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A legal update from Dechert's White Collar and Securities Litigation Group

SEC v. Talbot Expands Insider Trading Misappropriation Theory

Introduction

In a recent Ninth Circuit decision, *SEC v. J. Thomas Talbot,*[1] the U.S. Securities and Exchange Commission ("SEC") gained important judicial confirmation of its efforts to expand the reach of the misappropriation theory of insider trading. Under the misappropriation theory, which was approved by the U.S. Supreme Court in *U.S. v. O'Hagan,*[2] liability for insider trading extends not merely to corporate insiders trading on the basis of material non-public information, but to any person who misappropriates confidential information for securities trading purpose, in breach of a fiduciary duty owed to the source of the information.

Talbot involved a corporate director who, in the course of service as a board member, learned that another publicly traded entity in which his company held a stake could be the subject of a possible acquisition. Although the director defendant owed no duty to the target of the possible takeover bid, the Ninth Circuit found that the duty of confidentiality he owed to the company on whose board he sat was breached when he traded on information about the takeover in his capacity as director. Thus, while there was no breach of a duty of confidentiality to the target company itself, the director's breach of duty to his own company sufficed to render his trading a violation of the federal securities laws.

The SEC's victory in *Talbot* is likely to encourage the Commission to expand the scope of duties that subject potential traders to the insider's obligations to disclose their material non-public information about a public company or refrain from trading in that company's securities. Other investigations—not yet public—may test the limits of the concepts of "duty" that can trigger liability for insider trading.

Description of Case

The case arose from the alleged actions of J. Thomas Talbot, a member of the board of directors of Fidelity National Financial, Co. ("FNF"), a publicly-traded Delaware corporation that offers national title insurance. In 2003, the year of the conduct at issue, FNF owned an approximate 10% interest in LendingTree, Inc. ("LendingTree"), a publicly-traded online lending and realty services company.

In April 2003, LendingTree notified an FNF officer that a third party was negotiating a potential acquisition of LendingTree. LendingTree did not reveal the name of the potential acquirer, but did indicate that the information about the potential acquisition was confidential.

1 *SEC v. J. Thomas Talbot*, No. 06-55561, D.C. No. CV-04-04556-MMM, 2008 WL 2574513 (9th Cir. June 30, 2008).

2 521 U.S. 642, 117 S. Ct. 2149, 138 L.Ed.2d 724 (1997).

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The information about the potential acquisition was conveyed to FNF's board on April 22, 2003, at a regular quarterly board meeting. The board agreed that FNF would vote for the acquisition if negotiations progressed. At that meeting, a member of the board allegedly observed that knowledge of the potential acquisition was confidential, non-public information and that the board members should not trade in LendingTree stock. The Court of Appeals found that "All Board members . . . except for Talbot considered the . . . information to be confidential."

Two days after the board meeting, on April 24, Talbot purchased LendingTree shares on margin. The following day (i.e., *after* both the board meeting and Talbot's initial purchase), LendingTree sent FNF management a letter agreement addressing the flow of confidential information surrounding the potential acquisition. FNF management did not inform the board about the letter agreement. On April 30, 2003, Talbot purchased additional LendingTree shares on margin.

On May 5, 2003—five days after Talbot's second purchase of LendingTree shares—FNF executed an agreement to vote in favor of the acquisition. The parties issued a press release regarding the acquisition. LendingTree shares rose in value and, the same day, Talbot sold his entire holding in LendingTree for a substantial profit.

The SEC brought civil insider trading charges based on the misappropriation theory against Talbot in June 2004. Both parties moved for summary judgment. The U.S. District Court for the Central District of California granted Talbot's summary judgment motion on the grounds that, under *O'Hagan,* liability for insider trading could lie only where the alleged wrongdoer owed a fiduciary duty of confidentiality to the "originating source" of the information. Because Talbot, as a board member of FNF, owed no fiduciary duty to LendingTree, the originating source of the information, Talbot could not be liable for insider trading.

On appeal to the Ninth Circuit, the government argued that Talbot was liable under the misappropriation theory because he owed to FNF a duty to keep the LendingTree transaction confidential. The Court agreed and noted that, under Delaware law, "corporate officers and directors are not permitted to use their positions of trust and confidence to further their private interests. While technically not trustees, they stand in a fiduciary relation to the corporation and its stockholders."[3] The court agreed with the SEC and held that Talbot owed a duty of loyalty and confidentiality to FNF, and that FNF was the rightful owner of the information about the potential acquisition.

Possible Implications of *SEC v. Talbot*

The Ninth Circuit reasoned in *Talbot* that directors have a duty to hold as confidential essentially all material information that they learn as members of the board, and that they breach that duty if they use the information for personal gain. This is so even if the corporation would not have itself used the information or was not otherwise damaged (the breach supposedly occurs when the corporation is denied the exclusive use of the information) and even if the corporation itself might not then have been under a duty of confidentiality to its source. Further, such a duty attaches regardless of whether a particular member of the board affirms in any particular situation that he or she understands that he or she is under such a duty.

The Supreme Court has noted that, in "classical" insider trading scenarios, there is no "general duty between all participants in market transactions to forgo actions based on material, non-public information."[4] It has declared further that only a "specific relationship between two parties" would give rise to a duty to avoid trading on material nonpublic information. The court explained in *O'Hagan*, however, that outsiders may be liable for insider trading where the trader has misappropriated confidential information in breach of a duty owed to the source of the information.[5] Rather than relying on breach of a fiduciary or other duty owed to the other party to the transaction, as would be the case in classical insider trading, the misappropriation theory posits liability based on the trader's deception of those who entrusted him with access to the confidential information.

As noted, there are other ongoing investigations that involve potentially expansive definitions of "duty" for

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3 *Talbot* at *8, quoting *Guth v. Loft, Inc*., 5 A.2d 503, 510 (Del.Ch.1939); *see also Teren v. Howard*, 322 F.2d 949, 953 (9th Cir. 1963).

4 *Chiarella v. United States*, 445 U.S. 222, 233, 100 S.Ct. 1108, 63 L.Ed.2d 348 (1980).

5 *O'Hagan*, 521 U.S. at 652.

insider trading purposes. For example, the SEC is investigating trading in so-called "substitute" stocks. In these situations, the trader allegedly used information learned from one company to which he or she owed a duty of confidentiality to trade in the stock of another company, the stock of which could be expected to trade in correlation with the first company's stock. Thus, to the extent that *Talbot* validates the Commission's view that the breach of any duty—even if unconnected to the operative corporate event—supports an action under the misappropriation theory, the sweep of insider trading liability will continue to reach trading by ever-growing types of corporate "outsiders."

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