

WEEDING OUT A NEW THEORY OF INSIDER TRADING
LIABILITY AND CULTIVATING AN HEIRLOOM
VARIETY: A PROPOSED RESPONSE TO
SEC V. DOROZHKO

*Mark F. DiGiovanni**

INTRODUCTION

A weed is a plant that is unwanted and threatens to overgrow more desirable plants.¹ An heirloom plant is a variety of desired plant that was grown during early human history but is ill-suited for large-scale production.² Compared to modern varieties, heirlooms often have more desirable characteristics such as better taste, superior disease resistance, or greater suitability to a local climate.³ Two complimentary tasks facing every gardener are cultivating the desired plants and removing the weeds.

The Supreme Court is the gardener of American law.⁴ Sometimes it views a novel legal theory as a weed and uproots it from American jurisprudence.⁵ Other times the Court views a new legal concept as a desired plant, worthy of cultivation in our body of law. As is the case for most gardeners, for the Supreme Court there is more weeding and cultivating to do than there are days in a term to do it. Consequently, sometimes legal weeds grow unchecked and desired legal theories go unnurtured. The prudent gardener never puts the work off too long though, cognizant that it is most effective to “nip in the bud” any problems.⁶

* George Mason University School of Law, J.D. Candidate, May 2012; Production Editor, *GEORGE MASON LAW REVIEW*, 2011-2012; University of North Carolina-Chapel Hill, B.S., Business Administration, May 2005. I am very thankful to the professors and practitioners who provided valuable insights on the development of this Note, to Kendal Nicole Smith and Stephen Foster for their comments on earlier drafts, and to my wife and family for all of their love and support.

¹ *RODALE'S ALL-NEW ENCYCLOPEDIA OF ORGANIC GARDENING: THE INDISPENSABLE RESOURCE FOR EVERY GARDENER* 631 (Fern Marshall Bradley & Barbara W. Ellis eds., 1992) [hereinafter *ORGANIC GARDENING*].

² *Id.* at 308.

³ *Id.*

⁴ See Nancy K. Bowman, *Milkovich Meets Modern Federalism in Libel Law: The Lost Opinion Privilege Gives Birth to Enhanced State Constitutional Protection*, 42 *DEPAUL L. REV.* 583, 618 (1992).

⁵ *Id.*

⁶ *Bateman Eichler, Hill Richards, Inc. v. Berner*, 472 U.S. 299, 316-17 (1985) (“[T]he most effective means of [detering insider trading] is to nip in the bud the source of the information . . .” (quoting *Nathanson v. Weis, Voisin, Cannon, Inc.*, 325 F. Supp. 50, 57-58 (S.D.N.Y. 1971))); see also *ORGANIC GARDENING*, *supra* note 1, at 631-32.

*SEC v. Dorozhko*⁷ presents a problem that the Supreme Court should nip in the bud. In *Dorozhko*, the United States Securities and Exchange Commission (“SEC”) brought an enforcement action alleging that the defendant had committed insider trading when he hacked into a computer network, obtained nonpublic information, and used that information in connection with subsequent securities transactions.⁸

Insider trading involves buying or selling securities on the basis of material nonpublic information.⁹ And, the label “insider trading” encompasses such conduct whether perpetrated by corporate insiders or outsiders.¹⁰ Under federal securities law, insider trading liability typically requires that the defendant used a “device” that was either “manipulative” or “deceptive” and that the device was used “in connection with” a securities transaction.¹¹ The Supreme Court has consistently premised the “deceptive” element on the breach of a fiduciary duty or similar relationship of trust or confidence.¹²

The circumstances in *Dorozhko* were unique from previous insider trading decisions.¹³ The defendant was not a corporate insider who, by vir-

⁷ 574 F.3d 42 (2d Cir. 2009).

⁸ *Id.* at 44.

⁹ THOMAS LEE HAZEN, PRINCIPLES OF SECURITIES REGULATION 285-86 (3d ed. 2009).

¹⁰ *Id.*

¹¹ *Dorozhko*, 574 F.3d at 45 (quoting 15 U.S.C. § 78j(b) (2006)) (internal quotation marks omitted).

¹² See, e.g., *United States v. O’Hagan*, 521 U.S. 642, 652-53 (1997) (accepting the misappropriation theory of insider trading liability, which “premises liability on a fiduciary-turned-trader’s deception of those who entrusted him with access to confidential information”); *Dirks v. SEC*, 463 U.S. 646, 660 (1983) (“Thus, a tippee assumes a fiduciary duty to the shareholders of a corporation . . . when the insider has breached his fiduciary duty to the shareholders by disclosing the information to the tippee and the tippee knows or should know that there has been a breach.”); *Chiarella v. United States*, 445 U.S. 222, 227-28 (1980) (holding that a corporate insider who traded securities of his corporation without first disclosing material nonpublic information breached “a relationship of trust and confidence between the shareholders of a corporation and those insiders who have obtained confidential information by reason of their position with that corporation,” which qualified as deceptive); see also Donna M. Nagy, *Insider Trading and the Gradual Demise of Fiduciary Principles*, 94 IOWA L. REV. 1315, 1317 (2009) (“[T]he U.S. Supreme Court established that there are two complementary theories of insider trading liability, each with a fiduciary principle at its core.”).

¹³ The SEC has filed enforcement actions based on facts similar to *Dorozhko*; however, none of these cases were resolved on the merits. See *SEC v. Stummer*, Litig. Release No. 20,529, 93 SEC Docket 115 (Apr. 17, 2008), available at 2008 WL 1756796 (stating that the defendant consented to final judgment without admitting or denying the allegations and agreed to pay disgorgement, prejudgment interest, and a civil penalty); *SEC v. Blue Bottle Ltd.*, Litig. Release No. 20,018, 90 SEC Docket 268 (Feb. 26, 2007), available at 2007 WL 580798 (describing a temporary restraining order and asset freeze against a defendant that hacked into computer systems to view news releases, allowing the defendant to commit illegal trades); *SEC v. Lohmus Haavel & Viisemann*, Litig. Release No. 19,450, 86 SEC Docket 1591 (Nov. 1, 2005), available at 2005 WL 2861257 (stating that the SEC pursued injunctive relief and civil monetary penalties against a financial services firm for stealing confidential, electronic press releases); see also Nagy, *supra* note 12, at 1341-44 (discussing these cases).

tue of his position within the company, had access to nonpublic information relevant to the company's stock price.¹⁴ Nor had the company given the defendant access to nonpublic information within the context of a fiduciary or similar relationship of trust or confidence.¹⁵ Nor was he tipped off by anyone with access to the information.¹⁶ Instead, Dorozhko was a complete outsider who unilaterally accessed the nonpublic information.¹⁷

In *Dorozhko*, the Second Circuit Court of Appeals held that a breach of a fiduciary duty is a sufficient—but not a necessary—condition for insider trading liability.¹⁸ The court established a new, “straightforward” theory of insider trading liability which connects a defendant's actions directly to the “deceptive” element of the applicable federal statute, the Securities and Exchange Act of 1934.¹⁹ This holding, however, conflicts with an earlier decision of the Fifth Circuit Court of Appeals, which stated that conduct “is not ‘deceptive’ unless it involves breach of some duty of candid disclosure.”²⁰ Although some commentators have noted a gradual erosion of the fiduciary duty requirement to the point of nonexistence,²¹ no federal court had previously found insider trading liability without the breach of some fiduciary duty or similar relationship of trust and confidence.²² The Supreme Court should weed out the Second Circuit's holding from insider trading jurisprudence at the first available opportunity.²³

¹⁴ *Dorozhko*, 574 F.3d at 45 (“[W]e recognize that the SEC's claim against defendant—a corporate outsider who owed no fiduciary duties to the source of the information—is not based on either of the two generally accepted theories of insider trading.”).

¹⁵ *Id.*

¹⁶ *Id.*

¹⁷ *Id.*

¹⁸ *Id.* at 49.

¹⁹ *Id.* (second internal quotation marks omitted); *cf.* Nagy, *supra* note 12, at 1371-73 (discussing the “deceptive acquisition theory”). This Note focuses exclusively on the “deceptive” element of Section 10(b); however, at least one commentator has suggested that the Second Circuit necessarily also expanded the “in connection with” element of federal insider trading law. *See* Matthew T.M. Feeks, *Turned Inside-Out: The Development of “Outsider Trading” and How Dorozhko May Expand the Scope of Insider Trading Liability*, 7 J.L. ECON. & POL'Y 61, 83 (2010).

²⁰ *Regents of Univ. of Cal. v. Credit Suisse First Bos. (USA), Inc.*, 482 F.3d 372, 389 (5th Cir. 2007).

²¹ *See, e.g.*, Nagy, *supra* note 12, at 1319 (“Despite the Supreme Court's explicit dictate that fiduciary principles underlie the offense of insider trading, there have been recent repeated instances in which lower federal courts and the [SEC] have disregarded these principles.”); Robert Steinbuch, *Mere Thieves*, 67 MD. L. REV. 570, 602 (2008) (characterizing *SEC v. Rocklage*, 470 F.3d 1 (1st Cir. 2006), as “the final death-knell to any relationship-of-confidence element of the misappropriation theory”).

²² *See, e.g.*, *SEC v. Dorozhko*, 606 F. Supp. 2d 321, 339 (S.D.N.Y. 2008) (“[A]s far as this Court is aware, no federal court has ever held that those who steal material nonpublic information and then trade on it violate § 10(b).”), *vacated*, 574 F.3d 42 (2d Cir. 2009).

²³ *Dorozhko* no longer represents an opportunity to weed out the Second Circuit's rationale because *Dorozhko* did not file a petition for writ of certiorari. On remand the district court granted the SEC's unopposed motion for summary judgment. *SEC v. Dorozhko*, Litig. Release No. 21,465, 98 SEC Docket 448 (Mar. 29, 2010), *available at* 2010 WL 1213430. Some commentators have defended the

Notwithstanding this weeding out, the SEC should plant—and the courts cultivate—an heirloom theory of insider trading liability: the constructive breach theory.²⁴ In Chief Justice Burger’s dissent in the seminal decision of *Chiarella v. United States*,²⁵ he articulated a theory of insider trading liability premised upon on a duty between the person who unlawfully obtained nonpublic information and subsequent counterparties in securities transactions.²⁶ The constructive breach theory is a cross-pollination of Chief Justice Burger’s idea with the principles governing constructive trusts.²⁷

Under the constructive breach theory, when one wrongfully obtains property from another, that act creates a constructive trust between the wrongdoer and the victim as to that property.²⁸ The constructive trust gives

Second Circuit’s new theory of insider trading liability and argued that the Second Circuit did not go far enough. See, e.g., Michael Geeraerts, *Hackers Who Steal and Trade on Insider Information Finally Fear the Securities and Exchange Commission and Section 10(b)*, 17 PIABA B.J. 253 (2010).

²⁴ The label “constructive breach theory” appears in earlier scholarly work but is not attached to the same concept discussed in this Note. See, e.g., Donald C. Langevoort, *Insider Trading and the Fiduciary Principle: A Post-Chiarella Restatement*, 70 CALIF. L. REV. 1, 30-31 (1982) [hereinafter Langevoort, *Fiduciary Principle*]; Wendy Ehrenkranz, Comment, *Whistle Blowing as a Rule 10b-5 Violation: Dirks v. SEC*, 36 U. MIAMI L. REV. 987, 999-1000 (1982). Earlier uses of the term describe a theory of tippee liability under which the tippee’s mere receipt of nonpublic information from a corporate insider constructively imposes the corporate insider’s duty not to trade prior to public disclosure of the information upon the tippee. Langevoort, *supra*, at 30-31. For purposes of this Note, unless otherwise designated, the term “constructive breach theory” refers to the idea that unlawful acquisition of property creates a constructive trust between the wrongdoer and the victim, which in turn gives rise to a duty owed by the wrongdoer to the victim with respect to the wrongfully acquired property, the breach of that duty being sufficient to qualify as “deceptive” under the federal statute. See 18 DONALD C. LANGEVOORT, INSIDER TRADING: REGULATION, ENFORCEMENT AND PREVENTION § 6:14 n.5, at 6-51 (2011) [hereinafter LANGEVOORT, REGULATION].

²⁵ 445 U.S. 222 (1980); see also Michael D. Wheatley, *Apologia for the Second Circuit’s Opinion in SEC v. Dorozhko*, 7 J.L. ECON & POL’Y 25, 43 (2010) (acknowledging that “there is some support for the argument that mere theft of information can qualify for § 10(b) and Rule 10b-5 fraud”).

²⁶ *Chiarella*, 445 U.S. at 240 (Burger, C.J., dissenting) (arguing that federal securities law should recognize that a person who acquired an “informational advantage” by some “unlawful means” should have “an absolute duty to disclose that information or to refrain from trading”); see also *id.* at 239 (Brennan, J., concurring) (stating that he agrees with Chief Justice Burger’s formulation of federal securities law but cannot join in the Chief Justice’s dissent because that theory was not presented to the jury).

²⁷ See LANGEVOORT, REGULATION, *supra* note 24, § 6:14 n.5, at 6-51; cf. Langevoort, *Fiduciary Principle*, *supra* note 24, at 30 n.121 (explaining the then-labeled constructive breach theory’s reliance on principles of constructive trusts and, specifically, the idea that when a person receives confidential information from another under the expectation of confidence and misappropriates that information for personal benefit, the proceeds of the misappropriation are held in a constructive trust for the benefit of the person who granted the confidential information).

²⁸ LANGEVOORT, REGULATION, *supra* note 24, § 6:14 n.5, at 6-51; see also CARYL A. YZENBAARD ET AL., THE LAW OF TRUSTS AND TRUSTEES § 471, at 2 (3d ed. 2009). “Property” includes both tangible property, such as real or personal property, and intangible property such as information. See *infra* note 198 (addressing the distinction between tangible and intangible property).

rise to a duty, owed by the wrongdoer to the victim, with respect to the wrongfully acquired property.²⁹ This duty is a fiduciary or similar relationship of trust or confidence between the parties, and a finding that the breach of that duty is “deceptive” comports with the established jurisprudence of insider trading liability.³⁰

After *Chiarella*, courts never had to consider the wrongdoer theory articulated in Justice Burger’s dissenting opinion because subsequent cases were always based on the breach of a well-recognized fiduciary duty or similar relationship of trust or confidence.³¹ The facts of *Dorozhko*, however, demonstrate that trading on the basis of nonpublic information does occur outside of a breach of a traditionally recognized fiduciary duty. Had the Second Circuit applied the constructive breach theory, the court would have reached the same result in *Dorozhko* without deviating from the fiduciary duty requirement.³²

This Note analyzes *Dorozhko*, arguing that the Second Circuit’s theory should be weeded out and that the constructive breach theory be cultivated in its place. Part I outlines the different theories of insider trading liability, presents the facts of *Dorozhko*, and recounts the district court and Second Circuit opinions. Part II shows why the Second Circuit’s theory is a weed, with Section II.A scrutinizing the soundness of the Second Circuit’s doctrinal analysis and Section II.B examining the policy-based concerns and practical implications of *Dorozhko*. Part III advocates for the cultivation of the constructive breach theory to address the gaps in insider trading liability. Section III.A explains the constructive breach theory. An application of the constructive breach theory to several fact patterns follows in Section III.B, demonstrating why it is better adapted than the Second Circuit’s approach to the deal with the tough factual scenarios exemplified by *Dorozhko*. Section III.C concludes by identifying and addressing objections to the constructive breach theory.

I. BACKGROUND

Insider trading violations typically fall under Section 10(b) of the Securities and Exchange Act of 1934 (“1934 Act”) and Rule 10b-5 promulgated thereunder.³³ Section 10(b) prohibits the use of any manipulative or

²⁹ LANGEVOORT, REGULATION, *supra* note 24, § 6:14 n.5, at 6-51; *see also* YZENBAARD ET AL., *supra* note 28, § 543, at 217 (“[T]he most fundamental duty of a trustee is that he must display . . . complete loyalty to the interests of the beneficiary and must exclude all selfish interest . . .”).

³⁰ *See* sources cited *supra* note 29.

³¹ *See, e.g.,* United States v. O’Hagan, 521 U.S. 642, 653 (1997) (noting the duty of trust and confidence the defendant owed to his employer and its clients).

³² *See infra* Part III.B.1.

³³ Section 10(b) of the 1934 Act, codified at 15 U.S.C. § 78j (2006), provides:

deceptive device in connection with the purchase or sale of any security.³⁴ Rule 10b-5 contains seemingly broader language, but liability under a rule cannot exceed the scope specified by Congress in the relevant statute.³⁵ Thus, the three elements of a Rule 10b-5 violation are: (1) a device; (2) which is manipulative or deceptive; and (3) that is used in connection with the purchase or sale of securities.³⁶

The purpose of the 1934 Act was to restore confidence in the nation's securities market following the 1929 market crash by ensuring honest securities markets.³⁷ One principle supporting that purpose was to substitute "a philosophy of full disclosure for the philosophy of *caveat emptor*" in securities transactions.³⁸ Professor Thomas Lee Hazen has noted the irony that the 1934 Act and the corresponding rules do not contain an express prohibition of trading on the basis of nonpublic information even though that activity undermines the purpose of the statute.³⁹ Section 10(b) is characterized as a "catchall" provision,⁴⁰ which Professor Hazen has noted makes prosecuting insider trading "problematic."⁴¹ The general wording

It shall be unlawful for any person . . . [t]o use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Id. Similarly, Rule 10b-5 states:

It shall be unlawful for any person . . . (a) To employ any device, scheme, or artifice to defraud, (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading, or (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5 (2010); *see also* Matthew R. King et al., *Securities Fraud*, 46 AM. CRIM. L. REV. 1027, 1057 n.174 (2009) ("Currently, § 10(b) and Rule 10b-5 are the Government's primary means of regulating insider trading."). Insider trading can also fall under other statutes and rules such as Rule 14e-3 enacted pursuant to the Securities Act of 1933, which prohibits trading on the basis of nonpublic information concerning tender offers. *See* Danielle DeMasi Chattin, Note, *The More You Gain, the More You Lose: Sentencing Insider Trading Under the U.S. Sentencing Guidelines*, 79 FORDHAM L. REV. 165, 172 n.46 (2010) (citing 17 C.F.R. § 240.14e-3 (2010)). For further discussion of Rule 14e-3, see generally Jeff Lobb, Note, *SEC Rule 14e-3 in the Wake of United States v. O'Hagan: Proper Prophylactic Scope and the Future of Warehousing*, 40 WM. & MARY L. REV. 1853 (1999). This Note will only be examining insider trading liability under Section 10(b) and Rule 10b-5.

³⁴ 15 U.S.C. § 78j.

³⁵ *See O'Hagan*, 521 U.S. at 651 ("Liability under Rule 10b-5, our precedent indicates, does not extend beyond conduct encompassed by § 10(b)'s prohibition.").

³⁶ *See* 15 U.S.C. § 78j.

³⁷ *See SEC v. Zandford*, 535 U.S. 813, 819 (2002).

³⁸ *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128, 151 (1972) (quoting SEC v. Capital Gains Research Bureau, 375 U.S. 180, 186 (1963)) (internal quotation marks omitted).

³⁹ HAZEN, *supra* note 9, at 286.

⁴⁰ *Chiarella v. United States*, 445 U.S. 222, 234-35 (1980) ("Section 10(b) is aptly described as a catchall provision, but what it catches must be fraud.").

⁴¹ HAZEN, *supra* note 9, at 287 ("Using a general antifraud proscription as the catchall for insider trading is problematic. There are many insider trading abuses that do not fit into a traditional fraud

gives little guidance and has forced courts to define the limits of insider trading liability, making insider trading law analogous to common law in that it develops “on a case-by-case basis.”⁴²

A. *Theories of Insider Trading Liability Accepted by the Supreme Court*

In light of this common law style, the Supreme Court has validated two theories of insider trading liability.⁴³ Under the first theory, commonly referred to as the “classical theory,” a violation occurs when a corporate insider breaches the fiduciary owed to her company’s shareholders by trading on the basis of nonpublic information obtained through her position within the corporation prior to public disclosure of that information.⁴⁴ Under the second theory, known as the “misappropriation theory,” a violation occurs when a person outside of the corporation trades using nonpublic information obtained through a breach of a duty owed to the source of information.⁴⁵

The classical theory of insider trading bases liability on a corporate insider’s breach of the fiduciary duty she owes to the stockholders of the corporation.⁴⁶ As noted by the Supreme Court, “[t]hat the relationship between a corporate insider and the stockholders of his corporation gives rise to a disclosure obligation is not a novel twist of the law.”⁴⁷ The Court held that one commits fraud by failing to disclose material information prior to entering into an agreement only if he was under a duty to do so.⁴⁸ Such a disclosure duty arises when there is “a fiduciary or other similar relation of trust and confidence between them.”⁴⁹ Thus, the fiduciary relationship between a corporate insider and the stockholders compels the corporate insider to ei-

analysis. Applying Rule 10b-5 to insider trading is much like trying to fit a square peg into a round hole.”).

⁴² Thomas Lee Hazen, *Identifying the Duty Prohibiting Outsider Trading on Material Nonpublic Information*, 61 HASTINGS L.J. 881, 889-90 (2010).

⁴³ Nagy, *supra* note 12, at 1317. The Supreme Court has also recognized a derivative theory of tippee liability. See *Dirks v. SEC*, 463 U.S. 646, 660 (1983) (“Thus, a tippee assumes a fiduciary duty to the shareholders of a corporation . . . when the insider has breached his fiduciary duty to the shareholders by disclosing the information to the tippee and the tippee knows or should know that there has been a breach.”). For further discussion of tippee liability, see generally Kathleen Coles, *The Dilemma of the Remote Tippee*, 41 GONZ. L. REV. 181 (2006).

⁴⁴ *United States v. O’Hagan*, 521 U.S. 642, 651-52 (1997) (internal quotation marks omitted).

⁴⁵ *Id.* at 652 (internal quotation marks omitted).

⁴⁶ *Chiarella v. United States*, 445 U.S. 222, 227-28 (1980).

⁴⁷ *Id.* at 227. *But see* Nagy, *supra* note 12, at 1337 (noting that when the Supreme Court first validated the classical theory, the existence of a fiduciary relationship between an officer or director of a corporation and the shareholders was only recognized in a minority of jurisdictions).

⁴⁸ *Chiarella*, 445 U.S. at 228.

⁴⁹ *Id.* (quoting RESTATEMENT (SECOND) OF TORTS § 551(2)(a) (1976)) (internal quotation marks omitted).

ther disclose the nonpublic information or abstain from trading.⁵⁰ Failure to comply with that duty constitutes a violation of Section 10(b).⁵¹ Premising insider trading liability as the violation of a duty proved influential on the later development of the misappropriation theory.⁵²

Confining insider trading liability to corporate insiders proved insufficient because trading on the basis of nonpublic information is not exclusive to corporate insiders.⁵³ *Chiarella* is one example of the government's efforts to expand the scope of insider trading liability by prosecuting people who were not corporate insiders.⁵⁴ In *Chiarella*, the defendant was an employee of a financial printer who prepared documents in advance of corporate takeovers.⁵⁵ Despite precautions taken to conceal the identity of the acquiring and target companies,⁵⁶ the defendant was able to discern the identities of the target companies.⁵⁷ The defendant then used this information to engage in securities transactions, which netted him approximately \$30,000 over a fourteen month period.⁵⁸ The Second Circuit Court of Appeals affirmed the defendant's conviction, but the Supreme Court reversed.⁵⁹ The Court recognized that nondisclosure in connection with a securities transaction operates as conduct punishable under Section 10(b) if there is a pre-existing duty to disclose between the parties.⁶⁰ Yet, because the defendant was not a corporate insider and had not received confidential information from the company whose securities he had traded, he had no duty to disclose or abstain from trading.⁶¹ The *Chiarella* majority opined that they could not affirm the defendant's conviction "without recognizing a general duty between all

⁵⁰ *Id.* at 226-27 (citing *In re Cady, Roberts & Co.*, 40 S.E.C. 907, 911 (1961)); see also Hazen, *supra* note 42, at 890-91. Professor Hazen goes on to explain that disclosure of the nonpublic information is rarely a viable alternative, thus, the corporate insider must refrain from trading until the rightful owner of the nonpublic information discloses it to the market. *Id.*

⁵¹ *Chiarella*, 445 U.S. at 230.

⁵² See Nagy, *supra* note 12, at 1330 (observing that when the Supreme Court endorsed the misappropriation theory, the new theory of insider trading liability was "based once again on a fiduciary principle").

⁵³ See *SEC v. Dorozhko*, 606 F. Supp. 2d 321, 332 (S.D.N.Y. 2008) ("As securities markets grew increasingly complex, it became clear that deterring corporate insiders . . . was insufficient to prevent abuses of structural disparities in information."), *vacated*, 574 F.3d 42 (2d Cir. 2009); see also HAZEN, *supra* note 9, at 286 ("Defendants in insider trading cases have not been limited to corporate insiders and have included a wide range of people, including celebrities, psychiatrists, football coaches, former athletes, newspaper columnists, printers, leading arbitrageurs, and most unfortunately, lawyers.").

⁵⁴ *Chiarella*, 445 U.S. at 231.

⁵⁵ *Id.* at 224.

⁵⁶ The names of the companies were either replaced with false names or concealed with blank spaces in the documents until the night of the final printing. *Id.*

⁵⁷ *Id.*

⁵⁸ *Id.*

⁵⁹ *Id.* at 225.

⁶⁰ *Chiarella*, 445 U.S. at 230.

⁶¹ *Id.* at 231-32.

participants in market transactions to forgo actions based on material, non-public information.”⁶² The Court concluded that to do so would go beyond both the statutory language and legislative history of Section 10(b).⁶³

In its brief to the Supreme Court, the government advanced a new theory to support Chiarella’s conviction, arguing that he had violated Rule 10b-5 because he had breached a duty to the acquiring company by virtue of being an employee of the printer.⁶⁴ The Court did not decide the validity of this novel theory of insider trading liability on the grounds that such a theory was not submitted to the jury.⁶⁵ In his concurring opinion, Justice Stevens emphasized that the Court has “not necessarily placed any stamp of approval on what this petitioner did, nor have we held that similar actions must be considered lawful in the future.”⁶⁶ Justice Stevens instead noted that the Court “wisely leaves the resolution of this issue for another day.”⁶⁷

Despite the government’s defeat, *Chiarella* was the seed for what would later become the misappropriation theory.⁶⁸ The government promptly began advancing the misappropriation theory of insider trading liability in other cases.⁶⁹ In *United States v. Newman*,⁷⁰ the Second Circuit Court of Appeals became the first circuit court of appeals to validate the misappropriation theory.⁷¹ Newman was a securities trader who allegedly had received misappropriated confidential information from investment banking firm employees.⁷² Newman then funneled the information to two individuals living overseas who purchased securities using that nonpublic information.⁷³ The overseas individuals shared the profits from these transactions with Newman and the original sources of the misappropriated information.⁷⁴ The Second Circuit noted that “the Government attempted to remedy a deficiency that led to the Supreme Court’s reversal of a conviction in *Chiarella*” by basing the Rule 10b-5 violation on the breach of the

⁶² *Id.* at 233.

⁶³ *Id.*

⁶⁴ *Id.* at 235-36.

⁶⁵ *Id.* at 236; *see also Chiarella*, 445 U.S. at 238-39 (Brennan, J., concurring) (emphasizing that the misappropriation theory was not presented to the jury and that “to affirm the conviction without an adequate instruction would be tantamount to directing a verdict of guilty, and that we plainly may not do”). *But see id.* at 243-44 (Burger, C.J., dissenting) (deeming the jury instructions adequate to support a conviction under the government’s theory that the defendant traded on information acquired in the course of his confidential position at the printer).

⁶⁶ *Id.* at 238 (Stevens, J., concurring).

⁶⁷ *Id.*

⁶⁸ *See id.* (clarifying that the Court did “not necessarily placed any stamp of approval on what this petitioner did, nor [did it hold] that similar actions must be considered lawful in the future”).

⁶⁹ *See, e.g., United States v. Newman*, 664 F.2d 12, 14, 16 (2d Cir. 1981).

⁷⁰ 664 F.2d 12 (2d Cir. 1981).

⁷¹ *See id.* at 16.

⁷² *Id.* at 15.

⁷³ *Id.*

⁷⁴ *Id.*

relationship of trust and confidence between the misappropriators and their employers.⁷⁵ The Second Circuit stated that “deceitful misappropriation of confidential information by a fiduciary, whether described as theft, conversion, or a breach of trust, has consistently been held to be unlawful.”⁷⁶ The court ultimately concluded that the language of Rule 10b-5 prohibited the defendant’s conduct.⁷⁷

The Seventh⁷⁸ and Ninth⁷⁹ Circuits followed the Second Circuit’s lead, but the Fourth⁸⁰ and Eighth⁸¹ Circuits refused to accept the misappropriation theory. This circuit split culminated with *United States v. O’Hagan*,⁸² representing the “another day” foreshadowed in Justice Stevens’s concurring opinion in *Chiarella*.⁸³

In *O’Hagan*, the Supreme Court reversed the Eighth Circuit’s explicit rejection of the misappropriation theory for establishing liability under Rule 10b-5.⁸⁴ The defendant in *O’Hagan* was a partner at a law firm from whom a client was seeking counsel regarding a potential acquisition.⁸⁵ The defendant used this nonpublic information in connection with the purchase of a large amount of stock and options in the target company.⁸⁶ Following the public announcement of the tender offer, the defendant earned more than \$4.3 million in profits.⁸⁷ As in *Newman*, the government based the Rule 10b-5 violation on the premise that the defendant breached a duty of trust and confidence to his law firm and, indirectly, the law firm’s client.⁸⁸ The Supreme Court validated the misappropriation theory of insider trading liability, holding that a fiduciary that feigns loyalty to obtain nonpublic information and subsequently uses such information for personal benefit satisfies the “deceptive” requirement of Section 10(b).⁸⁹

⁷⁵ *Id.* at 15-16.

⁷⁶ *Newman*, 664 F.2d at 18 (citing *United States v. Girard*, 601 F.2d 69, 71 (2d Cir. 1979), *United States v. Kent*, 608 F.2d 542, 544-45 (5th Cir. 1979), *Abbott v. United States*, 239 F.2d 310, 313-14 (5th Cir. 1956), and *United States v. Buckner*, 108 F.2d 921, 926-27 (2d Cir. 1940)).

⁷⁷ *Id.* at 19.

⁷⁸ *SEC v. Cherif*, 933 F.2d 403, 410 (7th Cir. 1991).

⁷⁹ *SEC v. Clark*, 915 F.2d 439, 453 (9th Cir. 1990).

⁸⁰ *United States v. Bryan*, 58 F.3d 933, 943-44 (4th Cir. 1995).

⁸¹ *United States v. O’Hagan*, 92 F.3d 612, 618 (8th Cir. 1996), *rev’d*, 521 U.S. 642 (1997).

⁸² 521 U.S. 642 (1997).

⁸³ *See Chiarella v. United States*, 445 U.S. 222, 238 (1980) (Stevens, J., concurring); *see also* Christopher J. Bebel, *A Detailed Analysis of United States v. O’Hagan: Onward Through the Evolution of the Federal Securities Laws*, 59 LA. L. REV. 1, 3 (1998).

⁸⁴ *O’Hagan*, 521 U.S. at 649-50.

⁸⁵ *Id.* at 647.

⁸⁶ *Id.* at 647-48.

⁸⁷ *Id.* at 648.

⁸⁸ *Id.* at 653.

⁸⁹ *Id.* at 653-54.

Before and after *O'Hagan*, courts have applied the misappropriation theory in a variety of contexts.⁹⁰ Nevertheless, these cases all have one common element: liability premised upon the breach of a pre-existing fiduciary duty or similar relationship of trust or confidence.⁹¹ Some commentators have claimed that courts are at times manufacturing a fiduciary duty simply to satisfy this requirement, which is tantamount to eliminating the fiduciary duty requirement altogether.⁹² Notwithstanding those claims, commentators could only speculate as to what would happen in cases where a true outsider, such as a computer hacker or a mere thief, directly obtained nonpublic material information and used it in connection with subsequent securities transactions.⁹³

B. *Minding the Gap in Insider Trading Liability: SEC v. Dorozhko*

The need for speculation ended when the SEC brought an enforcement action against Oleksandr Dorozhko, a Ukrainian national and resident, for allegedly hacking into Thomson Financial's computer network, accessing a soon-to-be-released negative earnings announcement from IMS Health, and

⁹⁰ See, e.g., *Carpenter v. United States*, 484 U.S. 19, 22 (1987) (journalist); *United States v. Willis*, 737 F. Supp. 269, 270 (S.D.N.Y. 1990) (psychiatrist). In 2000, the SEC adopted Rule 10b5-2, which establishes three non-exclusive bases for determining the existence of a duty of trust or confidence for purposes of clarifying the misappropriation theory of insider trading liability. 17 C.F.R. § 240.10b5-2 (2010).

(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; *provided*, however, that the person receiving or obtaining the information may demonstrate that no duty of trust or confidence existed with respect to the information, by establishing that he or she neither knew nor reasonably should have known that the person who was the source of the information expected that the person would keep the information confidential, because of the parties' history, pattern, or practice of sharing and maintaining confidences, and because there was no agreement or understanding to maintain the confidentiality of the information.

Id.

⁹¹ See, e.g., *SEC v. Dorozhko*, 606 F. Supp. 2d 321, 323 (S.D.N.Y. 2008) ("Uniformly, violations of § 10(b) have been predicated on a breach of a fiduciary (or similar) duty of candid disclosure . . ."), *vacated*, 574 F.3d 42 (2d Cir. 2009).

⁹² See *supra* note 21 and accompanying text.

⁹³ See, e.g., Coles, *supra* note 43, at 221; Donna M. Nagy, *Reframing the Misappropriation Theory of Insider Trading Liability: A Post-O'Hagan Suggestion*, 59 OHIO ST. L.J. 1223, 1252-55 (1998); Robert A. Prentice, *The Internet and Its Challenges for the Future of Insider Trading Regulation*, 12 HARV. J.L. & TECH. 263, 293-307 (1999).

using that information to purchase put options⁹⁴ in IMS Health.⁹⁵ This conduct netted Dorozhko approximately \$275,000 in profits after the inevitable decline in IMS Health stock prices when the announcement was released the next day.⁹⁶

The United States District Court for the Southern District of New York began its opinion by expressing confusion as to why the SEC brought the enforcement action when, in the court's view, the evidence "would appear to be sufficient basis" for charging Dorozhko with violations of the Computer Fraud and Abuse Act, as well as the federal mail and wire fraud statutes.⁹⁷ Nonetheless, the district court analyzed the merits of the SEC's insider trading allegation, noting that "no federal court has *ever* held that the theft of material non-public information by a corporate outsider and subsequent trading on that information violates § 10(b)."⁹⁸ The court explained that the Supreme Court has only construed "deceptive" as used in Section 10(b) in conjunction with a "breach of some duty of candid disclosure."⁹⁹ Since the SEC did not allege that Dorozhko breached such a duty, the court ruled that his conduct could not amount to a Section 10(b) violation.¹⁰⁰ The court acknowledged the strong policy arguments to the contrary,¹⁰¹ but ultimately held that Supreme Court precedent precluded validating the SEC's "novel 'hacking and trading' theory."¹⁰² The district court stayed the effect of its order so as to allow the SEC to appeal.¹⁰³

⁹⁴ Black's Law Dictionary defines "put option" as "[a]n option to sell something (esp. securities) at a fixed price even if the market declines; the right to require one to buy." BLACK'S LAW DICTIONARY 1128 (8th ed. 2004). A put option allows investors to take advantage of a decline in the price of a security. SEC v. Dorozhko, 574 F.3d 42, 44 n.1 (2d Cir. 2009) (quoting DAVID L. SCOTT, WALL STREET WORDS 295 (2003)).

⁹⁵ *Dorozhko*, 606 F. Supp. 2d at 322-23.

⁹⁶ *Id.* at 323.

⁹⁷ *Id.* at 324. The court found a violation of the Computer Fraud and Abuse Act, which establishes liability for one who "knowingly and with intent to defraud, accesses a protected computer without authorization, or exceeds authorized access, and by means of such conduct furthers the intended fraud and obtains anything of value." 18 U.S.C. § 1030(a)(4) (2006); *Dorozhko*, 606 F. Supp. 2d at 324. Similarly, the court found that Dorozhko violated the mail fraud statute, which establishes liability for one who uses the Postal Service or an interstate commercial carrier "having devised or intending to devise any scheme or artifice to defraud." 18 U.S.C. § 1341; *Dorozhko*, 606 F. Supp. 2d at 324.

⁹⁸ *Dorozhko*, 606 F. Supp. 2d at 323.

⁹⁹ *Id.* at 330 & n.8 (quoting *Regents of Univ. of Cal. v. Credit Suisse First Bos. (USA), Inc.*, 482 F.3d 372, 389 (5th Cir. 2007)) (internal quotation marks omitted) (discussing the appropriate manner for defining "deceptive" (internal quotation marks omitted)).

¹⁰⁰ *Id.* at 324.

¹⁰¹ *Id.* at 341-42.

¹⁰² *Id.* at 323-24.

¹⁰³ *Id.* at 324.

The SEC did appeal, which prompted speculation as to the eventual result.¹⁰⁴ Contrary to the prediction of at least one commentator,¹⁰⁵ the Second Circuit Court of Appeals vacated the decision below.¹⁰⁶ The Second Circuit distinguished the Supreme Court precedent relied upon by the district court, stating that those cases involved fraud based on nondisclosure whereas the facts of *Dorozhko* embody an affirmative misrepresentation.¹⁰⁷ The court held that the precedent only shows that the breach of some fiduciary duty is a sufficient—but not a necessary—condition for conduct to qualify as “deceptive” under Section 10(b).¹⁰⁸ Accordingly, the Second Circuit validated the SEC’s “straightforward” theory by importing the ordinary meaning of “deceptive” and remanded the case to the district court with instructions to determine whether Dorozhko’s hacking was perpetrated in a “deceptive” manner.¹⁰⁹ On remand, the SEC’s motion for summary judgment was unopposed and judgment was entered against Dorozhko.¹¹⁰

II. ANALYSIS

It is too early to comment on how other circuits have received *Dorozhko*.¹¹¹ But, comparing the opinions of the district court and the Second Circuit, both courts agreed that Dorozhko was in the wrong, they simply disagreed as to whether or not Section 10(b) of the 1934 Act was a suitable vehicle to hold him accountable for his actions.¹¹² This Part analyzes the soundness of the Second Circuit’s rationale, ultimately concluding it is a

¹⁰⁴ See, e.g., Carolyn Silane, *Electronic Data Theft: A Legal Loophole for Illegally-Obtained Information—A Comparative Analysis of U.S. and E.U. Insider Trading Law*, 5 SETON HALL CIRCUIT REV. 333, 365 (2009) (predicting that the Second Circuit would likely find that Dorozhko’s actions did not violate Section 10(b)).

¹⁰⁵ See *id.*

¹⁰⁶ SEC v. Dorozhko, 574 F.3d 42, 51 (2d Cir. 2009).

¹⁰⁷ *Id.* at 49.

¹⁰⁸ *Id.* (“We are aware of no precedent of the Supreme Court or our Court that forecloses or prohibits the SEC’s straightforward theory of fraud.”).

¹⁰⁹ *Id.* at 49-51 (citing WEBSTER’S NEW INTERNATIONAL DICTIONARY 679 (2d ed. 1949)). The SEC argued that computer hacking falls into two categories: (1) where the hacker masquerades as another user; or (2) where the hacker exploits a weakness in the programming, causing it to malfunction in a way that grants the hacker access to the system. *Id.* at 50-51 (quoting Opening Brief of the SEC at 22-23, SEC v. Dorozhko, 574 F.3d 42 (2d Cir. 2009) (No. 08-0201-CV)). The Second Circuit stated that instances of the first type of hacking are “plainly ‘deceptive’ within the ordinary meaning of the word” but was undecided as to whether instances of the second type also could qualify as “deceptive.” *Id.* at 51 (second internal quotation marks omitted).

¹¹⁰ SEC v. Dorozhko, Litig. Release No. 21,465, 98 SEC Docket 448 (Mar. 29, 2010), available at 2010 WL 1213430.

¹¹¹ According to Westlaw, as of October 11, 2011, the Second Circuit’s *Dorozhko* decision has been cited in twenty other decisions. Only one is from a court outside of the Second Circuit. See SEC v. Berlacher, No. 0703800, 2010 WL 3566790 (E.D. Pa. Sept. 13, 2010).

¹¹² See *supra* Part I.B.

weed in the garden of insider trading jurisprudence. Section II.A begins by analyzing the Second Circuit's legal reasoning and finds that precedent does not support the departure from the fiduciary duty requirement. Section II.B completes the analysis by discussing the policy-based concerns and practical implications of the Second Circuit's holding, both of which bolster the argument for weeding out *Dorozhko*.

A. *Doctrinal Analysis of the Second Circuit's Rationale in Dorozhko*

The disparate results of the district court and the Second Circuit in *Dorozhko* hinge on different interpretations of “deceptive” in Section 10(b).¹¹³ With no definition of “deceptive” contained within the statute, the district court adopted the view advanced by the Fifth Circuit Court of Appeals.¹¹⁴ In *Regents of the University of California v. Credit Suisse First Boston (USA), Inc.*,¹¹⁵ the Fifth Circuit compared the methods used by the Supreme Court for establishing meanings for different terms within Rule 10b-5.¹¹⁶ The Fifth Circuit noted that in *Ernst & Ernst v. Hochfelder*,¹¹⁷ the Supreme Court defined “device” as used in Section 10(b) by referring to the dictionary meaning of the word.¹¹⁸ In contrast, the Fifth Circuit recognized that the Supreme Court has refused to employ a similar method for defining “deceptive.”¹¹⁹ The Fifth Circuit declared that “by losing sight of the limits that the statute place[d] on the rule, and by ascribing, natural, dictionary definitions to the words of [Rule 10b-5] . . . courts have gone awry.”¹²⁰ The Fifth Circuit refused to commit the same error, instead looking exclusively to Supreme Court precedent in determining the meaning of “deceptive.”¹²¹ In doing so, the Fifth Circuit held that conduct “is not ‘deceptive’ unless it involves breach of some duty of candid disclosure.”¹²²

¹¹³ See *supra* Part I.B.

¹¹⁴ SEC v. *Dorozhko*, 606 F. Supp. 2d 321, 330 (S.D.N.Y. 2008), *vacated*, 547 F.3d 42 (2d Cir. 2009).

¹¹⁵ 482 F.3d 372 (5th Cir. 2007).

¹¹⁶ *Id.* at 389.

¹¹⁷ 425 U.S. 185 (1976).

¹¹⁸ *Credit Suisse*, 482 F.3d at 389 (internal quotation marks omitted).

¹¹⁹ *Id.* at 389 n.30.

¹²⁰ *Id.* at 387.

¹²¹ *Id.* at 389 (“[D]efining ‘deceptive’ by referring to the . . . dictionary . . . is improperly to substitute the authority of the dictionary for that of the Supreme Court.”). The court also rejected the use of the common law meaning of “deceptive.” *Id.* (internal quotation marks omitted) (“[W]here the Supreme Court has authoritatively construed the pertinent language of the statute . . . the common law meaning of that language is irrelevant.”).

¹²² *Id.*

In *Dorozhko*, the Second Circuit took the opposite view, specifically importing the ordinary meaning of “deceptive” to Section 10(b).¹²³ The Second Circuit substantiated this “straightforward” theory by citing its previous observation that “conduct prohibited under Section 10(b) and Rule 10(b)-5 ‘irreducibly entails some act that gives the victim a false impression.’”¹²⁴ And the Second Circuit also declared this rationale consistent with “the Supreme Court’s oft-repeated instruction that Section 10(b) ‘should be construed not technically and restrictively, but flexibly to effectuate its remedial purposes.’”¹²⁵

This Section shows why the Second Circuit’s “straightforward” theory of insider trading liability lacks a strong legal foundation. Subsection II.A.1 discusses what was missing from the Second Circuit’s opinion—analysis of precedent construing “manipulative”—and explains why this analysis supports the Fifth Circuit’s conclusion. Subsection II.A.2 scrutinizes the Second Circuit’s distinction between nondisclosure and affirmative misrepresentation and questions the application of that distinction to *Dorozhko*.

1. Ignoring Precedent on “Manipulative”

In *Dorozhko*, the Second Circuit was tasked with interpreting the meaning of “deceptive” as used in Section 10(b).¹²⁶ Although the appeal did not require the Second Circuit to examine “manipulative” as used in Section 10(b),¹²⁷ analysis of the methods used to define “manipulative” would have helped the court determine the appropriate way to define “deceptive” given the parallel use of the terms within the statute.¹²⁸ Yet the Second Circuit’s opinion contains no such analysis, perhaps because it works against the court’s ultimate conclusion.

As noted by the district court in *Dorozhko*, the Supreme Court in *Ernst & Ernst* construed “manipulative” as used in Section 10(b) “very narrowly.”¹²⁹ In *Ernst & Ernst*, the Supreme Court imported the dictionary definition when construing “device” as used in Section 10(b).¹³⁰ The Court has

¹²³ SEC v. *Dorozhko*, 574 F.3d 42, 50 (2d Cir. 2009) (citing WEBSTER’S NEW INTERNATIONAL DICTIONARY, *supra* note 109, at 679) (“In its ordinary meaning, ‘deceptive’ covers a wide spectrum of conduct involving cheating or trading in falsehoods.”).

¹²⁴ *Id.* (quoting *United States v. Finnerty*, 553 F.3d 143, 148 (2d Cir. 2008)).

¹²⁵ *Id.* at 49-50 (quoting *SEC v. Zandford*, 535 U.S. 813, 819 (2002)).

¹²⁶ *Id.* at 45-46 (internal quotation marks omitted).

¹²⁷ *Id.* at 46 n.3 (quoting *SEC v. Dorozhko*, 606 F. Supp. 2d 321, 329 (S.D.N.Y. 2008), *vacated*, 574 F.3d 42 (2d Cir. 2009)) (internal quotation marks omitted).

¹²⁸ See 15 U.S.C. § 78j (2006).

¹²⁹ *Dorozhko*, 606 F. Supp. 2d at 329 (citing *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 199 (1976)) (first internal quotation marks omitted).

¹³⁰ *Ernst & Ernst*, 425 U.S. at 199 n.20 (internal quotation marks omitted).

not used the same methods when construing the meaning of “deceptive;”¹³¹ however, in *Ernst & Ernst*, the Supreme Court did reference the dictionary definition when discussing “manipulative.”¹³² But, unlike its treatment of “device,” the Court only imported a small portion of the dictionary meaning for “manipulative.”¹³³ This approach—referring to the dictionary meaning but only a very specific portion—spawned uncertainty as to the meaning of “manipulative” in Section 10(b).¹³⁴ In *Sante Fe Industries, Inc. v. Green*,¹³⁵ the Supreme Court clarified the uncertainty by limiting the meaning of “manipulative” in Section 10(b) to practices that “are intended to mislead investors by artificially affecting market activity.”¹³⁶

Sante Fe did not completely eliminate the debate as to the meaning of “manipulative,”¹³⁷ and there are other issues underlying the interpretation of “manipulative” that cannot fully be addressed in this Note.¹³⁸ Supreme

¹³¹ See *supra* note 119 and accompanying text.

¹³² *Ernst & Ernst*, 425 U.S. at 199 & n.21 (citing WEBSTER’S NEW INTERNATIONAL DICTIONARY, *supra* note 109, at 1496) (internal quotation marks omitted).

¹³³ Compare *id.* at 199 n.20 (“[The dictionary] defines ‘device’ as ‘[t]hat which is devised, or formed by design; a contrivance; an invention; project; scheme; often, a scheme to deceive; a stratagem; an artifice’” (second alteration in original) (quoting WEBSTER’S NEW INTERNATIONAL DICTIONARY, *supra* note 109, at 679)), with *id.* at 199 n.21 (“[The dictionary] defines ‘manipulate’ as ‘to manage or treat artfully of fraudulently; as to *manipulate* accounts 4. *Exchanges*. To force (prices) up or down, as by matched orders, wash sales, fictitious reports . . . ; to rig.” (quoting WEBSTER’S NEW INTERNATIONAL DICTIONARY, *supra* note 109, at 1496)).

¹³⁴ See, e.g., *Sante Fe Indus., Inc. v. Green*, 430 U.S. 462, 471-74 (1977) (addressing a suit by shareholders claiming that corporate mismanagement constitutes “manipulative” under Section 10(b)).

¹³⁵ 430 U.S. 462 (1977).

¹³⁶ *Id.* at 476 (first internal quotation marks omitted).

¹³⁷ Compare, e.g., *Regents of Univ. of Cal. v. Credit Suisse First Bos. (USA), Inc.*, 482 F.3d 372, 391 (5th Cir. 2007) (“The fact that the Supreme Court’s definition of ‘manipulation’ is consistent with the dictionary’s does not mean that it is coextensive with it; ‘manipulation’ is a term of art, and it applies only to conduct that takes place directly within the market for the relevant security.”), with *id.* at 399 n.9 (Dennis, J., concurring) (“Reference to the common, dictionary definition is, incidentally, the approach that the Supreme Court has used to define the words ‘manipulative,’ ‘device,’ and ‘contrivance.’”).

¹³⁸ More recently than *Sante Fe*, the Supreme Court has used the dictionary to define “manipulative.” *Schreiber v. Burlington N., Inc.*, 472 U.S. 1, 7 & n.5 (1985) (citing WEBSTER’S THIRD NEW INTERNATIONAL DICTIONARY 1376 (1971)) (interpreting “manipulative” consistent with the “traditional dictionary definition” of “manipulation” as “management with the use of unfair, scheming or underhanded methods” (first and fourth internal quotation marks omitted)). *Schreiber* interpreted “manipulative” as used in Section 14(e) of the 1934 Act, which prohibits “fraudulent, deceptive, or manipulative acts or practices . . . in connection with any tender offer.” *Id.* at 2 (alteration in original) (quoting 15 U.S.C. § 78n(e) (1982)) (internal quotation marks omitted). The Second Circuit has distinguished *Schreiber* from Section 10(b) cases on the grounds that, while part of the same overarching statute as Section 10(b), Section 14(e) “evinces a clear indication of congressional intent, while section 10(b) does not.” *United States v. Chestman*, 947 F.2d 551, 561 (2d Cir. 1991) (en banc) (contrasting language in Section 10(b)—“in contravention of such rules and regulations as the [SEC] may prescribe,” with language in Section 14(e)—“the [SEC] shall . . . prescribe means reasonably designed to prevent, such acts and practices as are fraudulent, deceptive, or manipulative” (first and second alterations in original) (emphases added) (internal quotation marks omitted)).

Court precedent, however, has clearly interpreted “manipulative” as used in Section 10(b) more narrowly than the dictionary meaning of the word.¹³⁹ That Supreme Court precedent supports the Fifth Circuit’s conclusion that to “defin[e] ‘deceptive’ by referring to the . . . dictionary . . . is improperly to substitute the authority of the dictionary for that of the Supreme Court.”¹⁴⁰ Accordingly, the Second Circuit’s failure to analyze Supreme Court methods of construing “manipulative” undermines the validity of its use of the dictionary meaning when construing “deceptive” in Section 10(b).

2. Inadequately Distinguishing Affirmative Misrepresentation from Nondisclosure

The Second Circuit’s holding in *Dorozhko* relies on a purported distinction between nondisclosure in the context of a fiduciary duty and an affirmative misrepresentation to the source of the nonpublic information.¹⁴¹ The Second Circuit cited *Basic Inc. v. Levinson*,¹⁴² to support the proposition that “[e]ven if a person does not have a fiduciary duty to ‘disclose or abstain from trading,’ there is nonetheless an affirmative obligation in commercial dealings not to mislead.”¹⁴³ The Second Circuit’s use of *Basic* is flawed for two reasons.¹⁴⁴

First, *Basic* does not adequately support the Second Circuit’s rationale. The portion of *Basic* cited by the Second Circuit pertained to the standards of materiality under federal securities law, not the proper interpretation of “deceptive” in Section 10(b).¹⁴⁵ Moreover, in *Basic*, the Court noted a distinction between “insiders . . . trad[ing] in abrogation of their duty to disclose” and “affirmative misrepresentations by those under no duty to disclose (but under the ever-present duty not to mislead)” but ultimately treated it as a distinction without a difference.¹⁴⁶ The Court held that there is no basis for varying the materiality standard based on “who brings the action or whether insiders are alleged to have profited” because devising different standards of materiality for each situation would effectively reduce

¹³⁹ See *supra* notes 129-36 and accompanying text.

¹⁴⁰ *Credit Suisse*, 482 F.3d at 389.

¹⁴¹ SEC v. *Dorozhko*, 574 F.3d 42, 49 (2d Cir. 2009) (citing *Basic Inc. v. Levinson*, 484 U.S. 224, 240 n.18 (1988)).

¹⁴² 485 U.S. 224 (1988).

¹⁴³ *Dorozhko*, 574 F.3d at 49.

¹⁴⁴ See Elizabeth A. Odian, Note, SEC v. *Dorozhko*’s *Affirmative Misrepresentation Theory of Insider Trading: An Improper Means to a Proper End*, 94 MARQ. L. REV. 1313, 1331-39 (2011) (arguing that the Second Circuit improperly conflated rules governing non-disclosure cases with rules governing affirmative misrepresentation cases).

¹⁴⁵ *Basic*, 484 U.S. at 240 n.18.

¹⁴⁶ *Id.*

the materiality assessment to an analysis of the defendant's disclosure obligations.¹⁴⁷ The Second Circuit's characterization of *Basic* supports its holding but does not accurately portray *Basic*. Consequently, the Second Circuit overreached by relying on the distinction between nondisclosure and affirmative misrepresentation when construing "deceptive."

Second, even accepting the distinction between nondisclosure and affirmative misrepresentation noted in *Basic*, the Second Circuit erred in applying that distinction to the facts of *Dorozhko*.¹⁴⁸ *Basic* noted a dichotomy between those who "traded in abrogation of their duty to disclose or abstain" and those who were "under no duty to disclose (but under the ever-present duty not to mislead)."¹⁴⁹ The SEC did not contend that Dorozhko, a corporate outsider, had a pre-existing duty to disclose or abstain from trading;¹⁵⁰ and therefore, the Second Circuit could not apply the first category of *Basic*'s dichotomy.¹⁵¹ Instead, the Second Circuit implied that Dorozhko's conduct falls under *Basic*'s second category because the alleged computer hacking was purportedly an affirmative misrepresentation.¹⁵² The problem is that Dorozhko's alleged affirmative misrepresentation, the computer hacking, was only made to the source of the information, not the counterparty in a subsequent transaction.¹⁵³ Thus, Dorozhko's actions do not fall under either category of the *Basic* dichotomy.¹⁵⁴ He did not have a duty to disclose or abstain from trading, and he did not "mislead" the counterparty in the securities transaction.¹⁵⁵ To conflate the different factual scenarios seems to revive the "special facts" doctrine advocated by Justice Blackmun in his dissent in *Chiarella*, a theory explicitly rejected by the *Chiarella* majority.¹⁵⁶

¹⁴⁷ *Id.*

¹⁴⁸ See 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, 376 (2010) ("*Basic* may not be the best foundation to solely ground an affirmative misrepresentation without further elaboration, as it dealt with the difference between abrogation of a duty to disclose and affirmative representations by corporate insiders. This opens up the counterargument that insiders are always under an obligation not to mislead." (footnote omitted)).

¹⁴⁹ *Basic*, 485 U.S. at 240 n.18.

¹⁵⁰ See *SEC v. Dorozhko*, 574 F.3d 42, 45 (2d Cir. 2009).

¹⁵¹ See Doyle, *supra* note 148, at 376.

¹⁵² See *Dorozhko*, 574 F.3d at 49; see also Doyle, *supra* note 148, at 376.

¹⁵³ *Dorozhko*, 574 F.3d at 44-45.

¹⁵⁴ See Doyle, *supra* note 148, at 376. *But see id.* at 377-78 (arguing that case law does in fact support the Second Circuit's conclusion that an affirmative misrepresentation satisfies "deceptive" despite the absence of a fiduciary duty (internal quotation marks omitted)).

¹⁵⁵ See *Dorozhko*, 574 F.3d at 44-45.

¹⁵⁶ See *Chiarella v. United States*, 445 U.S. 222, 251 (1980) (Blackmun, J., dissenting); *id.* at 235 n.20 (majority opinion). *But see* Doyle, *supra* note 148, at 377-78 (arguing that notwithstanding *Basic*'s weak support for the Second Circuit's rationale, other Supreme Court precedent supports the Second Circuit's conclusion).

B. *Other Arguments Against the Second Circuit's Rationale in Dorozhko*

In addition to the criticisms of the Second Circuit's legal analysis discussed above, policy-based concerns and the practical implications of the Second Circuit's "straightforward" theory support the position that it should be weeded out from insider trading jurisprudence.

1. Policy-Based Concerns Implicated by *Dorozhko*

Debates regarding insider trading liability typically focus on where to draw the line on the continuum of legal standards between permissible and impermissible conduct under Section 10(b) and Rule 10b-5.¹⁵⁷ On one end of the continuum, the parity-in-information standard imposes a disclose-or-abstain duty on any person with an informational advantage over a counterparty in a securities transaction.¹⁵⁸ On the other end is the idea that insider trading is beneficial and, therefore, should not only be legal but encouraged.¹⁵⁹ Assessing the relative merits of drawing the line at different points on the continuum is beyond the scope of this Note. Nevertheless, in *Dorozhko*, the Second Circuit moved the line significantly closer to the parity-in-information end of the continuum by creating a completely new theory

¹⁵⁷ See Robert A. Prentice & Dain C. Donelson, *Insider Trading as a Signaling Device*, 47 AM. BUS. L.J. 1, 71 (2010) ("While it is extremely unlikely that current U.S. insider trading jurisprudence draws the line between permissible and impermissible insider (and outsider) trading at the optimal location, the boundaries currently in place have worked reasonably well since 1983 and the current legal regime's impact has generally been salutary."). Compare *Chiarella*, 445 U.S. at 233 ("[R]ecognizing a general duty between all participants in market transactions . . . departs radically from the established doctrine that duty arises from a specific relationship between two parties, [and] should not be undertaken absent some explicit evidence of congressional intent."), with *id.* at 251 (Blackmun, J., dissenting) ("I would hold that persons having access to confidential material information that is not legally available to others generally are prohibited by Rule 10b-5 from engaging in schemes to exploit their structural informational advantage through trading in affected securities.").

¹⁵⁸ See *Chiarella*, 445 U.S. at 252 n.2 (Blackmun, J., dissenting) (describing the parity-in-information standard); see also Kimberly D. Krawiec, *Fairness, Efficiency, and Insider Trading: Deconstructing the Coin of the Realm in the Information Age*, 95 NW. U. L. REV. 443, 466 n.102 (2001) (explaining that no one seriously advocates for parity-in-information). Slightly more moderate than the parity-in-information theory is the parity-in-access-to-information theory, which is analogous to Justice Blackmun's "special facts" theory. See *Chiarella*, 445 U.S. at 246, 251 (Blackmun, J., dissenting) ("I also would find the petitioner's conduct fraudulent within the meaning of § 10(b) of the Securities and Exchange Act of 1934 and the Securities Exchange Commission's Rule 10b-5 even if he had obtained the blessing of his employer's principals before embarking on his profiteering scheme. . . . I would hold that persons having access to confidential material information that is not legally available to others generally are prohibited by Rule 10b-5 from engaging in schemes to exploit their structural informational advantage through trading in affected securities." (citations omitted)).

¹⁵⁹ See generally HENRY G. MANNE, *INSIDER TRADING AND THE STOCK MARKET* (1966).

of insider trading liability.¹⁶⁰ Any movement closer to parity-in-information standard encroaches on territory that the Supreme Court has explicitly declared to be “without support in the legislative history of Section 10(b) and would be inconsistent with the careful plan that Congress has enacted for regulation of the securities markets.”¹⁶¹

The Second Circuit’s decision also implicates a perennial due process concern surrounding insider trading liability regulation.¹⁶² In *Chiarella*, the majority expressed caution towards applying a “new and different theory” for establishing insider trading liability,¹⁶³ stating that “a judicial holding that certain undefined activities ‘generally are prohibited’ by Section 10(b) would raise questions of whether either criminal or civil defendants would be given fair notice that they have engaged in illegal activity.”¹⁶⁴ In *O’Hagan*, the Supreme Court validated the “new and different theory” not accepted in *Chiarella* but specifically declined to discuss the defendant’s due process challenge.¹⁶⁵ Lower courts have generally rejected due process challenges to Section 10(b) actions¹⁶⁶ but the Second Circuit’s drastic departure from established insider trading jurisprudence in *Dorozhko* presents fertile soil for a due process challenge if followed in other courts.

2. Impractical Implications of *Dorozhko*

The practical implications of *Dorozhko* also cast doubt on the soundness of the decision. Recall that the Second Circuit remanded the case to the district court with instructions to determine whether Dorozhko’s hacking was perpetrated in a “deceptive” manner.¹⁶⁷ The Second Circuit opined that “[h]ackers either (1) engage in false identification and masquerade as another user . . . or (2) exploit a weakness in [an electronic] code within a program to cause the program to malfunction in a way that grants the user

¹⁶⁰ See SEC v. Dorozhko, 574 F.3d 42, 45 (2d Cir. 2009) (“[W]e recognize that the SEC’s claim against defendant—a corporate outsider who owed no fiduciary duties to the source of the information—is not based on either of the two generally accepted theories of insider trading.”); Doyle, *supra* note 148, at 382.

¹⁶¹ *Chiarella*, 445 U.S. at 235.

¹⁶² See Stephen M. Bainbridge, *Insider Trading Regulation: The Path Dependent Choice Between Property Rights and Securities Fraud*, 52 SMU L. REV. 1589, 1641 n.242 (1999); Coles, *supra* note 43, at 228 n.274; Jill E. Fisch, *Starting to Make Sense: An Analysis and Proposal for Insider Trading Regulation*, 26 GA. L. REV. 179, 181 (1991).

¹⁶³ *Chiarella*, 445 U.S. at 234.

¹⁶⁴ *Id.* at 235 n.20.

¹⁶⁵ *United States v. O’Hagan*, 521 U.S. 642, 676-77 (1997) (declining to decide whether Rule 14e-3(a) violated due process).

¹⁶⁶ Coles, *supra* note 43, at 235 n.309 (citing *United States v. Newman*, 664 F.2d 12, 19 (2d Cir. 1981), and *SEC v. Willis*, 777 F. Supp. 1165, 1173-74 (S.D.N.Y. 1991)).

¹⁶⁷ See *supra* note 109 and accompanying text.

greater privileges.”¹⁶⁸ The court declared that Category One hacking “plainly” falls within the ordinary meaning of “deceptive.”¹⁶⁹ The court did not reach a similar conclusion for Category Two hacking, stating instead that it was “unclear” whether that form of hacking would qualify as “deceptive.”¹⁷⁰ Despite this recognized lack of clarity, the Second Circuit provided no guidance as to how, on remand, the lower court should analyze a Category Two hack.¹⁷¹ The negative implications of this aspect of the Second Circuit’s analysis are threefold.

First, under the Second Circuit’s regime, over-burdened courts now have the added task of assessing the validity of allegations of affirmative misrepresentations for claims arising out of federal securities laws.¹⁷² As alluded to in the now-overruled district court opinion, the Second Circuit’s removal of the fiduciary duty requirement eliminates a bright-line rule used by courts, regulators, and even market participants.¹⁷³ Under the Second Circuit’s rationale, courts are without the benefit of a bright-line rule and consequently are required to conduct a more onerous review of matters due to a mere allegation that conduct was perpetrated in a “deceptive” manner.¹⁷⁴

Second, the Second Circuit’s binary framework seems simple enough; however, it gives rise to analytic uncertainty because not every permutation of hacking fits neatly into either of the two categories.¹⁷⁵ For example, a

¹⁶⁸ SEC v. Dorozhko, 574 F.3d 42, 51 (2d Cir. 2009) (alterations in original) (quoting Opening Brief of the SEC at 22-23, SEC v. Dorozhko, 574 F.3d 42 (2d Cir. 2009) (No. 08-0201-CV)) (internal quotation marks omitted). For the purposes of this Note, “Category One” will refer to the former, and “Category Two” will refer to the latter.

¹⁶⁹ *Id.* (second internal quotation marks omitted).

¹⁷⁰ *Id.* (second internal quotation marks omitted).

¹⁷¹ *Id.*

¹⁷² See, e.g., *In re Bank of Am. Corp. Sec., Derivative, & Emp’t Ret. Income Sec. Act (ERISA) Litig.*, 757 F. Supp. 2d 260, 287-88 (S.D.N.Y. 2010) (finding an “absence of a plausible allegation for a fiduciary relationship” and dismissing allegations based on the fiduciary relationship but nonetheless proceeding with the onerous Private Securities Litigation Reform Act (“PSLRA”) and Rule 9(b) analysis because, “[i]n light of . . . *Dorozhko*,” the complaint also alleged the making of false or misleading statements).

¹⁷³ SEC v. Dorozhko, 606 F. Supp. 2d 321, 343 (S.D.N.Y. 2008), *vacated*, 574 F.3d 42 (2d Cir. 2009).

¹⁷⁴ See *Bank of America*, 757 F. Supp. 2d at 288 (“In light of *Chiarella* and *Dorozhko*, and the Securities Complaint’s absence of a plausible allegation for a fiduciary relationship running from Thain and Merrill to [Bank of America (“BofA”)] shareholders, plaintiffs’ Section 10(b) and Rule 10b-5 claims are dismissed to the extent that they are based on allegedly material omissions and the breach of a duty to disclose. . . . To the extent that the plaintiffs allege that Thain and Merrill were responsible for false and misleading statements to BofA shareholders, however, *Dorozhko* holds that no fiduciary obligation is necessary to proceed with such claims. The motion to dismiss plaintiffs’ Section 10(b) and Rule 10b-5 claims arising out of such statements by Merrill or Thain is denied. Whether plaintiffs have sufficiently alleged fraud under the PSLRA and Rule 9(b) as to any allegedly false and misleading statement is addressed below.”).

¹⁷⁵ See *Hazen*, *supra* note 42, at 901-02 & n.109.

denial-of-service attack (“DoS attack”) occurs when a hacker overwhelms the resources of a computer or server which in turn grants the hacker unlimited access to the victim computer or server.¹⁷⁶ A distributed denial-of-service attack (“DDoS attack”) can be used to accomplish the same ends; but, with a DDoS attack, instead of directly overwhelming the computer or server, the hacker uses unsuspecting third-party “zombie” computers to bombard the target computer or network.¹⁷⁷ A hacker can employ a variety of means to hijack the “zombie” computers, some of which would fall under Category One and some which would fall under Category Two.¹⁷⁸ Although debatable, a DoS attack would probably fall within the “unclear” Category Two. Even more uncertainty arises as to the proper method of analysis of a DDoS attack given the additional question of how the hacker gained control of the “zombie” computers.

Extending the dichotomy to acts of theft outside of the computer hacking context further illustrates the deficiency in this binary framework.¹⁷⁹ Suppose that, instead of hacking in himself, Dorozhko had paid someone else to break into the office and steal physical files. The hired thief could have masqueraded as an employee to gain access or could have exploited a weakness in the office’s security, such as an unlocked door.¹⁸⁰ If the hired thief gained access by exploiting an unlocked door, the Second Circuit probably would have found that the hired thief, and *a fortiori* Dorozhko, had not acted in a deceptive manner. But if the thief masqueraded as an employee, would the hired thief’s deception have been imputed to Dorozhko? The Second Circuit offers no guidance.

Finally, the Second Circuit’s proposed analysis is formalistic—not substantive—and thus could yield different liability for the same substantive act.¹⁸¹ If hackers were truly concerned about Section 10(b) liability, they would simply chose to execute their hacks in a non-deceptive manner and thus be beyond the reach of the Second Circuit’s “straightforward” theory of insider trading liability.¹⁸² The Second Circuit’s holding allows

¹⁷⁶ Charlotte Decker, Note, *Cyber Crime 2.0: An Argument to Update the United States Criminal Code to Reflect the Changing Nature of Cyber Crime*, 81 S. CAL. L. REV. 959, 966 (2008).

¹⁷⁷ *Id.* at 966-67.

¹⁷⁸ See Jonathan A. Ophardt, *Cyber Warfare and the Crime of Aggression: The Need for Individual Accountability on Tomorrow’s Battlefield*, 2010 DUKE L. & TECH. REV. 3, ¶ 5 (2010), available at <http://www.law.duke.edu/journals/dltr/articles/2010dltr003.html>.

¹⁷⁹ See Howard W. Goldstein, ‘Outsiders’ as ‘Insiders’: *Recent Insider Trading Cases*, N.Y. L.J., Sept. 3, 2009, at 5, 5 (noting hypothetical situations not easily addressed by the Second Circuit’s affirmative misrepresentation analysis).

¹⁸⁰ *See id.*

¹⁸¹ See Hazen, *supra* note 42, at 902 (“The *Dorozhko* court’s rationale leads to uneven results in two fact situations involving wrongdoing that have the same impact on the securities markets.”).

¹⁸² See Silane, *supra* note 104, at 364 (noting that following the district court’s decision in *Dorozhko*, there were internet postings advertising the apparent impunity for hackers-turned-traders). There is

two hackers—both of whom obtained the same nonpublic information, traded on the same information, and realized the same profits—to potentially have different liability under Rule 10b-5 based merely on the form of their hack.¹⁸³ Consequently, whatever deterrent effect the Second Circuit’s approach might have would be short-lived.

III. SOLUTION

Under the classical theory of insider trading liability, a corporate insider’s nondisclosure of material nonpublic information to a counterparty in a securities transaction qualifies as “deceptive” because of the fiduciary relationship between a corporate officer and his or her shareholders.¹⁸⁴ Under the misappropriation theory, a corporate outsider’s breach of a pre-existing fiduciary duty between the corporate outsider and the source of the nonpublic information satisfies the “deceptive” requirement for Section 10(b).¹⁸⁵ The Second Circuit’s new, “straightforward” theory of insider trading liability removes a step by connecting the defendant’s actions directly to the “deceptive” requirement.¹⁸⁶ This new approach is problematic for the reasons discussed above.¹⁸⁷

This Part advocates for an alternative approach: the constructive breach theory. The constructive breach theory would have allowed the Second Circuit to still find Dorozhko liable but would not have deviated from the well-established fiduciary duty requirement of insider trading liability. Section III.A begins by explaining the constructive breach theory, which is a cross-pollination of the heirloom theory advanced in Chief Justice Burger’s dissent in *Chiarella* with the principles governing constructive trusts. Application of the constructive breach theory to the facts of *Dorozhko* and other scenarios follows in Section III.B, demonstrating why the constructive breach theory should be cultivated in place of the Second Circuit’s “straightforward” theory. Finally, Section III.C identifies and addresses possible criticisms of the proposed alternative framework.

nothing preventing similar internet postings from publicizing the Second Circuit’s deceptive/non-deceptive hacking distinction.

¹⁸³ See *supra* note 181 and accompanying text.

¹⁸⁴ See *supra* Part I.A.

¹⁸⁵ See *supra* Part I.A.

¹⁸⁶ See *supra* Part I.B.

¹⁸⁷ See *supra* Part II.A-B.

A. *A Well-Adapted Solution to a Unique Problem: The Constructive Breach Theory*

During the development of the misappropriation theory, some advocated for basing Section 10(b) liability on wrongdoing.¹⁸⁸ In his dissent in *Chiarella*, Chief Justice Burger advocated for a theory of insider trading liability that encompasses anyone who trades on nonpublic information acquired by some unlawful means.¹⁸⁹ Chief Justice Burger's theory would establish an "absolute duty" between one who obtains nonpublic information through unlawful means and the parties with whom that person subsequently trades.¹⁹⁰ Under this theory, an informational advantage obtained through an unlawful act creates a duty to disclose or abstain, and the breach of that duty operates as "deceptive" under Section 10(b).¹⁹¹ Consideration of this theory was punted by the majority in *Chiarella*¹⁹² and not addressed in *O'Hagan*.¹⁹³

Like Chief Justice Burger's theory, the constructive breach theory requires some unlawful act. But, unlike Chief Justice Burger's theory, which creates a duty between the wrongdoer and the subsequent counterparty to the securities transaction, the constructive breach theory frames the duty between the wrongdoer and the victim of the wrongful act (i.e., the source of the nonpublic information).¹⁹⁴ To reframe the duty, the constructive breach theory relies on principles governing constructive trusts.¹⁹⁵ A constructive trust is an equitable device that compels one who wrongfully holds a property interest to convey that interest to the rightful owner.¹⁹⁶ For the

¹⁸⁸ See *Chiarella v. United States*, 445 U.S. 222, 240 (1980) (Burger, C.J., dissenting) ("Any time information is acquired by an illegal act it would seem there should be a duty to disclose that information." (emphasis omitted) (quoting W. Page Keeton, *Fraud—Concealment and Non-Disclosure*, 15 TEX. L. REV. 1, 25-26 (1936)) (internal quotation mark omitted)); see also *id.* at 239 (Brennan, J., concurring) (endorsing Chief Justice Burger's theory but agreeing with the majority that such a theory was not presented to the jury).

¹⁸⁹ *Id.* at 240 (Burger, C.J., dissenting).

¹⁹⁰ *Id.*

¹⁹¹ *Id.* at 239-40 ("As a general rule, neither party to an arm's-length business transaction has an obligation to disclose information to the other unless the parties stand in some confidential or fiduciary relation. . . [but] the rule should give way when an information advantage is obtained, not by superior experience, foresight, or industry, but by some unlawful means.").

¹⁹² *Id.* at 237 n.21 (majority opinion) (acknowledging Chief Justice Burger's theory but concluding that such a theory was not submitted to the jury).

¹⁹³ *United States v. O'Hagan*, 521 U.S. 642, 655 n.6 (acknowledging the theory contained in Chief Justice Burger's *Chiarella* dissent but noting that the government does not propose that theory in *O'Hagan*); see also Odian, *supra* note 144, at 1348.

¹⁹⁴ See LANGEVOORT, REGULATION, *supra* note 24, § 6:14, at 6-50 to -51; cf. Langevoort, *Fiduciary Principle*, *supra* note 24, at 30-31 (framing the duty element in tippee liability as the trader-tippee's constructive breach of the insider-tipper's duty to disclose or abstain).

¹⁹⁵ See LANGEVOORT, REGULATION, *supra* note 24, § 6:14 n.5, at 6-51.

¹⁹⁶ See YZENBAARD ET AL., *supra* note 28, § 471, at 2.

purposes of this discussion, the term “wrongfully” encompasses “unlawful” behavior as used in Chief Justice Burger’s theory.¹⁹⁷

Under the constructive breach theory, one who wrongfully obtains nonpublic information from another holds the proceeds of such misappropriation in a constructive trust for the benefit of the source of the information.¹⁹⁸ The wrongdoer is sometimes referred to as a trustee *ex maleficio*.¹⁹⁹ The constructive trust gives rise to a fiduciary duty, which is then breached by the wrongdoer’s nondisclosure of any intent to use the wrongfully acquired property.²⁰⁰ A breach of the duty owed to the source of the information thereby operates as “deceptive” under the misappropriation theory of insider trading liability.²⁰¹

The Supreme Court has not considered the constructive breach theory.²⁰² The Second Circuit also has not considered the constructive breach theory because the SEC did not advance the argument on appeal.²⁰³

The combination of several factors warrants the addition of the constructive breach theory to insider trading jurisprudence. First, as the string

¹⁹⁷ See *id.* at 2-3 (explaining that a constructive trust compels “one who unfairly holds a property interest . . . hav[ing] obtained the property interest by unjust, unconscionable, or unlawful means” to convey that property interest to the rightful owner).

¹⁹⁸ See LANGEVOORT, REGULATION, *supra* note 24, § 6:14 n.5, at 6-51. Concededly, there is a distinction between a non-tangible good such as information and tangible goods such as real or personal property. See James Boyle, *The Second Enclosure Movement and the Construction of the Public Domain*, 66 LAW & CONTEMP. PROBS. 33, 41 (2003) (“Unlike the earthy commons, the commons of the mind is generally ‘non-rival.’ Many uses of land are mutually exclusive. If I am using the field for grazing, it may interfere with your plans to use it for growing crops. By contrast, a gene sequence, an MP3 file, or an image may be used by multiple parties; my use does not interfere with yours.”). Unlike conversion of real or personal property, which necessarily excludes the rightful owner from possession, conversion of information does not exclude the rightful owner. *Id.* For the purposes of this Note, the distinction is moot, and such treatment is consistent with Supreme Court precedent. See *Carpenter v. United States*, 484 U.S. 19, 26 (1987) (“Confidential business information has long been recognized as property.”); see also *O’Hagan*, 521 U.S. at 654 (referencing statement made by counsel for Government at oral argument that “[t]o satisfy the common law rule . . . a trustee may not use the property that [has] been entrusted [to] him, [without] consent” (third and fourth alterations in original) (internal quotation marks omitted)); Nagy, *supra* note 93, at 1271 (explaining that in *O’Hagan*, the Supreme Court’s rationale for the misappropriation theory shifted away from the market integrity rationale to one of protecting a property right in nonpublic information).

¹⁹⁹ Black’s Law Dictionary defines “ex maleficio” as “by malfeasance.” BLACK’S LAW DICTIONARY, *supra* note 94, at 615; see also *United States v. Reed*, 601 F. Supp. 685, 700 (S.D.N.Y.) (“The misappropriator thus becomes the trustee *ex maleficio* . . . of the entrustor.”), *rev’d on other grounds*, 773 F.2d 477 (2d Cir. 1985).

²⁰⁰ See YZENBAARD ET AL., *supra* note 28, § 543, at 217.

²⁰¹ See *supra* Part I.A.

²⁰² See *supra* notes 192-93 and accompanying text.

²⁰³ The SEC did advance the constructive breach theory in its Posthearing Memorandum of Law filed with the district court. *SEC v. Dorozhko*, 606 F. Supp. 2d 321, 336 n.10 (S.D.N.Y. 2008), *vacated*, 574 F.3d 42 (2d Cir. 2009). For discussion of the district court’s treatment of the constructive-breach theory, see *infra* Part III.C.

of recent news articles on insider trading investigations reveals, insider trading remains a threat to the integrity of our nation's securities markets.²⁰⁴ Second, insider trading has significant costs as evidenced by an empirical study conducted in the late 1990s showing that illegal insider trading activities caused a 30 percent increase in the takeover premia paid by acquiring companies.²⁰⁵ Third, as evidenced by the facts of *Dorozhko*, technology has made nonpublic information increasingly accessible to true outsiders.²⁰⁶ Fourth, remedies available under other laws may not be sufficient to deter this hacking-and-trading misconduct.²⁰⁷ Finally, there is an emerging academic consensus that insider trading liability should encompass those who trade using wrongfully obtained nonpublic information.²⁰⁸

Together, these developments support the result of the Second Circuit's holding in *Dorozhko* but not the court's analysis. The constructive breach theory would have allowed the court to reach the same end without such a radical departure from existing insider trading jurisprudence.

Despite the victory in *Dorozhko*, the SEC should advance a constructive breach theory when bringing enforcement actions against persons who trade using nonpublic information—that they obtained unlawfully—but who were not breaching a traditionally recognized fiduciary duty.

B. *Applying the Constructive Breach Theory*

The district court in *Dorozhko* acknowledged the tension between the “unfairness inherent in [Dorozhko's actions]” and the current interpretation of the misappropriation theory of insider trading liability.²⁰⁹ The constructive breach theory would reduce that tension. The analysis below applies the constructive breach theory to different factual scenarios based on actual

²⁰⁴ See, e.g., Susan Pulliam et al., *Hedge Funds Raided in Probe: FBI Agents Seize Documents in 3 Cities as Insider-Trading Investigation Widens*, WALL ST. J., Nov. 26, 2010, at A-1 (discussing the raids of offices of three hedge funds); Michael Rothfeld et al., *With Insider Crackdown, Galleon Probe Bears Fruit*, WALL ST. J., Nov. 26, 2010, at C-1 (discussing an arrest related to the investigation into alleged insider trading activities involving hedge funds, corporate insiders, and the so-called “expert network” firms who introduce corporate insiders to funds seeking “an investing edge” (first internal quotation marks omitted)).

²⁰⁵ Lisa K. Meulbroek & Carolyn Hart, *The Effect of Illegal Insider Trading on Takeover Premia*, 1 EUR. FIN. REV. 51, 75-76. (1997).

²⁰⁶ Silane, *supra* note 104, at 363.

²⁰⁷ See Geeraerts, *supra* note 23, at 278-79 (noting the gap between the penalties for mail fraud, wire fraud, and computer fraud and the financial gains from the proscribed conduct).

²⁰⁸ See, e.g., LANGEVOORT, REGULATION, *supra* note 24, § 6:14 n.5, at 6-51; Coles, *supra* note 43, at 221; Hazen, *supra* note 42, at 914; Prentice, *supra* note 93, at 301; Steinbuch, *supra* note 21, at 591-92.

²⁰⁹ SEC v. *Dorozhko*, 606 F. Supp. 2d 321, 341 (S.D.N.Y. 2008) (internal quotation marks omitted), *vacated*, 574 F.3d 42 (2d Cir. 2009); see also *Chiarella v. United States*, 445 U.S. 222, 232 (1980) (“[N]ot every instance of financial unfairness constitutes fraudulent activity under § 10(b).”).

cases or hypothetical situations. The results highlight why the constructive breach theory should be cultivated in place of the Second Circuit's "straightforward" theory.

1. Hackers

In this scenario, as occurred in *Dorozhko*, a true corporate outsider hacks into a computer network, obtains nonpublic information, and trades using the information without first informing the information's source.²¹⁰ Hacking constitutes a wrongful act because it is unlawful.²¹¹ Applying the constructive trust theory, as a wrongful act, hacking creates a constructive trust and a corresponding fiduciary relationship between the hacker and the victim as to the property concerned (i.e. the nonpublic information).²¹² If the hacker fails to disclose to the victim that he intends to use the nonpublic information and trades anyway, he has breached the fiduciary duty to the victim.²¹³ A breach of a fiduciary duty to the source of nonpublic information satisfies the "deceptive" element of a Rule 10b-5 violation under the misappropriation theory.²¹⁴ Thus, using the constructive breach theory, the Second Circuit would have found *Dorozhko* liable for insider trading.

The constructive breach theory would similarly apply to the Category One and Category Two hacking—provided the hacking comports with the legal standards for liability under the applicable federal statutes—thereby avoiding the analytic uncertainty of the Second Circuit's approach.²¹⁵ Also, in contrast to the Second Circuit's rationale, the constructive breach theory is based on a substantive, not formalistic, distinction which eliminates the threat that two hackers—who performed, in substance, the same illegal act with the same illicit gains—could be found to have different levels of culpability based merely on the form of their hack.²¹⁶ And, the constructive breach theory is derivative of the misappropriation theory, not independent, so courts retain the bright-line rule of a fiduciary duty.²¹⁷ Concededly, the constructive breach theory requires courts to consider whether or not the defendant's gain of the nonpublic information involves unlawful conduct.

²¹⁰ *E.g.*, *Dorozhko*, 606 F. Supp. 2d at 325-26.

²¹¹ *See id.* at 324 ("Based on the evidence provided at the November 28, 2007 hearing there would appear to be sufficient basis to conclude that *Dorozhko*'s hack violated the Computer Fraud and Abuse Act, the mail fraud statute, and the wire fraud statute." (citations omitted)).

²¹² *See supra* note 198 and accompanying text.

²¹³ *See supra* note 200 and accompanying text.

²¹⁴ *See supra* note 201 and accompanying text.

²¹⁵ *But see supra* Part II.B.2 (criticizing the analytic uncertainty of the Second Circuit's approach).

²¹⁶ *See supra* notes 181-83 and accompanying text.

²¹⁷ *But see supra* Part II.B.2 (criticizing the Second Circuit's approach for removing the bright-line rule of the duty requirement).

Yet that task is simpler than divining whether the defendant's conduct was "deceptive" under the Second Circuit's murky guidance.

2. "Mere Thieves"²¹⁸

In this scenario, a thief breaks into an office, steals physical files containing nonpublic information, and trades using that information without informing the source of the information.²¹⁹ Similar to the Hackers scenario, the act of theft constitutes a wrongful act because it is unlawful.²²⁰ As in the Hackers scenario, the unlawful conduct would thus create a constructive trust, establishing a fiduciary duty between the thief and the victim as to the stolen property.²²¹ Using the nonpublic information to trade without informing the victim constitutes a breach of the fiduciary duty.²²² Hence, the thief's breach of that fiduciary duty is "deceptive" under the misappropriation theory of insider trading liability.²²³

3. Theft in the Context of a Pre-Existing Fiduciary Relationship

In this scenario, the thief has a pre-existing, traditionally recognized fiduciary duty to the victim. A variation of the facts of *O'Hagan* illustrates this scenario: an employee of a law firm steals nonpublic information pertaining to one of the law firm's clients and subsequently uses that information to purchase securities without disclosing this to the law firm.²²⁴ The constructive breach theory does not supplant established misappropriation theory precedent.²²⁵ Thus, by using the nonpublic information in connection with securities transactions without first disclosing that use to the source of the information, the employee violates the pre-existing employee-employer fiduciary relationship, which satisfies the "deceptive" requirement of Rule 10b-5.²²⁶ The constructive breach theory merely would provide another method of establishing a breach of a fiduciary duty if the circumstances of the misappropriation were themselves wrongful (i.e., the employee stole physical files from a co-worker's office).

²¹⁸ See generally Steinbuch, *supra* note 21.

²¹⁹ *Id.* at 593.

²²⁰ See National Stolen Property Act, 18 U.S.C. § 2314 (2006).

²²¹ See *supra* note 198 and accompanying text.

²²² See *supra* note 200 and accompanying text.

²²³ See *supra* note 201 and accompanying text.

²²⁴ *E.g.*, *United States v. O'Hagan*, 521 U.S. 642, 647-48 (1997).

²²⁵ See *supra* notes 201-03 and accompanying text.

²²⁶ See *supra* Part I.A (discussing the misappropriation theory).

4. Theft in the Context of a Terminated Fiduciary Relationship

In this scenario, the thief previously owed a fiduciary duty to the victim but that relationship ended prior to the theft. In *SEC v. Cherif*,²²⁷ an employee falsified a memo which allowed him to keep his employee access card beyond the termination date of his employment.²²⁸ After his termination, the defendant used the access card to steal nonpublic information that he then used in connection with securities transactions.²²⁹ Under the constructive breach theory, the previous fiduciary relationship is irrelevant because it is not necessary to establish liability.²³⁰ In essence, this scenario is no different from the “Mere Thieves” scenario discussed above. So long as the conduct used to obtain the nonpublic information was wrongful, it would be sufficient to establish a new fiduciary relationship through the creation of a constructive trust.²³¹ Thus, the former-employee-turned-thief’s use of that information without disclosure to the source constitutes a breach of a fiduciary duty and, thereby, qualifies as “deceptive.”²³²

In *Cherif*, the Seventh Circuit upheld the lower court’s finding of insider trading liability under the misappropriation theory.²³³ The Seventh Circuit concluded that the facts of the case supported liability under the misappropriation theory by holding that an employee’s obligation to protect confidential information continues past termination of employment arrangement.²³⁴ At least one commentator has questioned the validity of that reasoning,²³⁵ and at least one federal court construing state law has reached

²²⁷ 933 F.2d 403 (7th Cir. 1991).

²²⁸ *Id.* at 406.

²²⁹ *Id.* at 406-07.

²³⁰ See *supra* note 198 and accompanying text.

²³¹ See *supra* note 198 and accompanying text.

²³² See *supra* notes 200-01 and accompanying text.

²³³ *Cherif*, 933 F.2d at 411-12.

²³⁴ *Id.* at 411.

²³⁵ See Christopher D. Jones, Note, *The Misappropriation Theory of Rule 10b-5: The Ultimate Deception*, 23 J. CONTEMP. L. 439, 458 (1997) (“Given that Cherif was no longer an employee of the bank and therefore no longer had a duty or relationship of trust to violate, it appears that the *Cherif* court misapplied the misappropriation theory.”) The court in *Cherif* did not find the distinction persuasive. See *Cherif*, 933 F.2d at 411 (noting that while the defendant acquired some of the nonpublic information after his employment, he received the key and knowledge of how to access the information during his employment). The imprecision of this rationale has been decried as “the-ankle-bone-is connected-to-the-hip-bone logic” characteristic of the “absurd results that follow when statutory interpretation is replaced by policy justifications.” Michael P. Kenny & Teresa D. Thebaut, *Misguided Statutory Construction to Cover the Corporate Universe: The Misappropriation Theory of Section 10(b)*, 59 ALB. L. REV. 139, 201 (1995) (first internal quotation marks omitted). What result if *Cherif* never had access to nonpublic information during his employment and, instead of falsifying a memo to retain the key card, stole another employee’s key card after he was fired? Would the mere knowledge that his former employer possesses nonpublic information be sufficient to find liability premised on the breach of a fiduciary duty?

the opposite conclusion.²³⁶ Supplementing the misappropriation theory with the constructive breach theory would reduce the need for courts to stretch the traditionally recognized fiduciary duties in order to find liability.

5. Brazen Thieves²³⁷

In this scenario, start with the same facts of either the Hackers or Mere Thieves scenarios but suppose that the hacker or thief disclosed to the victim an intent to trade using the nonpublic information.²³⁸ Even accepting the constructive breach theory, there is no breach of the fiduciary duty established by the constructive trust if there was full, upfront disclosure between the parties.²³⁹ Thus, under the Hackers scenario, if Dorozhko had sent an email to the victim of his hacking—or under the Mere Thieves scenario, if the thief left a note—disclosing the intent to trade using the obtained nonpublic information, there would be no breach of the fiduciary duty. With no breach of the fiduciary duty, the action is not “deceptive” and, therefore, not in violation of Rule 10b-5.²⁴⁰

This deficiency is a limitation of the constructive breach theory, but is immaterial in assessing its validity for two reasons. First, this deficiency is not exclusive to the constructive breach theory. Instead, it is a recognized deficiency of the entire misappropriation theory, a deficiency that was explicitly acknowledged by the Supreme Court in *O’Hagan*.²⁴¹ Commentators have also noted that under the misappropriation theory, a “brazen fiduciary” who informs the source of the nonpublic information of his intent to trade using such information circumvents the “deceptive” requirement of Rule 10b-5 liability.²⁴² Second, whatever limitation this scenario exemplifies is

Cherif and the proposed hypothetical variants exemplify the tough factual scenarios that are not easily addressed by the traditional version of the misappropriation theory.

²³⁶ See *Dames & Moore v. Baxter & Woodman, Inc.*, 21 F. Supp. 2d 817, 823 (N.D. Ill. 1998) (construing Illinois law).

²³⁷ Cf. Nagy, *supra* note 12, at 1344-45 (discussing how the misappropriation theory would treat a “brazen fiduciary”).

²³⁸ Cf. *id.*; see also *SEC v. Zandford*, 535 U.S. 813, 825 n.4 (2002) (“[O]ur analysis does not transform every breach of fiduciary duty into a federal securities violation. If, for example, a broker embezzles cash from a client’s account . . . the fraud would not include the requisite connection to a purchase or sale of securities. Likewise, if the broker told his client he was stealing the client’s assets, that breach of fiduciary duty might be in connection with a sale of securities, but it would not involve a deceptive device or fraud.” (citation omitted)).

²³⁹ *Zandford*, 535 U.S. at 825 n.4.

²⁴⁰ See *supra* note 201 and accompanying text.

²⁴¹ *United States v. O’Hagan*, 521 U.S. 642, 655 (1997) (“Because the deception essential to the misappropriation theory involves feigning fidelity to the source of information, if the fiduciary discloses to the source that he plans to trade on the nonpublic information, there is no ‘deceptive device’ and thus no § 10(b) violation . . .”); see also *Zandford*, 535 U.S. at 825 n.4.

²⁴² E.g., Nagy, *supra* note 12, at 1344 (internal quotation marks omitted).

merely theoretical.²⁴³ Hacking and theft both give rise to liability for other offenses apart from insider trading.²⁴⁴ Thus, it is doubtful that hackers or thieves would provide such disclosures because it could determinatively establish liability for these other offenses and, at the very least, would aid in their prosecution.

C. *Identifying and Addressing Objections to the Constructive Breach Theory*

The constructive breach theory is not free from criticism. In its Posthearing Memorandum of Law before the district court, the SEC advanced the constructive breach theory, arguing that Dorozhko did in fact breach a fiduciary duty because he was a trustee *ex maleficio*.²⁴⁵ The *Dorozhko* district court rejected that argument on two grounds.²⁴⁶ First, the court stated that adopting the SEC's theory would "resurrect" the explicitly rejected "special facts" doctrine contained in Justice Blackmun's *Chiarella* dissent.²⁴⁷ Second, the court stated the Supreme Court has "squarely rejected" the trustee *ex maleficio* concept.²⁴⁸ Each criticism is addressed, and rejected, in turn.²⁴⁹

1. The Purported Resurrection of Justice Blackmun's Dissent

The *Dorozhko* district court rejected the SEC's constructive breach theory, claiming that validation of that theory would "resurrect" Justice

²⁴³ See HAZEN, *supra* note 9, at 287 (describing that under the abstain-or-disclose rule for corporate insiders, "disclosure is not a reasonable option").

²⁴⁴ See *supra* notes 211, 220 and accompanying text.

²⁴⁵ Posthearing Memorandum of Law in Support of Plaintiff Securities and Exchange Commission's Motion for Preliminary Injunction and Other Equitable Relief and in Opposition to Defendant Dorozhko's Motion to Dismiss at 16-17, SEC v. Dorozhko, 606 F. Supp. 2d 321 (S.D.N.Y. 2008) (No. 07 CV 9606), *vacated*, 574 F.3d 42 (2d Cir. 2009).

²⁴⁶ *Dorozhko*, 606 F. Supp. 2d at 336 n.10.

²⁴⁷ *Id.*

²⁴⁸ *Id.* ("It is not enough that, by the very act of wrongdoing out of which the contested debt arose, the bankrupt has become chargeable as a trustee *ex maleficio*. He must have been a trustee before the wrong and without reference thereto." (quoting *Davis v. Aetna Acceptance Co.*, 293 U.S. 328, 333 (1934)) (internal quotation marks omitted)).

²⁴⁹ The potential criticisms and the discussion that follows are not meant to be exhaustive. For example, validating new theories for establishing liability under Rule 10b-5 raises due process concerns. See discussion *supra* Part II.B.1. As is true for the Second Circuit's "straightforward" theory, the constructive breach theory similarly implicates due process concerns. Nonetheless, by working within the established principles of misappropriation theory precedent, a due process challenge of the constructive breach theory would be weaker than a due process challenge to the Second Circuit's rationale.

Blackmun's *Chiarella* dissent.²⁵⁰ In *Chiarella*, Justice Blackmun would have extended the "special facts" doctrine to affirm the defendant's conviction.²⁵¹ The "special facts" doctrine, Justice Blackmun observed, "has been prominent in cases involving confidential or fiduciary relations . . . as well as in cases where one party is on notice that the other is 'acting under a mistaken belief with respect to a material fact.'"²⁵² Justice Blackmun concluded that anyone who exploits a "structural information advantage" in connection with trading securities violates Rule 10b-5, regardless of whether or not such exploitation was conducted in a wrongful or unlawful manner.²⁵³ The *Chiarella* majority explicitly rejected Justice Blackmun's theory because it would create a "general duty between all participants in market transactions" that neither the language nor the legislative history of Section 10(b) supports.²⁵⁴ Equating the constructive breach theory and Justice Blackmun's dissent, however, is incorrect because of differences in the scope and operation of the two theories.

First, the scope of the constructive breach theory is not as broad as Justice Blackmun's theory. Justice Blackmun's dissent focused on parity in "access to information" and declared that any exploit of a disparity in access would constitute a violation of Rule 10b-5.²⁵⁵ In contrast, the constructive breach theory is limited to instances where nonpublic information was acquired in a wrongful manner.²⁵⁶ In this respect, the constructive breach theory is more similar to Chief Justice Burger's *Chiarella* dissent than to Justice Blackmun's.²⁵⁷ While Chief Justice Burger's formulation of the misappropriation theory ultimately was not the formulation adopted by the Supreme Court, it was not explicitly rejected either.²⁵⁸ Justice Blackmun's theory, on the other hand, was.²⁵⁹

The second distinction between Justice Blackmun's dissent and the constructive breach theory concerns how the two theories operate. Justice Blackmun premised liability upon the breach of a disclose-or-abstain duty

²⁵⁰ *Dorozhko*, 606 F. Supp. 2d at 336 n.10.

²⁵¹ *Chiarella v. United States*, 445 U.S. 222, 251 (1980) (Blackmun, J., dissenting) ("I would hold that persons having access to confidential information that is not legally available to others generally are prohibited by Rule 10b-5 from engaging in schemes to exploit their structural informational advantage through trading in affected securities.").

²⁵² *Id.* at 247 (quoting *Frigitemp Corp. v. Fin. Dynamics Fund, Inc.*, 524 F.2d 275, 283 (2d Cir. 1975)).

²⁵³ *Id.* at 251; *see also id.* at 246 ("I also would find petitioner's conduct fraudulent within the meaning of § 10(b) . . . even if he had obtained the blessing of his employer's principals before embarking on his profiteering scheme.").

²⁵⁴ *Id.* at 233 (majority opinion); *see also id.* at 235 n.20 (explicitly rejecting Justice Blackmun's theory).

²⁵⁵ *Chiarella*, 445 U.S. at 251 (Blackmun, J., dissenting).

²⁵⁶ *See supra* note 194 and accompanying text.

²⁵⁷ *See supra* notes 194-97 and accompanying text.

²⁵⁸ *See supra* notes 192-93 and accompanying text.

²⁵⁹ *See supra* note 254 and accompanying text.

between the one who exploited a structural disparity in access to nonpublic information and counterparties with whom that person trades.²⁶⁰ Framing the duty between the person in possession of nonpublic information and the person with whom he trades is analogous to the classical theory of insider trading liability.²⁶¹ In contrast, the constructive breach theory does not pre-empt liability on a duty between the wrongdoer and the counterparty to the subsequent securities transaction.²⁶² The constructive breach theory instead recognizes a duty between the wrongdoer and the victim.²⁶³ By framing the duty in this manner, the constructive breach theory comports with the misappropriation theory of insider trading liability.²⁶⁴

2. The Supreme Court's Purported Rejection of the Trustee *Ex Maleficio* Principle

The *Dorozhko* district court supported its rejection of the SEC's constructive breach theory by stating that in *Davis v. Aetna Acceptance Co.*²⁶⁵ the Supreme Court "squarely rejected" the argument that a wrongful act creates a fiduciary duty.²⁶⁶ Citing *Davis* in support of that proposition, however, is a mischaracterization of the Supreme Court's decision.

In *Davis*, the Supreme Court considered whether discharge in bankruptcy was a valid defense in a suit for conversion.²⁶⁷ Davis, a car salesman, had borrowed money from Aetna Acceptance Co. ("Aetna") to purchase a car to sell.²⁶⁸ The car served as collateral for the debt.²⁶⁹ Davis sold the car, but instead of remitting payment to Aetna, he filed a petition in bankruptcy and listed Aetna on the schedule of creditors.²⁷⁰ Aetna subsequently brought action against Davis for conversion of the funds.²⁷¹ Davis pleaded the affirmative defense of discharge in bankruptcy; however, the lower court rejected the defense and entered judgment in favor of Aetna.²⁷²

²⁶⁰ *Chiarella*, 445 U.S. at 251 (Blackmun, J., dissenting).

²⁶¹ See *supra* notes 46-51 and accompanying text.

²⁶² See *supra* note 194 and accompanying text.

²⁶³ See *supra* notes 194-201 and accompanying text.

²⁶⁴ See *supra* note 201 and accompanying text.

²⁶⁵ 293 U.S. 328 (1934).

²⁶⁶ SEC v. *Dorozhko*, 606 F. Supp. 2d 321, 336 n.10 (S.D.N.Y. 2008) ("It is not enough that, by the very act of wrongdoing out of which the contested debt arose, the bankrupt has become chargeable as a trustee *ex maleficio*. He must have been a trustee before the wrong and without reference thereto." (quoting *Davis*, 293 U.S. at 333)), *vacated*, 574 F.3d 42 (2d Cir. 2009).

²⁶⁷ *Davis*, 293 U.S. at 329.

²⁶⁸ *Id.* at 330.

²⁶⁹ *Id.*

²⁷⁰ *Id.*

²⁷¹ *Id.* at 331.

²⁷² *Id.*

On appeal, the Supreme Court had to determine whether or not the disputed debt fell under one of the exceptions in the Bankruptcy Act, which therefore would have precluded use of the discharge defense in the conversion suit.²⁷³ The Bankruptcy Act contained an exception for liabilities of a bankrupt that were “created by his fraud, embezzlement, misappropriation, or defalcation while acting as an officer or in any fiduciary capacity.”²⁷⁴ Aetna argued that the Supreme Court should affirm the lower court’s decision because Davis’s actions comported with this exception.²⁷⁵ The Supreme Court disagreed, stating that “[i]t is not enough that by the very act of wrongdoing out of which the contested debt arose, the bankrupt has become chargeable as a trustee *ex maleficio*. He must have been a trustee before the wrong and without reference thereto.”²⁷⁶

The district court’s use of *Davis* to reject the constructive breach theory was erroneous because the *Davis* holding does not apply to the facts of *Dorozhko*. In *Davis*, the Supreme Court was interpreting the language of the Bankruptcy Act, specifically the provision excepting discharge of liabilities “created by his fraud, embezzlement, misappropriation or defalcation *while acting* as an officer or in any fiduciary capacity.”²⁷⁷ The Supreme Court held that under this language, a wrongful act cannot simultaneously give rise to a fiduciary duty under the trustee *ex maleficio* principle and serve as the act of fraud, embezzlement, misappropriation, or defalcation required under the exception.²⁷⁸ Thus, the Supreme Court was not rejecting the trustee *ex maleficio* principle but instead was merely pointing out the temporal impossibility of one wrongful act simultaneously fulfilling both elements of the exception set forth in the statute.²⁷⁹ Conversely, the constructive breach theory does not entail a similar impossibility because the constructive breach theory relies on two separate actions.²⁸⁰ The first action is the wrongful act which creates a fiduciary duty with respect to the

²⁷³ *Davis*, 293 U.S. at 331.

²⁷⁴ *Id.* (quoting 11 U.S.C. § 35 (1925)).

²⁷⁵ *Id.* at 333.

²⁷⁶ *Id.*

²⁷⁷ *Id.* at 331 (emphasis added) (quoting 11 U.S.C. § 35 (1925)) (internal quotation marks omitted).

²⁷⁸ *Id.* at 333.

²⁷⁹ *See Davis*, 293 U.S. at 333 (“The language would seem to apply only to a debt created by a person who was already a fiduciary when the debt was created.” (quoting *Upshur v. Briscoe*, 138 U.S. 365, 378 (1901)) (internal quotation marks omitted)); *see also* Michael D. Sousa, *The Nondischargeability of Partners’ Debts Under § 523(a)(4): The Unresolved Collision Between the Bankruptcy Code and Partnership Law*, 14 J. BANKR. L. & PRAC. 43, 47 (2005) (explaining that *Davis*, “reaffirm[ed] that the scope of the exception was to be specifically limited to ‘technical trusts,’ . . . [and] refined the parameters of the discharge exception by stating in the negative how a fiduciary capacity could not arise; namely, the language applies only to an individual who was a fiduciary prior to the act creating the debt and without reference to that act”).

²⁸⁰ *See supra* notes 198, 200 and accompanying text.

wrongfully acquired property.²⁸¹ The second action is the breach of that duty by trading without disclosure to the source of the information.²⁸²

CONCLUSION

Ralph Waldo Emerson is credited with saying that a weed is “[a] plant whose virtues have not yet been discovered.”²⁸³ Unfortunately, the “straightforward” theory established by the Second Circuit in *Dorozhko* has no virtues to be discovered and consequently should be weeded out from insider trading jurisprudence.

There is another way to deal with the tough factual scenarios epitomized by *Dorozhko*. The constructive breach theory can bridge the gap between wrongful conduct and the “deceptive” requirement of Section 10(b), allowing courts to reach the instinctively right result in cases like *Dorozhko* without sacrificing a strong legal foundation. As was the case following its defeat in *Chiarella*, the government must again cultivate an innovative legal theory in the garden of insider trading jurisprudence. This cultivation is necessary despite *Dorozhko* ultimately being a victory.

Professor Daniel Langevoort writes, “[t]he flexibility of the fiduciary principle should not be underestimated.”²⁸⁴ Courts should remain within the boundaries imposed by the fiduciary duty requirement; but, they should also take advantage of the latitude within that restriction in order to address instances of true outsiders trading on the basis of nonpublic information.

²⁸¹ See *supra* note 200 and accompanying text.

²⁸² See *supra* note 200 and accompanying text.

²⁸³ RALPH WALDO EMERSON, FORTUNE OF THE REPUBLIC 3 (1878).

²⁸⁴ Langevoort, *Fiduciary Principle*, *supra* note 24, at 53.