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Channel Checking and Insider Trading Liability

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I. Introduction

When it comes to insider trading liability, Congress and the Securities and Exchange Commission ("SEC") intentionally play a game of "hide the ball." Instead of providing a clear statutory and regulatory definition of what constitutes insider trading, Congress and the SEC, in order to preserve broad latitude for enforcement, have seemingly eschewed certainty for obscurity.[1] Following the market upheaval of the financial crisis in 2008, the United States entered a period of zealous expansion of the limits of insider trading liability.[2] This has resulted in increased SEC enforcement efforts against market participants and an expanded scope of monitored industry conduct.[3] Therefore, given the obscurity of the law and the step-up in enforcement, it is all the more important to anticipate and understand what market practices may result in liability.

One market practice that may potentially become prohibited under insider trading law is the practice of channel checking.[4] Channel checking, the analysis of the upstream suppliers and downstream consumers of a given company's products, is reportedly common practice in the market analysis industry.[5] However, the SEC's interest in investigating channel checking in the marketplace puts the legality of this practice in doubt. As a consequence of the current broadness of insider trading liability, firms

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1. United States v. Chestman, 947 F.2d 551, 572 (2d Cir. 1991) (Winter, J., concurring in part, dissenting in part).

2. Robert A. Prentice, *Permanently Reviving the Temporary Insider,* 36 J. Corp. L. 344 (2011).

3. *Id.*

4. *See* Susan Pulliam, *Insider Probe Focuses on Supply-Chain Data,* Wall St. J., Nov. 24, 2010, *available at* http://online.wsj.com/article/SB10001424052748703730304575633173086330184.html; *see also* Pradheep Sampath, *Channel Check – Where Supply Chains Meet Insider Trading?* All About B2B (Nov. 29, 2010), http://www.gxsblogs.com/sampathp/2010/11/channel-check-where-supply-chains-meet-insider-trading.html.

5. *See, e.g.*, Pulliam, *supra* note 4.

that either outsource channel checking to market analysis firms or conduct the channel check in-house may be at risk of incurring insider trading liability.

This note addresses the potential legality or illegality of channel checking in the context of a private equity buyout. In Part II, this note uses a hypothetical to demonstrate a situation in which a private equity acquirer might engage in a channel check. In Part III, this note analyzes federal judicial and SEC cases that have developed various categories of insider trading liability, and provides a framework for insider trading liability. In Part IV, this note applies the analysis from Part III to the hypothetical described in Part II. Part IV attempts to reach a conclusion about whether the private equity acquirer, who engages in channel checking, could be found liable for insider trading given the current law. Part IV asks whether channel checkers should face potential insider trading liability, and concludes that the SEC's newfound focus on channel checking should be directed to regulating more harmful conduct.

II. Motivating Channel Checking Hypothetical

This part of the note provides a hypothetical involving a private equity firm looking to acquire one of two similar companies. The firm conducts a channel check, a reportedly common market analysis tool in order to aid its decision. This is a plausible scenario in which a firm might use a channel check to its advantage, but may also expose itself to insider trading liability.

The private equity firm of Byun, Munoz, & Winters (better known as "BMW"), perceiving the need to further diversify its investment portfolio, is considering an acquisition in the technology sector. The management of BMW, a little too enamored with the hype of Apple's iPad line, believes that tablet PCs are the wave of the future and will soon replace laptops and personal computers. In order to capitalize on the growth of this new technology, BMW is zeroing in on several candidates for a leveraged buyout.

The firm has narrowed the field to two candidates. The first target, Peppers Electronics, Inc., is a Delaware corporation publicly traded on several national stock exchanges. Second, BMW has also targeted Miller Technologies, Inc., another publicly traded Delaware corporation. To BMW, both targets are substantially similar in all discernible respects. According to the corporations' financial statements, both generate similar net income and have similarly clean balance sheets ideal for a buyout target.[6] However, due to limited resources, BMW can only acquire one of these companies.

6. This is a gross oversimplification of the process through which PE firms make investment decisions, but for the purposes of this note, it is only necessary to demonstrate in general terms that the two firms are substantially similar investments.

Research into the two companies yields that both would be ideal for a BMW acquisition; the firm could essentially flip a coin and choose between two identical acquisitions. On the other hand, BMW could try to dig deeper into information about the firms in order to find some way of determining the better of the two investments. BMW does not want to acquire the wrong company, and so it chooses to dig a little deeper into information about the two firms.[7] Since the impetus for this acquisition first came from BMW's strong desire to acquire a company with a line of tablet PCs, BMW decides to find a way to measure the performance of each target company's tablet PCs.

Unfortunately, BMW does not have much information to work with regarding the sales performance of each company's respective tablet PC lines other than cursory sales figures, which the target companies release to the public.[8] BMW wants to know more. For instance, what are the sales figures going to look like a year from now? In order to remedy this dearth of information, BMW resorts to looking outside the company for sources of information. It decides to conduct a channel check.[9] It contacts Peppers' and Miller's suppliers—companies that produce the various widgets that the target companies use to assemble their tablet PCs—and coaxes information from each supplier about the each target's orders for the next year. BMW repeats this inquiry with the targets' distributors. The suppliers and distributors inform BMW that they have previously entered into confidentiality agreements with the target companies as a condition of doing business. After the initial hesitation, however, they all ultimately comply with BMW's requests. The suppliers and distributors of each company fear that not complying with BMW's requests for information would cause friction and damage their future business prospects if BMW does indeed acquire either company.

BMW has concluded from the information gleaned from the suppliers and distributors that Peppers' tablet PC sales figures will continue to rise over the next six months, while Miller's sales will decline considerably. Armed with evidence that Peppers' earnings will outstrip Miller's in the near future, BMW proceeds with the acquisition of Peppers by buying out the existing shareholders of the corporation. Although long-form mergers are a much more common business combination structure utilized in these types of deals, BMW decides that in this case a tender offer is preferable.

7. Most acquirers at this point would reach out to management. After initial courting, if management is receptive, the parties will then sign a non-disclosure agreement, and the acquirer will start its due diligence process. This creates a relationship of trust between the two parties, and from this point on the acquirer must choose carefully what he is to do with information it obtains.

8. Let us assume for the purposes of this exercise that both companies have chosen not to disclose very much information to the market beyond the current sales figures of their tablet PC lines.

9. Alternatively, BMW can outsource the task to a market analysis company. As we will see in Part III, BMW would not be able to insulate itself from liability by outsourcing the channel check.

A tender offer will allow the firm to go directly to the shareholders of the target company with the deal, bypassing the various legal requirements of standard long-form mergers, allowing the firm to close the acquisition much more quickly.[10]

By using information it obtained from the suppliers and distributors of the two companies in order to choose the acquisition target, BMW makes a trading decision based on information gathered from a channel check. Given that BMW recently learned that the SEC has taken an interest in expanding insider trading liability to the practice of channel checking, management is nervous about a potential lawsuit. Assuming the SEC does go after the firm for insider trading, BMW would like a law firm to analyze whether a federal court is likely to find BMW liable for insider trading for its actions related to this transaction.

III. Legal Framework of Insider Trading Regulation

Before determining whether BMW is potentially liable for insider trading, this next part of the note establishes the legal framework for insider trading liability. It is important to understand the current legal framework for insider trading liability because, absent the development and acceptance of new theories of liability, the SEC is limited to working within its confines in any new enforcement effort.

In *Chiarella v. United States,* the Supreme Court articulated the "classical theory" of insider trading liability.[11] The Court held that trading on the basis of material, non-public information constitutes insider trading if the trader owes a duty to disclose such information or abstain from trading altogether ("duty to disclose or abstain"). A trader owes this duty to disclose or abstain only where a fiduciary relationship exists between the trader and the shareholders of the corporation. Therefore, classical theory liability only captures conduct by true insiders of the corporation.[12] Following *Chiarella*, courts developed several other theories of liability in order to remedy the central problem of classical theory liability, namely, its failure to prohibit seemingly wrongful conduct by non-insiders. Temporary insider theory extends insider-like duties to a non-insider professional who gains access to inside information in his vital capacity as an advisor of the corporation. Misappropriation theory bases liability on the fiduciary relationship between the trader and the source of the inside information, rather than the trader's status as an insider of the corporation. Tippee liability extends liability to a non-insider tippee who trades on the basis of inside information obtained in violation of the tipper's fiduciary duty. The immediate following sections of Part III explore the classic theory, tempo-

10. *See* Sasha Dai, *Bain 'Confident' about Its $1.8B Tender Offer for Gymboree,* Wall St. J. Private Equity Beat (Oct. 13, 2010, 7:42 PM), http://blogs.wsj.com/privateequity/2010/10/13/bain-confident-about-its-18b-tender-offer-for-gymboree.

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

12. The terms "insider" or "true insider" are used in this note to denote persons that are fiduciaries of the traded-in corporation's shareholders.

rary insider theory, misappropriation theory, and the tippee liability, respectively.

A. *§ 10(b) and the Classical Theory of Insider Trading*

The term "insider trading" is not mentioned in the Securities Exchange Act of 1934 ("Exchange Act"). Yet, this has not stopped the SEC and federal courts from shaping anti-fraud regulation as it applies to insider trading and other similar offenses. The broad and opaque language of the Exchange Act gives these actors enormous leeway in determining the scope of anti-fraud regulation since the passage of the Exchange Act.[13] Thus, the SEC and the courts have interpreted § 10(b) of the Exchange Act, which prohibits the use of any "manipulative or deceptive device. . .in connection with purchase or sale of any security,"[14] and SEC Rule 10b-5 implementing the statute,[15] as prohibiting insider trading.[16]

In 1961, the SEC first articulated the classical theory of insider trading liability in *In the Matter of Cady, Roberts & Co.*[17] The SEC ruled that a corporate insider, who by virtue of his position within a company obtains access to material non-public information,[18] has a duty to disclose such information before trading or to abstain from trading in the corporation's securities altogether ("duty to disclose or abstain").[19] Therefore, a corporate insider trading his corporation's securities on the basis of material non-public information would be liable for insider trading if he did not disclose such information before trading.

In *Chiarella,* the Supreme Court adopted the SEC's articulation of classical theory liability in *Cady, Roberts & Co*.[20] However, the Court also held that a trader's duty to disclose or abstain arises only when a fiduciary relationship exists between the trader and the shareholders of the traded-in corporation.[21] Therefore, the Court clarified that the "corporate insider" in *Cady, Roberts & Co.* is necessarily someone who is a fiduciary of the corporation's shareholders, and that only these corporate insiders can

13. *Chestman*, 947 F.2d at 572.

14. 15 U.S.C. § 78j(b) (2006).

15. 17 C.F.R. § 240.10b-5 (2012).

16. *E.g. Chiarella*, 445 U.S. 222 (noting that federal courts had long found § 10(b) violations where insiders had used undisclosed information for personal benefit).

17. In the Matter of Cady, Roberts & Co., Exchange Act Release No. 34-6668, 40 SEC Docket 907 (Nov. 8, 1961).

18. Although § 10(b) of the Exchange Act and Rule 10b-5 are invoked in a variety of different types of actions relating to securities fraud, the Supreme Court ruled in Basic v. Levinson, 485 U.S. 224, 231 (1988), that one standard of materiality applies in all § 10(b) and Rule 10b-5 cases. The standard is whether there is a substantial likelihood that a reasonable investor would consider that the information in question altered the total mix of information available.

19. *Cady, Roberts & Co.*, 40 S.E.C. 907 (1961).

20. *Chiarella*, 445 U.S. 222 (1980).

21. See *id.* at 228.

be liable for insider trading. Thus, non-insiders who somehow obtain and trade on the basis of material non-public information cannot be liable for possessing an informational advantage over the market under the classical theory of liability.[22] The Court stated that to hold otherwise would create a "general duty between all participants in market transactions to forgo actions based on material nonpublic information."–[23] The reason why the Court relied on a fiduciary relationship between the parties was that the Court viewed insider trading as a tool for preventing corporate insiders from taking advantage of uninformed minority shareholders.[24] Its purpose was not to ensure informational parity in the marketplace.

Accordingly in *Chiarella*, the Court found that the defendant, Vincent Chiarella, a markup man in the offices of a financial printer who profited from the information he gleaned from documents received on the job,[25] owed no fiduciary or similar duty to the selling shareholders. Therefore, he did not violate § 10(b).[26] Although the government argued that the defendant was guilty under the alternative theory of misappropriation,[27] the Court declined to rule on the merits of this theory since it was never presented before the jury at trial, leaving open the issue of liability under the misappropriation theory for another day.[28]

Despite the open issue of the misappropriation theory, the *Chiarella* ruling, nonetheless, had significant consequences. It marked the first time the Supreme Court's express recognition of insider trading liability, thus affirming a significant source of enforcement activity by the SEC. However, the Court also made clear that liability for insider trading also requires a finding of a fiduciary or similar type of relationship between the trader and the shareholders of the corporation, rather than a mere showing that the trader possessed an informational advantage. Therefore, it set a threshold for liability, narrowed what constituted insider trading, and established a substantial defense against a claim for insider trading. If the defendant, Chiarella, had been an employee of either of the two parties to the merger, he would certainly have been guilty of insider trading. Al-

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22. *Id.* at 235.

23. *See id*. at 233.

24. *Id.* at 228-29 (citing Speed v. Transamerica Corp., 99 F. Supp. 808, 829 (Del. 1951)).

25. *Id.* at 224. Chiarella deduced from the information he received while on the job that a corporation was about to make a tender offer for the shares of another corporation. He subsequently purchased shares of the target corporation on the open market. When the tender offer was announced to the public, the price of the shares appreciated and he was able to sell the shares he previously purchased for a profit.

26. *See id.* at 231-32.

27. The Government based this theory of liability around the fact that Chiarella had misappropriated the information *from his employer*. *Id.* at 235-36. Therefore, liability for misappropriation is based on a violation of duty owed to the source of the information, not to the other party in the transaction or to company whose securities are being traded. *See infra* Part III.C. below for more on the "misappropriation" theory.

28. *Chiarella*, 445 U.S. at 236.

though Chiarella traded on the basis of secret information, he escaped liability precisely because he was not technically an "insider."

B. *Temporary Insider Theory*

The "temporary insider" theory is an extension of the classical theory of insider trading liability. It developed as a partial response to the central problem arising from the high fiduciary threshold established by the holding in *Chiarella*, namely, the inability of the classical theory to capture wrongful conduct by non-insiders. Temporary insider theory addresses the threat of trading by outside professionals who gain access to sensitive information by virtue of their role as essential advisors to the corporation. In this case, these outsiders obtain access to material non-public information, but are not technically employees or insiders, and therefore, would likely escape liability under the classical theory of liability.

In *Shapiro v. Merrill Lynch,* the Second Circuit ruled that an underwriter that had obtained confidential information while providing services for a client had committed insider trading by passing along that information to its other clients.[29] In footnote 14 of *Dirks v. SEC*—a case that was decided under another theory of liability, discussed below, but in which the Court nevertheless addressed the topic of temporary insiders—the Supreme Court endorsed the idea that when a company reveals confidential information for legitimate corporate purposes to certain outside professionals, such as underwriters, lawyers, accountants, or management consultants, these outsiders are then considered temporary fiduciaries of the shareholders of the company.[30] Thus, this theory allows courts and the SEC to sidestep the narrow *Chiarella* holding by temporarily extending insider-like duties to an outsider who temporarily gains access to inside information.[31]

C. *Misappropriation Theory*

The misappropriation theory, like the temporary insider theory, addresses the classical theory's inability to capture wrongful conduct by non-insiders. However, unlike the classical or temporary insider theories, it does not rely on the trader's status as an actual or constructive insider of the corporation. Rather, liability is based on the existence of a fiduciary

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29. Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228 (2d. Cir. 1974). Although this is a tippee liability case, the court did not premise liability of the underwriter on a preexisting fiduciary relationship. Prentice, *supra* note 2, at 353. Therefore, this decision supports the theory that a party does not need to actually be a traditional corporate insider to be liable as if he were an insider.

30. Dirks v. Sec. & Exch. Comm'n, 463 U.S. 646, 655 n. 14 (1982) (citing, for example, Sec. & Exch. Comm'n v. Monarch Fund, 608 F.2d 938, 942 (2d. Cir. 1979) (noting that outsiders can obtain inside information due to their special relationship with a company)).

31. It is easy to imagine what the Court envisions here. For example, outside accounting firms must have access to inside information when auditing the financial statements of a client corporation.

relationship between the trader and the source of the insider information. Therefore, the trader need not be an insider of the corporation. In *Chiarella*, the Government argued that the defendant had engaged in activity that seemed inherently unfair and inappropriate.[32] While Chiarella was not an insider, the Government argued that he had nonetheless misappropriated information rightfully belonging to other parties.[33] However, the Court declined to address the Government's misappropriation argument. The Court returned to the question eighteen years after *Chiarella* in *United States v. O'Hagan* and validated the misappropriation theory.[34]

James O'Hagan was a partner of a law firm representing a potential acquirer in a tender offer transaction. Although he was not personally assigned to represent the client, he was aware of the potential transaction. In anticipation of the upcoming tender offer announcement and the commensurate jump in the price of target corporation stock, O'Hagan purchased shares of the target corporation stock. After the announcement, the price increased as anticipated, and O'Hagan reaped a sizeable profit from the transaction.[35] O'Hagan was initially convicted on the basis of misappropriation theory, but the conviction was reversed by the Eighth Circuit, only to be reversed again by the Supreme Court.

In overruling the Eight Circuit, the Supreme Court first held that misappropriation was a fraudulent act prohibited by § 10(b) and Rule 10b-5.[36] The Court reasoned that, by using information that a source entrusted to him in confidence, a misappropriator—a fiduciary of the source of inside information—defrauds the source by converting the information for personal gain.[37] Therefore, under the misappropriation theory, the duty to abstain or disclose is owed to the source of the information, rather than the corporation and its shareholders, and a fiduciary relationship must exist between the trader and the source.[38] The Court ruled that this type of

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32. Chiarella v. United States, 445 U.S. 222, 223 (1980).

33. *Id.* at 235-36.

34. United States v. O'Hagan, 521 U.S. 642, 658-59 (1997).

35. *Id.* at 647-48.

36. *Id.* at 653.

37. *Id.* at 653-54.

38. But note that in certain cases, misappropriation and the classical theory overlap. For instance, when the misappropriator is also a company insider, then the source and the corporation are one and the same, and both theories will operate to reach the same result. *See* Robert A. Prentice, *supra* note 2, at 351-52 (noting that misappropriation overlaps with other theories of insider trading liability in certain circumstances). In *O'Hagan*, 521 U.S. 642 (1997), however, the defendant's liability based on the classical and temporary insider theories would have been in doubt. The defendant's employer was the law firm representing the *acquirer* in a merger transaction, meaning that O'Hagan traded in shares of the *target.* Since his law firm was not representing the target corporation, and since he did not personally provide any services, O'Hagan would most likely not have been considered a temporary insider.

deception by misappropriation was consistent with the language of § 10(b) and Rule 10b-5.[39]

Second, the Court held that the misappropriation in question satisfied the requirement in § 10(b) that the fraud be "in connection with the purchase or sale" of securities.[40] Finally, the Court noted that prosecution of misappropriation is in tune with the "animating purpose" of the Exchange Act: to promote investor confidence by insuring that securities markets are honest.[41] The Court found no reason to hold a trader that has profited from the use of confidential information liable for fraud if he is a fiduciary of the shareholders of the issuing corporation.[42] In either case, the Court observed, the negative impact on the market would be identical.[43]

Therefore, even in cases where an outsider, who owes no duty to the corporation or its shareholders, trades that corporation's shares on the basis of material non-public information, he may be liable for insider trading through the misappropriation theory. Unlike classical theory liability, the misappropriator must be a fiduciary of the source of the inside information, rather than the corporation's shareholders. The misappropriator must then trade on the basis of the information in violation of the confidence of the source. Thus, like the classical theory, this theory of insider trading liability is still grounded in the fiduciary duty owed to another party, rather than the possession of an informational advantage.

D. *Tippee Liability*

Like the misappropriation and temporary insider theories, tippee liability rectifies the inability of classical theory liability to reach non-insiders. Tippee liability, functions by extending the tipper's breach of duty to traders who otherwise would not be considered fiduciaries of either the shareholders of the corporation or the original source of the information.

It is not difficult to imagine a scenario in which a tippee might benefit by trading on the basis of an inside tip. Take for example the case of a CEO who informs a close friend that he should sell his shares of the CEO's corporation. The corporation will be revealing previous overstatements of earnings, and the stock price will surely take a hit. The friend

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39. *See id.* ("We agree. . .that misappropriation, as just defined, satisfies §10(b)'s requirement that chargeable conduct involve a 'deceptive device or contrivance. . ..').

40. *O'Hagan*, 521 U.S. at 653 ("We agree. . .that misappropriation, as just defined, satisfies §10(b)'s requirement that chargeable conduct involve a 'deceptive device or contrivance. . ..').

41. *Id.* at 658.

42. *See id.* at 659 ("[I]t makes scant sense to hold a lawyer like O'Hagan a § 10(b) violator if he works for a law firm representing the target of a tender offer, but not if he works for a law firm representing the bidder.").

43. *See id.* at 652 (noting that the classical and misappropriation theories are complementary, each targeting situations in which insiders or outsiders harm the integrity of the securities markets by attempting to capitalize on nonpublic information).

willingly acts on the CEO's tip, even though he knows the CEO should not be disclosing this type of information ahead of the public announcement. The stock price plummets after the announcement, but the friend has avoided loss.

The classical, misappropriation, and temporary insider theories are insufficient to capture the tippee's conduct. Under *Chiarella,* a tippee does not become a fiduciary of the corporation just by virtue of possessing confidential information regarding the corporation.[44] Therefore, without the requisite fiduciary relationship between the tippee and the corporation's shareholders, a tippee cannot be liable under the classical theory. Alternatively, for misappropriation theory to apply, the tippee must perpetrate some fraud on the source of the information. In this case, the source of the information, i.e. the CEO, fully expects the tippee to trade on the basis of the information he has supplied. Finally, the tippee cannot be considered a temporary insider of the corporation because he is not a professional gaining access to the information in his capacity as an outside advisor.

Yet tippees are not completely insulated from insider trading liability. A tippee who receives confidential information through a tipper's breach of the duty to abstain or disclose may share responsibility for the breach under certain circumstances. In other words, the tippee may be contributorily or secondarily liable. The Court expressly endorsed and established the elements of tippee liability in *Dirks v. SEC*.[45]

In *Dirks*, the Court held that a tipper who breaches his duty to the shareholders or the source of the information by passing along the information to the tippee also transfers the breach of duty to the tippee.[46] Since the tippee's liability arises from his after-the-fact participation in the insider's breach, the tippee is only liable if the tippee knows or should have known that the tipper breached his fiduciary duty by passing along the tip.[47] The tip constitutes a breach of the tipper's fiduciary duty only if he personally benefits, directly or indirectly, from the tip (the "personal benefit test").[48] This test may be satisfied if there is evidence of a monetary gain, reputational benefit leading to future earnings, or a gift of confidential information to a relative or a friend.[49] Finally, tippee liability also extends to second tier tippees, traders who obtain inside information from other tippees. In this case, a second tier tippee is liable if he knows or should have known of the original tipper's breach.[50]

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44. Chiarella v. United States, 445 U.S. 222, 235 (1980).

45. Dirks v. Sec. & Exch. Comm'n, 463 U.S. 646.

46. *Id.* at 659.

47. *Id.* at 660.

48. *Id.* at 662.

49. *Id.* at 663-64.

50. *See*, *e.g.*, Sec. & Exch. Comm'n v. Maio, 51 F.3d 623 (7th Cir. 1995) (holding the tippee to the tippee liable for insider trading).

Therefore, the friend in our example would not be able to escape liability for insider trading based on the argument that he is not a fiduciary of the corporation's shareholders. Instead, as long as he knows or should have known that the CEO was breaching his duty to abstain or disclose by tipping him, and as long as there is a personal benefit accruing to the director as a result of the tip—even intangible benefit—he will be liable for insider trading as a tippee. If the friend passed along the tip to others who then traded on the basis of the tip, they could also be liable as second tier tippees.

E. *Misappropriation Theory and Tippee Liability*

A tippee may obtain information from two different types of tippers. First, a tipper may be tipped by an insider, in breach of the insider's fiduciary duty to the corporation's shareholders. In this case, tippee liability extends classical theory liability to non-insiders. Second, a tipper may be tipped by a misappropriator, in breach of the misappropriator's duty to the source of the information.[51] In this case, tippee liability extends misappropriation theory liability.

Although the courts have not expressly clarified the reasoning behind universal application of tippee liability, one obvious justification is that a non-insider misappropriator, as a fiduciary of the source of the confidential information, has the same duty to protect non-public information as any corporate insider. Although the duty is owed to different parties in each case, there is no difference in the duty itself. Therefore, since the duty to protect non-public information applies identically in both cases, a tippee is contributorily liable when he acts on information that breached the tipper's duty, regardless of whether the tipper is an insider or a non-insider misappropriator.

An unresolved question arising from the application of tippee liability to extend misappropriation theory liability is whether a finding of tippee liability depends on a showing of personal benefit to the tipper. Although the SEC does not dispute the tippee liability requirements as established in *Dirks* for classical theory cases, the SEC distinguishes tippee liability requirements in misappropriation cases. The SEC contends that the prosecution only needs to show that the tipper acted with severe recklessness in providing information to the tippee in order to establish a breach of duty; a showing of benefit gained by the tipper need not occur to extend liability to the tippee.[52] This view is supported by *United States. v. Libera*, in which the Second Circuit ruled that, for misappropriation cases, a showing of tippee's knowledge was sufficient to establish liability without more because a tip of confidential information is "not for nothing," but instead demonstrates severe recklessness on the part of the tipper in sharing the

51. United States v. Falcone, 257 F.3d 226, 234 (citing United States v. Libera, 989 F.2d 596, 600 (2d Cir. 1996)); Sec. & Exch. Comm'n v. Svoboda, 409 F. Supp. 2d 331, 340 (S.D.N.Y. 2006).

52. Sec. & Exch. Comm'n v. Yun, 327 F.3d 1263, 1274 (11th Cir. 2003).

information with the tippee.[53] In *SEC v. Musella*, a district court noted, in dictum, that no showing of personal benefit is required in misappropriation cases.[54]

However, the Eleventh Circuit split from the Second Circuit in *SEC v. Yun,* where it held that the personal benefit rule applies to both misappropriation and classic theory tippee liability cases.[55] The Eleventh Circuit reasoned that there was no cause to treat misappropriation tippees any differently from classic insider tippees.[56] Consequently, in order to establish tippee liability, the tipper must have breached his duty to the shareholders of the corporation or the source of the information by tipping. In the Eleventh Circuit at least, the tipper must also have received a personal benefit from sharing the information with the tippee in every case. In the Second Circuit, if the tipper is a misappropriator, then the tipper must have only been severely reckless by providing the tippee with material, non-public information.

F. *Resulting Framework*

From the cases discussed above, it is possible to create a framework of insider trading liability. Under the classical theory, a trader is liable for insider trading if he trades on the basis of material non-public information in breach of a fiduciary duty owed to the shareholders of the traded-in corporation. Therefore, because of the fiduciary relationship requirement, the trader must be an insider of the corporation in order to be liable under the classical theory. Alternatively, under misappropriation theory, a trader is liable if he trades on the basis of material non-public information in breach of a fiduciary duty owed to the source of the information. Therefore, in this case the trader need not be an insider of the corporation. Temporary insider theory extends classical theory liability to outside professionals who trade on the basis of material non-public information gained by virtue of their position as advisors to the corporation. Tippee liability extends liability to non-insider tippees who obtain material non-public information from either insiders of the corporation or misappropriators. Having established the basis legal framework of insider trading liability, this note proceeds to discuss BMW's liability in Part IV.

IV. Application of Legal Framework to Hypothetical

Having established the framework for insider trading liability, Part IV of this note will apply this framework to the hypothetical described in Part

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53. *Libera*, 989 F.2d at 601-02. An alternative reading of this opinion is that the issue of personal benefit was never in doubt, and so was not addressed by the court.

54. Sec. & Exch. Comm'n v. Musella, 748 F. Supp. 1028, 1038 n.4 (S.D.N.Y. 1989). For criticism of this case, see Jeffery Plotkin, *The Tipper Benefit Test Under the Misappropriation Theory,* N.Y.L.J., Aug. 15, 2003.

55. *Yun*, 327 F.3d at 1279.

56. *Id.* at 1277.

II. The purpose of this application is to determine whether the SEC would be able to sustain an insider trading charge against BMW if BMW's act of channel checking comes under SEC scrutiny. This section concludes by asking whether imposing liability for channel checking makes sense, or whether the SEC should instead direct its resources and enforcement efforts to other areas of industry conduct.

A. *Did BMW engage in insider trading?*

There are several questions to answer before a reaching a conclusion about BMW's liability for channel checking. First, there is the threshold question of the importance of the information obtained by BMW through its channel checking—that is, whether the information was material. Second, this section must determine which theory of insider trading would most likely apply to BMW's actions. If BMW is not directly liable through either the classical or misappropriation theory, the company may be liable under temporary insider theory or tippee liability.

1. Materiality

The information obtained by BMW through channel checking is likely material. In *TSC Industries, Inc. v. Northway, Inc.,* the Supreme Court ruled that material information is that material which has a substantial likelihood to have actual significance in the deliberations of a reasonable shareholder.[57] In other words, material information is information that would be viewed by a reasonable investor as having altered the total mix of available information. In the context of insider trading, courts have interpreted material information as that which is "reasonably certain to have a substantial effect on the market price."[58] Information that is "sufficiently directed to the matter of earnings" would satisfy this standard.[59] In the hypothetical, the tippers' information was reasonably certain to have a substantial effect on the market price because it was sufficiently directed to the matter of earnings. The information obtained by BMW indicated that the earnings of the two companies would soon diverge, and BMW thought this information was important enough to base its decision on it.

2. Liability Under Classical, Misappropriation, and Temporary Insider Theory

BMW would likely not be liable directly under the classical or misappropriation theory of insider trading. Additionally, it would not be considered a temporary insider. First, because BMW is not a fiduciary of either of the target companies, the classical theory does not apply to it under *Chiarella.* Second, BMW is not liable directly under misappropriation the-

57. TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976).

58. Elkind v. Liggett & Myers, Inc., 635 F.2d 156, 166 (2d Cir. 1980) (quoting Sec. & Exch. Comm'n v. Bausch & Lomb Inc., 565 F.2d 8, 15 (2d Cir. 1977)).

59. *Id.* at 167.

ory because it has not breached any duty owed to the source of the information, the suppliers and the distributors of the two companies. BMW is not a fiduciary of the sources, nor did the sources ever have an expectation that BMW would keep the information confidential. The sources knew exactly for what purpose BMW was using the information. Finally, BMW cannot be considered a temporary insider of the target companies because it is not an outside advisor of either of the two companies, and because it did not actually receive any information from the companies themselves for a corporate purpose. Therefore, if BMW is to be held liable for insider trading for its channel checking activities, it must be through tippee liability.

3. Tippee liability

A tippee is liable if the tipper breached his fiduciary duty to either the corporation's shareholders or the source of the information by sharing material non-public information with the tippee. First, in order for the tippee to be liable, the tipper must have actually violated a duty owed to the source of the information when he shared that information with the tippee. Second, the tipper must have given the tip in order to gain some personal benefit. Finally, the tippee must have known or should have known that his receiving the information constitutes a breach of the tipper's fiduciary duty to the corporation's shareholders or the source of the information.[60] As noted in Part III, there is a split between the Second and the Eleventh Circuits regarding whether these requirements are uniformly applied in situations where the tipper is a misappropriator as opposed to an insider. This note applies both approaches and concludes that BMW would likely be liable for insider trading through tippee liability in any circuit.

In the BMW hypothetical, there is a question whether a formal fiduciary relationship needs to be proved between the suppliers, the distributors, and the two target companies in order to show a duty existed between the parties to protect non-public information. Under misappropriation theory, some courts have held that a formal fiduciary relationship need not be proved between a misappropriator and his source in order for a duty to nonetheless exist between the two parties.[61] For example, in *SEC v. Yun*, the Eleventh Circuit ruled that there were circumstances in which a reasonable expectation of confidentiality could exist even without a fiduciary or similar relationship or an express confidentiality agreement.[62] Additionally, SEC Rule 10b5-2 also states that "a person has a duty of trust or

60. *See supra* Part III.C (laying out the elements of a claim under the misappropriation theory).

61. *See, e.g.*, Sec. & Exch. Comm'n v. Yun, 327 F.3d 1263 (11th Cir. 2003). *But see* United States v. Chestman, 947 F.2d 551 (2d. Cir. 1991) (holding that there must exist a strict fiduciary-like relationship between the misappropriator and the source of the information).

62. *See Yun*, 327 F.3d at 1273,

confidence for purposes of the 'misappropriation theory' of insider trading. . .[w]henever a person agrees to maintain information in confidence.[63]

The SEC appears then to adopt the Eleventh Circuit's broader prohibition of information sharing. In other words, the information shared need not be protected under a formal fiduciary obligation. Instead, the mere expectation that the information will be kept confidential is sufficient to give rise to the duty to disclose or abstain. The hypothetical in Part II details the fact that the distributors and suppliers of the target companies entered into a signed agreement to keep the information shared confidential. However, even without the formal signed agreement, the materiality of the information exchanged and the hesitation on the part of the suppliers and distributors to share information with BMW may be sufficient evidence of an agreement between parties to protect non-public information. Therefore, the SEC and courts following the Eleventh Circuit approach would likely rule that BMW's sources, the suppliers and distributors of the two companies, had a duty not to share the information with BMW.

On the other hand, the Second Circuit requires a strict fiduciary-like relationship between the trader and the source of the information. Such a relationship may not be easily established in the BMW hypothetical. However, even circuits that take a more strict approach to the duty requirement, such as the Second Circuit, have found that an expressly signed confidentiality agreement between parties may give rise to a duty to disclose or abstain.[64] Given that the sources here had signed confidentiality agreements with the target companies as a condition of doing business with them, the Second Circuit may likely find that parties owed a duty to disclose or abstain.

It is debatable whether the second requirement for finding tippee liability—the requirement that the tipper derive personal benefit from sharing non-public information with the tippee—is satisfied in the BMW hypothetical. In *Dirks,* the Supreme Court ruled that a tipper cannot breach his duty without deriving a personal benefit from sharing the information, and consequently no liability transfers to the tippee.[65] As noted in Part III, there is a split in the circuits regarding the universal applicability of the personal benefit requirement. A majority of the circuits, including the Eleventh Circuit, hold that personal benefit is a uniform requirement. On the other hand, a minority of circuits, including the Second Circuit and the SEC,[66] hold that that personal benefit is not required in misappropriation cases.

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63. 17 C.F.R. § 240.10b5-2(b)(1) (2012).

64. *E.g. Chestman*, 947 F.2d at 571 (holding that absent an express acceptance, a duty of confidentiality could be implied only through a pre-existing fiduciary-like relationship between the parties).

65. Dirks v. Security & Exch. Comm'n, 463 U.S. 646, 667 (1983).

66. For example, in United States v. Libera, 989 F.2d 596, 600-62 (2d Cir. 1993), the Second Circuit ruled that the fact that the tippers had knowingly violated their employer's confidentiality agreement was sufficient to establish breach of a fiduciary duty. Since no per-

The facts in the BMW hypothetical suggest that a court requiring proof of personal benefit on the part of the tippee would likely find such threshold has been met. If the personal benefit test must first be satisfied, the fact that the tippers provided BMW with the information sought in order to preserve future business prospects would likely suffice to meet this test. If no personal benefit test is required, then the fact that the tippers violated the confidentiality agreement by sharing information with BMW is alone sufficient to establish a breach of trust.[67]

Finally, BMW was aware that the tippers were providing information in violation of tippers' confidentiality agreements. Although the tippers eventually complied with BMW's request for information, they first informed BMW of the existence of the confidentiality agreements. This would be enough to establish BMW's actual knowledge that it was receiving the information in breach of the tippers' duties to the target companies. Therefore, this fact alone would satisfy the requirement that the tippee must know or should have known of the tipper's breach of duty.[68]

Therefore, the SEC, and likely most federal circuit courts too, would find BMW secondarily liable for insider trading pursuant to the tippee theory when it engaged in channel checking. The information that serves as BMW's basis for trading is material and confidential. BMW's tippers owed a duty to the target companies to keep information about the companies' supply and distribution numbers confidential, and it subsequently breached this duty by tipping BMW for personal gain. Finally, BMW knew that it was receiving the information as a result of the tippers' breach of duty. Even if BMW had outsourced the channel check to a market analyst, this conclusion would not change because BMW would then be considered a second tier tippee and suitably liable.

B. *Does it make sense to impose liability for channel checking?*

There are circumstances in which imposing liability for channel checking makes sense. The central purpose of the prohibition of insider trading is to preserve the integrity of the capital markets by protecting the general investing public from being taken advantage of by persons acting on the basis of information obtained through improper means.[69] Therefore, when the policy rationale and the legal results are in congruence, imposing insider-trading liability for channel checking is justified. For example, analysts and their clients should be punished where improperly obtained information allows clients of the analysts to be avoid large losses due to a negative earnings surprise. Here, the law operates to prevent a certain

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sonal benefit requirement is mentioned by the court, this ruling may suggest that merely violating a confidentiality agreement constitutes a breach, at least for the purposes of tippee liability

67. *See id*.

68. *See Dirks* 463 U.S. at 647.

69. United States v. O'Hagan, 521 U.S. 642, 658-59 (1997).

group of advantaged individuals from transferring losses to the unsuspecting investing public.

However, in other cases, the legal results are not strongly supported by a policy justification. The hypothetical of BMW is one such example. Why should the SEC go after BMW for insider trading when the shareholders of Peppers and the investing public have not been harmed? In fact, the information will likely lead to the shareholders realizing a premium over the market price of their shares, and it will allow BMW to make the smarter investment decision. It seems strange that the SEC should punish an action that ultimately benefits investors.

Additionally, it would make more sense to allow the shareholders of Miller, the company in the hypothetical that BMW rejected, to bring a private action against BMW. However, the law under current interpretations is not likely to permit this cause of action.[70] Finally, it is not clear that the shareholders of Miller ought to be allowed to take BMW to court, because the policy justification can cut in favor of BMW. In the long run, it may be more beneficial for the market to allow buyers to pursue deals that have a better chance of succeeding.

Although the extent to which channel checking is a prevalent practice in the marketplace is unclear, this note demonstrates that it can be a powerful and effective tool, particularly in the field of private equity acquisitions. Despite the fact that it likely is not an overtly harmful practice, current insider trading law allows the SEC and the courts to punish a private equity firm that chooses to engage in a channel check.

V. Conclusion

By applying the facts of the motivating hypothetical to the current legal framework of insider trading law, this note shows that at least in certain circumstances, a company in BMW's position could be found liable for insider trading by obtaining and trading on the basis of information obtained from suppliers and distributors of mergers and acquisitions targets. The suppliers and distributors, the tippers in this case, could be misappropriators of confidential information, and BMW would be secondarily liable under tippee liability. However, just because a certain legal result can be obtained does not mean that it should be. In cases where there is little policy justification for expanding insider-trading liability to previously un-prohibited marketplace practices, there is little advantage to

70. *See* Ian Ayres & Joe Bankman, *Substitues for Insider Trading,* 54 Stan. L. Rev. 235, 251-60 (2001). The authors conclude that in many circumstances, trading in stock substitutes, one facet of which is the practice of using inside information to trade alternatively in a rival company, is legal. Ostensibly, shareholders of the spurned company would not have standing to sue under Rule 10b-5 because they cannot meet the rule articulated in *Blue Chip Stamps v. Manor Drug Stores,* 421 U.S. 723, 733 (1975), that plaintiffs in private 10b-5 actions must have traded in the same stock as the defendant. In this case, the plaintiffs are *holding* stock, not trading, and the stock they are holding is not the same as those in which the defendant is trading. *Id.*

doing so. Despite the lack of a policy justification for imposing insider-trading liability for channel checking, this note shows that the current laws allow the courts to extend insider trading liability to this practice. Therefore, a private equity firm would do well to take this into consideration before engaging in a channel check.