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Securities Regulation

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Securities Regulation

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This Article surveys significant cases decided by the United States Supreme Court and the United States Court of Appeals for the Eleventh Circuit during 1997 and 1998 in the area of securities regulation.

I. Application of the Misappropriation Theory to Liability Under Section 10(b) and Rule 10b-5; Confirmation of Commission's Rulemaking Authority Under Section 14(e)

In *United States v. O'Hagan*,[1] the United States Supreme Court considered whether criminal liability under section 10(b) of the Securities Exchange Act of 1934, as amended ("the Exchange Act"),[2] and rule 10b-5[3] thereunder may be predicated on the "misappropriation

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1. 521 U.S. 642 (1997).
2. Section 10(b) of the Exchange Act provides that:

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

15 U.S.C. § 78j(b) (1994).

3. Commission Rule 10b-5 provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any

theory."[4] The Supreme Court also considered whether the Securities and Exchange Commission (the "Commission") exceeded its rulemaking authority by adopting rule 14e-3(a),[5] which prohibits trading on material, nonpublic information in the context of a tender offer. In *O'Hagan* James Herman O'Hagan ("O'Hagan") was a partner in a law firm that acted as local counsel to represent Grand Metropolitan PLC ("Grand Met") in connection with a potential tender offer for the common stock of the Pillsbury Company ("Pillsbury").[6] O'Hagan did not perform any work relating to the Grand Met representation.[7] During and following his firm's representation, however, O'Hagan purchased call options for Pillsbury common stock, with each option giving him the right to purchase shares of Pillsbury common stock at a specified price by a specified date.[8] O'Hagan also purchased shares of Pillsbury common stock at a price of slightly less than $39 per share.[9] Upon Grand Met's public announcement of its tender offer, the price of Pillsbury common stock rose to almost $60 per share, and O'Hagan sold his Pillsbury options and stock, making a profit in excess of $4.3 million.[10]

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national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5 (1998).

4. 521 U.S. at 652. The "misappropriation theory" holds that "a corporate 'outsider'" violates section 10(b) and rule 10b-5 when he misappropriates confidential information for securities trading purposes, in breach of a duty owed to the source of the information. *Id.* at 652. Traditional insider trading liability under section 10(b) and rule 10b-5 occurs when a corporate insider trades in the securities of the corporation for which he works on the basis of material, nonpublic information and thereby violates a "relationship of trust and confidence" with the shareholders of the corporation. *Id.*

5. 17 C.F.R. § 240.14e-3(a) (1998).

6. 521 U.S. at 647. O'Hagan's law firm withdrew from the representation prior to Grand Met's public announcement of the tender offer and O'Hagan's alleged fraudulent trades. *Id.*

7. *Id.*

8. *Id.* By the time Grand Met publicly announced its tender offer for Pillsbury stock, O'Hagan owned 2,500 options, with each option entitling him to purchase 100 shares of Pillsbury common stock. He held more options than any other individual investor. *Id.*

9. *Id.* at 647-48.

10. *Id.* at 648.

A Commission investigation resulted in a fifty-seven-count indictment.[11] The indictment charged O'Hagan with twenty counts of mail fraud;[12] seventeen counts of securities fraud in violation of section 10(b) of the Exchange Act and rule 10b-5 promulgated thereunder; seventeen counts of "fraudulent trading in connection with a tender offer" in violation of section 14(e) of the Exchange Act and rule 14e-3(a) promulgated thereunder; and three counts of violating federal money laundering statutes.[13]

A district court jury convicted O'Hagan on all counts.[14] The Eighth Circuit Court of Appeals reversed O'Hagan's securities fraud convictions under section 10(b) and rule 10b-5, holding that "§ 10(b) liability cannot be based on the misappropriation theory" because, "contrary to § 10(b)'s explicit requirements, the misappropriation theory does not require 'deception,' and, even assuming that it does, it renders nugatory the requirements that the 'deception' be 'in connection with the purchase or sale of any security.'"[15] The Eighth Circuit also reversed O'Hagan's securities fraud convictions under section 14(e) of the Exchange Act and rule 14e-3(a) promulgated thereunder, holding that the Commission "exceeded its rulemaking authority under § 14(e) when it promulgated Rule 14e-3(a) without including a requirement of a breach of a fiduciary

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11. *Id.* The SEC relied on a conversation between O'Hagan and the partner in his law firm heading the Grand Met representation as evidence that O'Hagan traded on misappropriated nonpublic information. *Id.* at 648 n.1.

12. 18 U.S.C. § 1341 (Supp. 1998). The federal mail fraud statute provides in part:

> Whoever, having devised or intending to devise any scheme or artifice to defraud . . . places in any post office or authorized depository for mail matter, any matter or thing whatever to be sent or delivered by the Postal Service, or deposits or causes to be deposited any matter or thing whatever to be sent or delivered by any private or commercial interstate carrier, or takes or receives therefrom, any such matter or thing, or knowingly causes to be delivered by mail or such carrier according to the direction thereon, or at the place at which it is directed to be delivered by the person to whom it is addressed, any such matter or thing, shall be fined under this title or imprisoned not more than five years, or both.

Id.

13. 521 U.S. at 648-49. The federal money laundering statutes make it unlawful for any person,

> knowing that the property involved in a financial transaction represents the proceeds of some form of unlawful activity, [to] conduct[ ] or attempt[ ] to conduct such a financial transaction which in fact involves the proceeds of specified unlawful activity . . . knowing that the transaction is designed in whole or in part to conceal or disguise the nature, the location, the source, the ownership, or the control of the proceeds of specified unlawful activity.

18 U.S.C. § 1956(a)(1)(B)(i) (1998).

14. 521 U.S. at 648.

15. United States v. O'Hagan, 92 F.3d 612, 617 (8th Cir. 1996).

obligation."[16] Finally, the Eighth Circuit reversed O'Hagan's convictions for money laundering and mail fraud because the indictment on each was structured to premise these charges on the acts allegedly constituting the securities fraud.[17]

The Supreme Court first addressed the reversal of O'Hagan's convictions under section 10(b) and rule 10b-5.[18] Section 10(b) of the Exchange Act provides, in pertinent part:

> [I]t shall be unlawful for any person, directly or indirectly, . . . [t]o use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.[19]

Rule 10b-5 provides, in part, that "[i]t shall be unlawful . . . [t]o employ any device, scheme, or artifice to defraud, [or] [t]o engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security."[20]

Examining the language of section 10(b), the Supreme Court determined that the statute "proscribes (1) using any deceptive device (2) in connection with the purchase or sale of securities, in contravention of rules prescribed by the Commission."[21] The Supreme Court also determined that section 10(b) "does not confine its coverage to deception of a purchaser or seller of securities, . . . rather the statute reaches any deceptive device used 'in connection with the purchase or sale of any security.'"[22] Furthermore, the Supreme Court stated that liability under Rule 10b-5 does not extend beyond the section 10(b) prohibitions.[23] In comparing the "classical theory" of insider trading liability with the misappropriation theory, the Supreme Court noted that

> [t]he classical theory targets a corporate insider's breach of duty to shareholders with whom the insider interacts; the misappropriation theory outlaws trading on the basis of nonpublic information by a

16. *Id.* at 627.
17. *Id.* at 627-28.
18. 521 U.S. at 648.
19. 15 U.S.C. § 78(b) (1998).
20. 17 C.F.R. § 240.10b-5 (1998).
21. 521 U.S. at 651.
22. *Id.*
23. *Id.*

> corporate "outsider" in breach of a duty owed not to a trading party, but to the source of the information.[24]

The misappropriation theory protects "against abuses by outsiders" to a corporation with material, nonpublic information "who owe no fiduciary or other duty to that corporation's shareholders."[25]

Next, the Supreme Court analyzed whether misappropriation satisfies the section 10(b) requirement of the use of a "deceptive device or contrivance" in order to establish liability.[26] In doing so, the Supreme Court referenced two of its earlier decisions, *Carpenter v. United States*[27] and *Santa Fe Industries, Inc. v. Green*.[28] In *Carpenter* the Supreme Court considered the federal mail fraud statute's proscription of "any scheme or artifice to defraud"[29] and held that the undisclosed misappropriation of a company's confidential information in violation of a fiduciary duty constitutes fraud.[30] In *Green* the Supreme Court considered allegations of section 10(b) violations and found no deception when those charged with the violations had disclosed all pertinent facts to those to whom they owed a duty.[31] The Court stated that "[b]ecause the deception essential to the misappropriation theory involves feigning fidelity to the source of information, if the fiduciary discloses to the source that he plans to trade on the nonpublic information, there is no 'deceptive device' and thus no § 10(b) violation."[32] Ultimately, the Supreme Court found that O'Hagan's misappropriation met the section 10(b) requirement "that there be 'deceptive' conduct."[33]

The Supreme Court then considered the section 10(b) requirement that the deceptive use of information be "'in connection with the purchase or sale of [a] security.'"[34] The Court determined that "[t]his element is satisfied because the fiduciary's fraud is consummated, not when the fiduciary gains the confidential information, but when, without disclosure to his principal, he uses the information to purchase or sell

24. *Id.* at 652-53.
25. *Id.* at 653. Because O'Hagan was not an insider of Pillsbury, the Commission could not have prosecuted him under the classical theory of insider trading liability. *Id.* at 653 n.5. Notably, O'Hagan gained the material, nonpublic information at issue from the bidder in the tender offer and not the target. *Id.*
26. *Id.* at 653.
27. 484 U.S. 19 (1987).
28. 430 U.S. 462 (1977).
29. 521 U.S. at 654 (citing 18 U.S.C. § 1341).
30. *Id.*
31. *Id.* at 655 (citing 430 U.S. at 473-76).
32. *Id.*
33. *Id.* at 659.
34. *Id.* at 655-56.

securities."[35] The Supreme Court emphasized that section 10(b) liability under the misappropriation theory does not arise from all forms of fraud involving confidential information, but only "fraudulent means of capitalizing on such information through securities transactions."[36] The Supreme Court concluded that O'Hagan's misappropriation was "'in connection with' securities transactions."[37] As a result of its analysis of the misappropriation theory, the Supreme Court held that the Eighth Circuit Court of Appeals erred in holding that the misappropriation theory is inconsistent with section 10(b).[38]

The Supreme Court next considered whether the Commission exceeded its rulemaking authority under section 14(e) of the Exchange Act by adopting rule 14e-3(a) without requiring the establishment of a breach of fiduciary duty in connection with the trading at issue.[39] Section 14(e) of the Exchange Act provides, in relevant part, that it shall be unlawful for any person to engage in any "fraudulent, deceptive or manipulative acts or practices," in connection with any tender offer.[40] The section further states that the Commission shall, "by rules and regulations define, and prescribe means reasonably designed to prevent, such acts and practices as are fraudulent, deceptive, or manipulative."[41]

Rule 14e-3(a) provides:

> [I]f any person has taken a substantial step or steps to commence, or has commenced, a tender offer (the 'offering person'), it shall constitute a fraudulent, deceptive or manipulative act or practice within the meaning of Section 14(e) of the [Exchange] Act for any other person who is in possession of material information relating to such tender offer which information he knows or has reason to know is nonpublic and which he knows or has reason to know has been acquired directly or indirectly from: (1) The offering person, (2) The issuer of the securities sought or to be sought by such tender offer, or (3) Any officer, director, partner or employee or any other person acting on behalf of the offering person or such issuer, to purchase or sell or cause to be purchased or sold any of such securities or any securities convertible into or exchangeable for any such securities or any option or right to obtain or to dispose of any of the foregoing securities, unless within a reasonable time prior to any purchase or sale such informa-

35. *Id.* at 656.
36. *Id.*
37. *Id.* at 659.
38. *Id.* at 666.
39. *Id.*
40. 17 C.F.R. § 240.14e-1 (1998).
41. *Id.*

tion and its source are publicly disclosed by press release or otherwise.[42]

Rule 14e-3(a) is a "disclose or abstain" requirement.[43] The thrust of rule 14e-3(a), as articulated by the Court of Appeals for the Second Circuit, is that "'[i]t creates a duty in those traders who fall within its ambit to abstain or disclose, *without regard to whether the trader owes a pre-existing fiduciary duty* to respect the confidentiality of the information.'"[44] The Eighth Circuit held that because rule 14e-3(a) may apply to a transaction without regard to whether the trading in question breaches a fiduciary duty, it exceeds the Commission's rulemaking authority under section 14(e).[45] The United States argued that rule 14e-3(a), as applied to activities such as O'Hagan's, "qualifies under § 14(e) as a 'means reasonably designed to prevent' fraudulent trading on material, nonpublic information in the tender offer context."[46]

Agreeing with this reasoning, the Supreme Court held that "under § 14(e), the Commission may prohibit acts, not themselves fraudulent under the common law or § 10(b), if the prohibition is 'reasonably designed to prevent . . . acts and practices [that] are fraudulent.'"[47] The standard for determining whether the rule 14e-3(a) "disclose or abstain" requirement is "reasonably designed to prevent fraudulent acts," is to afford the Commission's determination "controlling weight unless [it is] arbitrary, capricious, or manifestly contrary to the statute."[48] Finding that the Commission's position was not arbitrary, capricious, or manifestly contrary to the statute, the Supreme Court reversed the Eighth Circuit on the section 14(e) counts and remanded the case for further proceedings consistent with its opinion.[49] The

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42. 17 C.F.R. § 240.14e-3(a) (1998).

43. 521 U.S. at 669.

44. *Id.* (quoting United States v. Chestman, 947 F.2d 551, 557 (2nd Cir. 1991) (en banc), cert. denied, 112 S. Ct. 1759 (1992)).

45. 92 F.3d at 624, 627. The Eighth Circuit focused on the text of section 14(e) that authorizes the Commission to "'define' and 'prescribe means reasonably designated to prevent, such acts and practices' as are 'fraudulent.'" 521 U.S. at 670 (quoting 92 F.3d at 624). Thus, the Eighth Circuit concluded that section 14(e) only authorized the Commission to "'identify and regulate,' in the tender offer context, 'acts and practices' the law already defines as 'fraudulent' . . . [and] not 'create its own definition of fraud.'" *Id.* (quoting 92 F.3d at 624).

46. 521 U.S. at 672.

47. *Id.* at 673 (quoting 15 U.S.C. § 78n(e) (1994)).

48. *Id.* (quoting Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc., 467 U.S. 837, 844 (1984)).

49. *Id.* at 678.

Supreme Court also reversed the Eighth Circuit on the mail fraud counts in light of its holding with respect to the securities fraud counts.[50]

The dissent questioned both the Court's interpretation of the requirement for liability under section 10(b) that a deceptive device be "in connection with" a securities transaction and the finding of requisite rulemaking authority under section 14(e).[51]

II. ADOPTION OF THE "USE TEST" IN INSIDER TRADING VIOLATIONS UNDER SECTION 10(B)

In *Securities & Exchange Commission v. Adler*,[52] the Eleventh Circuit adopted the "use test" for determining whether there has been a violation of the insider trading provisions of section 10(b) of the Exchange Act. In *Adler* the Commission brought a civil action against investors for alleged insider trading violations arising out of two separate sets of transactions, one occurring in 1989 and the other in 1992.[53] Harvey Pegram ("Pegram") was a founder, former officer, and director of Comptronix Corporation ("Comptronix").[54] On September 14, 1989, Pegram attended a meeting of the Board of Directors of Comptronix. Although disputed by the parties, the minutes of the meeting reflect the presentation of a report stating that Comptronix "was expecting either a complete termination or a substantial reduction in orders" from its largest customer and that public dissemination of this information would likely have the effect of causing a decline in the price of Comptronix stock. From September 19, 1989, through September 26, 1989, Pegram sold twenty thousand shares of Comptronix stock. On October 6, 1989, Comptronix issued a press release containing news of the

50. *Id.*

51. *Id.* at 680 (Rehnquist, C.J. and Thomas, J., dissenting). The dissent argues that "the majority's explanation of how the misappropriation theory supposedly satisfies the 'in connection with' requirement is incomplete" because it appears to require not only that an embezzlement coincide with, or be consummated by, a securities transaction, but that it is "*necessarily* and *only* consummated by the transaction." *Id.* at 683. Thus, the misappropriation theory as explained by the majority would conceivably not cover some cases relating to "fraud on the source of information where the source has no connection with the other participant in a securities transaction." *Id.* at 685. As to the section 14(e) question, the dissent agreed with the Eighth Circuit's position that the enabling provision of section 14(e) does not grant the Commission "a license to redefine [the legal definition of fraudulent]." *Id.* at 695 (quoting 92 F.3d at 624).

52. 137 F.3d 1325, 1337 (11th Cir. 1998).

53. *Id.* at 1331.

54. *Id.* at 1327. Subsequent to the initial public offering of stock by Comptronix, five years after its founding, but prior to the alleged violation, Pegram was removed from his officer position but remained a director of Comptronix during the time of the alleged violations. *Id.* at 1327-28.

decreased sales, and the price of Comptronix stock dropped substantially over the two trading days following the release.[55] The Commission argued that Pegram sold his stock as a result of material, nonpublic information he possessed.[56] Pegram contended that the sales were instead part of a pre-existing plan to sell Comptronix stock in order to purchase a truck for his son.[57] Based on these facts, the district court granted Pegram's motion for summary judgment.[58]

On November 15, 1992, Richard Adler ("Adler"), an outside director of Comptronix, attended a meeting of the Board of Directors of Comptronix at which the directors were informed about potential acts of fraud concerning false accounting entries committed by officers of Comptronix. On November 16, 1992, Pegram, no longer a director of Comptronix, spoke with Adler by telephone and shortly thereafter spoke with his wife by telephone. Pegram's wife called the Pegrams' stockbroker immediately after speaking with Pegram and placed an order to sell Comptronix stock. Also on November 16, 1992, Pegram made a telephone call to Philip L. Choy ("Choy"), a business associate, and Choy subsequently telefaxed his stockbroker and placed an order to sell Comptronix stock. On November 23, 1992, both Pegram and Adler spoke with Domer Ishler ("Ishler"), another business associate of Pegram and Adler. On November 24, 1992, Ishler purchased three hundred put options for Comptronix stock. On November 25, 1992, Comptronix publicly announced the alleged fraudulent acts by management, which resulted in a substantial decline in the price of Comptronix stock. Ishler exercised his put options after the public announcement and realized approximately $368,750 in gains.[59] Stating that the "'facts and circumstances related to [Adler, Choy and Ishler] [are] similar . . . and the principles [are] the same'" as those of Pegram, the district court granted judgment as a matter of law in favor of Adler and Choy and summary judgment in favor of Ishler.[60]

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55. *Id.* at 1328. The price of the stock dropped from $3.63 per share to $2.63 per share, a $17,625 decrease in value for 20,000 shares. *Id.*

56. *Id.*

57. *Id.* In support of his argument, Pegram stated that (i) he had waited to sell his Comptronix stock until September 19, 1989 because he had been subject to a 120-day "lock-up" period beginning on May 19, 1989, the date of Comptronix's initial public offering of stock, (ii) he had obtained approval to sell his shares from the Comptronix general counsel on September 16, 1989, and (iii) he only sold 20,000 of his 869,897 shares of Comptronix stock. *Id.* at 1328-29.

58. *Id.* at 1329.

59. *Id.* at 1331.

60. *Id.* at 1332.

With respect to Pegram's 1989 transactions, the Commission argued that because Pegram knowingly possessed material, nonpublic information and traded in the stock of a company to which the information pertained, he violated the prohibition against insider trading under section 10(b) of the Exchange Act and rule 10(b)(5) promulgated thereunder, and section 17(a) of the Securities Act of 1933, as amended (the "Securities Act"), regardless of whether he used the information.[61] In its analysis of whether "possession" or "use" is the proper standard for an insider trading violation, the Eleventh Circuit first considered the language of the provisions in section 10(b), rule 10(b)(5) and section 17(a).[62] The Eleventh Circuit concluded that although none of these provisions explicitly addresses the issue, "the language suggests a focus on fraud, deception, and manipulation."[63]

The court next considered several Supreme Court decisions.[64] Although the language that the Eleventh Circuit considered was dicta, the Eleventh Circuit determined that in each of the cases considered, the Supreme Court had required more than mere possession of material, nonpublic information to substantiate an insider trading violation.[65] The Eleventh Circuit also considered other decisions by lower courts that had allowed insiders to introduce evidence of pre-existing plans and other evidence to rebut the inference of scienter.[66] Finally, the Elev-

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61. *Id.* Section 17(a) of the Securities Act of 1933 provides:

> it shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly—
>
> (1) To employ any device, scheme, or artifice to defaud, or
>
> (2) To obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (3) To engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

15 U.S.C. § 77(q) (1994).

62. 137 F.3d at 1333.

63. *Id.*

64. *Id.* The court considered decisions rendered in *Chiarella v. United States*, 445 U.S. 222 (1980) (stating that an insider's duty to disclose or abstain arises from the unfairness of allowing a corporate insider to take advantage of nonpublic information by trading without disclosure), *Dirks v. SEC*, 463 U.S. 646 (1983) (holding that an insider tipper must gain some personal advantage in order for a tippee to be liable for trading on material nonpublic information), and *United States v. O'Hagan*, 521 U.S. 642 (1997) (stating that trading based on material, nonpublic information qualifies as a "deceptive device" under section 10(b)).

65. 137 F.3d at 1337.

66. *Id.* at 1335. *See, e.g., In re* Worlds of Wonder Securities Litigation, 35 F.3d 1407, 1427-28 (9th Cir. 1994).

enth Circuit considered the language of the Insider Trading Sanctions Act of 1984[67] and determined that the reference in the Act to possession of material, nonpublic information set a condition for the Commission to seek the damages provided for in that Act, but did not relieve a court from finding a violation of the insider trading provisions in order to establish liability.[68]

The Eleventh Circuit concluded that the proper test for determining whether a violation of the insider trading provisions has occurred is whether one in possession of material, inside information used such information in connection with the trades that formed the basis for the alleged violations.[69] Thus, to establish a violation, a causal connection between material, inside information in the possession of an alleged violator and a particular trade must be established.[70] The Eleventh Circuit further stated that "when an insider trades while in possession of material nonpublic information, a strong inference arises that such information was used by the insider in trading. The insider can attempt to rebut the inference by adducing evidence that there was no causal connection between the information and the trade—*i.e.*, that the information was not used."[71]

Under the "use test," the Eleventh Circuit concluded that the fact that Pegram traded while in possession of material, nonpublic information gave rise to a "strong inference" that such information was used in connection with his trades.[72] However, the evidence that Pegram introduced regarding a pre-existing plan for the trades could rebut the inference.[73] The Eleventh Circuit reversed the lower court's grant of summary judgment in favor of Pegram, because a genuine issue of material fact remained (*i.e.*, whether the information that Pegram possessed was used in the trades).[74]

With respect to the 1992 transactions of Pegram, Choy, Ishler and Adler, the Commission contended that the timing of the telephone calls and sale of the stock should raise an inference that Pegram possessed

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67. 15 U.S.C.A. § 78u-1(a) (1998). The Insider Trading Sanctions Act gives the Commission authority to seek a civil penalty of up to three times the amount of profit gained or loss avoided by one who violates the federal securities laws "by purchasing or selling a security while in possession of material, nonpublic information." 137 F.3d at 1336 (quoting 15 U.S.C. § 78u-1(a) (1997)).

68. 137 F.3d at 1337.

69. *Id.*

70. *Id.*

71. *Id.*

72. *Id.* at 1339.

73. *Id.*

74. *Id.*

material, nonpublic information.[75] Thus, the Commission argued that an issue remained for a jury, regardless of whether Pegram had a pre-existing plan to sell Comptronix stock in the 1992 transactions.[76] The Eleventh Circuit stated that, "in order to establish liability under Section 10(b), Rule 10b-5, and Section 17(a)(1), [the Commission] must prove that [an insider] acted with scienter [which] necessarily requires that the insider [possess] material, nonpublic information at the time" of the alleged wrongful trades.[77] Furthermore, under the "use test," the Commission must prove that the material, nonpublic information was used in the trades.[78] As to Pegram's 1992 transactions, the Eleventh Circuit concluded that the "suspicious chronology" of telephone calls was sufficient evidence to raise a reasonable inference that Pegram had received material, nonpublic information from Adler.[79] The Eleventh Circuit further stated, however, that such inference could be rebutted by the evidence presented by Pegram that he and his wife had a pre-existing plan to sell Comptronix stock and other evidence of innocuous explanations for each of the telephone calls in question.[80] Having determined that questions of fact existed for a jury, the Eleventh Circuit reversed the district court's judgment as a matter of law in favor of Pegram.[81]

As to Choy's 1992 transactions, the Eleventh Circuit held that Choy's "relatively weak evidence of a pre-existing plan [was] not sufficient to rebut the inference that he received material, nonpublic information from Pegram" and used such information in trades.[82] Based on this holding, the Eleventh Circuit reversed the district court's grant of judgment as a matter of law in favor of Choy.[83] The court also found that an issue of fact existed with regard to Ishler's 1992 transactions and reversed the district court's grant of summary judgment in favor of Ishler.[84] Based on the same evidence used by Choy and Ishler, the

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75. *Id.* at 1340.
76. *Id.*
77. *Id.*
78. *Id.*
79. *Id.* at 1341-42.
80. *Id.* at 1342.
81. *Id.*
82. *Id.* Choy introduced evidence of several previous contacts with his stockbroker regarding Comptronix stock, but he did not take any action with regard to arranging a sale prior to November 16, 1989. *Id.* at 1342 n.44.
83. *Id.*
84. *Id.* at 1343. Ishler had not presented any evidence of a pre-existing trading plan, but had only argued that his purchase of the put options at issue was consistent with evidence of his past ordinary trading habits. *Id.* The Eleventh Circuit found that the evidence proffered was "clearly not sufficient to rebut the reasonable inference that Ishler

Eleventh Circuit also reversed the grant of summary judgment as a matter of law to Adler.[85]

III. APPLICATION OF ANTIFRAUD SECURITIES LAWS TO STOCK APPRECIATION RIGHTS

In *Clay v. Riverwood International Corp.*,[86] the Eleventh Circuit addressed an issue of first impression in the circuit - whether stock appreciation rights ("SARs") constitute securities, puts, calls, straddles, options or "privileges with respect to securities" for purposes of determining liability under sections 10(b),[87] 20(d)[88] and 20A(a)[89] of the Exchange Act and rule 10b-5[90] promulgated by the Commission under the Exchange Act.[91] The Eleventh Circuit also addressed whether certain events that occurred after a press release issued by Riverwood International Corporation ("Riverwood") gave rise to a duty to disclose subsequent events under section 10(b) of the Exchange Act and rule 10b-5.[92]

The Eleventh Circuit noted that "[u]nder the 'traditional' or 'classical theory' of insider trading liability, § 10(b) and Rule 10b-5 are violated when a corporate insider trades in the securities of his corporation on the basis of material, nonpublic information."[93] Section 20A(a) provides that any person who purchases or sells a "security" while in possession of material, nonpublic information in violation of the Exchange Act or the rules and regulations thereunder

> shall be liable . . . to any person who, contemporaneously with the purchase or sale of securities that is the subject of such violation, has purchased (where such violation is based on a sale of securities) or sold (where such violation is based on a purchase of securities) securities of the same class.[94]

Section 20(d) of the Exchange Act expands the liability provisions of sections 10(b) and 20A(a) to cover an insider's "purchase or sale of a put,

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possessed and traded on the basis of material nonpublic information." *Id.*

85. *Id.*
86. 157 F.3d 1259 (11th Cir. 1998).
87. 15 U.S.C. § 78j(b) (1994).
88. 15 U.S.C. § 78t(d) (1994).
89. 15 U.S.C. § 78t-1(a) (1994).
90. 17 C.F.R. § 240.10b-5 (1998).
91. 157 F.3d at 1264.
92. *Id.*
93. *Id.* at 1263 (quoting United States v. O'Hagan, 521 U.S. at 651-52).
94. *Id.*

call, straddle, option, or privilege with respect to such security."[95] Sections 10(b) and 20A and rule 10b-5 set forth the provisions often referred to as the "disclose or abstain" requirements.[96]

During the relevant time period, Riverwood was a publicly held corporation with approximately eighty-one percent of its outstanding common stock owned by Manville Corporation ("Manville"). In 1993 and again in 1994, Riverwood granted nontransferable SARs to certain of its executive officers, including its president and certain senior vice presidents (the "Executives").[97] Each SAR entitled the respective Executive to receive payment from Riverwood in an amount equal to the difference between the grant value of the SAR and the fair market value of Riverwood's stock at the time the Executive exercised the SAR. The grant values of the SARs ranged from $13.77 to $26 per SAR. Upon exercise of an SAR, Riverwood, in its discretion, could pay the exercising Executive in cash or Riverwood stock.[98] The agreements governing the terms of the SARs specifically provided that the SARs (1) did not provide the holder with rights as a stockholder; (2) did not constitute options or offers to sell stock; and (3) "could not be sold, assigned, or otherwise transferred."[99] The Eleventh Circuit also noted that Riverwood secured the SARs with Riverwood stock.[100]

In early 1995, after the grant of the SARs, the Boards of Directors of Riverwood and Manville formed a committee to consider strategic alternatives for Riverwood in light of Manville's need to raise cash to settle asbestos litigation claims. The committee met to consider various alternatives for Riverwood, including "maintaining the status quo," merging Riverwood with another company, selling Manville's share of Riverwood, or selling Riverwood in its entirety. The committee engaged financial advisors J.P. Morgan & Co., Inc. and Goldman Sachs & Co. to solicit prospective buyers of Riverwood. By June 1995, three prospective buyers had expressed interest in acquiring Riverwood.[101]

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95. *Id.*

96. *Id.* at 1264. The phrase "disclose or abstain" alludes to the general concept that if an insider has knowledge of material, nonpublic information regarding the company, the insider must abstain from trading in the company's securities until the company discloses to the public the material information. *Id.*

97. Clay v. Riverwood Int'l Corp., 964 F. Supp. 1559, 1564 (N.D. Ga. 1997).

98. 157 F.3d at 1261. The Eleventh Circuit noted that Riverwood could pay only cash upon exercise of some of the SARs and cash or stock upon exercise of other SARs. However, the Eleventh Circuit deemed this distinction between SARs "inconsequential" in light of Riverwood's ultimate decision to pay cash upon exercise of all of the SARs. *Id.* at 1261 n.2.

99. *Id.* at 1261.

100. *Id.*

101. *Id.*

On July 20, 1995, Riverwood issued its second quarter earnings press release.[102] The press release stated in part as follows:

> As announced earlier, Riverwood has begun a review of strategic alternatives which may be available to it and in the best interest of all Riverwood shareholders. One alternative is the possible sale or merger of Riverwood. J.P. Morgan & Co. and Goldman Sachs & Co. are contacting a selective set of potential buyers and working closely with Riverwood management to evaluate this alternative.[103]

Riverwood completed the nonbinding bidding process at the end of August 1995, having received only one bid. The bid was from Georgia Pacific Corporation ("Georgia Pacific") for a cash deal valued at $20 per share of Riverwood stock. The committee ultimately rejected Georgia Pacific's bid and, instead, pursued a leveraged buyout with a corporation led by Clayton, Dubilier & Rice ("CD&R") that included members of Riverwood's management.[104]

On September 21, 1995, the Executives exercised many of their SARs. On that date, the market value of the Riverwood stock was $25.25 per share, well above the bid submitted by Georgia Pacific in August. As a result, Riverwood paid over $7 million in cash to the Executives. The Eleventh Circuit noted that Riverwood "did not buy, sell or issue any stock to raise the necessary capital" to make the payments to the Executives upon exercise of the SARs.[105] During September 1995, appellant Forrest Clay ("Clay") purchased an aggregate of 36,400 shares of Riverwood stock at prices ranging from $23 to $26 per share. On October 25, 1995, the Board of Directors of Riverwood approved CD&R's proposal for a leveraged buyout of Riverwood at $20.25 per share. Riverwood announced the transaction to the public on the next day.[106]

In December 1995 Clay brought suit against Riverwood and its officers alleging that (1) the Executives engaged in insider trading in violation of sections 10(b) and 20A(a) of the Exchange Act and rule 10b-5 when they exercised their SARs; and (2) Riverwood and the Executives violated section 10(b) and rule 10b-5 in failing to update the July 20, 1995, press release when Riverwood rejected Georgia Pacific's bid and began pursuing CD&R's proposal.[107] The United States District Court for the Northern District of Georgia granted a motion for summary judgment in favor of Riverwood and the Executives on both of Clay's

102. *Id.* at 1262.
103. *Id.*
104. *Id.*
105. *Id.*
106. *Id.*
107. *Id.*

claims.[108] The district court concluded that there was no "transactional nexus between the individual defendants' exercise of their SARs . . . and Clay's purchase of Riverwood stock," and, as a result, Clay lacked standing under section 20A.[109] The court held that the SARs "were not privileges with respect to securities" under section 20(d) of the Exchange Act.[110]

The Eleventh Circuit affirmed the district court's grant of summary judgement in favor of Riverwood and the Executives.[111] The Eleventh Circuit concluded that the SARs were not "securities" within the meaning of sections 10(b), 20(d) or 20A(a) of the Exchange Act and, therefore, the "disclose or abstain" requirements of sections 10(b) and 20A(a) did not apply to the exercise of the SARs.[112]

The Eleventh Circuit stated that, as a result of the application of sections 10(b), 20A(a) and 20(d) under the Exchange Act and Rule 10b-5, "the viability of Clay's claim and this appeal hinges upon a narrow question: whether the SARs constituted 'securities[,]' 'put[s], call[s], straddle[s], option[s] or privilege[s] with respect to' securities."[113]

The Eleventh Circuit concluded that the SARs were not "securities" under the Exchange Act, noting that "noticeably absent from [the definition of security] is any reference to SARs or other cash-only instruments."[114] Likewise, the Eleventh Circuit concluded that the

108. Clay v. Riverwood Int'l Corp., 964 F. Supp. 1559, 1561 (N.D. Ga. 1997).

109. *Id.* at 1576.

110. *Id.* at 1572. The district court stated that

> [a]lthough the value of the [SARs] varied directly with the value of Riverwood stock, they did not provide the holders of the [SARs] with any rights relating to any stock. Further, exercise of the [SARs] did not affect the legal or beneficial ownership of any stock or the right to own, purchase, or sell any stock. Finally, and the Court believes this to be the most important, there was no market on which the [SARs] could be traded. The [SARs] at issue here were not privileges with respect to securities within the meaning of § 20(d) [of the Exchange Act]. =ft

Id. at 1571-72.

111. 157 F.3d at 1269.

112. *Id.*

113. *Id.* at 1264. In his concurring opinion, Circuit Judge Carnes stated that

> [w]e need not and should not reach the broad question of whether SARs are securities for purposes of insider trading rules. The reason we need not reach that question is that the plain language of § 20A makes it clear that Clay lacks standing to bring a claim under that provision.

Id. at 1270. Judge Carnes agreed that Clay has no standing because Clay purchased common stock of Riverwood, which are not the same class of securities as the SARs. Section 20A specifically limits standing to those who purchased or sold the "same class" of securities as the insider trader. *Id.*

114. *Id.* at 1264.

SARs were not puts, calls, straddles or options.[115] The court noted that "puts" represent the right to sell stock, "calls" represent the right to purchase stock, "straddles" "'involve [] the purchase or sale of an equal number of puts and calls on the same stock'" and that each of these instruments is a type of option.[116] The Eleventh Circuit stated:

> Importantly, all stock options when exercised involve a market transaction—even if it takes a split-second for holders to sell on the market the stock that they received in order to capture the difference between the grant and market values. Holders of SARs like the ones in this case, in material contrast, receive cash directly out [of] the issuer-company's treasury. They do not sell stock at any time.[117]

The Eleventh Circuit also concluded that the "SARs were not 'privileges with respect to' securities."[118] The court pointed out that section 20(d) of the Exchange Act "speaks of 'privileges' immediately after puts, calls, straddles and options."[119] The court cited the "statutory construction doctrine *noscitur a sociis*, 'a word is known by the company it keeps[.]'"[120]

The Eleventh Circuit distinguished the SARs from puts, calls, straddles or options noting that SARs, unlike the different types of options, "'did not affect the legal or beneficial ownership of any stock or the right to own, purchase, or sell any stock.'"[121] Additionally, the court noted that the SARs could not be traded whereas puts, calls, straddles and options are traded on markets.[122] As a result, the Eleventh Circuit noted that "'[t]raders in puts and calls rely on the integrity of information disseminated in the *market* just as do purchasers and sellers of the underlying security.'"[123] The court found compelling Riverwood's argument that "Congress foresaw 'privileges' as new types of instruments that can be traded like options and stock" when it enacted section 20(d) of the Exchange Act.[124]

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115. *Id.* at 1266.
116. *Id.*
117. *Id.*
118. *Id.*
119. *Id.*
120. *Id.* (citing Gustafson v. Alloyd Co., 513 U.S. 561 (1995)).
121. *Id.*
122. *Id.* at 1266-67 (citing Moskowitz v. Lopp, 128 F.R.D. 624, 631 (E.D. Pa. 1989)). The SAR agreements specifically provided that the SARs were not transferable. The authors note that not all puts, calls, straddles, and options are traded on markets and that in many instances, these instruments are not transferable pursuant to their terms. *Id.*
123. *Id.* at 1267.
124. *Id.*

As discussed above, Clay alleged that Riverwood violated section 10(b) and rule 10b-5 by failing to update its press releases in light of a subsequent change of circumstances.[125] The court cited its earlier decision in *Rudolph v. Arthur Andersen & Co.*[126] for the principal that "'[a] duty to disclose may . . . be created by a defendant's previous decision to speak voluntarily. Where a defendant's failure to speak would render the defendant's *own* prior speech misleading or deceptive, a duty to disclose arises.'"[127] The court also cited the Second Circuit's decision in *ZVI Trading Corp. Employees' Money Purchase Pension Plan & Trust v. Ross (In re Time Warner Inc. Sec. Litigation)*,[128] holding that "'when a corporation is pursuing a *specific business goal* and announces that goal as well as an *intended approach* for reaching it, it may come under an obligation to disclose other approaches to reaching the goal when those other approaches are under active and serious consideration.'"[129]

In rejecting Clay's claim of securities fraud, the Eleventh Circuit noted that "[t]he only course Riverwood committed to [in its press release] was 'a *review* of strategic *alternatives* that included the *possible* sale or merger of Riverwood.' In fact, with the abundance of watered-down intentions, it was almost as though Riverwood never spoke at all."[130] Accordingly, the Eleventh Circuit affirmed the judgment of the district court in granting summary judgment in favor of Riverwood and the Executives on the securities fraud claim.[131]

IV. DEFINITION OF "SECURITY"

In *United States v. Schlei*,[132] the Eleventh Circuit addressed whether counterfeit securities, in this case forged Japanese government bonds, fall within the definition of a "security" under the Securities Act. Defendant Norbert Schlei was convicted of multiple criminal charges of conspiracy and securities fraud. The charges stemmed from a complicated series of transactions involving the attempted sale of bond certificates purportedly issued by the government of Japan and cashier's checks purportedly issued by a Japanese bank. The jury concluded that the bond certificates and the cashier's checks were not genuine.[133]

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125. *Id.* at 1268.
126. 800 F.2d 1040 (11th Cir. 1986).
127. 157 F.3d at 1768 (citing 800 F.2d at 1043).
128. 9 F.3d 259 (2d Cir. 1993).
129. 157 F.3d at 1268 (citing 9 F.3d at 268).
130. *Id.* at 1269.
131. *Id.*
132. 122 F.3d 944, 972 (11th Cir. 1997).
133. *Id.*

Schlei appealed his conviction on numerous grounds, including that the district court's instructions to the jury misstated applicable law on the definition of a security under the Securities Act.[134] The district court included in its instructions the relevant portions of the definition of the term "security" set forth in section 2(a) of the Securities Act[135] and added the following: *"As used in these instructions, the term 'security' includes counterfeit and forged securities and securities that did not exist."*[136] Schlei argued that "the district court's expansion of this definition to include 'counterfeit and forged securities and securities that did not exist,' permitted the jury to convict him of a crime not created by Congress."[137] He further argued that "the securities laws were designed 'to prohibit only the sale of genuine securities by fraudulent means.'"[138]

The Eleventh Circuit rejected Schlei's arguments and found that the district court did not abuse its discretion in including counterfeit, forged, and nonexistent securities in the definition of a "security" provided to the jury.[139] The Eleventh Circuit cited the Supreme Court's instruction in *United States v. Naftalin*,[140] that "[t]he aim [of the Securities Act] is to prevent further exploitation of the public by the sale of unsound, fraudulent, and *worthless* securities through misrepresentation."[141]

134. *Id.*

135. *Id.* at 972. The jury instructions defined "security" as follows:

> [A]ny note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, or in general any interest or instrument commonly known as a "security," or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee for, or warrant or right to subscribe to or purchase, any of the foregoing.
>
> *As used in these instructions, the term "security" includes counterfeit and forged securities and securities that did not exist.*

Id. The last sentence of the instruction is not included in section 2(a)(1) of the Securities Act.

136. *Id.*

137. *Id.*

138. *Id.*

139. *Id.* at 972-73.

140. 441 U.S. 768 (1979).

141. 122 F.3d at 972-73 (quoting United States v. Naftalin, 441 U.S. at 775). The Eleventh Circuit also cited the decisions of the Fifth Circuit in *Seeman v. United States*, 90 F.2d 88 (5th Cir. 1937), and in *First Nat'l Bank of Las Vegas, New Mexico v. Estate of Russell*, 657 F.2d 668 (5th Cir. Unit A Sept. 1981) as supporting the position that the

V. EFFECT OF BANKRUPTCY ON CIVIL DISGORGEMENT AWARD

In *Securities & Exchange Commission v. Bilzerian*,[142] the Eleventh Circuit held that debt arising from a civil award for disgorgement of profits obtained fraudulently in violation of section 10(b) of the Exchange Act was not subject to discharge under section 523(a)(2)(A) of the United States Bankruptcy Code.

In 1989 Paul A. Bilzerian ("Bilzerian") was convicted of securities fraud for violations of section 10(b) of the Exchange Act. The Commission subsequently won a civil judgment against Bilzerian, forcing him to disgorge approximately $33 million in fraudulently obtained profits plus interest. Bilzerian filed for bankruptcy during the civil litigation. The Commission brought action in the bankruptcy court seeking to except the civil disgorgement award from discharge in bankruptcy under section 523(a)(2)(A) of the Bankruptcy Code.[143] The Commission argued that (1) the disgorgement award constituted debt for money obtained by fraud and, therefore, was subject to exception from discharge; and (2) a criminal conviction for securities fraud satisfies the requirement of "fraud" under section 523(a)(2)(A) based on the theory of collateral estoppel.[144]

The bankruptcy court ruled against the Commission on the basis that the Commission lacked standing to pursue a claim under section 523(a)(2)(A) and that its complaint "failed to state a claim because obtaining illegal profits was not a part of § 523(a)(2)(A)."[145] The district court reversed the decision of the bankruptcy court. On remand, the bankruptcy court ruled in favor of Bilzerian again by granting summary judgment for Bilzerian on grounds that the judgments against him did not meet the loss and reliance requirements for use of the theory of collateral estoppel in establishing fraud under section 523(a)(2)(A).

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definition of the term "security" in section 2(a)(1) of the Securities Act includes counterfeit, forged, and nonexistent securities. *Id.*

142. 153 F.3d 1278, 1281 (11th Cir. 1998).

143. *Id.* at 1280-81.

144. *Id.* Section 523(a)(2)(A) of the Bankruptcy Code provides:

> [a] discharge under section 727, 1141, 1228(a), 1228(b), or 1328(b) of this title does not discharge an individual debtor from any debt—
>
> . . . .
>
> (2) for money, property, services, or an extension, renewal, or refinancing of credit, to the extent obtained by—
>
> (A) false pretenses, a false representation, or actual fraud, other than a statement respecting the debtor's or an insider's financial condition.

11 U.S.C. § 523(a)(2)(A) (1994).

145. 153 F.3d at 1281.

The district court again reversed the bankruptcy court on the basis that the disgorgement judgment in favor of the Commission satisfies the collateral estoppel requirements for determining fraud under section 523(a)(2)(A).[146]

The Eleventh Circuit agreed with the district court's finding that "Bilzerian's debt is one for money, and that the disgorgement judgment was designed to remedy fraudulent behavior."[147] The Eleventh Circuit also agreed that Bilzerian's criminal conviction for securities fraud, combined with the civil disgorgement judgment, satisfies the collateral estoppel requirements for determining fraud under section 523(a)(2)(A).[148] The Eleventh Circuit pointed out that "courts require proof of causation and loss as elements of a private cause of action based on violations of rule 10b-5."[149] Furthermore, the Eleventh Circuit noted that

> the causation requirement of "materiality" in Rule 10b(5) [sic] satisfies the requirement for actual reliance necessary to apply collateral estoppel in a § 523(A)(2)(A) [sic] case . . . . [The Eleventh Circuit] has taken an expansive view of "debts obtained by fraud" because the malefic debtor may not hoist the Bankruptcy Code as protection from the full consequences of fraudulent conduct.[150]

The Eleventh Circuit upheld the district court's holding that collateral estoppel prevented Bilzerian from challenging the Commission's action to except the disgorgement judgment in bankruptcy.[151] The court also rejected Bilzerian's argument that failure to discharge the disgorgement judgement violates the Double Jeopardy Clause and constitutes an excessive fine in violation of the Eighth Amendment.[152]

VI. CONCLUSION

During the survey period, the United States Supreme Court held the misappropriation theory of insider trading liability valid, but limited its scope. The Eleventh Circuit adopted the "use" test for insider trading liability, requiring the establishment of actual use rather than knowing

146. *Id.*

147. *Id.*

148. *Id.* The Eleventh Circuit noted that in order to prove fraud for purposes of section 523(a)(2)(A) "[a] creditor must prove that: (1) the debtor made a false representation to deceive the creditor, (2) the creditor relied on the misrepresentation, (3) the reliance was justified, and (4) the creditor sustained a loss as a result of the misrepresentation." *Id.*

149. *Id.* at 1282.

150. *Id.*

151. *Id.* at 1283.

152. *Id.*

possession for satisfying the section 10(b) scienter element. The Eleventh Circuit also ruled that counterfeit, forged and nonexistent securities fall within the definition of a "security" for purposes of the Securities Act. Finally, the Eleventh Circuit found that a civil disgorgement award for violations of section 10(b) of the Exchange Act satisfies the collateral estoppel requirements for determining fraud under, and may not be discharged under, section 523(a)(2)(A) of the Bankruptcy Code.