New York Law Journal
SERVING THE BENCH AND BAR SINCE 1888
WWW.NYLJ.COM

An incisivemedia publication
VOLUME 242—NO. 43
MONDAY, AUGUST 31, 2009

SECOND CIRCUIT REVIEW

Expert Analysis

Fiduciary Duty and 'Deceptive' Fraudulent Conduct Under Rule 10(b)

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This month, we discuss *Securities and Exchange Commission v. Dorozhko*,[1] in which the U.S. Court of Appeals for the Second Circuit addressed the question of what constitutes "deceptive" conduct under Section 10(b) of the Securities Exchange Act of 1934. Reversing a lower court order that denied the SEC's motion for a preliminary injunction, the court held that trades in put options of a company's stock based on inside information obtained in the absence of a fiduciary relationship with the company may constitute fraud in violation of the federal securities laws.

The opinion, written by Judge Jose A. Cabranes and joined by Judge Peter W. Hall and District Judge Richard J. Sullivan of the U.S. District Court for the Southern District, expands the range of cases that the SEC can bring against defendants in an attempt to curb insider trading.

Background

IMS Health, a publicly traded company headquartered in Connecticut, announced that it intended to reveal its earnings for the 2007 fiscal year at 5 p.m. on Oct. 17, 2007. The company planned to inform the investing public that its performance for that period had fallen significantly below expectations, with its earnings per share 28 percent below the expectations of Wall Street analysts. That news ultimately would send the company's stock tumbling almost 28 percent upon the opening bell the next morning.

Beginning early on the morning of the announcement, a computer hacker attempted to gain access to the company's earnings report by hacking into a secure server at Thompson Financial, which hosted IMS Health's investor relations Web site. Four attempts proved unsuccessful, as the company had not yet sent its earnings report to the server. A fifth attempt, made after Thompson received the data and transferred it to a staging area on its Web site prior to the unveiling, succeeded at 2:15 p.m., and the hacker downloaded and viewed IMS Health's earnings report.

Oleksandr Dorozhko, a self-employed Ukrainian national living in the Ukraine, became the world's leading active trader of put options of IMS Health stock within an hour. By 2:52, he had commenced a pattern of trading that ultimately resulted in his purchasing $41,670.90 worth of IMS put options due to expire on Oct. 25 and Oct. 30. These purchases constituted 90 percent of all such purchases of IMS Health put options during the six weeks between Sept. 4, 2007, and Oct. 17, 2007. Mr. Dorozhko essentially bet heavily on IMS Health's stock falling substantially in a short space of time.

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IMS Health's announcement took place that afternoon. The market opened at 9:30 the next morning, and the stock's value immediately plummeted. By 9:36, Mr. Dorozhko had sold all of his put options, realizing a net profit of $286,456.59. Not long after, Interactive Brokers—with whom Mr. Dorozhko had only opened an account that month, registering no trading activity prior to the IMS Health trades—recognized the highly suspicious trading and referred the case to the SEC. On Oct. 29, 2007, the commission filed an emergency application before the Southern District of New York, requesting a temporary restraining order freezing the proceeds of the trades, along with other relief. The order was granted, and a preliminary injunction hearing followed.

The District Court Decision

The district court denied the SEC's request for a preliminary injunction because the commission did not show a likelihood of success on the merits.[2] Focusing on Section 10(b)'s prohibition of the use "in connection with the purchase or sale of any security… [o]f any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe,"[3] the lower court opinion devoted most of its analysis to whether the alleged scheme was "deceptive" within the meaning of the statute. That inquiry began with a review of precedent which stood for the proposition that a device "is not 'deceptive' unless it involves breach of some duty of candid disclosure."[4]

The district court's opinion explored the full history of the development of securities fraud law since the passage of the Securities and Exchange Act in 1934, analyzing the SEC's claim against the twin backdrops of the recognized "traditional" theory of insider trading (in which the corporate insider trades in securities of his own corporation or gives someone else an illegal "tip") and the "misappropriation" theory (in which the fiduciary duty violated is not owed to other participants in the market, but rather to the source of the information), along with possible other theories.

The district court concluded that under either recognized theory of insider trading, Mr. Dorozhko was not liable, owing to the absence of any "evidence that he is anything other than a true outsider, who owed no duties of disclosure to either other market participants or to the source of his information."[5] The

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lower court also observed that no precedent existed under which a person who simply stole material nonpublic information and traded on it was held to have violated §10(b). The lower court recognized that "computer hacking might be fraudulent and might violate a number of federal and state criminal statutes," but nonetheless ruled that the behavior did not violate §10(b) without a violation of a fiduciary duty.

The Second Circuit Decision

The Second Circuit reversed the district court's ruling, acknowledging at the outset that the SEC's claim against Mr. Dorozhko "is not based on either of the two generally accepted theories of insider trading."[6] Rather, the court analyzed the SEC's claim as a straightforward claim of affirmative fraud.

The court first reviewed the argument that the Supreme Court's interpretation of "deceptive" conduct under §10(b) required a breach of fiduciary duty. The Court analyzed each of three seminal U.S. Supreme Court decisions that the district court had relied upon in reaching its conclusion. In *Chiarella v. United States,*[7] an employee of a financial printer used information obtained through his work to buy shares in the target corporations. The government alleged that the employee committed fraud by failing to disclose his trades on the basis of material, nonpublic information to the market. His conviction was reversed by the Supreme Court, the majority of which found no fraud arising from the mere possession of nonpublic information where no duty to disclose existed and further declined to consider the theory that the employee had breached a duty to his employer.

In *United States v. O'Hagan*,[8] a lawyer who represented a party to a potential tender offer traded upon material information he came upon in the course of his representation. The Supreme Court held that the lawyer had a fiduciary duty to inform his firm that he was trading on inside information, but, as the district court observed, sidestepped any theory that the misappropriator was liable only as a result of any unfairness to the broader market. The district court cited this as a Supreme Court endorsement of the view that "§10(b) does not reach all structural disparities in information that result in securities transactions, only those disparities obtained by dint of a breach of fiduciary duty of disclosure."

Finally, in *SEC v. Zandford*,[9] a securities broker's fraudulent conduct consisted of selling the securities in a client's account and transferring the proceeds to his own. The Supreme Court, addressing the question of whether the scheme was "in connection with" the purchase or sale of a security, held that Charles Zandford's sale was a central part of his scheme to defraud his client. Notably, as the district court observed, the Supreme Court recognized that if Mr. Zandford had disclosed his plan to steal the money to his client, he would not have been liable under 10(b), as no deceptive device would have been involved. By the district court's reading of *Zandford*, even where a separate fraudulent scheme that did not involve insider trading gave rise to the allegations, a breach of fiduciary duty was required to establish a "deceptive" violation.

According to the Second Circuit, however, none of these Supreme Court opinions establish an across-the-board fiduciary-duty requirement as an element of a 10(b) violation. Although the Second Circuit recognized that the U.S. Court of Appeals for the Fifth Circuit had recently concluded to the contrary,[10] the court observed that in each of the above cases, the theory of fraud was one of a failure to disclose, rather than an affirmative representation. Observing that "what is sufficient is not always what is necessary," the court held that where silence or nondisclosure may satisfy the requirement of a "deceptive device or contrivance" in those cases in which a fiduciary duty exists, that fact does not amount to a requirement that a fiduciary duty be present in every example of fraud.[11] Specifically, the court distinguished Mr. Dorozhko's alleged conduct as an instance of affirmative fraud, implicating obligations not to mislead in commercial dealings that exist even in the absence of an affirmative duty.

The court then observed that the district court, having denied the preliminary injunction for lack of a fiduciary duty, did not have the opportunity to entertain the question of whether the hacking involved in the case involved "deception" under the statute, or even whether it involved any misrepresentation.[12] Recognizing that the hacking conduct that allegedly enabled Mr. Dorozhko to access the IMS Health report could be the product of deception, which would trigger 10(b) liability, or mere theft, which would not, the court remanded the case to the district court for consideration of whether the specific computer hacking conduct supported a claim under the securities laws. That question could very well turn on whether the technical mechanism employed by the hacker more accurately mimicked that of one who gains access to someone's home or business via an active ruse, or a burglar, who simply exploits a structural vulnerability without having to make a misrepresentation.

The Second Circuit has unexpectedly carved out a new potential area of enforceable territory under §10(b), and subjected a broader range of potential defendants to possible civil liability under the securities laws.

Conclusion

The Second Circuit decision has already prompted a considerable outcry from practitioners and academics, with several expressing concern that the SEC now has a free hand to initiate fraud cases where no fiduciary duty is present.[13] This power, however, is limited to those cases in which some basis for fraud other than silence in the face of a duty to disclose exists.

The court affirmed the traditional fiduciary duty requirement in those cases in which nondisclosure is the conduct at issue. And, of course, not every set of facts that could prompt charges of "deceptive" conduct under the traditional framework offers an alternate, affirmative theory of misrepresentation. At this point, it is unclear that even Mr. Dorozhko's specific conduct will be held to fit that category.

Nevertheless, the Second Circuit has unexpectedly carved out a new potential area of enforceable territory under §10(b), and subjected a broader range of potential defendants to possible civil liability under the securities laws. Given the split on this issue with the Fifth Circuit, it is possible that the Supreme Court will review this issue in the near future.

1. Docket No. 08-0201-cv, 2009 WL 2169201 (2d Cir. July 22, 2009) ("*Dorozhko II*").
2. *SEC v. Dorozhko* ("*Dorozhko I*"), 606 F.Supp.2d 321 (S.D.N.Y.2008).
3. 15 U.S.C. §78j(b).
4. *Dorozhko I*, 606 F.Supp.2d at 330 (citing *Regents of University of California v. Credit Suisse First Boston (USA) Inc.*, 482 F.3d 372, 389 (5th Cir. 2007); *United States v. O'Hagan*, 521 U.S. 642, 655, 117 S.Ct. 2199, 138 L.Ed.2d 724 (1997); *Chiarella v. United States*, 445 U.S. 222, 100 S.Ct. 1108, 63 L.Ed.2d 348 (1980).
5. *Dorozhko I*, 606 F.Supp.2d at 336.
6. *Dorozhko II*, 2009 WL 2169201 at *2.
7. *Chiarella*, 100 S.Ct. at 1112.
8. *O'Hagan*, 117 S.Ct. at 2205.
9. *SEC v. Zandford*, 535 U.S. 813, 122 S.Ct. 1899, 153 L.Ed.2d 1 (2002).
10. *Dorozhko II*, 2009 WL 2169201 at *4 (citing *Regents of the Univ. of Cal.*, 482 F.3d at 389).
11. Id. at *5.
12. Id. at *5.
13. "Bloggers Fuel Debate Over Circuit's Hacker Ruling," NYLJ, Aug. 3, 2009 at 3.