Johnson, *Delaware's Non-waivable Duties*, B.U. L. REV. 91 (2011) (stating the fiduciary duties of officers and directors cannot be waived).

365. United States v. O'Hagan, 521 U.S. 642, 643 (1997).

366. R3RUE § 43 cmt. b.

367. *Id.* § 43 cmt. d.

368. *Id.* § 43 cmt. f.

369. *Id.* § 43 cmt. a.

370. *Id.* § 43 cmt. b.

> by the rule of this section is likewise the basis of a corporation's claim to profits earned through prohibited insider trading in its securities.[371]

The example the R3RUE gives for this is classic insider trading, where a director of public corporation sells stock on the basis of confidential information about its business activities.[372]

As mentioned above,[373] because federal insider trading law must be grounded in *fraud* rather than in property standing alone, in *Dirks*, the U.S. Supreme Court held that mere access to information cannot impose the duty to refrain or disclose on a tippee.[374] Since the tipper's liability must be derivative of her tipper's violation of a duty, liability depends in large part on the government's proof that the tippee had knowledge of the tipper's violation of her duties to the source.

In contrast, the burden of proof should be the opposite in a *property* regime. That is, a transferee of property with voidable title is liable to the owner of the misappropriated property unless she can show she had no knowledge of her transferor's misdeeds. The R3RUE clarifies:

> Once property has been transferred in breach of the transferor's fiduciary duty, the beneficiary may obtain restitution from any subsequent transferee who does not qualify as a bonafide purchaser . . . . Benefits derived from a fiduciary's breach of duty may therefore be recovered from third parties not themselves under any special duty to the claimant, who acquired such benefits with notice of the breach.[375]

VI. APPLICATION OF TAKING MISAPPROPRIATION SERIOUSLY

Taking the common law of misappropriation and restitution seriously would go far toward solving some vexing issues that have arisen in the application of the misappropriation theory. Before continuing, however, let me specify one issue that I will not be raising. In insider trading cases, courts rarely specify whether they are applying state or developing a federal common law let alone the *Erie* federalism questions this raises. This important subject is beyond the scope of this Article since I am assuming that in cases brought in state courts the judges will apply their own state's common law.[376]

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371. *Id.* § 43 cmt. c.

372. *Id.*

373. *See supra* text at notes 52–57.

374. Dirks v. SEC, 463 U.S. 646, 654 (1983).

375. R3RUE § 43 cmt. c.

376. Such a cause of action would not be preempted by the State Law Litigation Uniformity Standards Act, 15 U.S.C. 28(f), which requires securities fraud class actions to be brought in federal court. First, the causes of action would not be class actions, but rather direct or derivative actions brought by the source of the information. Second, the cause of action would not be for fraud, but for breach of fiduciary duty and/or the

A. Duties

There has been much confusion as to what type of relationship creates the type of duty to a source of information that would make trading on the basis of the information actionable. An examination of the law of rescission reveals that this analysis is backwards. Rather, we should ask whether the common law would find that the source had a property right in the information that would give it the right to seek restitution against the party who used it. As Weinrib notes, in examining whether an unlicensed transfer of property constitutes unjust enrichment justifying a restitutionary remedy, the judge should not merely address his moral intuition but ask "if its conditions are . . . consistent with the norms of justice that govern transfers generally."[377] That is, despite the unfortunate historical nomenclature, the question as a legal matter should be not whether the enrichment is unjust, but whether it is legally unjust*ifiable*.

All too frequently, in my opinion, judges conflate moral outrage with legal liability. I have addressed the inconsistent caselaw elsewhere and will only discuss a few examples here.[378] For instance, in *SEC v. McGee*[379] and its criminal partner *United States v. McGee*,[380] the District Court for Eastern District of Pennsylvania and the Third Circuit Court of Appeals considered whether trading on the basis of material nonpublic information gleaned from an insider by a friend he met through Alcoholics Anonymous meetings, in which participants are supposed to respect the confidentiality of participants, could be the basis of an misappropriation action.[381] The courts, held for the government on a motion to dismiss and an appeal for conviction respectively, on the grounds of *Chevron* deference to the SEC's adoption of the controversial Rule 10b5-2, which purports to create a rebuttable presumption of a duty of trust or confidence for the purposes of the misappropriation theory.[382] They also stated, somewhat misleadingly, that the Supreme Court did not require the duty always be fiduciary in nature,[383] ignoring the fact that it has stated that the duty must be either fiduciary or "similar."[384] The court gave no consideration to the issue of whether the source of the information would have had any legally recognizable claim against the defendant.

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misappropriation of information analyzed as property.

377. WEINRIB, *supra* note 25, at 200.

378. Schroeder, *Taking Stock*, *supra* note 105.

379. 895 F. Supp. 2d 669 (E.D. Penn. 2012).

380. 763 F.3d 304 (3d Cir. 2014).

381. *Id.* at 309.

382. 763 F.3d at 310–16; 895 F. Supp. 2d at 676–81.

383. 763 F.3d at 313–15; 895 F. Supp. 2d at 677–78.

384. *See supra* text at notes 123–24.

More egregiously in *SEC v. Conradt*,[385] Judge Jed Rakoff of the Southern District of New York allowed an SEC enforcement tipping action to proceed on the basis of an intense friendship between two foreign young men living in New York City even though he admitted that the defendant's argument that the SEC did not sufficiently allege that the "bond [between the two men] went beyond mere friendship into an actionable relationship of trust and confidence" and was "not without force."[386] The two friends regularly shared both personal and business confidences.[387] When one, an associate in a law firm, mentioned an upcoming business acquisition involving a client, the "friend" traded on the information and tipped off other friends who also did so.[388] But it does not follow that this breach of the bonds of friendship should be legally actionable. However, Judge Rakoff opined in an earlier case that the issue of duty is established by federal common law.[389]

I would argue that in *McGee* and *Conradt*, the courts and the SEC should not have relied on their intuition that someone committed an unjust or immoral act — precisely the criticism so often aimed at unjust enrichment law.[390] They should have asked whether, under general principles of applicable law, the source had a legally recognizable proprietary, fiduciary, or functionally similar interest in the nonpublic information that would give the source a cause of action against the unfaithful confidant. That is, the question should be, whether the defendants' acts were *legally* just*ifiable*.

To further illustrate the *ad hoc* nature of judicial decision in this area compare *United States v. Kim*[391] with *SEC v. Kirsch*.[392] In *Kim,* the defendant belonged to a club for young executives in which it was understood that discussions of business matters would be private. Moreover, members were required to sign confidentiality agreements.[393] Nevertheless, in his thoughtful opinion, Judge Charles Breyer held that this did not create the sort of fiduciary-type relationship of trust that should impose liability under the under the misappropriation theory.[394]

385. 947 F. Supp. 2d 406 (2013).

386. *Id.* at 411.

387. *Id.*

388. *Id.*

389. United States v. Whitman, 904 F. Supp. 2d 363, 374 (S.D.N.Y. 2010). Accordingly, he upheld the validity of Rule10b5-2. This is so, even though the Second Circuit in *Chestman* expressly analyzed the duties of spouses under New York State law. *See supra* text at notes 398–401.

390. SEC v. McGee, 895 F. Supp. 2d 669, 675 (E.D. Penn. 2012); Rogers, *supra* note 316, at 1388.

391. 184 F. Supp. 2d 1006, 1008 (N.D. Cal. 2002).

392. 263 F. Supp. 2d 1144, 1149–50 (N.D. Ill. 2003).

393. *Kim*, 184 F. Supp. 2d at 1015.

394. *Id.*

In contrast, in *Kirsch*, Judge Milton Shadur granted summary judgment against a defendant on the grounds that membership in a business roundtable *did* establish such a duty.[395] In doing so, Judge Shadur stated that the Supreme Court in *O'Hagan* did not limit misappropriation to breaches of fiduciary duties, but recognized other duties of trust and confidentiality.[396] He ignored the fact that it required these duties to be functionally similar to traditional fiduciary duties and citing no legal precedent for his holding. In other words, Judge Shadur engaged in precisely the type of ad hoc intuition that has put unprincipled invocation of unjust enrichment in such bad odor.[397]

Compare this to the Second Circuit's opinion in *Chestman v. United States.*[398] In considering whether spouses owe fiduciary or similar duties of trust and confidence to each other for the purposes of the misappropriation theory, the court looked at a number of traditionally recognized fiduciary relationships, "attorney and client, executor and heir, guardian and ward, principal and agent, trustee and trust beneficiary, and senior corporate official and shareholder"[399] to induce, in classic common law fashion, what they all have in common. The court found that in each relationship there was a position of superiority, control, and dominance on the side of the fiduciary and dependence on the side of the beneficiary.[400] Although it is possible that in a specific fact pattern, such a relationship could come to exist between two spouses, under modern law marital status *per se* does not create such a relationship of dominance and subordination. Consequently, the government failed to prove that a husband breached a fiduciary duty to his wife when he tipped off his broker with material nonpublic information.[401] To paraphrase, although my husband may not be able to testify against me in a court of law, and I would be very upset if he relayed or used information I told him in confidence, I would not have legal redress against him if he did so other than, perhaps, divorce.

The SEC's troublesome response to *Chestman* was to promulgate the notorious Rule 10b5-2,[402] which purports to impose a presumption of a duty

395. *Kirsch*, 263 F. Supp. 2d at 1150.

396. *Id.*

397. One potential way of reconciling *Kim* and *Kirsch* is that the former was a criminal action and the latter a civil, thus a stricter standard applied to the former. The courts, however, never discussed this issue. As Langevoort noted, courts tend to interpret the law identically in criminal and civil cases. *See supra* note 59.

398. 947 F.2d 551 (2d Cir. 1991).

399. *Id.* at 568.

400. *Id.* at 568–70.

401. Although, the Second Circuit did not expressly say it was applying New York law, it cited New York state cases along with another Second Circuit opinion citing to New York law, as well as the Restatement (Second) of Agency. *See id.*

402. 17 C.F.R. § 240.10b5-2 (2021).

of "trust *or* confidence" in three circumstances. It reads in relevant part:

> (b) *Enumerated "duties of trust or confidence."* For purposes of this rule, a "duty of trust or confidence" exists in the following circumstances, among others:
>
> (1) Whenever a person agrees to maintain information in confidence:
>
> (2) Whenever the person communicating the material nonpublic information and the person to whom it is communicated have a history, pattern or practice of sharing confidences, such that the recipient of the information knows or reasonably should know that the person communicating the material nonpublic information expects that the recipient will maintain its confidentiality; or
>
> (3) Whenever a person receives or obtains material, nonpublic information from his or her spouse, parent, child, or sibling, . . . [403]

The validity of this rule is controversial in the academic literature.[404] As Nagy has correctly stated, this is an attempt to write the Supreme Court's fiduciary requirement out of the law.[405] It also completely ignores the property aspect of *O'Hagan.*[406]

Of course, there is no logical or doctrinal reason why a legally recognizable duty functionally equivalent to a fiduciary one could not be established by contract. Indeed, the proprietary nature of trade secrets is frequently established through confidentiality and non-disclosure agreements. And traditional contract law principles — such as establishment of contract by course of custom — should be recognized. Indeed, the U.S. Supreme Court in *Carpenter* relied on the source's employee manual and noted that a confidentiality agreement need not be in writing.[407] Moreover, the common, if not dominant, analysis of a corporation as a nexus of contracts conceptualizes the fiduciary duties of officers and directors as

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403. *Id.*

404. *See, e.g.*,

> [T]he rule was untethered from even the messy bounds of existing fiduciary or fiduciary-like relationships, extending legal obligations of loyalty and confidentiality to familial relations and friendships. The relationships listed in Rule 10b5-2(b)(2)–(3) do not evince the critical qualities that would render them even quasi-fiduciary.

Sarah Baumgartel, *Privileging Professional Insider Trading*, 51 GA. L. REV. 71, 98 (2016); *see also* Jorge Pesok, *Insider Trading: No Longer Reserved for Insiders*, 14 FLA. ST. U. BUS. REV. 109 (2015); Joseph Pahl, *A Heart As Far from Fraud As Heaven from Earth: SEC v. Cuban and Fiduciary Duties Under Rule 10b5-2*, 106 NW. U. L. REV. 1849 (2012).

405. *See supra* text at note 125.

406. *See* United States v. O'Hagan, 521 U.S. 642, 643 (1997) ("A company's confidential information qualifies as property to which the company has a right of exclusive use; the undisclosed misappropriation of such information constitutes fraud akin to embezzlement.").

407. Carpenter v. United States, 484 U.S. 19, 26 (1987).

default contract terms.[408] Nevertheless, despite qualms in academia, the trend seems to be that courts are upholding the rule.[409]

These were implicitly the issues in *McGee* (which upheld Rule 10b5-2), *Kim,* and *Kirsch.* However, when looking at express contracts (*Kim*) and implied contracts (*Kirsch*) one needs to look at the scope and purpose of the confidentiality agreement. I would argue, as the *Kim* court did, that the use of the nonpublic information to trade securities probably did not violate the purposes of the confidentiality agreements which was presumably to encourage frank conversations among the participants by promising not to reveal sensitive information to third parties. In *Kim*, Judge Breyer noted, correctly in my opinion, that, under the confidentiality agreement, no one had a legally enforceable right against the defendant for his trading.[410]

As Judge Sydney Fitzwater of the Northern District of Texas noted in the well-known case of *SEC v. Cuban*, an agreement not to *disclose* information is not the same thing as an agreement not to *use* it.[411] Thomas Hazan has argued that there should be an assumption that information divulged in confidence should be presumed to fall within the misappropriation rule and impose a duty not to use it.[412] This is, of course, what the SEC has tried to

408. *See, e.g.*, Frank Easterbrook & Daniel Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1416 (1989). In the words of Delaware Chancellor Allan writing over 25 years ago, "[a]s a matter of intellectual interest, the debate over the contractual nature of the firm is over." William T. Allen, *Contracts and Committees in Corporation Law*, 50 WASH. & LEE L. REV. 1395, 1400 (1993). This view implies, of course, that they should be waivable by express contract terms. Consequently, as discussed *supra* in note 119, limited liability company law allows such duties to be disclaimed in a company's organic documents, which raises issues about the application of the classic theory of insider trading with respect to companies that do so. Nevertheless, as discussed below (*see infra* text at note 473–84), whether these duties *should* be waivable, they probably are not under corporate, as opposed to limited liability company, law.

409. *See, e.g.*, United States v. Kosinski, No. 3:16-CR-00148, 2017 U.S. Dist. LEXIS 130420 (D. Conn. Aug. 16, 2017); United States v. McPhail, 831 F.3d 1 (1st Cir. 2016); United States v. Whitman, 904 F. Supp. 2d 363 (S.D.N.Y. 2012); SEC v. De La Maza, No. 09-21977-CIV, 2011 U.S. Dist. LEXIS 157010 (S.D. Fla. Feb. 15, 2011); SEC v. Nothern, 598 F. Supp. 2d 167 (D. Mass. 2009). I discuss the judicial reaction to Rule10b5-2 in Schroeder, *Taking Stock*, *supra* note 105, at 198–206. For a more recent survey of judicial reactions to Rule 10b5-2, see Zachary J. Gubler, *Insider Trading As Fraud*, 98 N.C. L. REV. 533, 554–57 (2020).

410. United States v. Kim, 184 F. Supp. 2d 1006, 1013 (N.D. Cal. 2002).

411. SEC v. Cuban, 634 F. Supp. 2d 713, 730–31 (N.D. Tex. 2009). Jonathan Macey notes that the judge's distinction is "rather obvious." Jonathan R. Macey, *The Distorting Incentives Facing the U.S. Securities and Exchange Commission*, 33 HARV. J.L. & PUB. POL'Y 639, 661 (2010). I agree. Bainbridge made a similar point several years before the *Cuban* case. Bainbridge, *Incorporating*, *supra* note 68, at 1200.

412. Thomas Lee Hazen, *Identifying the Duty Prohibiting Outsider Trading on Material Nonpublic Information*, 61 HASTINGS L.J. 881 (2010). I find Hazen's suggestion incorrect both empirically and as a matter of policy. He seems to suggest that, in the case of written contracts, it would be a drafting burden. I disagree. Contracts should set forth their terms. In my previous career as a practitioner, one of my specialties

smuggle into the law through Rule 10b5-2. As I have just said, there is no conceptual problem with a duty to abstain or disclose functionally similar to a fiduciary duty being imposed by contract.[413]

Of course, in many situations, confidentiality arrangements can be more informal, and terms must be implied by custom and practice. However, I believe that it defies common understanding to say that when I tell someone that I will keep a secret I have accepted a legal as opposed to a moral duty.

B. Measure of Liability

The law of restitution provides an appropriate measure of recovery in misappropriation cases in other circumstances. As discussed,[414] one of the perplexing questions concerning private fraud action under Rule 10b-5 for classic insider trading over the securities markets is that it would result in either no damages or disproportionate damages. Therefore, Congress limited the recovery that a contemporaneous trader can obtain under Sec 20A.[415]

If, however, we conceive of insider trading as a common law restitution action for misappropriation of property then there is only one plaintiff — the issuer or the other source of the information. The recovery would be the net profits earned (or losses avoided) of the trader and the plaintiff would not have to prove loss causation. This follows from the fact that restitution is not an action for damages, but for unjust enrichment.

C. Tippee Liability

There has been confusion as to when a tippee inherits the duty of his tipper not to trade on material nonpublic information. In *Dirks*[416] the Supreme Court first articulated the rule as to when a tippee violates Rule 10b-5 when she trades on material nonpublic information. The more recent trilogy of *Newman*,[417] *Salman v. United States*,[418] and *Martoma II*[419] shows how

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was intellectual property, and I drafted and negotiated dozens, if not scores, of confidentiality agreements. What could or could not be done with information, and the remedies for breach, were of the essence and carefully negotiated. In the case of information that my clients considered to be trade secrets, we negotiated for a property analysis that would allow for injunctive relief. In other cases, monetary damages were important. I would note that the Uniform Trade Secrets Act defines misappropriation of trade secrets as disclosure, not as use.

413. UNIF. TRADE SECRETS ACT §1(2) (UNIF. L. CMM'N 1985).

414. *See supra* text at notes 135–37.

415. *See supra* text at notes 137–39.

416. 463 U.S. 646 (1983).

417. 773 F.3d 438 (2d Cir. 2014).

418. 137 S. Ct. 420 (2016).

419. 894 F.3d 64 (2d Cir. 2018).

difficult the personal benefit prong of *Dirks* is to apply.[420] *Newman* also illustrates the difficulty courts have in determining precisely what the tippee must know, especially in the case of remote tippees who might not know the identity of the original tippee.[421]

I will not discuss the substantive federal law on these issues for two reasons. First, there is already a voluminous literature on tipping, particularly after *Newman* was decided.[422] But more importantly, if we look

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420. One study purports to show how sensitive sophisticated traders are to changes in insider trading law and prosecutions with circumstantial evidence, suggesting that the amount of insider trading increased significantly after *Newman* was decided but decreased when the Ninth Circuit's opinion in *Salman* came down. Mannish S. Patel, *Does Insider Trading Law Change Behavior? An Empirical Analysis*, 53 U.C. DAVIS L. REV. 447 (2019).

421. *See infra* text at notes 448–54 for a brief discussion of *Salman*.

422. *See, e.g.*, Andrew W. Marrero, *Insider Trading: Inside the Quagmire*, 17 BERKELEY BUS. L.J. 234 (2020); United States v. Martoma*: Second Circuit Redefines Personal Benefit Requirement for Insider Trading*, 132 HARV. L. REV. 1730 (2019); Sari Rosenfeld, *The Ever-Changing Scope of Insider Trading Liability for Tippees in the Second Circuit*, 8 MICH. BUS. & ENTREPRENEURIAL L. REV. 403 (2019); Jessica Historied, *Great Expectations, Good Intentions, and the Appearance of the Personal Benefit in Insider Trading: Why the Stage Needs Reset After Martoma*, 43 S. ILL. U. L.J. 703 (2019); Andrew Carl Spokane, *The Second Circuit's Curious Journey Through the Law of Tippee Liability for Insider Trading: Newman to Martoma*, 24 ROGER WILLIAMS U. L. REV. 1 (2019); Tai H. Park, *Newman/Martoma: The Insider Trading Law's Impasse and the Promise of Congressional Action*, 25 FORDHAM J. CORP. & FIN. L. 1 (2019); Langevoort, *Wobble*, *supra* note 61; Jonathan Macey, *Martoma and Newman: Valid Corporate Purpose and the Personal Benefit Test*, 71 SMU L. REV. 869 (2018); Merritt B. Fox & George N. Tepe, *Personal Benefit Has No Place in Misappropriation Tipping Cases*, 71 SMU L. REV. 767 (2018); Zachary J. Gubler, *"Maximalism with an Experimental Twist": Insider Trading Law at the Supreme Court*, 56 WASH. U. J.L. & POL'Y 49 (2018); Joan MacLeod Heminway, *Tipper/Tippee Insider Trading As Unlawful Deceptive Conduct: Insider Gifts of Material Nonpublic Information to Strangers*, 56 WASH. U. J.L. & POL'Y 65 (2018); Peter J. Henning, *Making Up Insider Trading Law As You Go*, 56 WASH. U. J.L. & POL'Y 101 (2018); Matthew J. Wilkins, *You Don't Need Love . . . but It Helps: Insider Trading Law After Salman*, 106 KY. L.J. 433, 434 (2018); Matthew Williams, *Mind the Gap(s): Solutions for Defining Tipper-Tippee Liability and the Personal Benefit Test Post-Salman v. United States*, 23 FORDHAM J. CORP. & FIN. L. 597 (2018); *Securities Exchange Act of 1934-Insider Trading- Tippee Liability-Salman v. United States*, 131 HARV. L. REV. 383 (2017); Jonathan R. Macey, *Beyond the Personal Benefit Test: The Economics of Tipping by Insiders*, 2 U. PA. J.L. & PUB. OFF. 25 (2017); Austin J. Green, *(Beyond) Family Ties: Remote Tippees in A Post-Salman Era*, 85 FORDHAM L. REV. 2769 (2017); Ellen S. Podgier, *Salman: The Court Takes A Left-Hand Turn*, 49 CONN. L. REV. ONLINE 1 (2017); James Walsh, *"Look Then to Be Well Edified, When the Fool Delivers the Madman": Insider-Trading Regulation After Salman v. United States*, 67 CASE W. RES. L. REV. 979 (2017); Wendy R. Becker, *Friends with Benefits: Redefining Personal Gain in Insider Trading Under Salman v. United States*, 12 DUKE J. CONST. L. & PUB. POL'Y SIDEBAR 47 (2016); Donna M. Nagy, *Beyond Dirks: Gratuitous Tipping and Insider Trading*, 42 J. CORP. L. 1 (2016); Sara Almousa, *Friends with Benefits? Clarifying the Role Relationships Play in Satisfying the Personal Benefit Requirement Under Tipper-Tippee Liability*, 23 GEO. MASON L. REV. 1251 (2016); Maria Babajanian, *Rewarded for Being Remote: How United States v. Newman Improperly*

to the common law of rescission, then the *Dirks* analysis is backwards. First, as Richard Epstein correctly argues, if one takes the Supreme Court's misappropriation theory seriously, then there should be no personal benefit test at all.[423] That is, under the basic derivation principle of property and unjust enrichment, if I transfer stolen or fraudulently obtained property to a third party, my transferee inherits only my void or voidable title and the property and its proceeds are encumbered by a constructive trust, regardless of whether or not I benefit from the transfer. As discussed below, however, personal benefit to the tipper *is* relevant to the measurement of the profits that the tipper should be required to disgorge.

Strangely, Epstein discusses the Third Circuit *McGee* opinion discussed above,[424] as involving the "personal benefit" test for tipping in his argument (with which I agree) as to why this element is inconsistent with the property rationale of the misappropriation.[425] Unfortunately, in this case, even though the source of McGee's information was a traditional insider of the issuer whose stock the defendant purchased, the government did *not* allege that he was a tippee and the personal benefit test of *Dirks* is *never* even mentioned let alone discussed in the case. Rather, the government argued the alternate theory that the defendant misappropriated information from his source.[426] Presumably, the government did not pursue a tipping theory precisely

Narrows Liability for Tippees, 46 STETSON L. REV. 199 (2016); Taylor Essner, *Insider Trading in Flux: Explaining the Second Circuit's Error in United States v. Newman and the Supreme Court's Correction of That Error in United States v. Salman*, 61 ST. LOUIS U. L.J. 117 (2016); Jonathan R. Macey, *The Genius of the Personal Benefit Test*, 69 STAN. L. REV. ONLINE 64 (2016); Jill E. Fisch, *Family Ties: Salman and the Scope of Insider Trading*, 69 STAN. L. REV. ONLINE 46 (2016); Mark Hayden Adams, *Insider Trading Law That Works: Using Newman and Salman to Update Dirks's Personal Benefit Standard*, 49 LOY. L.A. L. REV. 575 (2016); Ronald J. Colombo, *Tipping the Scales Against Insider Trading: Adopting A Presumption of Personal Benefit to Clarify Dirks*, 45 HOFSTRA L. REV. 117 (2016); Brett T. Atanasio, *"I'll Know It When I See It . . . I Think": United States v. Newman and Insider Trading Legislation*, 121 PENN ST. L. REV. 221 (2016); Katherine Drummonds, *Resuscitating Dirks: How the Salman "Gift Theory" of Tipper-Tippee Personal Benefit Would Improve Insider Trading Law*, 53 AM. CRIM. L. REV. 833, 833 (2016); Reed Harasimowicz, *Nothing New, Man! — The Second Circuit's Clarification of Insider Trading Liability in United States v. Newman Comes at A Critical Juncture in the Evolution of Insider Trading*, 57 B.C. L. REV. 765, 765 (2016); Richard A. Epstein, *Returning to Common-Law Principles of Insider Trading After United States v. Newman*, 125 YALE L.J. 1482 (2016); A.C. Pritchard, *Dirks and the Genesis of Personal Benefit*, 68 SMU L. REV. 857 (2015); Carlyle H. Dauenhauer, *Justice in Equity: Newman and Egalitarian Reconciliation for Insider-Trading Theory*, 12 RUTGERS BUS. L. REV. 39 (2015).

I did not include in this list other articles that discuss these cases as part of a broader discussion. No doubt, there probably are more articles that I may have missed.

423. Epstein, *supra* note 73.

424. *See supra* text at notes 379–90.

425. Epstein, *supra* note 73, at 1527–28.

426. United States v. McGee, 763 F.3d 304, 309–10 (3d Cir. 2014).

because there is no evidence that the associate received any benefit from confiding to his false friend.

The misappropriation theory and first-generation tipping theory are, in fact, logically incompatible. In misappropriation, the source reveals the information to the confidant with the understanding that he may *not* use it for his own purposes. In contrast, in tipping, the tipper gives the information to the tippee so that the tippee *will* use the information for his own purposes. Presumably, the government did not pursue the tipping theory of liability because the person disclosing the information did not intend that his friend trade on it. Rather, he indiscreetly blurted out the information in a moment of emotional distress. As such, in trading, the defendant was not acting in accordance with the tipper's intent, but in a betrayal of his friendship. My issue is that not all moral wrongs should be legal ones.

Moreover, under common law principles, *if* insider trading is a violation of a property right in information, then the *plaintiff* should *not* have the burden to prove the tippee's guilty knowledge. Rather, it is the *tippee* as the transferee of misappropriated property who should have the burden of showing that he is a good faith purchaser of value who took the misappropriated information free of the source's adverse claim.[427]

As discussed,[428] a person who obtains property through fraud acquires only voidable title in that property. Consequently, the original owner can bring an action to replevy the property or the proceeds from the disposition of the property or, more likely in the case of insider trading where tracing is unlikely to be possible, to bring an in personam action for an amount equal

427. In the case of *United States. v. Blaszcak*, 947 F.3d 19, 35–37 (2d Cir. 2019), the Second Circuit found that the personal benefit element of *Dirks* does not apply to tipping cases brought under wire fraud law or the criminal securities fraud provision added by Sarbannes-Oxley because it was designed to further the policies of the Exchange Act but is not a traditional element of embezzlement. Langevoort questions this reduction of insider trading to a violation of property rights that downplays the role of breach of duty, noting that, although the Supreme Court in *O'Hagan* said that misappropriation of information is "akin to" embezzlement, "'[a]kin to' is not the same as 'is.'" Langevoort, *Wobble (draft)*, *supra* note 101, at 48. Once again, Langevoort's candid assessment did not make it into the final version of the article.

Without defending the merits of *Blasczcak* under *federal* law, this one aspect of the case is consistent with a misappropriation theory because all one should have to show is that the original tipper obtained information as property from the source in violation of an appropriate duty. The concern should not be whether the tippee "inherited" the tipper's fiduciary type *duty* to her source, as articulated in *Dirks.* It should be enough that the tippee obtained *voidable title in the property*. Indeed, a pure misappropriation theory would go further than *Blasczcak* in that case the government had to show that the tippees knew of the misappropriation.

As one commentator has noted, the *Blasczcak* opinion creates the oddity that the standard for convicting for criminal insider trading is now less stringent in the Second Circuit than for finding liability in civil insider trading cases. *See supra* note 153.

428. *See supra* text at notes 269–74, 332–45.

to the profits gained, or the loss avoided, from the exploitation of the information.

Nevertheless, the transferee would take the information free of the source's interest in it, and be able to use it freely, if she can establish that an applicable bona fide purchaser ("BFP") exception applies. At first blush this analysis might seem inapt in that BFP rules have developed to protect markets in property.[429] That is, in the classic fraudulently obtained property dispute there is one guilty, but potentially two innocent parties and two competing values of property law. The fraudster is a bad person who should have liability for any losses suffered by the innocent parties. But fraudsters tend to abscond, be judgment proof, or both. Consequently, we must adopt an uneasy and always unsatisfactory compromise whereby one of the innocent parties gets the disputed property while the other bears the loss and the responsibility of tracking down the fraudster for compensation.

On the one hand, the fraudster has deprived the original owner of possession (the right to exclude and control), which the law guards zealously because it is necessary for all other property rights. Therefore, the default rule of property is the derivation principle. On the other hand, the transferee of the fraudster may have innocently paid good money for it. If we want markets to be efficient, we do not want to put an overly burdensome due diligence requirement on purchasers. Society also has an interest in encouraging the free alienability of property. Accordingly, we often have BFP exceptions to the derivation principle. BFP exceptions are often justified by the assertions that in some cases it might be less costly for owners to police their transferees, so that they are not defrauded, than it would be for buyers to perform due diligence with respect to title.[430] Of course, this rationale is based on untestable empirical assumptions, but it has intuitive appeal.

This is why BFP rules usually require the acquirer to have an appropriate "innocent" state of mind and engage in favored market transactions, which always require that the BFP gave value.[431] We have already met the good faith purchaser of value of goods who takes free of voidable title under UCC § 2-403(1).[432] A holder in due course and a protected purchaser takes free of

429. *See, e.g.*, Alan Schwartz & Robert E. Scott, *Rethinking the Laws of Good Faith Purchase*, 111 COLUM. L. REV. 1332, 1360 (2011) (writing that "Article 3 of the U.C.C. governs property right contests between an original owner of a lost or misappropriated instrument and a subsequent bona fide purchaser").

430. *See, e.g.*, Stephen L. Sepinuck, *The Various Standards for the "Good Faith" of a Purchaser*, 73 BUS. LAW. 581, 587–88 (2018) (noting the "enhanced rights of good faith purchasers" represent policy considerations that the law is serving).

431. 12 U.S.C. § 3752(1).

432. *See supra* text at note 272.

adverse claims in instruments[433] and securities, respectively.[434] Property, such as information, that is not governed by a statutory schema, is governed by common law BFP principles. What all of the BFP rules I reference have in common is the requirement that the transferee be a purchaser,[435] with the requisite innocent state of mind, who has given value.[436]

One might be tempted to say that the application of BFP principles to nonpublic information is inapt in the context of securities laws because, unlike the context of goods and instruments, we do not *want* there to be a market for misappropriated information. This objection is misplaced. Although we might not want a market in *misappropriated* information, we also do not want to encourage a market for *misappropriated* goods. Nevertheless, there is a widespread consensus that we want to promote efficient markets for securities and our securities laws are based on the assumption that this is furthered by the discovery and dissemination of material information.[437] Efficient securities markets depend on professionals who investigate, gather, analyze, and trade on information about issuers and their securities and further disseminate the information to their clients.[438] We should be encouraging, not discouraging this behavior. This was precisely Justice Powell's concern in *Dirks* when he declined to find that all tippees inherit the tipper's disclose-or-abstain duty.[439]

One might also be also tempted to argue that the analogy to the BFP rules for goods and instruments is imperfect because they required the buyer to

433. U.C.C. § 3-306 (AM. L. INST. & UNIF. L. COMM'N 2012).

434. *Id.* § 8-303(b).

435. Although the two terms are synonyms in colloquial English, the legal definition of purchaser is broader than that of buyer. U.C.C. § 1-201(b)(29) includes in the term "purchase," "any other voluntary transaction creating an interest in property." Similarly, Bankruptcy Code § 101(43) defines "purchaser" as "transferee of a voluntary transfer, and includes immediate or mediate transferee of such a transferee." 11 U.S.C. § 101(43). For example, a donee is a purchaser, but not a purchaser for value. A lien creditor, however, is not a purchaser.

436. The 1984 and 2000 amendments to the U.C.C. have reversed this traditional burden with respect to important subclasses property, such as money, deposit accounts, and security accounts, where liquidity is considered of the essence. For example, the transferee of money takes free of security interests unless the claimant can prove that transferee acted in collusion with the transferor to violate the rights of the secured party. *See, e.g.*, U.C.C. § 9-332. I discuss these super-negotiability rules in Schroeder, *Bitcoin*, *supra* note 250.

437. *See* Roger J. Dennis, *Materiality and the Efficient Capital Market Model: A Recipe from the Total Mix*, 25 WM. & MARY L. REV. 373, 373 (1983) (noting the "prodigious empirical and theoretical research and commentary" on the operations of markets and the dissemination of information).

438. The classic law review article on the relationship between professional trading and the efficient market hypothesis is Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549 (1984).

439. Dirks v. SEC, 463 U.S. 646, 657–59 (1983).

give value for the property and we do not want to encourage corruption in securities markets. Once again, this is inapt. There is nothing wrong with paying for information *per se*. Indeed, brokers hire analysts to discover information and I pay fees to my broker in connection with trades based on this. It is, however, problematic to pay for information one *knows* is misappropriated in the same way it is problematic to pay for goods that one knows have been fraudulently obtained. But if the buyer knows this, then he is not in good faith and cannot maintain the defense.

I am, however, concerned by my analysis in the case of remote tippers. For example, in *Newman* one of the grounds on which the Second Circuit Court of Appeals overturned the conviction of the alleged tippees who were three or four steps down the chain from the alleged original tippers (who were classic insiders) was that the government did not prove beyond a reasonable doubt that they met the *Dirks* element that they knew or should have known that the original tippers breached their fiduciary duties to the issuer.[440] Under a property-based state court action, the defendants would have to prove they were in good faith (i.e., they neither knew nor should have known of the breach) and gave value.

In this fact pattern, the defendants may very well have been able to convince a jury that they were in good faith because they had no reason to know the origin of this specific information.[441] Security markets are driven by the search for information by market professionals who, among other things, exchange rumors. That is, the SEC's argument that the defendants must have known that the information was misappropriated is just empirically wrong. In addition, given that the original "tippers" were in the one instance an employee in the issuer's investor relations office and in the other an employee in the issuer's finance unit, the defendants may have reasonably assumed that their disclosure of the information was authorized by the issuers and, therefore, not tips. At worst, they may have suspected that they were violating Regulation FD,[442] by making selective disclosures. However, there is no evidence in *Newman* that the transferees of the

440. United States v. Newman, 773 F.3d 438, 442 (2d Cir. 2014). This part of the opinion was not challenged by the Supreme Court in *Salman* and presumably stands as the law in the Second Circuit. Whether or not *Newman* (a criminal case), which seems to require scienter on the behalf of tippees, affects the holding in *SEC v. Obus*, 693 F.3d 276 (2d Cir. 2012), which can be read as implying that remote tippees can be subject to *civil* liability on a *negligence* standard, is beyond the scope of this Article. Pritchard, *Edge*, *supra* note 102, at 949–50. In *Newman*, the Second Circuit Court of Appeals also held that the government did not prove the personal benefit prong of *Dirks* as well. 773 F.3d at 442.

441. Presumably, a *Brophy* action would be governed by a predominance of the evidence standard.

442. 17 C.F.R. § 243 (2021).

information gave value so even if they were good faith purchasers, they were not good faith purchasers for *value*.

Moreover, I would question whether, as the circle of market professionals who know about the information becomes increasingly large, eventually the information has effectively become public.[443] To state the obvious, one of unusual aspects of treating material nonpublic information as property is that it constitutes property only insofar as it is, in fact, nonpublic. Certainly, the source would have lost its right to sue remote parties if the original tippee divulged the information in an online newsletter, even if it were subscription only. Under my interpretation of misappropriation, the tippee/publisher might have liability to the source of the information, but not subsequent traders.

Of course, it does not follow from this that we should allow remote tippees off the hook if they are members of a tipping ring who regularly exchanged information. Perhaps in these cases an alternate theory of liability for the remote tippees, such as aiding and abetting, could be used.[444] These are the types of distinctions that common law courts are traditionally considered competent to make.

D. Tipper Liability for the Profits of a Tippee

Taking the misappropriation theory seriously and combining it with the Supreme Court's tipping jurisprudence justifies the one aspect of disgorgement that bothered the Supreme Court the most in *Kokesh*. There, the Court found that disgorgement was punitive in nature because a tipper

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443. As Gilson and Kraakman famously argued, a semi-strong efficient information in securities does not require that information be universally known by all market participants, merely that it becomes known by professional traders. Gilson & Kraakman, *supra* note 438.

Epstein makes a related point with respect to the facts of *Newman* where the defendants, all market professionals, were many links away in the beginning of the chain of the distribution of information. Epstein, *supra* note 73, at 1523.

In addition, remote tippees might be protected by the shelter rule, the affirmative variation of the derivation principle that a transferee inherits the title of her transferor. We have seen this in the negative form where the transferee of a party with voidable title only received voidable title unless she can show she is a BFP under the applicable rule. However, this means that a transferee from a BFP receives *good* title even though she is not herself a BFP because she did not give value or have notice of the original owner's adverse claim. Obviously, the shelter rule does not protect a remote transferee who was a party to the original transaction that rendered the title in the property voidable. This is most clearly stated in U.C.C. §3-302(b), which states that the shelter principle does not apply to a transferee who "engaged in fraud or illegality affecting the instrument."

444. At least one court, applying Delaware law, failed to dismiss a claim alleging that a first generation tippee aided and abetted an insider in a *Brophy* action. Heartland Payment Sys., LLC v. Carr, No. 3:18-cv-9764, 2020 U.S. Dist. LEXIS 15302 (D.N.J. Jan. 27, 2020).

was often ordered to disgorge an amount equal to her tippee's profit even when she did not herself participate in this profit.[445] Further, in *Liu*, the Supreme Court indicated in dictum that it might be inappropriate to find joint-and-several liability in "remote, unrelated tipper-tippee arrangements."[446] However, following the logic of *O'Hagan* and *Dirks*, the tipper *should*, in some cases, be liable to disgorge an amount equivalent to the tippee's profits in close and related tipper-tippee arrangements. This is because in the context of gifts, the tippees' profits should be considered the ill-gotten gains of the tipper.

That is, in *Dirks*, the Supreme Court held that a tipper only violates her duty to her source insofar as she receives a personal benefit from the tip and that one way a tipper can personally benefit if she intended to make a gift to the tippee.[447] The Supreme Court confirmed this in *Salman*,[448] when a tipper passed on material nonpublic information to help his brother who was in need of funds, who traded on the information. The brother then re-tipped a close friend who was also the brother-in-law of the original tipper.[449]

Under the law of restitution, the tipper should have to account to the source for the value of the benefit she received from her use of the misappropriated information. In the case where the benefit received by the tipper was a kickback or other quid pro quo, the benefit would be the amount of the payment by the tippee to the tipper. In some cases, such as where the *quid pro quo* is the expectation of future favors, this might be *empirically* difficult to measure but is not *logically* problematic.

In the case of a tip made as a gift, however, the tipper should have to disgorge the value of the gift. The most reliable measure of this value would be the profit gained (or loss avoided) by the tippee when she traded on the gifted information. This disgorgement would be the direct and primary, not a vicarious or secondary, liability of the tipper on a theory of joint-and-several liability or of aiding and abetting. In *Salman*, the source of the information should have been able to sue the original tipper who passed on information to his brother as a gift for an amount equal to his brother/tippee's profits and also sue the brother/tippee for his profits and perhaps also the profits or his friend/tippee.

Unfortunately, although restitution would give a proper measure of damages in a tip-as-gift case, it would not solve the morass raised in the *Newman*, *Salman*, and *Martoma II* cases.[450] That is, how does one establish

445. *See* Kokesh v. SEC, 137 U.S. 1635, 1644–45 (2020).
446. Liu v. SEC, 140 S. Ct. 1936, 1949 (2016).
447. Dirks v. SEC, 463 U.S. 646, 663–66 (1983).
448. 137 U.S. 420 (2016).
449. *Id.* at 423–24.
450. *See supra* text at notes 416–21.

that a tip was in fact meant as a gift? This type of case-by-case adjudication is precisely the bailiwick of state common law courts.[451]

E. "Solving" Dorozhko

Taking misappropriation seriously would erase the embarrassment of *Dorozhko*.[452] This case illustrates the unsatisfactory nature of the Supreme Court's insider trading jurisprudence. To recap, under federal law, for trading on the basis of material nonpublic information to be unlawful, it is not sufficient that the trader exploit information conceptualized as property belonging to the issuer or other source. To fall within the catch-all provisions of Sec. 10(b) and Rule 10b-5, the trader must also engage in fraud. That is, trading on the basis of stolen, as opposed to fraudulently obtained, information would not violate the federal securities law. This is so even though we usually treat theft as a greater violation of property rights than fraud (as shown in the distinction between the void title obtained by a thief and the voidable title obtained by a fraudster).

In *Dorozhko*, a hacker gained access to an issuer's computer and traded on securities based on the material nonpublic information it learned.[453] As discussed,[454] as an *empirical* matter insider trading almost always involves silence, which is why a fiduciary or similar duty to speak is required to make the trading fraudulent. The *Dorozhko* court recognized that trading could also be fraudulent if the trader made affirmative misstatements to the source of the information (in which case a fiduciary or similar duty would not be required).[455]

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451. Donald Langevoort summarizes the academic debate after *Martoma II*:

> Textualism aside, is it cogent and sufficiently compelling to proscribe deliberate gift tips outside the circle of family and friends as breaches of loyalty? Commenting on *Obus* and *Newman*, Pritchard says no; in contrast, Donna Nagy and Joan Heminway both say yes in part by reference to more recent Delaware fiduciary duty case law, which puts in the category of disloyalty and bad faith actions deliberately taken without regard for the interests of the corporation. Even without such resort, I think that there is benefit whenever fiduciaries takes something valuable as their own to do with as they please without serving their master (the issuer or source), regardless of what they ultimately choose to do. The exercise of dominion is itself a form of (unjust) enrichment.

Langevoort, *Wobble*, supra note 61, at 515 (citations omitted). Obviously, I agree with Langevoort's reading, although I argue that it is more coherent for an unjust enrichment claim to be brought under state law.

452. 574 F.3d 42 (2d Cir. 2009).

453. *Id.* at 44.

454. *See supra* text at notes 114–19.

455. *Dorozhko*, 574 F.3d at 49–50.

Because, in this case, the hacker had no duty to make disclosures to the source, the question then becomes, "is hacking a fraudulent misstatement or merely theft?" The Second Circuit Court of Appeals concluded that the answer is "it depends."

> In our view, misrepresenting one's identity in order to gain access to information that is otherwise off limits, and then stealing that information is plainly "deceptive" within the ordinary meaning of the word. It is unclear, however, that exploiting a weakness in an electronic code to gain access is "deceptive," rather than being mere theft.[456]

To use an analogy from the physical world, assume that the material nonpublic information was unreleased earnings results contained in a hard-copy draft report sitting on the desk of the issuer's CFO. If the misappropriator persuaded the CFO to give her a copy of the draft by lying about her identity, this would constitute an affirmative misstatement and, therefore, could be fraud. If, however, the misappropriator broke into the office and purloined the draft, this would be theft, not fraud. The use of the information in the former case might constitute federal securities fraud but could not in the latter case. Consequently, the Second Circuit remanded the case to determine whether the hacking in this instance was more like the former (fraud) or the latter (theft).[457]

Although this result seems absurd on policy grounds,[458] I agree with the Second Circuit that this is *O'Hagan* taken to its logical extreme.[459] A state common law restitution claim, in contrast could be brought for either outright theft or fraud.[460]

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456. *Id.* at 51.

457. *Id.*

458. Needless to say, it has generated a tremendous amount of controversy. *See, e.g.*, Pesok, *supra* note 404, at 132–35.

459. Bainbridge questions as to how hacking could be deceptive if "the hacker 'lies' to a computer network, not a person." Bainbridge, *Post-Fiduciary Duty*, *supra* note 120, at 88. He agrees, however, that the securities laws have always made a distinction between "traditional" theft and fraud. *Id.* at 88–89. He thinks that the Second Circuit's finding that hacking could be fraudulent should be "understood to be an end run" around this distinction. *Id.*

I disagree. We now allow "bots" to cause parties to enter into contracts, thereby implicitly establishing the necessary intent of the persons employing the bot (*see, e.g.*, Electronic Signatures in Global and National Commerce Act (E-SIGN), 15 U.S.C. § 7001, and Uniform Electronic Transactions Act § 14, which have been adopted in every state except Illinois and New York who have their own similar, albeit non-uniform, acts). If we allow bots to establish the terms of a contract and the intent of the entity using it necessary to form a binding contract, I don't see why we can't also attribute deception of a bot to the entity as well.

460. *Dorozhko* has proven to be a fertile source for student notes. One note takes a very critical view of the Second Circuit's finding in *Dorozhko* that an affirmative misstatement absent a fiduciary duty can constitute unlawful insider trading under federal current doctrine. Elizabeth A. Odian, *SEC v. Dorozhko's Affirmative Misrepresentation*

Note, the R3RUE does not expressly discuss *stolen* property. But this is presumably because the owner's rights with respect to stolen property are not restitutionary at all. That is, the owner does not need to rescind a transfer of property because, in theft, there is no transfer of either equitable or legal title. Indeed, an action for stolen property would be stronger than fraudulently obtained property since there is no defense for good faith purchasers for value.[461]

F. The Brazen Misappropriator

Following from the last point, replacing the fraud aspect of insider trading law with the law of restitution would do away with perhaps the most unsatisfying aspect of *O'Hagan* — the possibility of a brazen misappropriator. Justice Ginsberg conceptualized the *fraudulent* aspect of misappropriation as an implied *misrepresentation* of fidelity made by the recipient of material nonpublic information to the source of the material.[462] She analogized the misappropriation of information by a disloyal confidant akin to the embezzlement of money.[463] Justice Ginsberg, reluctantly admitted that this meant that the confidant would not commit fraud if she disclosed her intent to trade to the source.[464] The brazen *theft* of information disclosed in confidence would not be fraudulent. She stated:

> [F]ull disclosure forecloses liability: Because the deception essential to

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Theory of Insider Trading: An Improper Means to A Proper End, 94 MARQ. L. REV. 1313 (2011). The author argues that a property rights theory would, on the one hand, solve this problem since it would eliminate the need to show breach of fiduciary duty but, on the other, might be overly broad in that it could lead to over-enforcement. *Id.* Consequently, she calls for reviving Justice's Burger's dissent in *Chiarella. Id.* Unfortunately, abandoning the fiduciary or similar duty to establish that silence can be deceptive would be to abandon forty years of federal jurisprudence, which is one reason why I am looking at state law. Moreover, as state law would limit the right to seek disgorgement to the source of the information, it would do away with the over-enforcement issue.

In contrast, another student defended *Dorozhko* on the grounds that it is a straightforward application of the concept of deception. Sean F. Doyle, *Simplifying the Analysis: The Second Circuit Lays Out A Straightforward Theory of Fraud in SEC v. Dorozhko*, 89 N.C. L. REV. 357 (2010). A third student both characterizes the defendant as a deceptive thief but argues that the Second Circuit's holding should be expanded to all thieves. Adam R. Nelson, *Extending Outsider Trading Liability to Thieves*, 80 FORDHAM L. REV. 2157 (2012). Like Odian, he would like to revive Justice Burger's *Chiarella* dissent. *Id.* Unfortunately, although I agree with the intuition that the distinction seems to be absurd in this context, Section 10(b) is limited to fraud, and commercial law has long distinguished between theft and fraud for many purposes. Once again, this is one reason why I argue for a state law remedy.

461. *See supra* text at notes 266–68.

462. *See supra* text at notes 126–29.

463. United States v. O'Hagan, 521 U.S. 642, 643 (1997).

464. *Id.* at 655.

> the theory involves feigning fidelity to the source of information, if the fiduciary discloses to the source that he plans to trade on the information, there is no "deceptive device" and thus no § 10(b) violation . . . . [Second, § 10(b)'s requirement that the misappropriator's deceptive use of information be "in connection with the purchase or sale of [a] security" [is] satisfied [by the misappropriation theory] because the fiduciary's fraud is consummated, not when [he obtains] the confidential information, but when, without disclosure to his principal, he uses the information in purchasing or selling securities.[465]

In contrast, a fiduciary cannot avoid liability for self-dealing with the property of her beneficiary or otherwise profiting from her position by *unilaterally* warning her beneficiary.[466] A thief cannot avoid liability by announcing her intent to commit larceny: The stereotypical mugger who threatens "your money or your life!" is a robber.

G. Permitted Trading

Taking misappropriation seriously, however, would not solve the final aspect of *O'Hagan* that some might find problematic. That is, if the nonpublic information belongs to the source, then the source should be able to give the trader permission to trade on it under the misappropriation theory. This is logically correct, however. In most cases, if the source of the information is not the issuer of the securities traded, the source can buy and sell the securities since it has no fiduciary or similar duties to the market and is not subject to statutory restrictions on its trading.[467] If it can trade on this

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465. *Id.* at 655–56.

466. And, Justice Ginsberg does suggest, although the brazen misappropriator would not violate the federal securities law, she might remain liable under state law.

In *SEC v. Rocklage*, 470 F.3d 1 (1st Cir. 2006), the First Circuit Court of Appeals largely vitiated the problem of the brazen misappropriator by finding, on the facts of the case, that a confidant's post acquisition disclosure of her intent to tip her brother was made too late to insulate her from liability. *See* Nagy, *supra* note 125, at 1344 (*Rocklage* "essentially eviscerate[d] *O'Hagan*'s dictate that a fiduciary's full disclosure to his principal forecloses Rule 10b-5 liability."). However, as sensible as this position might seem from a policy standpoint, it is arguably inconsistent with Justice Ginsberg's language that the fraud is not consummated until the confidant purchases or sells securities. This issue has yet to be considered in other circuits.

Note, if we follow the common law of unjust enrichment and eliminate the *Dirks* personal benefit element of tipping, then *Rocklage* becomes an easy case. Mr. Rocklage was a classic insider of the issuer. The SEC could not sue Mrs. Rocklage as a tippee because Mr. Rocklage did not give the information to her as a gift. He was distraught about his company's unannounced financial results and confided the information to her, expecting her to keep it confidential. Consequently, the SEC had to argue that she was a dishonest confidant who misappropriated her husband's material nonpublic information.

467. Cox is particularly concerned about this implication of a purely property analysis of insider trading. Cox, *supra* note 51, at 709.

information, it should be able to give others the permission to do so. In other words, insider trading is completely lawful if the source of the information consents, at least under the misappropriation theory.

Let us return once again to the *ur*-misappropriation case of *Carpenter* previously discussed.[468] In that case, the source of the information was the *Wall Street Journal*, the misappropriator was a columnist, and the misappropriated property was the *Journal's* production schedule.[469] It was clear the *Journal* considered this information to be confidential and the columnist understood that the terms of his employment agreement prohibited him from trading in securities on the basis of the information. However, so long as the *Journal* was not engaging in price manipulation,[470] it would have been completely legal under the federal securities laws for it to have traded securities based on its production schedule (although that may have violated journalistic ethics) because it had no fiduciary or functionally similar duties to the public.[471] As such, there was also no reason why the *Journal* could not legally permit its employees to trade on this information as well, perhaps as a form of compensation.[472]

There are, of course, exceptions. Most importantly, in the case of a tender offer, both the bidder and the target are subject to both disclosure obligations and substantive restrictions on the purchases of the target's securities. *See* Rule 13d-1 (17 C.F.R. § 240.13d-1 (2021)); Rule 13e.3 (17 C.F.R. § 240.13e-3 (2021)); Rule 14d-3 (17 C.F.R. § 240.14d-3 (2021)); Rule 14d-4 (17 C.F.R. § 240. 14d-4 (2021)); 14d-10 (17 C.F.R. § 240.14d-10 (2021)). The federal tender offer regime is beyond the scope of this Article.

Moreover, after a party has taken substantial steps towards the commencement of a tender offer, Rule 14e-3 prophylactically prohibits (with certain exceptions) trading by any person who is in possession of material nonpublic information who has reason to know that the information comes from the bidder, the target or their insiders. 17 C.F.R. § 240.14e-3 (2021).

468. *See supra* text at notes 276–93.

469. United States v. Carpenter, 484 U.S. 19, 22–24 (1987).

470. Intentionally publishing certain information with the intent of affecting the price of securities can in some circumstances be unlawful manipulation under Exchange Act § 9(a). 15 U.S.C. 78i(e). Manipulation is beyond the scope of this Article.

471. Bainbridge notes that the *Carpenter* implications are "incongruous" insofar as it purports to be based on investor confidence and market integrity, but it does make sense if, instead, we ground insider trading policy in property principles. Bainbridge, *Incorporating*, *supra* note 68, at 1243–44; Bainbridge, *Post-Fiduciary Duty*, *supra* note 120, at 85, 96–97.

472. As Langevoort says:

> A fundamental implication of the property rights idea is that the owner gets to do with the information as it wishes, free of government meddling at least so far as the securities laws are concerned. [] While an early version of this said that there was no need for federal regulation at all — owners can protect themselves using common law agency, fiduciary, tort, contract and property principles — that idea has faded in favor of seeing insider trading law as a useful federal law tool for sanctioning informational embezzlers.

There is a question as to whether this analysis also applies to insider trading under the classic theory. Saikrishna Prakash once suggested that this was already the rule.[473] Although this position arguably logically follows from the Supreme Court's analysis that information is the property of its source and that, for insider trading to be actionable, there must be a breach of fiduciary duties, it seems to be incorrect as a description of the federal case law.

As discussed,[474] the federal court's understanding of fiduciary duty seems to go beyond state law in the case of classic insider trading, recognizing direct duties not only to the corporation, but also to its existing and future stockholders. That is, in *Cady, Roberts* the SEC held that a classic insider must either abstain or disclose the material nonpublic information to the market,[475] a position that Justice Powell reiterated in *Chiarella*.[476] As such, there seems to be a de facto federal fiduciary duty law that prohibits permissioned trading by traditional insiders under the classic theory. Consequently, Bainbridge argues, "[a]uthorization of insider trading by the issuer's board of directors, or even a majority of the shareholders, does not constitute consent by the specific investors with whom the insider trades."[477] I suspect that federal courts would agree with Bainbridge's interpretation of federal law.

However, with respect to a *state* law *Brophy*/*Diamond* action for classic or misappropriation insider trading, Prakash might be correct. These disgorgement claims are derivative actions brought in the name of a corporation against its officers and directors for self-dealing. In other contexts, self-dealing and takings of corporate opportunity can be "sterilized" by the vote of disinterested directors and/or stockholders after full disclosure.[478] This suggests that any "abstain or disclose" duty should run to the corporation itself, through its board. The information that must be disclosed would not be the material nonpublic information itself (which is already known by the corporation vicariously through the insider) but the fact that the insider intends to trade on the information. There would seem to be no *theoretical* reason why, for instance, a special committee consisting entirely of disinterested outside directors could not be able to grant an officer

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Langevoort, *Wobble*, *supra* note 61, at 524.

473. Prakash, *supra* note 14, at 1511.

474. *See supra* text at notes 118–20.

475. *See* Cady, Roberts & Co., 40 S.E.C. 907, 911 (1961).

476. Chiarella v. United States, 445 U.S. 222, 227 (1980).

477. BAINBRIDGE, INSIDER TRADING, *supra* note 55, at 97.

478. Jonathan Macey argues that, based on a property theory of information "[t]he question of whether and how to trade or otherwise utilize material inside information is, from a corporation's perspective, a matter of business judgment," relying in part on Ginsberg's footnote 9 in *O'Hagan*. Macey, *Martoma II*, *supra* note 162, at 872–73.

or director the right to trade on certain information, for example, as part of his compensation package, at least if there is full disclosure to stockholders.[479]

Nevertheless, I suspect that it is highly unlikely that this will happen. Whether or not classic insider trading could be "sterilized"[480] by a disinterested director or stockholder vote under state law eliminating a *Brophy* action, it would still probably remain unlawful under federal law.[481] It would also probably continue to violate stock exchange listing requirements.[482] Perhaps more importantly, the existence of such an arrangement would have to be disclosed by an issuer, in its proxy statement seeking stockholder approval, and in the *Executive Compensation* section[483] that must be included in a number of Securities Act and Exchange Act filings. Even the proponents of legalizing insider trading with the issuer's permission insist that this must be disclosed.[484] However, given the wide-spread revulsion against insider trading by the public generally, I would hazard that few issuers would risk such a public-relations *faux pas.*

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479. Of course, the granddaddy of the argument that issuer permitted insider trading might be an appropriate form of compensation is Henry Manne. MANNE, *supra* note 78. He has reiterated this argument as late as Henry G. Manne, *Entrepreneurship, Compensation, and the Corporation*, *in* HANDBOOK, *supra* note 62, at 67. For another classic defense of legalization of insider trading see Daniel R. Fischel & Dennis W. Carlton, *The Regulation of Insider Trading,* 35 STAN. L. REV. 857 (1983). Epstein makes a more nuanced version of this argument based on the assertion that insider trading may or may not be efficient based on the specific context. Therefore, rather than having a blanket rule, we should allow boards to determine this on a case-by-case basis. Epstein, *supra* note 73.

For a recent discussion of the efficiency of doing so, see James C. Spindler, *The Coasian Firm and Insider Trading, Revisited*, 71 SMU L. REV. 967 (2018), expanding on a model developed by David Haddock and Jonathan Macey over 30 years ago. David D. Haddock & Jonathan R. Macey, *A Coasian Model of Insider Trading*, 80 NW. U. L. REV. 1449 (1986).

480. *See, e.g.*, DEL. CORP. ANN. tit. 8, § 144 (2021).

481. More recently, Thomas Lambert has suggested issuers should be allowed to permit insider trading with full disclosure as a way of enhancing informational efficiency while constraining agency costs. Thomas A. Lambert, *Decision Theory and the Case for an Optional Disclosure-based Regime for Regulating Insider Trading*, *in* HANDBOOK, *supra* note 62, at 130 [hereinafter Lambert, *Decision Theory*].

482. *See* WILLIAM K.S. WANG & MARC I. STEINBERG, INSIDER TRADING 613–14 (3d. Ed. 2010); Nick Walter, *Prioritizing Enforcement in Insider Trading*, 30 YALE L. & POL'Y REV. 521, 529, n.38 (2011).

483. *Regulation S-K — Standard Instructions for Filing Forms Under Securities Act of 1933, Securities Exchange Act of 1934 and Energy Policy and Conservation Act of 1975, Item 402 Executive Compensation*, 17 C.F.R. § 229.402 (2021).

484. *See* Lambert, *Decision Theory*, *supra* note 481, at 130 (explaining that disclosure should be necessary, and that disclosure should always make insider trading permittable).

VII. CONCLUSION

Although the Supreme Court's understanding of the law of restitution and disgorgement as illustrated in its decisions in *Kokesh* and *Liu* is flawed, the logic of the Supreme Court's insider trading jurisprudence suggests that the proper party to bring a disgorgement cause of action for insider trading should not be the SEC, but the issuer or other source of the material nonpublic information. Moreover, the cause of action should be brought in state courts under property, breach of fiduciary duty, or fraud grounds under the traditional common law of restitution. To do so would greatly simplify and do away with the absurdities and excrescences that currently deform federal case law and send people to prison for what is a de facto common law crime.

However, such state law cases sounding in unjust enrichment can be expected to be relatively few and far between. If one is concerned with deterrence, they should be a supplement to, not a substitution for, federal civil and criminal actions. Indeed, implicit in my argument is that these state law causes of action designed protect the individual *private* rights of owners of information are inadequate as the basis of a federal securities law that is concerned with *public* policies such as market integrity, efficiency, and protection of investors.

The Supreme Court's strained amalgam or property, fiduciary duty, and fraud justifications for insider trading liability does not capture what, if anything, is wrong about purchasing or selling securities on the basis of material nonpublic information from the perspective of the securities markets generally. The Supreme Court correctly believes that the federal case law is currently bound by the fact that Sec. 10(b) of the '34 Act only bans fraud, not bad acts generally. Consequently, coherence in federal law requires Congressional action which, in turn, would require identifying what is wrongful about insider trading from a market perspective so that we can define it. Unfortunately, although there is a widespread, albeit far from universal, intuition that some trading on the basis of material nonpublic information violates the policies underlying the federal securities laws so far there is no consensus as to why.