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THE CORPORATION AS INSIDER TRADER

BY MARK J. LOEWENSTEIN* AND WILLIAM K.S. WANG**

ABSTRACT

With regard to issuer purchases, some of the traditional policy rationales against insider trading do not apply or apply with less force. Nevertheless, courts, commentators, and the SEC have all stated or assumed that a public corporation violates rule 10b-5 by buying its own shares in the market based on material, nonpublic information. In rule 10b-5 cases involving face-to-face transactions, several circuit courts have ruled that the company may not purchase its own stock based on material information not known to the seller. No good reason exists not to apply these precedents to stock market trades by issuers, especially because block trades blur the distinction between face-to-face transactions and stock market trades.

Some decisions involving face-to-face transactions have relied on a fiduciary duty running from the corporation to the seller. Although this duty has some appeal, it is unsupported by traditional state law fiduciary duty analysis. The company can act only through its board of directors, officers, employees, and other agents. These actors are obligated to act in the best interests of the corporation, which may not coincide with the best interests of an individual shareholder transacting business with the company.

Under rule 10b-5, the most compelling reason for issuer insider trading liability may simply be that no strong reason exists to distinguish the corporation from a corporate "insider," i.e., an employee or independent contractor. Such an "insider" has a Chiarella/Dirks classical relationship with the innocent shareholder on the other side of the insider trade because of a mutual relationship with the issuer. When an issuer trades on material, nonpublic information, innocent shareholders have a "classical relationship" with the corporation because of their investment. In other words, the relationship between the issuer and one of its

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shareholders is, if anything, closer than the relationship between an employee/independent-contractor and a shareholder.

I. INTRODUCTION

Corporations sometimes repurchase their own shares, either in a privately negotiated transaction or in the stock market. If such a purchase is based on material, nonpublic information, the question arises whether the corporation, qua corporation, has violated rule 10b-5 or some other applicable law. Most commentators who have considered the issue have concluded that the corporation does violate rule 10b-5.¹ Such analysis draws on the extensive rule 10b-5 jurisprudence on insider trading.² Yet the question is not free from doubt because a possible doctrinal underpinning of federal insider trading law—state law fiduciary duty—does not apply with equal force to the corporation. The question is also important because no court has directly addressed it in the context of a public corporation purchasing its shares in the stock market, although several circuit courts have concluded that a corporation violates rule 10b-5 when buying its shares based on material, undisclosed information in a face-to-face transaction.³

This article explores this question both from the perspective of state law fiduciary duties and the evolving rule 10b-5 jurisprudence. We conclude that the violation of the rule is at least problematic to the extent that rule 10b-5 is dependent on a finding that, when repurchasing its own securities, the corporation breached a state law fiduciary duty to the seller. Nevertheless, we also conclude that the jurisprudence under rule 10b-5 is not moored solely on state law fiduciary duty, and a court directly faced with the issue would likely hold that a corporation is subject to the same strictures as a traditional corporate insider. Indeed, the Securities and Exchange Commission has clearly taken that position.⁴

We consider here only corporate purchases; sales of corporate stock are regulated by the Securities Act of 1933⁵ as well as antifraud provisions in both that Act⁶ and in the Securities Exchange Act of 1934.⁷ We do not

¹See *infra* note 48.

²See *id.*; *infra* Parts III and IV.

³See *infra* notes 60-64 and accompanying text.

⁴See *infra* Part V.

⁵15 U.S.C. § 77a-2 (2000).

⁶Section 17(a) of the 1933 Act. 15 U.S.C. § 77q(a) (2000). For a general discussion of the application of § 17(a) to sales of stock based on material, nonpublic information, see WILLIAM K.S. WANG & MARC I. STEINBERG, *INSIDER TRADING* ch. 10 (1996 & Supp. 2002).

⁷15 U.S.C. §§ 78a-78mm (2000).

discuss state securities law statutes, though under some of these statutes, a buyer of securities commits fraud if it fails to disclose material, nonpublic information to the seller.⁸

Part II analyzes the question of whether, under *state* law, a public or closely-held company has a fiduciary duty to its shareholders either in general or when buying its own stock. While there is authority that fiduciary duties limit a corporation's ability to repurchase its shares based on material, nonpublic information, this section casts doubt on those cases.

Part III argues that, under the *Chiarella/Dirks* classical relationship theory, rule 10b-5 prohibits purchases by a corporation based on material, nonpublic information. This section concludes that, although state law may be relevant by analogy, the rule 10b-5 obligation goes beyond state law.

Part IV discusses court decisions on rule 10b-5 liability for corporate stock repurchases, including cases involving face-to-face transactions. This section argues that the face-to-face precedents imposing liability should apply to stock market trades by the issuer.

Part V describes the SEC's position on the question, including rule 10b5-1.

Part VI advances some policy arguments for and against prohibiting insider trading by a corporation in its own stock.

Part VII is the Conclusion.

II. UNDER STATE LAW, DOES A CORPORATION OWE A FIDUCIARY DUTY TO ITS SHAREHOLDERS?

This section considers whether, when purchasing its own stock, a company has a state law fiduciary obligation to the seller. In other words, may the corporation repurchase its own shares without disclosing to the seller material, nonpublic information of which the seller is unaware? The few courts grappling with this issue have found that, indeed, a fiduciary

⁸See, e.g., CAL. CORP. CODE § 25402 (West 1977).

It is unlawful for an issuer . . . to purchase or sell any security of the issuer in this state at a time when he knows material information about the issuer . . . which would significantly affect the market price of that security and which is not generally available to the public, and which he knows is not intended to be so available, unless he has reason to believe that the person selling to or buying from him is also in possession of the information.

Id. For a discussion of CAL. CORP. CODE § 25402, see WANG & STEINBERG, *supra* note 6, § 16.4.3.1(a).

For discussion of § 352-c of the Martin Act, the New York securities law, see WANG & STEINBERG, *supra* note 6, § 16.4.3.2. Section 352-c is an antifraud provision broad enough to encompass purchases by an issuer of its own stock based on material, nonpublic information. See *id.*

duty exists and imposes a disclosure obligation on the corporation.⁹ Because of the paucity of cases, generalization is difficult.

On the more general question as to whether the corporation owes fiduciary duties to an individual stockholder, the decided cases are surprisingly mixed.¹⁰ Some courts hold, as a general proposition, that a corporation does owe a fiduciary duty to an individual shareholder,¹¹ while

⁹See *Jordan v. Duff & Phelps, Inc.*, 815 F.2d 429, 435 (7th Cir. 1987) (rule 10b-5 case holding that a corporation has duty to disclose material, nonpublic information when purchasing its shares; noting that "[c]lose corporations buying their own stock, like knowledgeable insiders of closely held firms buying from outsiders, have a fiduciary duty to disclose material facts"; for additional discussion of *Jordan*, see *infra* notes 64-74 and accompanying text); *Rizzo v. MacManus Group, Inc.*, 158 F. Supp. 2d 297, 302-03 (S.D.N.Y. 2001) (rule 10b-5 opinion briefly quoting *Jordan*). Cf. *Lawton v. Nyman*, 327 F.3d 30, 40 (1st Cir. 2003) (holding that Rhode Island would "recognize a heightened duty of disclosure in a close corporation setting by officers who are majority shareholders with undisclosed information, who are purchasing minority shares or causing the corporation to do so"); *Fausek v. White*, 965 F.2d 126, 131 (6th Cir. 1992) (rejecting close corporation's argument that it had no fiduciary duty to its shareholders; noting that Tennessee law once allowed directors to trade like outsiders, but that now officers, directors, and control shareholders owe a fiduciary duty to other shareholders); *Smith v. Duff & Phelps, Inc.*, 891 F.2d 1567, 1572-75 (11th Cir. 1990) (rule 10b-5 opinion holding that a company must disclose material, nonpublic information when purchasing its shares and mentioning, that, under Louisiana law, officers and directors owe a fiduciary duty to shareholders); *Wood v. MacLean Drug Co.*, 266 Ill. App. 5 (Ill. App. Ct. Dist. 1932) (finding defendant officers and directors liable for causing the corporation to buy the shares of the plaintiff without disclosing pending negotiations for the sale of the company).

¹⁰See *infra* notes 11-12. See generally 4 ALAN R. BROMBERG & LEWIS D. LOWENFELS, BROMBERG & LOWENFELS ON SECURITIES FRAUD & COMMODITIES FRAUD § 6:534 (2004) (noting that "there is considerable doubt whether a company has the fiduciary duty to an individual security holder"); Alison Grey Anderson, *Fraud, Fiduciaries, and Insider Trading*, 10 HOFSTRA L. REV. 341, 362 n.92 (1982) (stating that, under state law, corporations do not generally owe fiduciary duties to individual shareholders, but only to shareholders as a group); Mark J. Loewenstein, *Does a Corporation Owe a Fiduciary Duty to Its Shareholders?*, 15 INSIGHTS, July 2001 (discussing cases both recognizing and rejecting the duty).

¹¹E.g., *Shewmake v. Badger Oil Corp.*, 654 F. Supp. 1184, 1188 (D. Colo. 1987) (acknowledging in dictum a general trustee-like fiduciary duty of a corporation to its stockholders); *Wright v. Bayly Corp.*, 587 P.2d 799 (Colo. Ct. App. 1978) (holding that corporation's refusal to lift transfer restrictions on corporate stock may violate corporate fiduciary duty to act in good faith); *Schneider v. Union Oil Co. of Cal.*, 86 Cal. Rptr. 315 (Cal. Ct. App. 1970) (holding that defendant corporation breached its fiduciary duty to the plaintiff in transferring plaintiff's stock pursuant to a forged endorsement).

For citations to federal cases taking the view that an issuer has a common law fiduciary relationship with its shareholders, see Robert H. Rosenblum, *An Issuer's Duty Under Rule 10b-5 to Correct and Update Materially Misleading Statements*, 40 CATH. U. L. REV. 289, 304-05 n.65 (1991) (citing *Kohler v. Jacobs*, 138 F.2d 440, 442-43 (5th Cir. 1943)); *Seymour v. National Biscuit Co.*, 107 F.2d 58, 63 (3d Cir. 1939), *cert. denied*, 309 U.S. 665 (1940); *Shewmake*, 654 F. Supp. at 1188).

others conclude the opposite.¹² Possibly, in some jurisdictions, a company otherwise has no fiduciary duty to an individual stockholder, but does breach a fiduciary duty to a shareholder from whom it purchases stock without disclosing material, nonpublic information. Obviously, from a doctrinal viewpoint, this is troubling. So, from the initial question noted above, one is led quickly to the general question of the corporate fiduciary duty to an individual stockholder and its implications.

In a few cases, a shareholder has brought suit against the company claiming that some corporate action violated an owed fiduciary duty. A

¹²E.g., *Powers v. Ryan*, No. 00-10295-00, 2001 U.S. Dist. LEXIS 1389, at *4 (D. Mass. Jan. 9, 2001) (holding that allegations of fraudulent actions by plaintiff's co-shareholder do not constitute breach of fiduciary duty by corporation and noting that "[t]he case law is less settled on whether a corporation owes a fiduciary duty to a shareholder. . . . As plaintiff concedes, no Massachusetts case recognizes a fiduciary duty owed by a corporation to a shareholder."); *PPI Enters. (U.S.), Inc. v. Del Monte Foods Co.*, No. 99 Civ. 3794(BSJ), 2000 WL 1425093, at *6-*10 (S.D.N.Y. Sept. 26, 2000) (applying Maryland law, holding that plaintiff shareholder adequately alleged claim against corporation for fraud, breach of contract, and negligent misrepresentation, but dismissing claim against corporation for breach of fiduciary duty because "the parties have not uncovered a single Maryland case which has held that a corporation owes a fiduciary duty to its shareholders"); *Arnold v. Soc'y for Savings Bancorp.*, No. 12,883, 1995 Del. Ch. LEXIS 86, at *18 (Del. Ch. June 15, 1995), *reprinted in* 21 DEL. J. CORP. L. 157, 168 (1996) (stating that corporate defendants, including Bancorp, "did not owe fiduciary duties to Bancorp's stockholders"); *In re Wheelabrator Techs. Inc. S'holders Litig.*, No. 11,495, 1992 Del. Ch. LEXIS 196, at *32 (Del. Ch. Sept. 1, 1992), *reprinted in* 18 DEL. J. CORP. L. 778, 798 (1993) (noting in dictum that "it is correct that the corporate entity as such is not a fiduciary to its stockholders and cannot be held liable on them on that basis").

For an argument that a corporation does not owe a state law fiduciary obligation to its own shareholders, see Deborah A. DeMott, *Beyond Metaphor: An Analysis of Fiduciary Obligation*, 1988 DUKE L.J. 879, 916-21. See generally *Jordan v. Global Natural Res. Inc.*, 564 F. Supp. 59, 67-68 (S.D. Ohio 1983) (stating that a corporation does not have a state law fiduciary obligation to its shareholders, but may be vicariously liable for the acts of its directors in breach of the director's fiduciary obligation to the shareholders); *Berberman v. West Publ'g Co.*, 615 N.W. 2d 362, 367-72 (Minn. Ct. App. 2000) (holding that a close corporation did not have a duty to disclose "tentative, speculative" discussions about a possible merger to a shareholder who retired from the corporation and sold his stock back to the company; *id.* at 372). But cf. Mark J. Loewenstein, *Does a Corporation Owe a Fiduciary Duty to Its Shareholders?*, 15 INSIGHTS, July 2001, at 10, 14.

The view that a corporation owes no fiduciary duty to its stockholders seems weakest when the corporation is dealing directly with a stockholder. . . . In such cases, the plaintiff has a reasonable expectation that the corporation will deal fairly and the breach of that expectation ought to give rise to a cause of action. *Alessi v. Beracha*, 849 A.2d 939, 940-41 (Del. Ch. 2004), involved a Delaware corporation that announced a program to allow shareholders holding less than 100 shares of stock to buy or sell shares to third parties for a below-market processing fee. Applying Delaware law, the opinion held that the program was a "request" for this group of shareholders to take action." *Id.* at 944. This "request for action" created a duty for the board, but not the corporation, to disclose any material information they possessed. See *id.* at 944-50. The company's need to preserve the secrecy of business negotiations might or might not be a defense. See *id.* at 947 & nn.49-50.

typical and compelling case involved a claim by PPI Enterprises (PPIE), a stockholder of Del Monte Foods Co.¹³ PPIE was experiencing financial difficulties and decided to sell its Del Monte shares. The stock was closely held, and there were restrictions on PPIE's ability to sell.¹⁴ Therefore, to sell, PPIE was dependent on Del Monte's cooperation.

In response to an inquiry from PPIE, Del Monte represented to PPIE that its holdings were "worthless," but that Del Monte would offer PPIE \$1.0 million "to facilitate an ongoing reorganization of Del Monte to avoid [Del Monte's] bankruptcy."¹⁵ Over the next several months, Del Monte and its financial advisor reassured PPIE that its stock was worthless, denied that there were plans to sell the company, and represented that all material information had been disclosed to PPIE.¹⁶ Ultimately, PPIE sold its Del Monte stock for \$10.6 million to one of PPIE's creditors.¹⁷ Less than three months later, a third party bought Del Monte for \$890 million, with the stake sold by PPIE valued at \$33 million.¹⁸

Following disclosure of this transaction, PPIE brought suit against Del Monte and its financial advisor, alleging fraud, breach of contract, negligent misrepresentation, breach of fiduciary duty, and (against the financial advisor) aiding and abetting a breach of fiduciary duty.¹⁹ In ruling on the defendants' motions for judgment on the pleadings, the district court denied the motions as to all counts except the claims relating to breach of fiduciary duty. The court found that the plaintiff had adequately alleged that defendants knowingly made materially false and misleading statements on which the plaintiff had relied, thus stating a claim for fraud, breach of contract and negligent misrepresentation.²⁰ As to the fiduciary duty claims, however, the court granted defendants' motions because it could find no precedent under Maryland law holding that a corporation owes a fiduciary duty to its shareholders.²¹ In the absence of such precedent, the federal court expressed its unwillingness to "imply such a cause of action."²²

¹³*PPI Enters. (U.S.), Inc. v. Del Monte Foods Co.*, No. 99 Civ. 3794(BSJ), 2000 WL 1425093 (S.D.N.Y. Sept. 26, 2000).

¹⁴*Id.* at *2.

¹⁵*Id.* at *2-*3.

¹⁶*Id.*

¹⁷*PPI Enters. (U.S.), Inc.*, 2000 WL 1425093, at *4.

¹⁸*Id.* at *5.

¹⁹*Id.* at *6-*7.

²⁰*Id.* at *7-*10.

²¹*PPI Enters. (U.S.), Inc.*, 2000 WL 1425093, at *10.

²²*Id.*

In contrast to *PPI Enterprises* are cases such as *Wright v. Bayly Corp.*²³ In *Wright*, the plaintiffs were the holders of restricted stock that they desired to sell pursuant to Rule 144 of the Securities Act of 1933. In accordance with the terms of the restriction, plaintiffs submitted to the corporate defendant an opinion of counsel that the proposed sale would comply with Rule 144, a broker's assurance letter, and the required Rule 144 forms.²⁴ Notwithstanding plaintiffs' apparent compliance with the restrictive legend on their stock certificates, the defendant company failed to consent to the sale. The shares subsequently declined in value, and plaintiffs brought a claim for damages, alleging a breach of fiduciary duty by the corporation.²⁵ The trial court granted summary judgment in favor of the defendant,²⁶ but the Colorado Court of Appeals reversed.

In reversing, the appellate court mapped out a rather exacting standard for corporations: "As a trustee for its stockholders, the corporation is bound to protect their interests, and occupies a fiduciary relationship with them."²⁷ This fiduciary relationship includes a duty to deal with shareholders "in good faith."²⁸ The court recognized that the company might have legitimate reasons to refuse consent, but ruled that this would be a question for the jury and could not be determined on a motion for summary judgment.

The holding of *Wright* would seem to support the proposition that a corporation repurchasing its shares has a fiduciary duty to disclose all material information to the selling shareholder. Nevertheless, the reasoning of *Wright* and similar cases may be questionable. Rather than find a fiduciary duty, the court in *Wright* could have more simply concluded that either the corporate defendant breached its express contractual obligations or, at least, its implied contractual obligation of good faith. The parties had a contract that required the corporation to facilitate plaintiff's transfer of shares if certain conditions were satisfied, which was apparently the case in *Wright*. Even if the understanding of the parties left discretion to the corporation, it had a duty to exercise that discretion in good faith. The appellate decision in *Wright* may be better characterized as one in which a corporation breached its obligations under a contract, rather than under an amorphous concept of fiduciary duty.

²³587 P.2d 799 (Colo. Ct. App. 1978).

²⁴*Id.* at 800.

²⁵*Id.* at 801.

²⁶*Id.* at 800.

²⁷*Wright*, 587 P.2d at 801.

²⁸*Id.*

The very idea that a corporation has a fiduciary duty to individual shareholders is troubling. The corporation can act only through its board of directors, officers, employees, and other agents. These actors are obligated to act in the best interests of the corporation, which may not coincide with the best interests of an individual shareholder transacting business with the corporation. There is no reason to impose a fiduciary obligation on these actors to act in the best interests of an individual shareholder when that shareholder proposes a course of conduct not in the best interests of the corporation.²⁹

To take *Wright* as an example, assume that a corporate officer resisted the transfer of shares contemplated by the plaintiff because the nature of the transferee would prohibit the corporation from participating in certain governmental contracts. The corporation may have been contractually bound to facilitate the transfer, but that is a far cry from concluding that *fiduciary* concepts may have compelled that result. Indeed, fiduciary concepts may compel the opposite result because the officer's fiduciary obligations run to the corporation, not to a contractual partner who happened to be a shareholder. In fact, failing to resist the transfer, to

²⁹Compare the "special facts doctrine," which imposes an obligation on a corporate officer to disclose material facts when purchasing corporate stock from a shareholder in a face-to-face transaction. See *Strong v. Repide*, 213 U.S. 419 (1909). The rationale for this rule rests on notions of fairness and, possibly, the reasonable expectations of the selling shareholder. Conceivably, if an individual officer has such a duty when acting in an individual capacity, he might also have the same duty when acting in a representative capacity for the corporation.

In other words, in a "special facts doctrine" jurisdiction, a court may impose liability on the officer for causing the corporation to purchase based on material, nonpublic information. See *Lawton v. Nyman*, 327 F.3d 30, 37-42 (1st Cir. 2003) (holding that Rhode Island would probably adopt the "special facts" doctrine and would "recognize a heightened duty of disclosure in a close corporation setting by officers who are majority shareholders with undisclosed information, who are purchasing minority shares or causing the corporation to do so" thereby imposing liability under Rhode Island law on officers and controlling shareholders for causing the corporation to redeem stock without making adequate disclosures); *id.* at 40-42; *Wood v. MacLean Drug Co.*, 266 Ill. App. 5 (Ill. App. Ct. 1932) (defendant officers and directors held liable for causing the corporation to buy the shares of the plaintiff without disclosing pending negotiations for the sale of the company).

In such a situation, conceivably, the corporation itself might be liable under agency principles of respondeat superior. Cf. *Jordan v. Global Natural Res. Inc.*, 564 F. Supp. 59, 68 (S.D. Ohio 1983) (stating that a corporation does not have a state law fiduciary obligation to its shareholders but may be vicariously liable for the acts of its directors in breach of the director's fiduciary obligation to the shareholders).

One argument against extending the special facts doctrine to the situation of a corporate repurchase is that the undisclosed information belongs to the corporation, not to any officer, director or employee of the corporation, so the equities of imposing a disclosure obligation are less on the officer when acting in a corporate capacity than when acting in an individual capacity.

For a general discussion of the "special facts doctrine" and the similar "minority rule," see WANG & STEINBERG, *supra* note 6, § 16.2.3.

the extent that resistance was consistent with the contract, might constitute a breach of fiduciary duty by the officer. The possibility of conflict of interest is only one, though a powerful reason, why a corporation cannot owe a fiduciary duty to an individual shareholder.

Assume that a corporation does *not* owe a state law fiduciary duty to an individual shareholder either in general or when purchasing its own stock. Does that mean that the company does not violate rule 10b-5 when buying its own shares without disclosing material information? Part III below addresses this question and concludes that, irrespective of state law fiduciary duty, such a corporation does violate rule 10b-5.

III. UNDER THE *CHIARELLA/DIRKS* CLASSICAL RELATIONSHIP THEORY, RULE 10b-5 FORBIDS "INSIDER" PURCHASES BY A CORPORATION

The starting points for the analysis of whether corporate stock repurchases violate rule 10b-5 are the two U.S. Supreme Court decisions in *Chiarella v. United States*³⁰ and *Dirks v. Securities and Exchange Commission*.³¹ *Chiarella* and *Dirks* establish that when an "insider" and the party on the other side of a stock trade have a certain mutual relationship with the corporation, the "insider" cannot purchase or sell shares on material, undisclosed information.³² In this and many other respects, *Chiarella* and *Dirks* went beyond traditional state law.³³

Development of the state common law in this area drastically slowed starting a half century or so ago because of the explosion of state statutory law and federal law on insider trading. When this state common law ceased developing, it was still unsettled.³⁴ Furthermore, most of the old state common law cases dealt with top officers and/or directors *buying* shares from another shareholder in a face-to-face transaction.³⁵ In contrast, *Chiarella* and *Dirks* expanded the rule 10b-5 prohibition on insider trading

³⁰445 U.S. 222 (1980).

³¹463 U.S. 646 (1983).

³²For discussion of the *Chiarella/Dirks* classical relationship, see *United States v. O'Hagan*, 521 U.S. 642, 651-52 (1997). For discussion of the *Chiarella/Dirks* classical relationship triangle, see WANG & STEINBERG, *supra* note 6, § 5.2.1; William K.S. Wang, *Stock Market Insider Trading: Victims, Violators, and Remedies—Including an Analogy to Fraud in the Sale of a Used Car with a Generic Defect*, 45 VILL. L. REV. 27, 46-49 (2000). For a diagram of the triangle, see *infra* text accompanying notes 43-44.

³³See WANG & STEINBERG, *supra* note 6, § 5.2.2.

³⁴For a general discussion of the state common law of insider trading, see *id.* § 16.2.

³⁵See *id.* § 16.2.3.1 & nn.23-25.

to anonymous stock market transactions,³⁶ to sales by the defendant,³⁷ and to a broader class of individuals (such as lower-level employees,³⁸ independent contractors,³⁹ tippers,⁴⁰ and tippees⁴¹). In short, in defining the classical relationship, the Court has extrapolated from state law, but has not been bound by it.⁴²

³⁶See *Chiarella*, 445 U.S. at 228-30, 233; sources cited *infra* note 42; WANG & STEINBERG, *supra* note 6, § 5.2.1 & n.24.

³⁷See *Chiarella*, 445 U.S. at 227 n.8; WANG & STEINBERG, *supra* note 6, § 5.2.1 & n.31.

³⁸See WANG & STEINBERG, *supra* note 6, § 5.2.3.1.

³⁹See *Dirks v. SEC*, 463 U.S. 646, 655 n.14 (1983); WANG & STEINBERG, *supra* note 6, § 5.2.3.2.

⁴⁰See *Dirks*, 463 U.S. at 659-64; WANG & STEINBERG, *supra* note 6, § 5.2.8.

⁴¹See *Dirks*, 463 U.S. at 659-64; WANG & STEINBERG, *supra* note 6, § 5.3.

The U.S. Supreme Court has also extended the rule 10b-5 insider trading prohibition to those who trade on material, nonpublic information in breach of a duty to the information source. See *United States v. O'Hagan*, 521 U.S. 642, 649-66 (1997); WANG & STEINBERG, *supra* note 6, § 5.4.1 (Supp. 2001).

⁴²WANG & STEINBERG, *supra* note 6, § 5.2.2, at 291. See DONNA M. NAGY ET AL., SECURITIES LITIGATION AND ENFORCEMENT: CASES AND MATERIALS 475 (2003) (explaining that "*Chiarella* itself construed Rule 10b-5 in a manner that departed from at least two common law limitations on recovery for a fiduciary's silence"); Harry S. Gerla, *Issuers Raising Capital Directly from Investors: What Disclosure Does Rule 10b-5 Require?*, 28 J. CORP. L. 111, 120-21 (2002) (finding on the issue of rule 10b-5 liability for insider trading of debt, the position of state courts is not determinative because "[n]o state court had recognized, under state corporate law, a fiduciary duty of disclosure between corporate insiders and shareholders in anonymous stock market transactions. Nonetheless, federal courts, including the Supreme Court, have uniformly recognized such a duty under Rule 10b-5."); Ray J. Grzebielski, *Friends, Family, Fiduciaries: Personal Relationships as a Basis of Insider Trading Violations*, 51 CATH. U. L. REV. 467, 472-74, 489 & n.165 (2002); *id.* at 474 (going beyond state law, "the Court created a uniform fiduciary duty for corporate insiders under Rule 10b-5."); Donna M. Nagy, *The "Possession vs. Use" Debate In the Context of Securities Trading by Traditional Insiders: Why Silence Can Never Be Golden*, 67 U. CIN. L. REV. 1129, 1166-68, 1174 (1999) (noting that *Chiarella* went beyond state law by extending rule 10b-5's insider trading prohibition to anonymous stock market transactions, sales by traditional insiders to those not previously owning shares, and trades by non-officer employees, independent contractors, and certain tippees of insiders); Donna M. Nagy, *Reframing the Misappropriation Theory of Insider Trading Liability: A Post-O'Hagan Suggestion*, 59 OHIO ST. L.J. 1223, 1298 (1998).

[T]he *Chiarella* Court's classical theory of insider trading predicated liability on a traditional insider's failure to disclose material information to the shareholders with whom he was trading, even though the majority of courts at common law did not recognize a fiduciary relationship between insiders and shareholders, and most certainly did not recognize duties of disclosure in market transactions, such as those conducted on a stock exchange.

Id.; Richard M. Phillips & Robert E. Kohn, *Applying the Insider Trading Doctrine to Debt Securities*, INSIGHTS, Nov. 1992, at 27-28 ("An actionable state law breach of duty is not a prerequisite to liability for insider trading under Rule 10b-5."). See also Stephen M. Bainbridge, *Incorporating State Law Fiduciary Duties into the Federal Insider Trading Prohibition*, 52 WASH. & LEE L. REV. 1189, 1212-13 (1995) ("With no analysis or citation of authority . . . [Justice] Powell [in *Dirks*] extrapolated from this common-law duty the rule that all 'insiders [are] forbidden by their fiduciary relationship from personally using undisclosed corporate information

to their advantage.") (footnote omitted) [hereinafter Bainbridge, *Incorporating*]; Stephen M. Bainbridge, *Insider Trading Regulation: The Path Dependent Choice Between Property Rights and Securities Fraud*, 52 SMU L. REV. 1589, 1601 (1999) ("with no analysis or citation of authority") [hereinafter Bainbridge, *Insider Trading Regulation*]; Douglas M. Branson, *Discourse on the Supreme Court Approach to SEC Rule 10b-5 and Insider Trading*, 30 EMORY L.J. 263, 277-78 (1981) ("Thus, even if *Chiarella* can be characterized as a return to the common law, it is surely not common law in its traditional form. Instead, it may represent a generalized application of the most advanced state the common law had reached in a handful of jurisdictions."); Edward A. Fallone, *Section 10(b) and the Vagaries of Federal Common Law: The Merits of Codifying the Private Cause of Action Under a Structuralist Approach*, 1997 U. ILL. L. REV. 71, 92 ("To a certain extent, the Court in *Chiarella* appears to have used state law as an analogy for delimiting the scope of a federal duty, rather than as an independent legal standard incorporated into Section 10(b).") (footnote omitted); Donald C. Langevoort, *Rereading Cady, Roberts: The Ideology and Practice of Insider Trading Regulation*, 99 COLUM. L. REV. 1319, 1322 n.15 (1999) ("No court has thus far suggested that the fiduciary analysis in insider trading cases is anything but a matter of federal law, and it is difficult to imagine any logic behind so doing except a desire to limit or confuse the scope of the insider trading prohibition."); Joel Seligman, *The Reformulation of Federal Securities Law Concerning Nonpublic Information*, 73 GEO. L.J. 1083, 1091-103 (1985) (discussing the extent that *Chiarella* and *Dirks* extended liability beyond state law). Cf. Theresa A. Gabaldon, *State Answers to Federal Questions: The Common Law of Securities Regulation*, 20 J. CORP. L. 155, 199 (1994) (noting that "it is not at all clear whether the federal courts believe that they are incorporating state laws relating to fiduciary duty or if they are drawing a general analogy"); Richard W. Painter et al., *Don't Ask, Just Tell: Insider Trading After United States v. O'Hagan*, 84 VA. L. REV. 153, 207 (1998) (discussing the rule 10b-5 misappropriation doctrine and stating that "[d]eveloping a federal common law of fiduciary duty would provide a more effective approach and would better serve policies of predictability, consistency, and judicial economy than would incorporating state law fiduciary duty concepts into the federal rule of decision") (footnote omitted; for discussion of the misappropriation theory, see WANG & STEINBERG, *supra* note 6, § 5.4); Elliott J. Weiss, *United States v. O'Hagan: Pragmatism Returns to the Law of Insider Trading*, 23 J. CORP. L. 395, 404 (1998) (*Chiarella* went beyond state law); R. René Pengra, Note, *Insider Trading, Debt Securities and Rule 10b-5: Evaluating the Fiduciary Relationship*, 67 N.Y.U. L. REV. 1354, 1372-74 (1992) (absence of fiduciary obligation at state law should not preclude liability for insider trading under rule 10b-5). But see *Jordan v. Duff & Phelps, Inc.*, 815 F.2d 429, 435-37 (7th Cir. 1987) (Easterbrook, J.) (ruling that corporation had a rule 10b-5 obligation to disclose material information before buying its own stock; basing the rule 10b-5 obligation on "the fiduciary duty of corporate law"; *id.* at 435), *cert. dismissed*, 485 U.S. 901 (1988). But cf. *United States v. Chestman*, 947 F.2d 551, 560 (2d Cir. 1991) (en banc) ("Confronted with both congressional and SEC silence on the issue . . . the Court [in *Chiarella*] applied common law principles of fraud."), *cert. denied* 503 U.S. 1004 (1992).

Finally, *Chiarella* faced not only statutory silence on the issue before it but also administrative reticence. Neither the language of Rule 10b-5, SEC discussions of the rule, nor administrative interpretations of the rule offered any evidence that the SEC, in drafting Rule 10b-5, intended the rule to go beyond common law fraud.

Id. at 561; *Barker v. Henderson, Franklin, Starnes & Holt*, 797 F.2d 490, 496 (7th Cir. 1986) (Easterbrook, J.) (noting that in the whistleblowing context "the defendant must have a duty to blow the whistle. And this duty does not come from § 10(b) or Rule 10b-5; if it did the inquiry would be circular. The duty must come from a fiduciary relation outside securities law.") (citing *Dirks*, 463 U.S. at 653-64; *Chiarella*, 445 U.S. at 227-35)). Bainbridge, *Incorporating*, *supra*, at 1252-57, 1268-69 (sole basis for the federal insider trading prohibition should be the protection of property rights in information as defined by state law); Bainbridge, *Insider Trading Regulation*,

An employee/independent-contractor has a classical relationship with the shareholder on the other side of the insider trade because of a

supra, at 1626-32 (arguing that property rights should be the rationale for insider trading regulation and, to determine whether the relationship is fiduciary in nature, federal courts should look to state law (i.e., the law of the state of incorporation of the issuer)). See generally *Herman & MacLean v. Huddleston*, 459 U.S. 375, 388-89 (1983).

Moreover, the antifraud provisions of the securities laws are not coextensive with common-law doctrines of fraud. . . . [A]n important purpose of the federal securities statutes was to rectify perceived deficiencies in the available common-law protections by establishing higher standards in the securities industry

We therefore find reference to the common law in this instance unavailing.

In at least one respect, *Dirks* was more restrictive than state law. See *SEC v. Yun*, 327 F.3d 1263, 1277 n.30 (11th Cir. 2003) ("After all, an 'intent to benefit' is clearly not an essential element of a case against a fiduciary under the common law."). For discussion of the *Dirks* personal benefit test for tippees under the classical relationship theory, see WANG & STEINBERG, *supra* note 6, § 5.2.8.

SEC v. Cochran, 214 F.3d 1261, 1264-65 (10th Cir. 2000), discussed what body of law determines whether a *Chiarella* classical relationship exists. The opinion mentioned that the Fourth Circuit held that the duty must arise outside the federal securities laws, for example, from state law. See *id.* at 1264 (citing *Fortson v. Winstead, McGuire, Sechrest & Minick*, 961 F.2d 469, 472 (4th Cir. 1992) (citing *Windon Third Oil & Gas Drilling P'ship v. FDIC*, 805 F.2d 342, 347 (10th Cir. 1986); *Barker*, 797 F.2d at 496)).

Cochran also noted the Eighth Circuit's view that the requisite classical relationship results from state or federal law or from "the nature of the parties' relationship and other . . . factors." *Cochran*, 214 F.3d at 1265 (citing *Camp v. Dema*, 948 F.2d 455, 460 (8th Cir. 1991)). *Cochran* further stated:

We agree with the Eighth Circuit to the extent that a duty to disclose under § 10(b) may be present if either a federal statute (other than [sic] § 10(b) itself) or state statutory or common law recognizes a fiduciary or similar relationship of trust and confidence giving rise to such a duty between the defendant and the plaintiff. We express no view as to whether there might be additional sources for such a duty, such as professional rules of conduct or federal common law.

Id.

Applying Oklahoma law, *Cochran* held that whether a *Chiarella* relationship existed depended on the facts and circumstances surrounding the relationship between the parties. See *id.* The court remanded to the district court for a determination whether the requisite relationship existed under Oklahoma law. See *id.* at 1265, 1269.

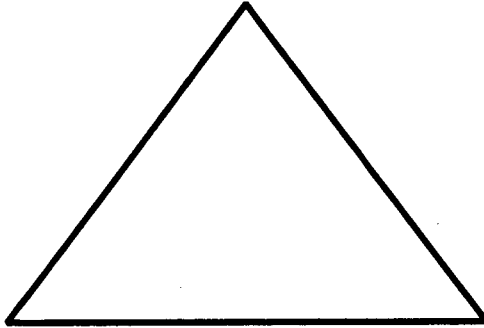
As noted above, *Cochran* cited *Camp v. Dema*. *Camp* said that the *Chiarella* relationship of trust and confidence "may be established by state or federal law." *Camp*, 948 F.2d at 460. The opinion also said that where neither state nor federal law had established such a duty, the court could still find one by examining five non-exclusive factors:

1. the relationship of the defendant to the plaintiff;
2. the defendant's access to information relative to the plaintiff's;
3. the benefits derived by the defendant in the relationship with the plaintiff;
4. the defendant's awareness of plaintiff's reliance; and
5. the defendant's activity in initiating the transaction in question.

Id. (citing *Roberts v. Peat, Marwick, Mitchell & Co.*, 857 F.2d 646, 653-54 (9th Cir. 1988); *Arthur Young & Co. v. Reves*, 937 F.2d 1310, 1330 (8th Cir. 1991)).

mutual relationship with the issuer. Below is a diagram of the "classical relationship triangle."⁴³

ISSUER (A) OF THE STOCK TRADED ON INSIDE INFORMATION



EMPLOYEE/INDEPENDENT-
CONTRACTOR TRADER (B)

INNOCENT PARTY ON OTHER
SIDE OF TRADE (C)
(ALREADY A S/H OR
BECOMES ONE WITH THE
TRADE)

The trading employee/independent- contractor (B) is in the triangle because of his or her employment by the issuer (A). The shareholder (C) is in the triangle because he or she has invested in the corporation (A) or "steps into the shoes" of an original investor.⁴⁴

When the issuer (A) trades on material, nonpublic information, no "triangle" analysis is necessary. The shareholder (C) on the other side of the transaction has invested in the company or "steps into the shoes" of an original investor. Thus, the shareholder (C) has a "classical relationship" with the corporation (A). In other words, the relationship between the issuer (A) and one of its shareholders (C) is, if anything, closer than the relationship between a corporate employee/independent-contractor (B) and a shareholder (C).

⁴³For a more complex diagram of this triangle, see WANG & STEINBERG, *supra* note 6, § 5.2.1, at 289 Fig. 5.1; Wang, *supra* note 32, at 46. For discussion of this triangle, see WANG & STEINBERG, *supra* note 6, § 5.2.1 text accompanying Figure 5-1 and accompanying text; Wang, *supra* note 32, at 46-49.

⁴⁴See WANG & STEINBERG, *supra* note 6, § 5.2.1 text accompanying Figure 5-1; Wang, *supra* note 32, at 46-49.

In short, because an officer or employee has a classical *Chiarella*⁴⁵/*Dirks*⁴⁶ relationship with the shareholders,⁴⁷ *a fortiori*, the issuer should also have this relationship. Numerous commentators have concluded that the issuer violates rule 10b-5 by trading its own stock on material, inside information.⁴⁸

⁴⁵*Chiarella v. United States*, 445 U.S. 222 (1980).

⁴⁶*Dirks v. SEC*, 463 U.S. 646 (1983).

⁴⁷*See United States v. O'Hagan*, 521 U.S. 642, 652 (1997) (noting in dictum that the classical theory applies to both permanent and temporary insiders of a corporation, making insider trading by those parties a violation of rule 10b-5); *Dirks v. SEC*, 463 U.S. 646, 670 (1983) (Blackmun, J., dissenting) ("No one questions that Secrist himself [a former officer of Equity Funding] could not trade on his inside information to the disadvantage of uninformed shareholders and purchasers of Equity Funding securities."); WANG & STEINBERG, *supra* note 6, § 5.2.3.1; Annotation, *Who Is an "Insider" within § 10(b) of the Securities Exchange Act of 1934 (15 USC § 78j(b))—and SEC Rule 10b-5 Promulgated Thereunder—Making Unlawful Corporate Insider's Nondisclosure of Information to Seller or Purchaser of Corporation's Stock*, 2 A.L.R. FED. 274, § 4 (1969 & Supp. 2003).

⁴⁸ LOUIS LOSS & JOEL SELIGMAN, *SECURITIES REGULATION* 3499 (3d ed. rev. 2003) ("When the issuer itself wants to buy or sell its own securities, it has a choice: desist or disclose."); 8 LOUIS LOSS & JOEL SELIGMAN, *SECURITIES REGULATION* 3605 (3d ed. rev. 2004) ("The term *insider* traditionally has been held to include . . . issuers when repurchasing their own stock."); 1 HAROLD MARSH, JR. & ROBERT H. VOLK, *PRACTICE UNDER THE CALIFORNIA SECURITIES LAWS* § 14.04[4][a], at 14-36 (rev. ed. 1989) (discussing rule 10b-5 and stating that "[o]bviously, the issuing corporation itself is also included in this category [of insider]"); Ian Ayres & Joe Bankman, *Substitutes for Insider Trading*, 54 STAN. L. REV. 235, 259 (2001) (stating that "insider trading law restricts corporations from trading on their own shares on the basis of material nonpublic information"); Dale E. Barnes, Jr. & Karen Kennard, *Greater Expectations: Risk Disclosure Under the Private Securities Litigation Reform Act of 1995—An Update*, 2 STAN. J.L. BUS. & FIN. 331, 335 (1996); Steven E. Bochner & Samir Bukhar, *The Duty to Update and Disclosure Reform: The Impact of Regulation FD and Current Disclosure Initiatives*, 7 STAN. J.L. BUS. & FIN. 225, 229 (2002) ("[A] duty to disclose arises if the issuer is engaging in market transactions, such as those pursuant to a stock purchase program."); Victor Brudney, *Equal Treatment of Shareholders in Corporate Distributions and Reorganizations*, 71 CAL. L. REV. 1072, 1108 (1983) ("Federal securities laws contemplate repurchases but require that the corporation adequately disclose the relevant considerations to the sellers") (footnote omitted); Gabaldon, *supra* note 42, at 198 (arguing that "[t]he duty . . . applies, at a minimum, to the issuer"); Theresa A. Gabaldon, *The Disclosure of Preliminary Merger Negotiations as an Imperfect Paradigm of Rule 10b-5 Analysis*, 62 N.Y.U. L. REV. 1218, 1255 (1987); Gerla, *supra* note 42, at 116 n.32 ("All courts and most commentators who have considered the issue have concluded that an issuer of securities is an insider for purposes of the 'insider trading' prohibitions."); *id.* at 118-20 (arguing on both legal and policy grounds that the issuer is an insider for purposes of the "insider trading" prohibition); Joan MacLeod Heminway, *Materiality Guidance in the Context of Insider Trading: A Call for Action*, 52 AM. U. L. REV. 1131, 1134-36 & n.10 (2003) ("At the core of our nation's insider trading prohibitions is the notion that public issuers of securities and their insiders cannot trade in the issuer's securities while in possession of material nonpublic information."); Marcel Kahan, *Securities Laws and the Social Costs of "Inaccurate" Stock Prices*, 41 DUKE L.J. 977, 984 n.31 (1992); Donald C. Langevoort, *Investment Analysts and the Law of Insider Trading*, 76 VA. L. REV. 1023, 1052 (1990) (noting that "[e]ven after *Dirks*, it has been assumed without serious question that issuers themselves cannot purchase their own securities while possessing undisclosed material information"); Nagy, *supra* note 42,

On the other hand, a few commentators have mentioned arguments against issuer liability. One argument against rule 10b-5 liability for issuer trading on material, nonpublic information is that the issuer is serving its shareholders, not harming them.⁴⁹ This argument is dubious. The classical relationship breached is with the party on the other side of the transaction, not the shareholders generally.⁵⁰ That party is a victim regardless of any

at 1177-79; Daniel J. Winnike, *Rule 10b-5's Effect on Employer Stock Repurchases and Option Cancellations on Termination of Employment*, 19 SEC. REG. L.J. 227, 237-38 (1991) ("[T]here is little doubt that the relationship between a corporation and its shareholders engenders the type of trust and confidence to which the U.S. Supreme Court referred [in *Chiarella*]."); Nicholas J. Gutilla, Case Comment, *Securities Regulation—Disclosure of Intra-Quarter Performance Information Constituting Extreme Departure from Public Information Required in Shelf Registration Prospectus*—Shaw v. Digital Equipment Corp., 82 F.3d 1194 (1st Cir. 1996), 31 SUFFOLK U.L. REV. 1023, 1028 (1998) ("This proscription on insider trading applies equally to a corporation executing transactions in its own stock.") (footnote omitted). See also NAGY ET AL., *supra* note 42, at 475 ("Is the circle wide enough to include the issuer itself? Again, the answer appears to be yes."); Mitu Gulati, *When Corporate Managers Fear a Good Thing Is Coming to an End: The Case of Interim Nondisclosure*, 46 UCLA L. REV. 675, 720-22 (1999) (stating that "[c]ourts have consistently shown the willingness to treat a corporation trading in its own securities as an insider for the purposes of the disclose or abstain rule") (footnote omitted); but also stating that "[i]t is less clear when the breach of fiduciary duty occurs when the corporation is selling securities to investors who are not yet owners of the corporation"). Cf. Alan Strudler & Eric W. Orts, *Moral Principle in the Law of Insider Trading*, 78 TEX. L. REV. 375, 436 (1999) (arguing that it is immoral for the corporation to trade its own shares on material, nonpublic information: "By competing with its own investors' rights to the company's profits when using information in which its investors have an interest, the firm or its authorized insiders would steal information that rightly belongs to its investors"). But cf. 4 ALAN R. BROMBERG & LEWIS D. LOWENFELS, *BROMBERG & LOWENFELS ON SECURITIES FRAUD & COMMODITIES FRAUD* § 6:534, at 6-1394 (2d ed. 2004) ("From the cases there are the strong . . . arguments that a company is not a 10b-5 insider when trading its own securities in the open market. However, the conclusion is startling enough to raise doubts about its validity."); Gulati, *supra*, at 721-23 (stating that it is unclear whether issuers are prohibited from selling shares based on material, nonpublic information).

After raising arguments against issuer liability, one commentator concludes that the issuer would still be liable for insider trading in its own stock. See Deborah I. Mitchell, Note, *Laventhall v. General Dynamics Corporation: No Recovery for the Plaintiff-Option Holder in a Case of Insider Trading Under Rule 10b-5*, 79 NW. U. L. REV. 780, 791 n.70 (1984).

For a conclusion that the issuer has a *Chiarella/Dirks* classical relationship with its own shareholders, see Rosenblum, *supra* note 11, at 304-05 & n.65.

For pre-*Chiarella* commentary supporting the conclusion that an issuer is covered by the rule 10b-5 insider trading prohibition, see Victor Brudney, *Insiders, Outsiders, and Informational Advantages Under the Federal Securities Laws*, 93 HARV. L. REV. 322, 346-47 (1979).

⁴⁹See Mitchell, *supra* note 48, at 791 n.70. See also 4 BROMBERG & LOWENFELS, *supra* note 10, § 6:534, at 6-1390-92 (noting that one argument against issuer liability is that insider trading by issuer may serve a corporate purpose).

⁵⁰See, e.g., *Chiarella*, 445 U.S. at 229 ("[A] purchaser of stock who has no duty to a prospective seller because he is neither an insider nor a fiduciary has been held to have no obligation to reveal material facts.") (emphasis added, citations omitted); *Chiarella* also noted that "liability is premised upon a duty to disclose arising from a relationship of trust and confidence between parties to a transaction. . . . A duty arises from the relationship between parties [to a

benefit to the corporation or the remaining shareholders as a whole.

Rule 10b-5 prohibits fraud even when the fraud benefits a relatively worthy group. A charitable foundation's endowment fund would not be immune from rule 10b-5 when trading on material, nonpublic information.⁵¹ If a charity would be liable for insider trading, a for-profit corporation should also be liable when trading its own stock.

A second argument against issuer liability is that the issuer does not

transaction] . . . and not merely from one's ability to acquire information because of his position in the market." (emphasis added); *id.* at 230-32 & n.14. The Court, therefore, reversed *Chiarella's* § 10b conviction finding that the lower courts failed to "identify a relationship between the petitioner and the *sellers*." *Id.* at 232-33 (emphasis added). As a result, "[n]o duty could arise from petitioner's relationship with the *sellers* of the target company's securities. . . . [H]e was not a person in whom the *sellers* had placed their trust and confidence. He was, in fact, a complete stranger who *dealt with the sellers* only through impersonal market transactions." *Id.* (emphasis added).

In *Dirks*, Justice Powell stated:

We were explicit in *Chiarella* in saying there can be no duty to disclose where the person who has traded on inside information ". . . was not a person in whom the *sellers* [of the securities] had placed their trust and confidence." Not to require such a fiduciary relationship, we recognized, would "depar[t] radically from the established doctrine that duty arises from a specific relationship between *two parties*."

Dirks v. SEC, 463 U.S. 646, 654-55 (1983) (bracketed material in original, emphasis added) (quoting *Chiarella*, 445 U.S. at 232-33).

Later in *Dirks*, the majority commented: "We reaffirm today that '[a] duty [to disclose] arises from the relationship between *parties* . . .'" *Id.* at 657-58 (emphasis added) (quoting *Chiarella*, 445 U.S. at 231-232 n.14).

Still later, *Dirks* states that a "general duty to forego market transactions 'based on material nonpublic information.' . . . would 'depar[t] radically from the established doctrine that duty arises from a specific relationship between *two parties*.'" *Dirks*, 445 U.S. at 666 n.27 (citing and quoting *Chiarella*, 445 U.S. at 233) (emphasis added).

For commentary with the same conclusion, see WANG & STEINBERG, *supra* note 6, § 5.2.1; David M. Becker & Robert F. Hoyt, *Secrets and Securities: Who's an Insider?*, LEGAL TIMES, Sept. 18, 1995, at S28-S29 (stating that "if the person trading on the basis of the inside information has some duty of disclosure running to the party on the other side of the transaction" and noting the *Chiarella* court's holding that "a duty to speak arises from a fiduciary relationship or some other relationship of trust and confidence between parties to a securities transaction"). For related discussion, see WANG & STEINBERG, *supra* note 6, § 6.7.

⁵¹In *SEC v. Offer*, a director was accused of insider trading both in his own account and that of his family foundation. The director consented to entry of an injunction, without admitting or denying the Commission's allegations. *SEC v. Offer* (D.D.C. Feb. 24, 1986), described in 18 Sec. Reg. & L. Rep. (BNA) 283 (Feb. 28, 1986).

In *Backman v. Polaroid Corp.*, 540 F. Supp. 667, 668 (D. Mass. 1982), the plaintiffs initially alleged that a charitable foundation sold Polaroid common stock based on undisclosed inside information and upon Dr. Edwin Land's (Polaroid's founder's) instructions. On appeal, the plaintiffs made no mention of any insider trading allegations. See *Backman v. Polaroid Corp.*, 893 F.2d 1405, 1990 U.S. App. LEXIS 787, at *77 (1st Cir. 1990) (opinion withdrawn) (substitute opinion at 910 F.2d 10, 1990 U.S. App. LEXIS 13140 (1st Cir. 1990)).

obtain a *Dirks* "personal benefit"⁵² when purchasing its own shares based on material, inside information.⁵³ This reasoning is not persuasive. The *Dirks* "personal benefit" test applies to tipping, not trading.⁵⁴

The "personal benefit" test is necessary to distinguish between proper and improper tips. Suppose a corporate insider conveys adverse material, nonpublic information to her spouse. Surely, no rule 10b-5 violation occurs if she provides the information to explain why she must work late at the office. In contrast, the insider may be liable if she is giving the information with the intent that her husband sell his holdings in the company. Similarly, suppose an insider conveys adverse material, nonpublic information to a friend, who is also the insider's personal attorney. Certainly, the insider would not be liable if she reveals the information in the course of obtaining legal advice. In contrast, a violation might occur if the insider is giving the information with the intent that the attorney sell his or her stock in the corporation.

As opposed to tipping, insider trading does not require the "personal benefit" test because such trading is always for a "personal benefit." Assume *arguendo* that the "personal benefit" test applies to insider *trading*. *Issuer* trading on material, nonpublic information would be for a "personal benefit." Both corporations and human beings may obtain such a benefit. Assume that the "personal benefit" test applies to both trades and tips and that only human beings can obtain a "personal benefit." Suppose Douglas Aircraft Corporation gives adverse material, nonpublic information to its investment banker, Merrill Lynch. Based on this news, Merrill Lynch's trading department sells its holdings of Douglas Aircraft. The brokerage firm also tips major clients, who sell. Because Merrill Lynch is a corporation and not a human being, the firm would not violate rule 10b-5 by either trading or tipping. This result is absurd.

In short, neither of these two arguments against issuer liability are persuasive.

IV. COURT DECISIONS ON RULE 10b-5 LIABILITY FOR PURCHASES BY A CORPORATION OF ITS OWN STOCK

While discussing whether public issuers have a rule 10b-5 affirmative duty to disclose material corporate developments, a number of

⁵²For discussion of the "personal benefit" test, see *Dirks v. SEC*, 463 U.S. 646, 661-64 (1983); WANG & STEINBERG, *supra* note 6, §§ 5.2.8.-5.2.8.3.

⁵³See 4 BROMBERG & LOWENFELS, *supra* note 10, § 6:534; Gerla, *supra* note 42, at 118-19 (describing the argument of Bromberg and Lowenfels).

⁵⁴See *Dirks*, 463 U.S. at 661-64; WANG & STEINBERG, *supra* note 6, §§ 5.2.8.1, 5.2.8.3.

courts have stated that corporations have no such general duty, except under certain circumstances.⁵⁵ One such circumstance involves the company trading in its own securities.⁵⁶ By negative implication, such dictum strongly suggests that the corporation cannot engage in insider trading in its own stock.

A few lower courts have held that a public corporation violates rule 10b-5 when buying on material, inside information in mergers and acquisitions.⁵⁷ Dicta in other lower court opinions have stated that rule 10b-5 forbids a public corporation from purchasing its own shares based on material, nonpublic information.⁵⁸ In a face-to-face transaction in *public*

⁵⁵See *Gallagher v. Abbott Labs.*, 269 F.3d 806, 808 (7th Cir.2001); cases cited *infra* note 56. For discussion of when the issuer has an affirmative duty to disclose material developments, see *WANG & STEINBERG*, *supra* note 6, § 13.6.2.4.

⁵⁶*Glazer v. Formica Corp.*, 964 F.2d 149, 157 (2d Cir. 1992) ("There was no suggestion that defendants [including the issuer] were trading in Formica stock."); *Backman v. Polaroid Corp.*, 910 F.2d 10, 13 (1st Cir. 1990) (en banc) (holding that even if issuer did not disclose material corporate developments, rule 10b-5 complaint is dismissed because, among other reasons, "there had been no indication that defendant [corporation] traded its own stock"); *Levinson v. Basic, Inc.*, 786 F.2d 741, 746 (6th Cir. 1986), *vacated on other grounds and remanded*, 485 U.S. 224 (1988); *Staffin v. Greenberg*, 672 F.2d 1196, 1204 (3d Cir. 1981) ("[T]he plaintiffs have not called our attention to any case, including *TGS*, which imposed any duty of disclosure under the Federal Securities Laws on a corporation which is *not* trading its own stock and which has *not* made a public statement.") (footnote omitted). See 7 *LOSS & SELIGMAN*, *supra* note 48, at 3510-11 ("As a general matter in federal securities law, there is no affirmative duty to disclose unless . . . (2) an 'insider' (or the issuer itself) is trading . . ."). Cf. *Greenfield v. Heublein, Inc.*, 742 F.2d 751, 756 (3d Cir. 1984) ("If a corporation is not trading in its securities and is not otherwise under a duty to disclose material nonpublic information . . ."), *cert. denied*, 469 U.S. 1215 (1985).

Language in the SEC release of *In re Carnation Co.* seems to assume that the issuer would be liable for insider trading of its own securities: "This prohibition is triggered whenever the issuer speaks, regardless of whether the issuer is trading in its own securities or is otherwise required to disclose material facts." *In re Carnation Co.*, [1984-85 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,801, at 87,595 (Exch. Act. Rel. No. 22,214, July 8, 1985).

⁵⁷*Tse v. Ventana Med. Sys., Inc.*, No. 97-37-SLR, 1998 U.S. Dist. LEXIS 16760, at *29 (D. Del. 1998) ("In the instant action, the acquiring corporation traded in its own securities . . . [b]y asking plaintiffs to become equity shareholders in the acquiring corporation [through a merger] . . . [The] plaintiffs' complaint adequately states a claim based on defendants' duty to disclose material information." *Id.* (citing *Voit v. Wonderware Corp.*, 977 F. Supp. 363, 369 (E.D. Pa. 1997)); *Voit*, 977 F. Supp. at 369 (refusing to dismiss plaintiff's claims against an issuer for insider trading when the issuer used its allegedly overvalued shares to acquire another corporation). Cf. *In re Ivan Boesky Sec. Litig.*, 36 F.3d 255, 261-62 (2d Cir. 1994) (in recapitalization, management shareholders maintained current equity holdings and public shareholders exchanged a portion of their equity for a pro rata distribution of corporate assets; corporation owed duty "to disclose fully all information relevant to the public shareholders' evaluation of the deal"; *id.* at 261 (citing, *inter alia*, *Chiarella*)) (the corporation "had no legitimate interest in realizing a gain at its public shareholders' expense" *id.* at 262).

⁵⁸See *Shaw v. Digital Equip. Corp.*, 82 F.3d 1194, 1203 (1st Cir. 1996) (public corporation case, stating that "[c]ourts, including this one, have treated a corporation trading in its own securities as an 'insider' for purposes of the 'disclose or abstain' rule") (dictum) (citing

McCormick v. Fund Am. Cos., Inc., 26 F.3d 869 (9th Cir. 1994); Rogen v. Ilikon Corp., 361 F.2d 260, 268 (1st Cir. 1966); Kohler v. Kohler Co., 319 F.2d 634, 638 (7th Cir. 1963); Green v. Hamilton Int'l Corp., 437 F. Supp. 723, 728-29 (S.D.N.Y. 1977)); *McCormick*, 26 F.3d at 876 (although case involved a face-to-face transaction in public corporation shares by CEO of issuer's wholly owned subsidiary, opinion broadly stated that "[n]umerous authorities have held or otherwise stated that the corporate issuer in possession of material nonpublic information, must, like other insiders in the same situation, disclose the information to its shareholders or refrain from trading with them"); Simon v. American Power Conversion Corp., 945 F. Supp. 416, 425 (D.R.I. 1996) (public corporation case; quoting *Shaw*, 82 F.3d at 1203-04) (dictum). Cf. *San Leandro Emergency Med. Group Profit Sharing Plan v. Philip Morris Cos., Inc.*, 75 F.3d 801, 814-15 (2d Cir. 1996) (apparently assuming that insider trading by the publicly traded issuer would violate rule 10b-5, but dismissing the complaint for other reasons); *Fausek v. White*, 965 F.2d 126, 131 (6th Cir. 1992) (close corporation case; issue was whether, under state law, closely held corporation could assert attorney-client privilege in suit by some of its shareholders against other defendants; court rejected corporation's argument that it has no fiduciary duty to its shareholders, noting that, under Tennessee law, directors could once trade like outsiders, but that now officers, directors, and control shareholders owe a fiduciary duty to other shareholders due to change in the law). But cf. *Cooperman v. Individual, Inc.*, 171 F.3d 43, 47, 49 (1st Cir. 1999) (in a suit brought against public corporation under §§ 11 and 15 of the 1933 Securities Act and not under rule 10b-5, stating that "it is clear that an issuer of securities owes no absolute duty to disclose all material information"; surprisingly citing *Shaw v. Digital Equip. Corp.*, 82 F.3d 1194, 1202 (1st Cir. 1996), which does not seem to support the proposition stated); *American Gen. Ins. Co. v. Equitable Gen. Corp.*, 493 F. Supp. 721, 742-45 (E.D. Va. 1980) (a post-*Chiarella* case apparently ignoring the possibility that an issuer buying a 9.9% block of its own stock may be liable under rule 10b-5 for material nondisclosure; court held the corporation liable for material affirmative misrepresentations).

A pre-*Chiarella* opinion stated: "If the corporation were to attempt to exploit such non-public information by dealing in its own securities, it would open itself up to potential liability under federal and state securities laws, just as do the insiders when they engage in insider trading." *Freeman v. Decio*, 584 F.2d 186, 194 (7th Cir. 1978).

For another pre-*Chiarella* case supporting the proposition that an issuer is covered by the rule 10b-5 insider trading prohibition, see *Green v. Hamilton Int'l*, 437 F. Supp. 723, 728-29 (S.D.N.Y. 1977). *Green* involved a public corporation redeeming its convertible debentures. See *id.* at 725-26.

In *Laventhall v. General Dynamics Corp.*, 704 F.2d 407 (8th Cir. 1983), the plaintiff had bought call options on General Dynamics common stock. The complaint alleged that the company had purchased its own common stock on the open market based on undisclosed material, inside information. *Id.* at 408-09. Although the court denied standing to the plaintiff because he was an option trader, the opinion assumed arguendo that the defendant public corporation could not trade its own stock based on material, nonpublic information. See *id.* at 410-15.

Brody v. Transitional Hosps. Corp., 280 F.3d 997, 1000-02, (9th Cir. 2002), assumed that insider trading by the publicly traded issuer would violate rule 10b-5, but dismissed the complaint for other reasons. With reference to the issuer, THC, the opinion stated:

[T]he allegation is that THC traded its own stock on the basis of inside information. Such allegations would state a "'traditional' or 'classical' theory of insider trading liability [under] Rule 10b-5 based on 'a relationship of trust and confidence . . . between the shareholders of a corporation and those insiders who have obtained information by reason of their position with that corporation.'"

Id. at 1004 (quoting *O'Hagan*, 521 U.S. at 651-52 (quoting *Chiarella*, 446 U.S. at 228)) (word "under" in brackets in original; ellipses in original).

A pre-*Chiarella* case held that a public company would violate rule 10b-5 if it concealed material information in order to depress the market price and acquire its own stock at favorable

corporation shares, the Ninth Circuit has broadly stated that a corporation has a duty to disclose material, nonpublic information to a shareholder with which it trades.⁵⁹ In that Ninth Circuit case, the public corporation bought shares directly from the plaintiff, the CEO of a wholly owned subsidiary.⁶⁰ The Second,⁶¹ Seventh,⁶² and Eleventh⁶³ Circuits have held that rule 10b-5 obligates a closely held corporation to disclose material information before purchasing stock from a shareholder.

A leading opinion is *Jordan v. Duff & Phelps*,⁶⁴ where the plaintiff was an employee and stockholder of defendant Duff & Phelps. Under the terms of his "Stock Restriction and Purchase Agreement," upon the termination of his employment for any reason, plaintiff was required to sell (and the corporation required to buy) his stock at an adjusted book value price. Plaintiff informed Duff & Phelps in late 1983 that he planned to

prices. See *Britt v. Cyril Bath Co.*, 417 F.2d 433 (6th Cir. 1969).

A separate question is whether to impute to the issuer the trades of its officers. For discussion of this issue, see WANG & STEINBERG, *supra* note 6, § 4.6.2 & n.48.

If the issuer sells stock to someone not already a shareholder, the buyer enters the classical relationship triangle simultaneous with the transaction. See *Chiarella*, 445 U.S. at 227 n.8; WANG & STEINBERG, *supra* note 6, § 5.2.1 & n.31.

⁵⁹*McCormick*, 26 F.3d at 876 (citing *Jordan v. Duff & Phelps, Inc.*, 815 F.2d 429 (7th Cir. 1987), *cert. dismissed*, 485 U.S. 901 (1988)).

⁶⁰See *id.* at 872.

⁶¹See *Castellano v. Young & Rubicam, Inc.*, 257 F.3d 171, 179 (2d Cir. 2001) (citing *Jordan*, 815 F.2d at 434, and stating that "closed corporations that purchase their own stock have a special obligation to disclose to sellers all material information").

For district court opinions stating that a closely held corporation must disclose material information when purchasing its own stock, see *Rizzo v. MacManus Group, Inc.*, 158 F. Supp. 2d 297, 302-03 (S.D.N.Y. 2001) (citing *Jordan*, 815 F.2d at 435); *Piccirillo v. FCB/Leber Katz Partners, Inc.*, [1988-89 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,016, at 90,750, 90,752 (S.D.N.Y. 1988). Cf. *Western Hemisphere Group v. Stan West Corp.*, [1984-85 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 91,858, at 90,275, 90,279 (S.D.N.Y. 1984) (holding that defendant officers and directors were liable for failure to disclose material information when corporation purchased its own stock; corporation was liable because officers and directors were acting within scope of their authority and course of their employment).

⁶²*Jordan*, 815 F.2d at 431, 434 (citing *Michaels v. Michaels*, 767 F.2d 1185, 1194-97 (7th Cir. 1985), which apparently assumed that rule 10b-5 requires a closely held company to disclose material information to those from whom it buys its stock). But cf. *DeMott*, *supra* note 12, at 916-21 (criticizing *Jordan's* assumption that a corporation in repurchasing its own shares owes a fiduciary obligation to its shareholders); Calvin Massey, *American Fiduciary Duty in an Age of Narcissism*, 54 SASKATCHEWAN L. REV. 101, 113-15 (1990) (arguing that a corporation itself cannot owe a separate fiduciary duty to its shareholders).

⁶³See *Smith v. Duff & Phelps, Inc.*, 891 F.2d 1567, 1572-75 (11th Cir. 1990).

For pre-*Chiarella* opinions stating that a closely held corporation must disclose material, nonpublic information when buying its own securities, see *Arber v. Essex Wire Corp.*, 490 F.2d 414, 418 (6th Cir. 1974); *Rogen v. Ilikon Corp.*, 361 F.2d 260, 268 (1st Cir. 1966); *Kohler v. Kohler Co.*, 319 F.2d 634, 638 (7th Cir. 1963).

⁶⁴*Jordan*, 815 F.2d at 432.

resign. By mutual agreement, plaintiff remained in defendant's employ until the end of the year, allowing his stock to be valued as of December 31 of that year, which was expected to yield a better price to plaintiff than the previous year's book value. Shortly after the end of the year, Duff & Phelps sent plaintiff a check for \$23,225, the amount to which he was entitled under the agreement.

On January 10, 1984, Duff & Phelps announced a merger that valued the company at \$50 million. Under the terms of the announced merger, had it been consummated and had plaintiff remained in the company's employ, his shares would have been worth \$452,000 in cash, with the opportunity to obtain up to an additional \$194,000 in an earn-out.⁶⁵ While that transaction never closed, eventually Duff & Phelps was acquired by an employee stock ownership trust, with the shareholders of the company receiving a combination of cash, notes and beneficial interests in the trust. The plaintiff asserted that, had he still owned the stock, the package he would have received would have been worth \$497,000 at the time of the sale. In any event, when he learned that a sale of Duff & Phelps was a real possibility, plaintiff sought to rescind the sale of his stock, claiming that the company's failure to disclose sale negotiations constituted a violation of rule 10b-5. The trial court dismissed plaintiff's claim on summary judgment, concluding that Duff & Phelps had no duty to disclose to plaintiff the possible sale of the company.⁶⁶ The Court of Appeals for the Seventh Circuit reversed, in an opinion by Judge Easterbrook, with a sharp dissent from Judge Posner.

The primary issue before the appellate court was whether Duff & Phelps had a rule 10b-5 duty to disclose, to an employee seeking a stock buyout, that the board of the company was actively seeking a purchaser for the company and that a lucrative sale was a reasonable probability. A majority of the panel thought that the company did have such a duty, noting that under "the fiduciary duty of corporate law . . . [c]lose corporations buying their own stock, like knowledgeable insiders of closely held firms buying from outsiders, have a fiduciary duty to disclose material facts."⁶⁷ The court suggested that, despite Exchange Act section 29(a),⁶⁸ the parties might have contracted around this duty, but as they failed to do so, the

⁶⁵*Id.* at 432-33.

⁶⁶*Jordan v. Duff & Phelps, Inc.*, No. 84 C 2428, [1986-1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,724, at 93,516, 93,517 (N.D. Ill. Mar. 17, 1986). The trial court held that where one negotiating party is a publicly-held corporation, an agreement in principle must occur before the merger negotiations are material.

⁶⁷*Jordan*, 815 F.2d at 435.

⁶⁸Exchange Act § 29(a) prohibits waivers of the provisions of the Exchange Act. See *Jordan*, 815 F.2d at 435.

default rule recognizing a fiduciary duty applied.⁶⁹ In concluding that the corporation had a rule 10b-5 disclosure obligation, the majority opinion rejected the argument that the combination of plaintiff's status as an at-will employee, together with stock repurchase agreement, effectively eliminated the disclosure obligation.⁷⁰

In *Jordan*, Judge Easterbrook distinguished between public and private corporations because of the possible effects of disclosure. Negotiations must often be secret to increase the likelihood of success.⁷¹ With a public company, "[i]nvestors are entitled to the benefits of secrecy during the negotiations; a law designed to prevent frauds on investors tolerates silence that yields benefits for investors as a group."⁷² In contrast, when a close corporation deals with one of its own shareholders, the face-to-face negotiations enable the company to disclose the necessary information after extracting promises of confidentiality.⁷³

One response to Judge Easterbrook is that, even if a public corporation is obligated to disclose before purchasing, it may always maintain secrecy by abstaining from buying. The "disclose or abstain" rule in effect becomes "abstain or abstain." Indeed, anyone who signs a confidentiality agreement or otherwise has an obligation not to disclose material, nonpublic information may in effect confront a rule of "abstain or abstain." Even with a close corporation like *Duff & Phelps*, the choice in effect may be "abstain or abstain." Were *Duff & Phelps* to disclose (after obtaining a confidentiality agreement), the prospective seller would likely refuse to sell at all or sell only at a much higher price.

In short, the precedents involving face-to-face transactions by the issuer on inside information should apply to the issuer's stock market insider trades.⁷⁴ Indeed, the line between face-to-face transactions and

⁶⁹*Jordan*, 815 F.2d at 436.

The Seventh Circuit also held that with a close corporation, as opposed to a public corporation, an agreement in principle need not occur before merger negotiations are material. *See id.* at 433-35.

Subsequently, the Supreme Court held that, with either a close or a public corporation, an agreement in principle need not occur for merger negotiations to be material. *See Basic Inc. v. Levinson*, 485 U.S. 224, 232-36 (1988).

⁷⁰*See id.* at 436-39.

⁷¹*See id.* at 431.

⁷²*Id.*

⁷³*See Jordan*, 815 F.2d at 431. For similar reasoning, see *Lawton v. Nyman*, 327 F.3d 30, 40 (1st Cir. 2003) (citing *Jordan v. Duff & Phelps, Inc.*, 815 F.2d 429 (7th Cir. 1987), *cert. dismissed*, 485 U.S. 901 (1988); *Michaels v. Michaels*, 767 F.2d 1185, 1196-97 (7th Cir. 1985)).

⁷⁴*See Winnike, supra* note 48, at 238 n.33 ("It is difficult to see that a close corporation owes any greater or lesser fiduciary responsibility to its shareholders than a publicly held company.").

stock market trades is blurred.⁷⁵ Many commentators assume that stock exchange transactions are anonymous. This is an oversimplification, at least with trades with a block positioner.⁷⁶

A transaction with a block positioner has face-to-face aspects.⁷⁷ The

The Eleventh Circuit decision in *Smith v. Duff & Phelps, Inc.*, 891 F.2d 1567 (11th Cir. 1990), involving a fact pattern similar to *Jordan*, assumed that a public company could not purchase its own stock based on material, nonpublic information: "Thus, the Duff & Phelps [defendant's] non-disclosure approach would produce the anomalous result that public corporations, which have a justifiable reluctance to disclose, must disclose under section 10(b), while closely held corporations, which appear to have no justifiable reason not to disclose, need not do so." *Id.* at 1574.

⁷⁵*Cf.* WANG & STEINBERG, *supra* note 6, § 8.2.2 (discussing the practical problems of distinguishing between "fortuitous" and "nonfortuitous" transactions as defined in the American Law Institute's proposed Federal Securities Code); William K.S. Wang, *Trading on Material Nonpublic Information on Impersonal Stock Markets: Who is Harmed and Who Can Sue Whom Under SEC Rule 10b-5?*, 54 S. CAL. L. REV. 1217, 1306-11 (1980) (same); Wang, *supra* note 32, at 28-45 (analogizing stock market insider trading to an executive's face-to-face sale of a used car that the executive knows has a generic defect).

⁷⁶*See* Wang, *supra* note 32, at 30-31. For discussion of transactions with block positioners, see ROBERT W. HAMILTON & RICHARD A. BOOTH, BUSINESS BASICS FOR LAW STUDENTS § 14.7, at 365-66 (3d ed. 2002); WANG & STEINBERG, *supra* note 6, § 3.3.1, at 52-56.

Measured by number of shares traded, almost half of all New York Stock Exchange reported volume in 2001 consisted of block trades (transactions of 10,000 shares or more). *See* New York Stock Exchange, Fact Book for the year 2001, at 16, 99 (2002) (defining a "block trade" as a transaction of 10,000 or more shares, "block trades" constituted 48.1% of all New York Stock Exchange reported volume in 2001). In 2002, "block trades" constituted about forty-five percent of all New York Stock Exchange volume. In 2003, "block trades" constituted about thirty-eight percent of all New York Stock Exchange volume. *See* <http://www.nyse.com/about/FactBook> "Stock Market Activity" "Distribution of NYSE share volume by trade size (percent of total)."

Such blocks are often bought and sold by block positioning brokerage firms. *See* New York Stock Exchange, Fact Book for the year 2001, at 16 (2002) (based on 1994 study, New York Stock Exchange estimates that roughly twenty-seven percent of New York Stock Exchange block volume (transactions of 10,000 or more shares) is facilitated by "block positioners" or "block traders").

⁷⁷*See* WANG & STEINBERG, *supra* note 6, § 3.3.1 & nn. 14-21. *Cf.* Steven A. Fishman, *Duty to Disclose Under Rule 10b-5 in Face-to-Face Transactions*, 12 J. CORP. L. 251, 256 (1987) ("Face-to-face transactions do not lend themselves to generalization because they can take many forms [T]hey may include transactions similar to typical insider trading transactions on the open market, except that the transactions are negotiated directly between dealers or brokers representing the parties.").

For a case in which a block positioner sued an institutional investor under rule 10b-5 for allegedly selling a 35,000 share block of stock based on material, nonpublic information, see *duPont Glore Forgan, Inc. v. Arnold Bernhard & Co.*, [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,346, at 93,173 (S.D.N.Y. 1978). The head of the defendant's trading department telephoned the plaintiff block positioner and "asked if duPont was interested in purchasing 5,000 shares of Jet Air common stock." *Id.* at 93,175. Subsequently, the two parties had other telephone conversations, in which duPont first bought 5,000 shares and then another 30,000 shares. *See id.* at 93,176.

For discussion of a stockbrokerage firm (Hayden, Stone) invoking Exchange Act § 29(b)

two parties communicate with each other by telephone or electronic system prior to a transaction.⁷⁸ When buying or selling a block, a market-maker may act either as agent or principal.⁷⁹ If the firm acts as a principal, the initial block trade resembles a face-to-face deal (although the positioner

when refusing to pay for or accept delivery of Equity Funding stock because of a suspicion of insider trading, see *Jefferies & Co. v. Arkus-Duntov*, 357 F. Supp. 1206, 1212-13 (S.D.N.Y. 1973). Apparently, Hayden, Stone purchased the Equity Funding shares for its own account. See *id.* at 1210 ("On March 26, Jefferies sold the entire block of 24,475 shares to member firms."). "Hayden, Stone refused to accept delivery on the ground that Duntov had allegedly violated the securities laws." *Id.* at 1212-13. Unclear is whether Hayden, Stone was a block positioner. For discussion of rescission under Exchange Act § 29(b) in insider trading cases, see WANG & STEINBERG, *supra* note 6, §§ 4.9.2, 4.9.3.

Energy Factors Inc. v. Nuevo Energy Co., [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,883 (S.D.N.Y. 1992), is another example of a case in which the distinction between a face-to-face and anonymous transaction is blurred. Energy Factors was the third largest shareholder of Nuevo Energy Company, whose stock was listed on the New York Stock Exchange. *Id.* at 93,607. Energy Factors received several telephone calls from a "buy-side" broker-dealer that expressed interest in buying the Nuevo shares. In one call, the broker-dealer expressed impatience with Energy's delay in making a decision. Energy sold most of its Nuevo shares to the broker-dealer at a price above that on the New York Stock Exchange. The broker-dealer subsequently sold the shares to four institutional clients. Energy Factors alleged that the broker-dealer had material, nonpublic information about Nuevo at the time of Energy Factors' sale. *Id.* at 93,608.

⁷⁸See HAMILTON & BOOTH, *supra* note 76, § 14.7, at 366 ("When a department receives an order to buy or sell a large block of stock, it contacts other institutions to see whether they want to participate on the other side of the trade."); WILLIAM A. KLEIN & JOHN C. COFFEE, JR., BUSINESS ORGANIZATION AND FINANCE: LEGAL AND ECONOMIC PRINCIPLES 389 (6th ed. 1996) ("An elaborate electronic network connects the trading desks of the major institutional investors so that it is possible to solicit hundreds of institutions very quickly to ascertain if they wish to take a piece of the block."); 5 LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 2603 (3d ed. rev. 2001); Report of the Presidential Task Force on Market Mechanisms VI-9 (Jan. 1988) ("Typically the institutional trading departments of these [positioner] firms maintain direct phone lines to the trading desks of hundreds of these institutions. . . . Once the firm has been given an order to buy or sell a large block of stock by an institution, it will contact other institutions to see whether they want to participate on the other side of the trade."); Daniel R. Fischel, *Organized Exchanges and the Regulation of Dual Class Common Stock*, 54 U. CHI. L. REV. 119, 126 (1987) ("A broker dealing in a large block of stock will call other dealers and institutions to find one interested in the other end of the deal."); Mahlon M. Frankhauser & David S. Frye, *Front Running*, 21 REV. OF SEC. & COMMODITIES REG. 179, 180 (1988) ("[T]he price of the block is . . . negotiated directly between the parties . . ."); Committee on Futures Regulation of the Assn. of the Bar of the City of New York, *Large Order Execution in the Futures Markets*, 44 BUS. LAW. 1335, 1336 (1989) [hereinafter *Large Order*]; Joel Seligman, *The Future of the National Market System*, 10 J. CORP. L. 79, 115 (1984) ("Because the block trading market is not centralized, institutions and block houses rely on telephone or electronic systems to communicate trading interest.").

⁷⁹5 LOSS & SELIGMAN, *supra* note 78, at 2601 ("The block trader may act as an agent and operate on a straight commission basis. Alternatively, the block trader may act as a dealer . . ."); Report of the Presidential Task Force, *supra* note 78, at VI-10; Seligman, *supra* note 78, at 115.

will unload all or most⁸⁰ of the block immediately after the initial transaction). Even when the positioner decides to act as an agent, it frequently ends up taking part of a block into its own account because of insufficient matching orders on the other side.⁸¹

Suppose that a public corporation has material, nonpublic beneficial information about its prospects. The company then purchases its own shares either (1) in one block from an institutional investor, (2) in one block from a block positioner, or (3) through a large number of anonymous stock exchange trades. The first block trade is face-to-face. The second block trade (with a block positioner) has face-to-face aspects. In both instances, there is no good reason not to apply the face-to-face precedents⁸² that a company violates rule 10b-5 when buying its stock based on material, inside information. In addition, there is no reason that rule 10b-5 should distinguish between the two block trades and the anonymous stock exchange transactions.

Indeed, the Supreme Court in *Chiarella* seemed to extrapolate from face-to-face transactions to impersonal stock market trading.⁸³ Justice Powell apparently felt that if the president of a closely held corporation cannot purchase stock from a shareholder based on material, nonpublic information, the president of a publicly traded corporation cannot do so *for the same reason*. In both instances, the "gravamen of the offense is the nondisclosure, and the president has a fiduciary duty to disclose to the shareholder."⁸⁴ Thus, Justice Powell's *Chiarella* decision indicates that, in anonymous stock market trades as well as face-to-face transactions, an insider may owe a duty to disclose (based on a classical relationship) to the party in privity. In exonerating *Chiarella*, Justice Powell repeatedly emphasized that *Chiarella* had no special relationship with those who sold

⁸⁰To facilitate a block trade, a block positioner may buy shares for its own inventory or sell from its inventory. See HAMILTON & BOOTH, *supra* note 76, § 14.7, at 366; KLEIN & COFFEE, *supra* note 78, at 389; Report of the Presidential Task Force, *supra* note 78, at VI-10 ("Once the firm has put together as many of the buyers and sellers as it can find, it may choose to commit its own capital to complete the transaction . . ."); Large Order, *supra* note 78, at 1336 ("[T]he [block positioning] firm may determine to take all or part of the other side for its own account.").

⁸¹See *supra* sources cited note 80; Division of Market Regulation, SEC, Market 2000: An Examination of Current Equity Market Developments, II-14 (Jan. 1994).

⁸²See *supra* notes 59-70 and accompanying text.

⁸³See *Chiarella*, 445 U.S. at 228-30, 233; sources cited *supra* note 42; WANG & STEINBERG, *supra* note 6, § 5.2.1 & n.24.

⁸⁴WANG & STEINBERG, *supra* note 6, § 5.2.1, at 286.

to him,⁸⁵ all of whom presumably were anonymous marketplace traders.⁸⁶

V. THE SEC'S POSITION, INCLUDING RULE 10b5-1

The SEC has taken the position that a public corporation cannot buy its own stock based on material, nonpublic information.⁸⁷

In August 2000, the SEC adopted rule 10b5-1, which provides that insider trading liability generally arises when someone trades while "aware" of material, nonpublic information, but also provides certain exceptions from liability.⁸⁸ The rule states that a person trades "on the

⁸⁵See *supra* note 50.

⁸⁶Chiarella engaged in the following transactions:

1. bought 300 shares of USM on 9/5/75 and sold them on 9/9/75.
2. bought 2300 shares of Riviana Foods from 2/5/76 to 2/10/76 and sold them from 2/26/76 to 3/16/76.
3. bought 1100 shares of FoodTown Stores on 10/11/76 and sold them from 10/21/76 to 12/1/76.
4. bought 100 shares of Booth Newspapers on 10/21/76 and sold them on 10/22/76.
5. bought 3200 shares of Sprague Electric on 11/10/76 and sold them on 11/15/76.

From all these transactions, he realized a profit of \$30,011.39. See *United States v. Chiarella*, 588 F.2d 1358, 1363 n.3 (2d Cir. 1978), *rev'd*, *Chiarella v. United States*, 445 U.S. 222 (1980).

⁸⁷See *SEC v. General Dynamics Corp.*, Litig. Rel. No. 9021, 19 SEC Docket 792, [1979-1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,293, at 97,021 (Feb. 27, 1980) (consent decree; SEC alleged that the defendant public corporation purchased its own common stock "while in the possession of material non-public information concerning the proposed payment of a cash dividend"). See also SEC Sec. Act Rel. No. 6434 n.5 (Nov. 17, 1982), 26 SEC Docket 868, 869 n.5 (1982), [1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,276, at 85,478 n.5 ("Rule 10b-18 confers no immunity from possible Rule 10b-5 liability where the issuer engages in repurchases while in possession of favorable, material non-public information concerning its securities."). Cf. *Purchases of Certain Equity Securities by the Issuer and Others*; Adoption of Safe Harbor, Securities Act Rel. No. 6434, Investment Co. Rel. No. 12823, 26 SEC Docket 868, [1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,276, at 85,477 part II(B) (Nov. 17, 1982) (SEC had proposed rule 13e-2, which included a general antifraud provision in connection with issuer purchases of its common and preferred stock; commentators argued that the provision was unnecessary in light of existing rule 10b-5 and of existing Exchange Act §§ 9(a)(2) and 10(b); commentators also argued that the general nature of the antifraud provision would detract from the certainty otherwise provided by proposed rule 13e-2; SEC concluded that the proposed antifraud provision was not necessary); SEC Comment on Timely Disclosure of Material Corporate Developments, Securities Act Rel. No. 5092, Securities Exchange Act Rel. No. 8995, Investment Co. Rel. No. 6209, [1970-71 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,915, at 80,035, 80,036 (Oct. 15, 1970) (pre-*Chiarella* statement by the Commission noting that "unless adequate and accurate information is available, a company may not be able to purchase its own securities or make acquisitions using its securities"); *In re Ward La France Truck Corp.*, Securities Act Release No. 3445, 13 S.E.C. 373, 1943 SEC LEXIS 463 (May 20, 1943) (public corporation case; pre-*Chiarella* statement by the Commission that a corporation violates rule 10b-5 if it buys its own stock based on material, nonpublic information).

⁸⁸For the full text of rule 10b5-1 and the accompanying release, see SEC Rel. Nos. 33-7881, 34-43154, IC-24599, File No. S7-31-99, 73 SEC Docket 3 (Aug. 15, 2000), [2000 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,319, at 83,676, available at <http://www.sec.gov/rules/final/>

basis of" material, nonpublic information if he or she is "aware" of the information at the time of the transaction.⁸⁹

One of the three alternative affirmative defenses available to *both* individuals and entities is that prior to awareness of the information, the individual or entity had adopted a *written* plan for trading securities.⁹⁰ The SEC release, accompanying the adoption of the rule, specifically mentioned that this defense is available to an issuer engaging in a stock repurchase program.⁹¹

Rule 10b5-1 also contains an affirmative defense available only to entities. An entity is not liable if it shows that the person making the investment decision on behalf of the entity was not aware of the information and that the entity:

had implemented reasonable policies and procedures, taking into consideration the nature of the person's business, to

33-7881.htm [hereinafter *Adopting Release*].

For the SEC staff's answers to some frequently asked questions about rule 10b5-1, see <http://www.sec.gov/interps/telephone/phonesupplement4.htm> [hereinafter *Telephone*]. For discussion of how to implement rule 10b5-1 trading plans, see Steven E. Bochner & Leslie A. Hakala, *Implementing Rule 10b5-1 Stock Trading Plans*, INSIGHTS, June 2001, at 2; Peter J. Romeo & Alan L. Dye, *The SEC's New Insider Trading Rules*, 34 REV. SEC. & COMMODITIES REG. 1, 1-11 (2001); John H. Sturc et al., *New Insider Trading Rules Present Opportunities*, INSIGHTS, Oct. 2000, at 2.

For additional discussion of rule 10b5-1, see WANG & STEINBERG, *supra* note 6, §§ 4.4.5, 4.5A, 5.2.3.7 n.147, 13.2.3 & n.41, 13.2.4, 13.3.3, 13.5.2.3(ba), 13.6.2.2 & nn.31e-31i (1996 & Supp. 2001).

⁸⁹Rule 10b5-1(b).

⁹⁰Rule 10b5-1(c)(1)(i)(A)(3).

⁹¹See *Adopting Release*, *supra* note 88, part III.A.2, text at note 116.

The SEC's release further discusses how an issuer might implement a rule 10b5-1 plan:

For example, an issuer operating a repurchase program will not need to specify with precision the amounts, prices, and dates on which it will repurchase its securities. Rather, an issuer could adopt a written plan, when it is not aware of material nonpublic information, that uses a written formula to derive amounts, prices, and dates. Or the plan could simply delegate all the discretion to determine amounts, prices, and dates to another person who is not aware of the information—provided that the plan did not permit the issuer to (and in fact the issuer did not) exercise any subsequent influence over the purchases or sales. . . . A person would not satisfy this provision of the rule by establishing a delegation of authority under which the person retained some ability to influence the decision about how, when, or whether to purchase or sell securities.

Adopting Release, *supra* note 88, part III.A.2, note 116 and accompanying text.

See also Bochner & Hakala, *supra* note 88, at 2, 7-8 (discussing the protections rule 10b5-1(c) provides issuers); Romeo & Dye, *supra* note 88, at 5, 10-11 (noting that rule 10b5-1 provides an affirmative defense for issuer repurchases); Sturc et al., *supra* note 88, at 5-6 (reviewing rule 10b5-1). For additional discussion of how an issuer might implement a rule 10b5-1 plan, see Bochner & Hakala, *supra* note 88, at 4-8; Romeo & Dye, *supra* note 88, at 8-11.

ensure that individuals making investment decisions would not violate the laws prohibiting trading on the basis on material nonpublic information. These policies and procedures may include those that restrict any purchase, sale, and causing any purchase or sale of any security as to which the person has material[,] nonpublic information, or those that prevent such individuals from becoming aware of such information.⁹²

The Commission staff has noted that this affirmative defense is available to the issuer.⁹³

In other words, both the Commission's release accompanying rule 10b5-1 and the staff's interpretation of the rule assume that the issuer would incur rule 10b-5 liability by buying its own stock while "aware" of material, nonpublic information.

VI. POLICY ARGUMENTS FOR AND AGAINST A RULE 10b-5 PROHIBITION OF ISSUER INSIDER BUYING

A. *Equitable Considerations*

Equitable principles may be one basis for prohibiting a corporation from buying its own shares on material, nonpublic information. An

⁹²Rule 10b5-1(c)(2). For discussion of Rule 10b5-1(c)(2), see WANG & STEINBERG, *supra* note 6, §§ 4.4.5 & nn.52w-52aa, 13.2.4.

⁹³See *Telephone*, *supra* note 88, question number 18 about rule 10b5-1:

Is the institutional defense provided by Rule 10b5-1(c)(2) available to the issuer of the securities for a repurchase plan?

Yes, assuming the conditions of that rule are satisfied.

The rule 10b5-1(c)(2) exemption deals with when to impute information to the issuer. Suppose a scientist working for a drug company reports a major research breakthrough to an officer of the corporation. At the same time, the issuer makes open market purchases of its own stock.

Under rule 10b5-1(c)(2), the above corporation would not be liable for insider trading under rule 10b-5, provided (1) the decision maker for the purchase was not aware of the information, and (2) the company had reasonable policies and procedures to prevent such decision makers from becoming aware of such information.

Even prior to the adoption of rule 10b5-1, multi-service financial firms established "Chinese Walls," i.e., policies and procedures to control the flow of material nonpublic information within the organization. For discussion of "Chinese Walls," see WANG & STEINBERG, *supra* note 6, §§ 13.5.2, 13.5.3.

In a number of contexts, the SEC has endorsed the efficacy of "Chinese Walls." See *id.* § 13.5.2.3. The most notable example is in rule 10b5-1(c)(2).

For discussion of judicial cases addressing the efficacy of "Chinese Walls," see WANG & STEINBERG, *supra* note 6, § 13.5.2.3(a).

analogy is payments made by an insolvent corporation. While the general rule is that a corporation is free to prefer some creditors to others⁹⁴ (assuming that the payment does not constitute a fraudulent conveyance⁹⁵ or a preference under the federal bankruptcy law⁹⁶), when the corporation is insolvent, it is not free to favor a creditor who is also a corporate insider.⁹⁷ The rationale behind this well-accepted rule has been stated as "merely applied common honesty."⁹⁸ In a 1934 opinion, the Delaware Court of Chancery explained that the "doctrine [is] nothing more than a particular expression of the fundamental principle which good morals exact, that men should act in honesty and fairness."⁹⁹ By analogy, a corporation repurchasing its own shares should act "in honesty and fairness" and disclose material information to the selling shareholder.

Nevertheless, countervailing fairness arguments exist. The corporation buying its own stock on material, nonpublic information would be acting in the best interests of its non-selling shareholders, who might prefer that no disclosure be made. As in so many instances, fairness cuts both ways. In addition, those who regard insider trading as wrong may have the image of a corporate officer trading shares just in advance of disclosure of material information. With an insider purchase by the corporation, no identifiable individual directly profits.

B. *Protection of Informational Property*

One common objection to insider trading is that the insider has misappropriated property—in this case, information that belongs or should belong to the corporation.¹⁰⁰ When the corporation is the purchaser, this misappropriation element is absent.

C. *Economic Analysis*

Economic analysis has frequently been applied to insider trading. For instance, commentators have argued that insider trading is desirable

⁹⁴*In re Pharr-Luke*, 259 B.R. 426, 431 (Bankr. S.D. Ga. 2000); *Curtis, Jones & Co. v. Smelter Nat'l Bank*, 96 P. 172, 174 (Colo. 1908); *Advanced Dry Wall Co. v. Regency Homes, Inc.*, 173 N.W.2d 827, 828 (Mich. App. 1969); *Mills v. Miller Harness Co., Inc.*, 326 S.E.2d 665, 666 (Va. 1986).

⁹⁵U.F.T.A. § 1-13, 7A U.L.A. 639-67 (1985).

⁹⁶*See* 11 U.S.C. § 547 (West 2000).

⁹⁷*Penn. Co. for Ins. v. South Broad St. Theatre Co.*, 174 A. 112 (Del. Ch. 1934).

⁹⁸*Id.* at 116 (quoting *Stuart v. Larson*, 298 F. 223, 227 (8th Cir. 1924)).

⁹⁹*Id.*

¹⁰⁰*See* WANG & STEINBERG, *supra* note 6, § 2.3.2 (Supp. 2001).

because it may cause the company's share price to reflect more accurately underlying value.¹⁰¹ Moreover, trading volume and price movements created by insider trading may send a signal to the market, suggesting the existence of material, nonpublic information.¹⁰² Although the interval between the insider trading and dissemination of the news may be short, the more accurate stock price may improve resource allocation.¹⁰³

Any salutary effects of trading on nonpublic information apply, whether the trader is a corporate insider, tippee, or the corporation itself.¹⁰⁴ The critical question is whether there are countervailing arguments—whether or not based on economic analysis—to offset this theoretical efficiency gain.

One major counter-argument is that such trading harms the stock market generally. The public may be deterred from investing in the market by the presence of insider trading.¹⁰⁵ The SEC has stated that insider trading has a significantly "deleterious" effect on the "investing public's confidence in corporate institutions and the securities markets."¹⁰⁶ Congress has expressed similar concerns.¹⁰⁷ Corporations have the resources and the knowledge to engage in a great deal of repurchasing activity based on material, nonpublic information. This may damage investor confidence.

When a corporation trades on inside information, it (and, indirectly, the non-selling shareholders) gain an immediate benefit equal to the immediate harm to the victims of the inside trade.¹⁰⁸ At first blush, a shareholder may seem to have a roughly equal chance of being either a victim or an (indirect) beneficiary. Even if this were true, investors are

¹⁰¹See *id.* § 2.2.2. *Contra id.* § 2.2.2 at 28 & n.43 (citing authorities questioning whether insider trading would have a significant effect on stock prices); William K.S. Wang, *Selective Disclosure by Issuers, Its Legality and Ex Ante Harm: Some Observations in Response to Professor Fox*, 42 VA. J. INT'L L. 869, 885 (2002) (same).

¹⁰²See WANG & STEINBERG, *supra* note 6, § 2.2.2, at 26-27.

¹⁰³See *id.* § 2.2.2 & n.35; Wang, *supra* note 101, at 884 & n.78. *But see* WANG & STEINBERG, *supra* note 6, § 2.2.2, at 28-29 (stock price effects of insider trading may not improve resource allocation); Wang, *supra* note 101, at 885 (same).

¹⁰⁴See WANG & STEINBERG, *supra* note 6, § 2.2.2, at 27.

¹⁰⁵See *id.* § 2.3.1.

¹⁰⁶*In re Faberge, Inc.*, Securities Exchange Act Release No. 10174 (May 25, 1973), 45 S.E.C. 249, 254, 1 SEC Docket 21 (1973), [1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79,378 at 83,100, 83,104.

¹⁰⁷See House Comm. on Energy and Commerce, Insider Trading and Securities Fraud Enforcement Act of 1988, H.R. Rep. No. 910, 100th Cong., 2d Sess. 8 (1988).

¹⁰⁸See WANG & STEINBERG, *supra* note 6, §§ 3.3.5, 3.3.6 (discussing induced and preempted traders and the "law of conservation of securities"); Wang, *supra* note 32, at 28-40 (same); Wang, *supra* note 75, at 1234-38 (same).

risk averse.¹⁰⁹ The possibility of being a victim of the corporation's insider trade may override the possibility of indirectly gaining as a non-selling shareholder.

Furthermore, outside shareholders would not necessarily have an equal chance of being either a victim or an (indirect) beneficiary. Corporate manager/shareholders might have access to the same inside information as the company. Except in rule 10b5-1 plans,¹¹⁰ these managers might not be selling when the corporation is buying on material, nonpublic information.¹¹¹ Therefore, manager/shareholders might disproportionately be (indirect) beneficiaries of the issuer's insider purchases, and the outside shareholders might disproportionately be victims. The corporation's cost of raising capital from outsiders might then rise.

Market-makers may bear a disproportionate share of the harm from corporate insider trading.¹¹² Nevertheless, they may sometimes pass part or all of the injury on to others prior to disclosure by altering prices and thereby readjusting inventory to the level preferred.¹¹³ *Ex ante*, market-makers may respond to the threat by increasing bid-ask spreads.¹¹⁴ The resulting increase in spreads may reduce market liquidity.¹¹⁵

What is the overall effect? The answer is unclear. Long-term holders are less likely to be victims of stock market insider trading than short term traders.¹¹⁶ If market-makers widen their spreads to compensate for the risk of becoming a victim,¹¹⁷ the increase harms frequent traders more than infrequent traders.¹¹⁸

¹⁰⁹See sources cited in WANG & STEINBERG, *supra* note 6, § 2.2.1 n.6 (source citations for a general discussion of risk and risk aversion).

¹¹⁰For discussion of rule 10b5-1, see *supra* notes 88-93 and accompanying text.

¹¹¹Abstaining from trading based on material, nonpublic information almost certainly does not violate rule 10b-5. See WANG & STEINBERG, *supra* note 6, § 4.5A; Jesse M. Fried, *Insider Abstention*, 113 YALE L.J. 455, 456 (2003) ("Although Rule 10b-5 prohibits corporate insiders from trading while in possession of material nonpublic information, it does not prohibit them from using such information to *abstain* from trading.").

¹¹²See WANG & STEINBERG, *supra* note 6, §§ 2.3.4, 3.3.6 & n.50a (Supp. 2001); Wang, *supra* note 32, at 38 & n.36.

¹¹³See WANG & STEINBERG, *supra* note 6, §§ 3.3.6, 3.3.7 (1996 & Supp. 2001); Wang, *supra* note 32, at 38 & n.37; Wang, *supra* note 75, at 1233-34, 1236-38.

¹¹⁴See WANG & STEINBERG, *supra* note 6, §§ 2.3.1., 2.3.4 (1996 & Supp. 2001); Wang, *supra* note 101, at 882 & n.70; Wang, *supra* note 32, at 38 & n.38.

¹¹⁵See WANG & STEINBERG, *supra* note 6, § 2.3.1 & n.10f (Supp. 2001).

¹¹⁶See WANG & STEINBERG, *supra* note 6, § 3.3.6, text accompanying n.50; Wang, *supra* note 32, at 37-40.

¹¹⁷See *supra* note 114 and accompanying text.

¹¹⁸See WANG & STEINBERG, *supra* note 6, § 3.3.6, text accompanying n.50; Wang, *supra* note 32, at 40.

On balance, when a corporate board authorizes share repurchases on the basis of undisclosed information, the board is probably acting in the best interests of its long-term shareholders.¹¹⁹ The same rationale that supported the Delaware Supreme Court's preference for the interests of "long-term" shareholders over "speculators" in the case of *Paramount Communications, Inc. v. Time Inc.*¹²⁰ would support a board policy of repurchasing shares on the basis of undisclosed information. Unclear is whether these interests outweigh the interests of the victims of the insider trade and the other adverse effects of insider trading.¹²¹

Prior to pressure from Congress and the SEC to adopt compliance programs policing insider trading,¹²² companies generally did not prohibit or vigorously monitor employee trading on nonpublic information, much less publicize such efforts.¹²³ If insider trading injures the corporation, what explains this behavior? One possible answer is that the probability of detection is so low that heavy penalties are necessary to deter the conduct.¹²⁴ Private companies cannot impose criminal penalties, so the corporation might not find it worthwhile to try to curtail insider trading by employees, even after concluding that such trading harms the company.¹²⁵ This argument does not apply to the corporation itself. The cost of the company's monitoring itself is zero.

In short, even though some of the policy arguments against insider trading do not apply or apply with less force to insider trading by the

¹¹⁹Cf. Todd A. Bauman, Comment, *Insider Trading at Common Law*, 51 U. CHI. L. REV. 838, 854-55 (1984). This comment contains descriptions of some gains from stock market insider trading, including more accurate share prices, and concludes:

It is likely, however, that the increased risk to outsiders that is associated with insider trading that induces outsiders to pay lower prices for shares of firms, offsets, to some extent the first two gains. Nonetheless, it appears likely that the existence of these gains alone would lead shareholders to prefer that insider trading [by the corporation] occur.

Id. at 855 (footnote omitted).

¹²⁰571 A.2d 1140 (Del. 1989).

¹²¹For an argument that issuer insider trading favors one group of shareholders over others and that this favoritism "is inconsistent with basic principles of corporate governance," see 18 DONALD C. LANGEVOORT, *INSIDER TRADING: REGULATION, ENFORCEMENT & PREVENTION* § 3:6, at 3-7 (2004).

When an issuer tips material, nonpublic information to an existing shareholder who trades, the issuer is in effect favoring one shareholder over others. For discussion of the rule 10b-5 liability for the issuer for tipping, see WANG & STEINBERG, *supra* note 6, § 5.2.3.3(b) (1996 & Supp. 2001).

¹²²For a description of this pressure, see WANG & STEINBERG, *supra* note 6, § 13.2.

¹²³*See id.* § 2.3.2, at 36 & n.22.

¹²⁴*See id.* § 2.3.2, at 37 & n.24.

¹²⁵*See id.*

company, many of the other traditional arguments against such trading do apply,¹²⁶ including the harm to individual victims.¹²⁷

VII. CONCLUSION

With regard to issuer purchases, some of the traditional policy rationales against insider trading do not apply or apply with less force. Nevertheless, courts, commentators, and the SEC have all stated or assumed that a public corporation violates rule 10b-5 by buying its own shares in the market based on material, nonpublic information. In rule 10b-5 cases involving face-to-face transactions, several circuit courts have ruled that the company may not purchase its own stock based on material information not known to the seller. No good reason exists not to apply these precedents to stock market trades by issuers, especially because block trades blur the distinction between face-to-face transactions and stock market trades.

Some decisions involving face-to-face transactions have relied on a fiduciary duty running from the corporation to the seller.¹²⁸ Although this duty has some appeal, it is unsupported by traditional state law fiduciary duty analysis. The company can act only through its board of directors, officers, employees, and other agents. These actors are obligated to act in the best interests of the corporation, which may not coincide with the best interests of an individual shareholder transacting business with the company.

Under rule 10b-5, the most compelling reason for issuer insider trading liability may simply be that no strong reason exists to distinguish the corporation from a corporate "insider," i.e., an employee or independent contractor. Such an "insider" has a *Chiarella/Dirks* classical relationship with the innocent shareholder on the other side of the insider trade because of a *mutual* relationship with the issuer.

The *Chiarella/Dirks* classical relationship is a triangle.¹²⁹ At the apex is the issuer. At one point of the base is the trading employee/independent-contractor, who is in the triangle because the issuer employs this person. At the opposite point of the triangle's base is the innocent shareholder on the other side of the insider trade, who is in the triangle because this individual has invested in the corporation or "steps into the

¹²⁶For a general discussion of the policy arguments against insider trading, see *id.* § 2.3.

¹²⁷For discussion of the individual victims of a stock market insider trade, see *supra* sources cited in note 108.

¹²⁸See *supra* Part II.

¹²⁹For a diagram of the triangle, see *supra* text accompanying notes 43-44.

shoes" of an original investor.

When the issuer trades on material, nonpublic information, no "triangle" analysis is necessary. The innocent shareholder has a "classical relationship" with the corporation because of her investment. In other words, the relationship between the issuer and one of its shareholders is, if anything, closer than the relationship between an employee/independent-contractor and a shareholder.