Article

Uncorporate Insider Trading

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INTRODUCTION

Federal securities law has long restricted company insiders from trading on the informational advantages they enjoy. This prohibition serves a variety of purposes. Some justify it as protecting the capital markets, safeguarding ordinary investors and their companies from opportunism.[1] Others characterize insider trading restrictions as preventing the "inherent unfairness" that would result from insiders systematically trading with superior information.[2] Still others focus on preventing share price distortions that could arise from legalized insider trading.[3]

For these goals to be realized and for insider trading liability to attach, fiduciary duties are required between either insiders and their trading partners or between insiders and their provider of information. The Supreme Court prominently and unanimously reiterated this requirement just under four years ago in *Salman v. United States*, affirming a conviction based in part on disclosing information in violation of fiduciary duties owed to the source.[4]

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1. *See, e.g.*, 18 DONALD C. LANGEVOORT, INSIDER TRADING: REGULATION, ENFORCEMENT & PREVENTION §§ 1:3–4 (2019) (citing scholarship that looks at the effect of insider trading on non-inside traders).

2. Victor Brudney, *Insiders, Outsiders, and Informational Advantages Under the Federal Securities Laws*, 93 HARV. L. REV. 322, 355 (1979).

3. *E.g.*, LANGEVOORT, *supra* note 1, § 1:5 (discussing the effect of delayed disclosures on market prices).

4. Salman v. United States, 137 S. Ct. 420, 424 (2016).

Although a breached fiduciary duty has been a remarkably stable requirement of insider trading law,[5] the state of business law fiduciary duties has recently undergone seismic change. Historically, and through most of insider trading law's substantive development, most businesses were structured as corporations and general partnerships.[6] In these business forms, company insiders owe mandatory fiduciary duties of at least loyalty and care to their companies and owners.[7] This existence of mandatory fiduciary duties made it comparatively easy, across a broad range of insider activity, to satisfy insider trading liability's requirement that fiduciary duties be breached.

However, the last twenty years have seen a shift away from corporations and general partnerships as means of conducting business. New types of entities, especially limited liability companies (LLCs) and, to a lesser extent, limited partnerships (LPs), have emerged as the entities of choice.[8] Sometimes referred to as "uncorporate" entities,[9] to highlight their difference from traditional corporations, these alternative entities now dwarf the rate of new corporate formations.[10]

5. The fiduciary duty requirement was first recognized by the Supreme Court in *Chiarella v. United States*, 445 U.S. 222, 227 (1980). The requirement of a special relationship was recognized even earlier, in 1909, although it was not formalized to a fiduciary duty breach until 1980. Strong v. Repide, 213 U.S. 419, 431 (1909).

6. Rodney D. Chrisman, *LLCs Are the New King of the Hill: An Empirical Study of the Number of New LLCs, Corporations, and LPs Formed in the United States Between 2004–2007 and How LLCs Were Taxed for Tax Years 2002–2006*, 15 FORDHAM J. CORP. & FIN. L. 459, 465 (2010).

7. *See, e.g.*, Williams v. Geier, 671 A.2d 1368, 1381 (Del. 1996) (noting corporations have governance flexibility subject to honoring judicial principles of fiduciary duty); REVISED UNIF. P'SHIP ACT § 103(c)(i), (UNIF. LAW COMM'N 1997) (allowing partnerships to reduce the duty of loyalty if not manifestly unreasonable and to reduce but not eliminate the duty of care); Mohsen Manesh, *Contractual Freedom Under Delaware Alternative Entity Law: Evidence from Publicly Traded LPs and LLCs*, 37 J. CORP. L. 555, 560–62 (2012) (contrasting corporations' mandatory fiduciary duties with rules of modern uncorporate entities). Corporations also subject managers and officers to a mandatory fiduciary duty of good faith, which is generally categorized as a specific species of the duty of loyalty. *See, e.g.*, Julian Velasco, *The Diminishing Duty of Loyalty*, 75 WASH. & LEE L. REV. 1035, 1036–37 (2018).

8. Chrisman, *supra* note 6, at 460.

9. The term "uncorporations" was developed by Larry Ribstein. LARRY E. RIBSTEIN, THE RISE OF THE UNCORPORATION (2010).

10. *See, e.g.*, Chrisman, *supra* note 6, at 460 (estimating LLC formations outpace corporate formations by a two to one ratio).

The law often grants these alternative entities, unlike their corporate and general partnership counterparts, wide latitude in their contractual ability to modify or eliminate entirely the mandatory fiduciary duties traditionally owed by company insiders. For example, Delaware, the leader in new LLC formations,[11] expressly provides that "to the extent that, at law or in equity, a member or manager or other person . . . has duties (including fiduciary duties) to [the LLC or its owners, those] duties may be expanded or restricted or eliminated by provisions in [an LLC] agreement."[12] Similar accommodations are made for Delaware LPs.[13]

States' permissive attitudes toward alternative entities have generated a host of concerns,[14] but until now none has focused on the implications for insider trading liability. When core insider trading restrictions rest on the existence of fiduciary duties, that liability seemingly evaporates when those fiduciary duties have been eliminated. Company insiders could trade on

11. *See* CARTER G. BISHOP & DANIEL S. KLEINBERGER, LIMITED LIABILITY COMPANIES: TAX AND BUSINESS LAW ¶ 14.01[2] (Warren Gorham & Lamont/RIA 1994 & Supp. 2007-2) (describing the "almost gravitational pull" of Delaware's LLC law); Jens Dammann & Matthias Schündeln, *Where Are Limited Liability Companies Formed? An Empirical Analysis*, 55 J.L. & ECON. 741, 743 (2012) (finding large LLCs generally choose Delaware when forming outside their home state).

12. DEL. CODE ANN. tit. 6, § 18-1101(c) (2013).

13. DEL. CODE ANN. tit. 6, § 17-1101(d) (2010); Manesh, *supra* note 7, at 561.

14. Scholars have generally examined whether governance flexibility is used to enhance entity efficiency or instead to expropriate welfare from owners. *See, e.g.*, RIBSTEIN, *supra* note 9 (arguing for the general efficiency of alternative entity contractual freedom); Daniel S. Kleinberger, *Two Decades of "Alternative Entities": From Rationalization Through Alphabet Soup to Contract as Deity*, 14 FORDHAM J. CORP. & FIN. L. 445, 458–59 (2009) (arguing that unfettered governance flexibility will unduly disadvantage minority owners); Benjamin Means, *Contractual Freedom and Family Business*, *in* RESEARCH HANDBOOK ON PARTNERSHIPS, LLCS AND ALTERNATIVE FORMS OF BUSINESS ORGANIZATIONS (Robert Hillman & Mark Loewenstein eds., 2015) (analyzing the particular case of family businesses); Manesh, *supra* note 7, at 558; Sandra K. Miller, *The Role of the Court in Balancing Contractual Freedom with the Need for Mandatory Constraints on Opportunistic and Abusive Conduct in the LLC*, 152 U. PA. L. REV. 1609, 1612 (2004) (arguing the same as Kleinberger); Peter Molk, *How Do LLC Owners Contract Around Default Statutory Protections?*, 42 J. CORP. L. 503, 505 (2017); Larry E. Ribstein, *Fencing Fiduciary Duties*, 91 B.U. L. REV. 899, 900 (2011) (arguing the same as RIBSTEIN); Myron T. Steele, *Freedom of Contract and Default Contractual Duties in Delaware Limited Partnerships and Limited Liability Companies*, 46 AM. BUS. L.J. 221, 224 (2009) (same).

material, nonpublic information with impunity[15] and pass (or sell) that information to others to do the same. Prosecution arsenals against insider trading would not only be severely depleted, but also the public policy concerns that have long supported insider trading liability would go unrealized with these new uncorporate entities. Rank and file employees would continue to face restrictions, resulting in executives', but not low-level employees', being free to engage in insider trading.[16]

This problem is not confined solely to privately held companies, which LLCs dominate. LLCs span both privately held and publicly traded companies.[17] Moreover, insider trading restrictions, and the threat of SEC and private enforcement, apply equally to privately held and publicly traded companies.[18] The potential to eliminate this liability through fiduciary duty waivers requires careful analysis.

This Article proceeds in four Parts. Part I traces the history of insider trading law's development. It highlights how, from its inception, the law reflects a focus on insiders' fiduciary duties to either their companies or their shareholders to find liability. The Supreme Court has repeatedly refused to find liability when these duties are not present, and it has also refused to extend restrictions outside the realm of fiduciary duties. In other words,

15. Of course, there may be non-legal reasons for insiders to obey insider trading restrictions, such as the desire to preserve one's reputation or to conform with social pressure. *See, e.g.*, Robert J. Rhee, *A Legal Theory of Shareholder Primacy*, 102 MINN. L. REV. 1951, 2006–07 (2018) (casting shareholder primacy as an institutionalized, although non-legal, obligation of management).

16. *See infra* note 91 and accompanying text.

17. *See infra* note 91 and accompanying text.

18. SEC Litigation Release No. 22187, *Securities and Exchange Commission v. Stiefel Laboratories Inc. and Charles W. Stiefel*, Dec. 12, 2011, https://www.sec.gov/litigation/litreleases/2011/lr22187.htm (alleging insider trading by CEO of private company that bought back shares at allegedly undervalued prices). *See generally* WINSTON & STRAWN LLP, *SEC Renews Focus on Insider Trading in Private Company Stock* (2011) (noting that the *Stiefel* case "emphasizes that the SEC will prosecute cases involving private companies"); SEC Press Release (Dec. 12, 2011) (SEC director noted that "[p]rivate companies and their officers must understand that they are not immune from the federal securities laws"). Private insider trading actions in privately held companies are also commonly brought as business opportunity claims. *See, e.g.*, Pappas v. Tzolis, 2012 N.Y. Slip Op. 08053 (Ct. App. Nov. 27, 2012). For a recent example involving such a claim, see Colorado Boxed Beef Co., Inc. v. Evanston Insurance Co., No. 8:18-cv-1237-T-02JSS, 2019 WL 77376 (M.D. Fla. Jan. 2, 2019).

fiduciary duties are an essential and necessary component of traditional insider trading liability.

In light of this focus on fiduciary duties, Part II introduces the problem posed by the modern development of organizational alternatives to general partnerships and corporations. Recent years have seen an explosion in the popularity of LLCs and LPs, and state statutes often authorize complete waiver of fiduciary duties for these entities in ways never allowed for corporations or general partnerships. Wielding this freedom, companies devoid of fiduciary duties, both publicly traded and privately held, have begun competing with corporate counterparts for investment dollars without offering the protection of insider trading prohibitions.

Part III then addresses the resultant public policy concerns raised when insider trading liability vanishes. It surveys arguments for and against insider trading liability and concludes that, in many respects, alternative entities present a similar case for proscribing insider trading as do corporations and general partnerships. Indeed, some alternative entities are practically indistinguishable from their corporate and partnership counterparts, suggesting a need for similar treatment of insider trading liability. In other words, unless regulators have decided to do away with insider trading liability altogether—and there is little reason to think they have—as a policy matter at least some alternative organizations should be prohibited from eliminating insider trading liability through wholesale fiduciary duty waivers.

On the other hand, there are material differences between LLCs and LPs versus corporations and general partnerships. Alternative entities are attractive to highly sophisticated investors because of their unparalleled latitude to craft individualized governance provisions. Insider trading restrictions may be less needed and, indeed, harmful in these circumstances. Tailoring insider trading law to reflect alternative entity differences could still allow insider trading law to achieve its public policy goals, while at the same time allowing certain uncorporate entities to craft maximally efficient governance relationships.

Part IV therefore considers ways to reintroduce insider trading liability to alternative entities. The solution requiring the least change would be to use alternative entities' existing sole mandatory protection of the implied obligation of good faith and fair dealing to support insider trading liability. This route, however, provides only a very weak means to police insider trading;

among other disadvantages, it would seemingly preclude SEC enforcement.

Part IV ultimately concludes that the most direct and effective solution would be to mandate, for at least some alternative entities, a fiduciary duty for management upon which insider trading liability could be premised. There are several options when doing so. This duty could stem from the duty of loyalty, or it could be a new duty based on existing fiduciary relationships to accomplish insider trading's policy goals. States could accomplish this solution by reforming their state organizational law statutes, or the duty could be imposed through adventurous federal common law rulemaking. It could apply on a mandatory basis to all alternative entities, or only those that would most benefit from insider trading restrictions.

I. INSIDER TRADING LAW

Regulation of insider trading—trading in securities using material, nonpublic information—has a history dating back to the early 1900s. I focus first on the original "classical" theory of insider trading prohibitions, the source through which core company management is limited from trading in their own company's securities. As we will see, the classical theory focuses on the fiduciary relationship among insiders, the firm, and its shareholders. Next I turn to the more recent "misappropriation" theory, where liability also hinges on a fiduciary duty of loyalty between the trader and her information source. Because both theories are based on the existence of managerial fiduciary duties, both are affected by new uncorporate entities that allow elimination of these duties.[19]

A. THE CLASSICAL THEORY

Federal regulation of classical insider trading began with the 1909 United States Supreme Court opinion of *Strong v. Repide*.[20] Recognizing insider trading as a species of fraud, the

19. SEC Rule 14e-3 is another potential source of liability that applies to trades by insiders or others in the context of an impending tender offer. 17 C.F.R. § 240.14e-3 (2020). Because the Rule does not require the existence of a fiduciary duty, it proscribes insider trading in the limited tender offer context for all companies, even alternative entities that have waived fiduciary duties. But because its scope is only the takeover context, its prohibition on general insider trading by core insiders is limited.

20. 213 U.S. 419 (1909). Prior to this point, state and federal courts generally did not hold insiders accountable for trades in their private capacity. *See,*

court developed a "special facts" doctrine.[21] According to the Court, special circumstances could create a fiduciary duty between an insider and her trading partner that required the insider to disclose private information to her partner before trading.[22] The Court concluded these special facts were satisfied, and a fiduciary duty arose, where a director, in a face-to-face transaction, concealed his identity from his trading partner and did not reveal his knowledge that the company's stock was about to increase.[23] The director's failure to reveal this information to his trading partner before buying shares breached this fiduciary duty and constituted actionable fraudulent concealment.[24]

While the precise contours of the "special facts" necessary to invoke liability were not laid out in the opinion, insider trading's reliance on breached fiduciary duties was made clear.[25] Conceding for argument's sake that "the ordinary relations between directors and shareholders in a business corporation are not of such a fiduciary nature as to make it the duty of a director to disclose [inside information]," the Court used its "special facts" inquiry to identify the "cases where, by reason of the special facts, such duty exists."[26] Later summarizing *Strong*'s holding in 1939, the Court noted that it is "clear that breach of that [insider's] fiduciary duty" was one of the key components to establishing insider trading liability.[27]

The next major development in insider trading law's landscape came in 1934 with Congress's passage of the Securities and Exchange Act. Passed in response to a spectacular stock market

e.g., HENRY G. MANNE, INSIDER TRADING AND THE STOCK MARKET 1 (1966) ("Prior to the year 1910 no one had ever publicly questioned the morality of officers, directors, and employees trading in the shares of corporations."); H.L. Wilgus, *Purchase of Shares of a Corporation by a Director from a Shareholder*, 8 MICH. L. REV. 267, 267 (1910). This did not stop isolated attempts to hold parties liable for insider trading in state court. *See, e.g.*, Oliver v. Oliver, 45 S.E. 232 (Ga. 1903); Stewart v. Harris, 77 P. 277 (Kan. 1904). State law still generally refuses to recognize insider trading liability, at least when that trading occurs over impersonal securities exchanges. *See, e.g.*, Stephen M. Bainbridge, *Incorporating State Law Fiduciary Duties into the Federal Insider Trading Prohibition*, 52 WASH. & LEE L. REV. 1189, 1222 (1995).

21. *Repide*, 213 U.S. at 431.
22. *Id.*
23. *Id.* at 431–34.
24. *Id.* at 432–33.
25. *Id.* at 431–34.
26. *Id.* at 431.
27. Pepper v. Litton, 308 U.S. 295, 307 n.15 (1939).

boom, crash, and the Great Depression, the Act aimed to curb various types of securities manipulation and speculation.[28] Section 10(b)[29] and SEC Rule 10b-5[30] provided a catch-all antifraud provision, capturing knowing misconduct that deceived investors.[31] In doing so, Congress established the statutory source for federal insider trading liability begun in 1909's *Strong* opinion. By failing to disclose material, nonpublic information to a trading partner when faced with a fiduciary duty to disclose that information (such as arising in *Strong*'s "special facts"), company insiders engage in fraudulent concealment of that information that trigger's liability under Section 10(b).[32] In essence, then, Section 10(b) and Rule 10b-5 served as the statutory means to continue what *Strong* had already declared unlawful: fraudulent concealment of material nonpublic information by core company insiders.

Beginning in *Strong* and continuing in its statutory embodiment, classical insider trading liability is a theory founded in fraud.[33] Liability requires the insider first to possess a duty to disclose her information that she breaches by trading without disclosure. Without a duty to disclose, the insider's nondisclosure cannot constitute fraud.

Subsequent cases thus focused on figuring out when an insider possessed such a disclosure duty with her trading partner. The main source of this duty was the fiduciary relationship that insiders occupied relative to their companies and their trading partners. The classic Supreme Court cases of *Chiarella v. United States*[34] and *Dirks v. SEC*[35] emphasized the point. In *Chiarella*, the petitioner was employed by a financial printer that, among other things, printed materials distributed as part of corporate

28. *See, e.g.*, Steve Thel, *The Original Conception of Section 10(b) of the Securities Exchange Act*, 42 STAN. L. REV. 385, 409 (1990) (analyzing the purpose of the Act).

29. 15 U.S.C. § 78j(b) (2018).

30. 17 C.F.R. § 240.10b-5 (2020).

31. *See, e.g.*, Thel, *supra* note 28, at 386–87 (describing this catch-all nature).

32. *See, e.g.*, LANGEVOORT, *supra* note 1, § 1:8 (explaining fraudulent concealment of information).

33. *See, e.g.*, Chiarella v. United States, 445 U.S. 222, 247–48 (1980) (Blackmun, J., dissenting) (focusing on common law fraud in considering classical insider trading liability).

34. *Id.* at 222 (majority opinion).

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

takeovers.[36] By virtue of his position, Chiarella identified five impending mergers before their public announcement, bought stock in the target companies based on this material nonpublic information, and realized gains of approximately $30,000 over the course of a year.[37] After entering into a consent decree with the SEC, Chiarella was then prosecuted by the Department of Justice for violating Rule 10b-5's antifraud prohibition.[38]

In overturning his convictions, the Supreme Court summarized insider trading liability as being premised upon failure to disclose information "that the other party is entitled to know because of a fiduciary or similar relation of trust and confidence between them."[39] Chiarella, however, had no relationship with any of his trading partners: he was not a core insider of the target companies and had no particular relationship with any of his open market trading partners that might establish the requisite fiduciary duty.[40] Since Chiarella had no fiduciary duty that would give him an obligation to disclose information before trading, his nondisclosure could not constitute securities fraud, making him not liable for his trades despite his use of material nonpublic information.[41]

Dirks v. SEC followed closely on the heels of *Chiarella* and likewise stressed the importance of a fiduciary duty breach before insider trading liability would be imposed. Dirks, a financial

36. *Chiarella*, 445 U.S. at 224.

37. *Id.*

38. *Id.*

39. *Id.* at 228; *cf. id.* at 228 n.10 (reiterating the importance of fiduciary duties dating back to the *Strong* opinion of 1909); *id.* at 239 (Brennan, J., concurring) ("[N]o violation of § 10(b) could be made out absent a breach of some duty arising out a fiduciary relationship between buyer and seller."); *id.* at 246 (Blackmun, J., dissenting) (highlighting the majority's "requirement of a 'special relationship' akin to fiduciary duty before the statute gives rise to a duty to disclose or to abstain from trading upon material, nonpublic information"). *See generally* Bainbridge, *supra* note 20, at 1194 (summarizing *Chiarella* and *Dirks* as "ma[king] clear that liability could be imposed only if the defendant was subject to a duty to disclose prior to trading" and that "a duty to disclose only arose where the inside traders breached a pre-existing fiduciary duty owed to the person with whom they traded"). Although the language might suggest a difference between fiduciary duty and relationships of trust and confidence, the two have been read to be functionally equivalent. *See, e.g.*, United States v. Chestman, 947 F.2d 551, 568 (2d Cir. 1991) ("A 'similar relationship of trust and confidence,' therefore, must be the functional equivalent of a fiduciary relationship.").

40. *Chiarella*, 445 U.S. at 232–33.

41. *Id.* at 232.

analyst, received material, nonpublic information from Secrist, a former insurance company officer, that the insurer's shares were dramatically inflated due to company fraud.[42] Dirks investigated the claims and discussed his findings with some of his firm's clients, some of whom sold their holdings as a result. Although Dirks and his company never traded in the insurer's shares, the SEC nevertheless censured him for aiding and abetting securities fraud in passing inside information to his firm's clients, which Dirks appealed.[43]

Just as in *Chiarella*, the Supreme Court focused in *Dirks* on whether Dirks possessed a fiduciary duty that he breached by passing information to his firm's clients. The Court first noted that Dirks "was a stranger to [the insurer], with no pre-existing fiduciary duty to its shareholders."[44] Traditional insider trading restrictions therefore did not immediately apply to him, as he owed no fiduciary duty to the company or the information's source.[45] And, since neither he nor his clients owed duties to the insurer's shareholders, the trades did not breach any fiduciary duties.[46]

However, even though Dirks was not a company insider and therefore owed no traditional fiduciary duties to the company or its shareholders, as a "tippee" of Secrist, a company insider, he could nevertheless be liable as "a participant after the fact in [an] insider's breach of a fiduciary duty," effectively inheriting Secrist's disclosure duties.[47] The Court held that for tippee liability to result, the first step is to "determine whether the insider's 'tip' constituted a breach of the insider's fiduciary duty," which occurs when the tipper insider benefits directly or indirectly from the tip.[48] The Court also noted that "[t]he elements of fiduciary duty and exploitation of nonpublic information also exist when an insider makes a gift of confidential information . . . ."[49] In addition to the tipper's breach of fiduciary duty, the tippee must also "know[] or should know that there has been a breach" of the tipper's fiduciary duty when the tippee

42. Dirks v. SEC, 463 U.S. 646, 648–49 (1983).

43. *Id.* at 648–52.

44. *Id.* at 665.

45. *Id.* at 665–67.

46. *Id.*

47. *Id.* at 667 (quoting Chiarella v. United States, 445 U.S. 222, 230 n.12 (1980)).

48. *Id.* at 661.

49. *Id.* at 664.

receives the tip.[50] Without a fiduciary duty breach by the tipper and the tippee's knowledge of that breach, the tippee does not inherit the tipper's disclosure duty, rendering her free to use the information without facing insider trading liability. As the Court summarized, "a tippee assumes a fiduciary duty to the shareholders of a corporation not to trade on material nonpublic information only when the insider has breached his fiduciary duty to the shareholders . . . ."[51] Because Dirks's inside source Secrist wanted to expose fraud, and was not seeking any direct or indirect personal benefit, Secrist breached no duty in giving the information to Dirks, so Dirks inherited none of Secrist's fiduciary duties.[52] Dirks, therefore, could use the material nonpublic information however he wished, including passing it to clients to trade.

Since its establishment, the requisite fiduciary duty breach has remained firmly entrenched in classical Supreme Court insider trading jurisprudence.[53] Just recently in 2016, the Court faced another tippee liability case in *Salman v. United States*.[54] Finding the tippee liable, the Court reiterated its prior holdings that "a tippee is exposed to liability for trading on inside information only if the tippee participates in a breach of the tipper's fiduciary duty."[55] In that case, the Court held Salman to have inherited his insider brother-in-law's fiduciary duty when the brother-in-law gave tips as a gift; Salman breached the duty by making $1.5 million in profits for his own account without first disclosing the information.[56] Without a breach of the brother-in-law's fiduciary duty, however, no derivative liability could have resulted.[57]

The Supreme Court has not been explicit about the particular fiduciary duty that is necessary for classical insider trading liability to result. However, defining fiduciary duties has long

50. *Id.* at 660.

51. *Id.*

52. *Id.* at 667.

53. *See, e.g.*, A.C. Pritchard, United States v. O'Hagan: *Agency Law and Justice Powell's Legacy for the Law of Insider Trading*, 78 B.U. L. REV. 13, 18–28 (1998) (tracing the history of insider trading law's requisite fiduciary duty breach).

54. Salman v. United States, 137 S. Ct. 420 (2016).

55. *Id.* at 427.

56. *Id.* at 423–24.

57. *See id.* at 427–28 (premising liability on brother's fiduciary duty breach).

been within the purview of state law, and the general[58] consensus is that this duty arises from state law, not federal. Circuit courts, for example, have echoed this focus on linking insider trading liability to state fiduciary duties. The Fourth Circuit has noted that "the federal securities laws are not the source of such a duty [to disclose or face insider trading] . . . . Rather, the duty to disclose . . . arises only where there is some basis outside the securities laws, such as state law . . . ."[59] The Sixth Circuit has held that "[b]ecause the 'fiduciary duty' [requisite for insider trading liability] is not defined under § 10(b) itself, courts have incorporated state law definitions of fiduciary duty."[60] The Seventh Circuit has similarly held that "[t]he obligation to break silence [or face insider trading liability] is itself based on state law, and so may be redefined to the extent state law permits."[61] Many district courts have similarly followed suit.[62]

Academics have similarly turned to state law as the source of insider trading liability's fiduciary duty. For example, in summarizing the state of insider trading liability in 1982, Donald Langevoort noted that

> The insiders who will always have such an obligation [to refrain from insider trading] are corporate directors, officers, and employees. Each of these acts in an agency (or quasi-agency) capacity . . . . Hence, such a person owes fiduciary duties of loyalty and care to the corporation and derivatively to its shareholders. As a result, most of the pre-*Chiarella* cases brought under rule 10b-5 are not subject to question.[63]

58. This is not the exclusive consensus, however. Recently the Second Circuit bucked this consensus by holding that the fiduciary duty arises from federal common law. Steginsky v. Xcelera, Inc., 741 F.3d 365 (2d Cir. 2014). I discuss this development *infra* in Part IV.

59. Fortson v. Winstead, McGuire, Sechrest & Minick, 961 F.2d 469, 472 (4th Cir. 1992).

60. Nolfi v. Ohio Ky. Oil Corp., 675 F.3d 538, 549 (6th Cir. 2012).

61. Jordan v. Duff & Phelps, Inc., 815 F.2d 429, 436 (7th Cir. 1987) (internal citations omitted).

62. For example, in *SEC v. Obus*, the Southern District of New York noted that "[i]n the wake of *Chiarella* and its progeny, courts have consulted state law to identify a duty adequate to support insider trading liability. . . . While the SEC may promulgate a rule that imposes such a duty, provided the rule conforms to the rulemaking powers conferred to it by Congress, the SEC, has not requested statutory clarification of the duty necessary to impose insider trading liability." No. 06 CIV 3150 GBD, 2010 WL 3703846, at *11 (S.D.N.Y. Sept. 20, 2010).

63. Donald C. Langevoort, *Insider Trading and the Fiduciary Principle: A Post-*Chiarella *Restatement*, 70 CALIF. L. REV. 1, 20 (1982).

More recently, Richard Epstein identified the classical insider trading theory's problems from "not tak[ing] into account the notion that the fiduciary duties in question sound in contract, not in regulatory fiat."[64] He goes on to argue that we should "treat the law of fiduciary duties as the baseline for Rule 10b-5. The hard question here is whether the breach of these contractual duties of loyalty should be regarded as serious enough to merit criminal prosecution."[65] This focus on state law fiduciary duties, often the duty of loyalty, as the source for insider trading's fiduciary duty is common.[66]

B. THE MISAPPROPRIATION THEORY

The misappropriation theory was developed well after the classical theory was established. Unlike the classical theory, the misappropriation theory applies to "outsiders": traders in company stock who owe no traditional fiduciary duties to that company or its investors.[67] The theory was adopted by the Supreme

64. Richard A. Epstein, *Returning to Common-Law Principles of Insider Trading After* United States v. Newman, 125 YALE L.J. 1482, 1496 (2016).

65 *Id.* at 1502.

66. *See, e.g.*, Ian Ayres & Joe Bankman, *Substitutes for Insider Trading*, 54 STAN. L. REV. 235, 253 (2001) (noting that "a director of Intel could use [material nonpublic information about Intel] to trade in Compaq stock. The director of Intel is not a fiduciary of Compaq and so owes no duty of loyalty to Compaq shareholders."); Sarah Baumgartel, *Privileging Professional Insider Trading*, 51 GA. L. REV. 71, 72 (2016) ("[M]odern insider trading enforcement is premised on the idea that personal relationships, such as friendship, can give rise to legally-enforceable duties of loyalty and confidentiality."); Sung Hui Kim, *Insider Trading as Private Corruption*, 61 UCLA L. REV. 928, 940–41 (2014) (arguing that in *Dirks* the Supreme Court "silently substituted the insider's duty of disclosure owed to the shareholders . . . with the insider-tipper's breach of his duty of loyalty and confidentiality. . . ."); Michael R. Siebecker, *Political Insider Trading*, 85 FORDHAM L. REV. 2717, 2740 (2017) ("It is precisely because silence would constitute a breach of a fiduciary duty of loyalty that the Supreme Court imposes upon insiders a special disclosure duty prior to trading.").

67. Zachary Gubler has proposed that the misappropriation theory also be applied to classical insiders, entirely displacing the classical theory because of the misappropriation theory's ability to unify insider trading liability under a single, intuitive approach. Zachary J. Gubler, *A Unified Theory of Insider Trading Law*, 105 GEO. L.J. 1225 (2017). Donna Nagy also recently argued that the misappropriation theory should be extended to classical insider trading cases. Donna M. Nagy, *Beyond* Dirks*: Gratuitous Tipping and Insider Trading*, 42 J. CORP. L. 1 (2016) (proposing that insider trading restrictions be broadened to include "fraud on contemporaneous traders."); Donna M. Nagy, Salman v. United States*: Insider Trading's Tipping Point?*, 69 STAN. L. REV. ONLINE 28

Court in 1997 in *United States v. O'Hagan*.[68] Liability attaches to outsiders who trade on information when those outsiders have a duty to keep that information confidential.[69] The trader's "misappropriation" of confidential information for personal gain while, at the same time, feigning loyalty to the information's source constitutes fraud under Section 10(b).[70]

While the misappropriation theory applies to outsiders trading in another company's stock, the trader's information source can be the employer with respect to which they are an insider. Suppose the CEO of a technology company knows of a nonpublic impending product release that will take significant market share from competitors. News of the release will increase her company's share price and reduce competitors'. The classical theory prohibits the CEO from trading in her company stock without first disclosing the nonpublic information; as an insider of the company, she owes fiduciary duties to the company and her trading partners that are breached when she trades. With respect to competitors, though, the CEO is an outsider; she owes no fiduciary duties to competing companies or their shareholders, so the traditional theory would not keep her from shorting competitors' stock.

These trades, however, would fall within the scope of the misappropriation theory. By secretly misappropriating information for her personal use, the CEO violates the fiduciary duty of loyalty she owes to her company and shareholders, even though she ultimately trades with parties to whom she owes no duties.[71] So even though the misappropriation theory applies formally to "outsiders," it is highly relevant to determining the scope of core insiders' trading restrictions.

The misappropriation theory requires three conditions to be satisfied for it to apply to trading on nonpublic information.[72] First, the trader must owe a fiduciary duty of loyalty, or a duty

(2016), https://www.stanfordlawreview.org/online/salman-v-united-states-insider-tradings-tipping-point/ [https://perma.cc/YPK3-769L].

68. United States v. O'Hagan, 521 U.S. 642, 658 (1997). The theory had been accepted by some lower courts several years prior to its Supreme Court acceptance. *See* Chiarella v. United States, 445 U.S. 222, 239–45 (1980) (Burger, C.J., dissenting) (summarizing misappropriation theory but noting that it had not been presented to the jury).

69. *O'Hagan*, 521 U.S. at 652–53.

70. *Id.* at 653–54.

71. *Id.* at 652.

72. *See* Gubler, *supra* note 67, at 1255 (collapsing these three elements into two).

of trust and confidence, to her information's source.[73] These duties typically come from the agency relationship between the agent-trader and the principal-source, as with a CEO and her employing firm/shareholders, but they can also arise by agreement[74] or strong circumstances indicating their presence.[75] Second, the trader must be required not to trade on the information, often by keeping the information confidential.[76] Third, the trader must not inform her source that she will use information for personal gain prior to her trade, to preserve the fraud element of "feigning loyalty."[77] If all three elements are satisfied, misappropriation theory does not attach to the trades.

Like the classical theory, then, misappropriation theory liability relies on the presence of fiduciary duties. Unlike the classical theory, the misappropriation theory is explicit about the duty at issue—state law—based on a fiduciary duty of loyalty to the information source.[78] Indeed, the Supreme Court has noted that, while full disclosure of one's trading plans negates the "deception" element of securities fraud, "the fiduciary-turned-trader may remain liable under state law for breach of a duty of loyalty."[79] Without this fiduciary duty, misappropriation theory liability collapses.

C. SATISFYING THE FIDUCIARY DUTY REQUIREMENT

Throughout insider trading law's development, the requirement for a trader to owe fiduciary duties has been constant. Under the classical insider trading theory, the insider must breach a fiduciary duty owed to her trading partners before insider trading liability can be imposed, with the source of this duty typically

73. One could argue that misappropriation theory actually rests more squarely on the business opportunity doctrine, which is a particular subset of the duty of loyalty. Although the distinction does not matter when the entire duty of loyalty has been waived, it could be important when entities waive only the business opportunity doctrine but not the broader duty of loyalty. Gabriel Rauterberg & Eric Talley, *Contracting Out of the Fiduciary Duty of Loyalty: An Empirical Analysis of Corporate Opportunity Waivers*, 117 COLUM. L. REV. 1075, 1143–44 (2017); *see, e.g.* Diamond v. Oreamuno, 248 N.E.2d 910 (N.Y. 1969) (alleged insider trading action couched as taking of a corporate opportunity).

74. *O'Hagan*, 521 U.S. at 653–54.

75. 17 C.F.R. § 240.10b5-2 (2018).

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

77. *Id.* at 655.

78. *Id.*

79. *Id.*

state law fiduciary duties of loyalty.[80] Under the misappropriation theory, the insider must breach a fiduciary duty owed to her information, with the source of this fiduciary also being state law-based duties of loyalty. As summarized by Delaware Vice Chancellor Laster,

> Federal law does not give rise to or establish the fiduciary duties of directors or officers. Those matters are governed by state law. Thus the federal insider trading regime as currently structured rests on a foundation of state law fiduciary duties. If Delaware were to hold that the fiduciary duties of directors and officers did not limit their insider trading, the cornerstone of the federal system would be removed.[81]

Until relatively recently, meeting these fiduciary duty requirements has been unproblematic for company executives trading on material information acquired in their executive capacity. Most businesses were organized as either corporations or as general partnerships, both of which have mandatory state law fiduciary duties of loyalty and care imposed on their management.[82] For example, the Revised Uniform Partnership Act (RUPA), adopted in thirty-nine states, requires mandatory fiduciary duties of loyalty and of care of company management.[83] These fiduciary duties can be reduced, but not entirely eliminated. The Model Business Corporation Act, which forms the basis of thirty-two states' business corporation statutes, imposes on directors and officers mandatory fiduciary duties of care, loyalty, and good faith;[84] adopting states have refused to allow corporations to eliminate these fiduciary duties entirely.[85] Delaware, whose business law has been widely influential across the country, imposes RUPA-like duties of care and loyalty on partnerships, while allowing parties broad flexibility to waive liability for fiduciary duty breaches, but not the fiduciary duties

80. *Id.*

81. Pfeiffer v. Toll, 989 A.2d 683, 704 (Del. Ch. 2010).

82. *See supra* note 6 and accompanying text.

83. REVISED UNIFORM PARTNERSHIP ACT § 409 (UNIF. LAW COMM'N 1997). For a helpful and comprehensive summary of alternative entity fiduciary duties, see Mohsen Manesh, *Fiduciary Principles in Unincorporated Entity Law*, *in* OXFORD HANDBOOK OF FIDUCIARY LAW (2018).

84. MODEL BUS. CORP. ACT §§ 8.30, 8.42 (AMERICAN BAR ASS'N 2010); 2016 REVISION TO MODEL BUSINESS CORPORATION ACT, (AMERICAN BAR ASS'N 2016), https://www.americanbar.org/content/dam/aba/administrative/business_law/corplaws/2016_mbca.authcheckdam.pdf [https://perma.cc/TK7D-42VW].

85. *See* Henry N. Butler & Larry E. Ribstein, *Opting out of Fiduciary Duties: A Response to the Anti-Contractarians*, 65 WASH. L. REV. 1, 10 (1990) ("[M]odern corporate statutes . . . include many mandatory terms, including voting rules, fiduciary duties and legal capital rules.").

themselves.[86] Delaware corporate managers and officers are subject to mandatory fiduciary duties of loyalty, care, and good faith, which can also be reduced but not wholly eliminated.[87] Even Nevada, widely recognized as the state with the least burdensome fiduciary duty requirements, imposes a mandatory fiduciary duty on corporate actors that prohibits intentional misconduct and knowing violations of the law, which presumably could be used for finding insider trading liability.[88]

Because company management was historically subjected to mandatory state law fiduciary duties, the main issues in insider trading cases tended to be whether these duties had been breached[89] or whether tippees had inherited the tipper's pre-existing fiduciary,[90] rather than the existence of a fiduciary duty by insiders in the first place. As long as the tipper was a core insider of the company—a director or officer—the tipper's possession of a fiduciary duty when trading in her company stock simply was not an issue; fairly uniform fiduciary duties were imposed by operation of mandatory state law.

Recent developments have upended this insider trading framework. New uncorporate organizational forms, most prominently LLCs and LPs, have arisen, and many states grant these alternative entities the power for complete elimination of core insiders' state law fiduciary duties. Under these states' laws, core insiders (but not rank and file employees)[91] no longer face

86. DEL. CODE. ANN. tit. 6, §§ 15-103(f), 15-404.

87. DEL. CODE. ANN. tit. 8, §§ 122(17) (allowing waivers of specific corporate opportunities, but not wholesale corporate opportunity waivers); *id.* § 102(b)(7) (not allowing exculpations of duty of loyalty or duty of good faith violations, but allowing exculpations of duty of care); Malpiede v. Townson, 780 A.2d 1075, 1095 (Del. 2001) (explaining that exculpating duty of care still allows parties to seek non-financial relief and leaves the duty of care's obligations intact); Williams v. Geier, 671 A.2d 1368, 1381 (Del. 1996) (requiring corporate actors to comply with fiduciary duties).

88. Michal Barzuza, *Market Segmentation: The Rise of Nevada as a Liability-Free Jurisdiction*, 98 VA. L. REV. 935, 951–52 (2012).

89. *See, e.g.*, Dirks v. S.E.C., 463 U.S. 646 (1983).

90. *See, e.g.*, Salman v. United States, 137 S. Ct. 420 (2016).

91. The governance agreement could, of course, eliminate fiduciary duties for employees as well as management, freeing employees from insider trading liability to the extent those duties exist. *See, e.g.*, RESTATEMENT (THIRD) OF AGENCY §§ 8.02–8.03 (AM. LAW. INST. 2006) (imposing duty of loyalty on company employees). Waivers, however, are typically written to focus on executives' and officers', and sometimes owners', fiduciary duties, rarely addressing other employees. *See, e.g.*, Manesh, *supra* note 7, at 575 (identifying fiduciary duty

mandatory fiduciary duties. The implications from this wholesale fiduciary duty elimination for insider trading law have gone unnoticed. But because breaching a fiduciary duty is a predicate element for imposing insider trading liability, when fiduciary duties disappear, so too does the apparent liability under existing legal theories. Alternative entities therefore raise the problematic potential for companies to operate without the threat of insider trading liability. The next Part begins to address this issue by reviewing the law related to these new organizational forms.

II. THE RISE OF DUTILESS ALTERNATIVES

Although general partnerships and corporations dominated organizational law for many years, that is no longer the case. New uncorporate forms have gained significant traction in recent years. In particular, LPs and especially LLCs have emerged as the preferred means for conducting business enterprise.[92] New LLC formations began to exceed new corporate formations beginning in 2004,[93] and non-corporate alternatives have grown only more popular since then:[94] existing Delaware LLCs and LPs now outnumber corporations by more than a three-to-one margin.[95]

Alternative entities have been adopted by companies both large and small and both privately and publicly held. Prominent examples of privately-owned LLCs include the automobile maker Chrysler, the financial firm Fidelity Investments, and PJM Interconnection, which manages the electrical grid that reaches sixty-five million people in the United States.[96] Publicly

waiver language that addresses managerial but not lower level employee fiduciary duties).

92. Daniel M. Häusermann, *For a Few Dollars Less: Explaining State to State Variation in Limited Liability Company Popularity*, 20 U. MIAMI BUS. L. REV. 1 (2011).

93. *Id.* at 6.

94. *See, e.g.*, Chrisman, *supra* note 6, at 460 (showing that new LLC formations were more than double new corporate formations).

95. Mohsen Manesh, *Creatures of Contract: A Half-Truth about LLCs*, 42 DEL. J. CORP. L. 391, 393 n.5 (2018). The divergence continues to grow over time; 2017 saw 143,996 new Delaware LLCs organized, compared to only 41,553 corporations. *Annual Report Statistics*, DEL. DIV. OF CORPS., https://corp.delaware.gov/stats/ [https://perma.cc/E5TV-8AC8]. In the same year, 11,517 combined LPs and limited liability partnerships were organized, but the number of LPs alone was not broken out. *Id.*

96. *About Us*, FCA, http://www.fcanorthamerica.com/company/AboutUs/

traded LLCs span a variety of industries. TravelCenters of America is a publicly traded LLC that operates and franchises a series of interstate service centers across the country.[97] MGM Growth Properties owns a series of recognizable real estate properties that include The Mirage, Mandalay Bay, the Monte Carlo Resort and Casino, and the Excalibur Hotel and Casino.[98] Apollo Global Management, Fortress Investment, and Och-Ziff Capital Management are prominent publicly traded LLC investment firms.[99] Bloomberg is perhaps the best known privately owned LP; it is the thirty-sixth largest private company measured by revenue.[100] Publicly traded LPs are mainly found in the oil and gas and real estate management areas.[101] For instance, Enterprise Products Partners, with a market capitalization of $63 billion, engages primarily in natural gas and crude oil processing and transportation.[102] Publicly traded LPs also populate a handful of other industries. The Blackstone Group, for example, is a publicly traded investment management limited partnership with $450 billion of assets under management and a market capitalization of $44 billion.[103]

LLCs and LPs have grown in popularity for two principal reasons. Some choose them for their relatively easy way of combining limited liability protection with the favorable tax treatment of partnerships.[104] Others, however, use LLCs and LPs for

Pages/AboutUs.aspx [https://perma.cc/Y59G-MKUB]; *Our Heritage*, FIDELITY, https://www.fidelity.com/about-fidelity/our-heritage https://perma.cc/WA5G-TKHF]; *Who We Are*, PJM, https://www.pjm.com/about-pjm/who-we-are.aspx [https://perma.cc/MA78-2G5P].

97. *TravelCenters of America – Investors*, TRAVELCENTERS, http://investors.ta-petro.com/investors/default.aspx [https://perma.cc/5ADD-G2MV].

98. MGM GROWTH PROPERTIES, ANNUAL REPORT 2 (2017).

99. Apollo Global Management LLC, Annual Report (Form 10-K) (2018); Fortress Investment Group LLC, Annual Report (Form 10-K) (2016); Och-Ziff Capital Management Group LLC, Annual Report (Form 10-K) (2017).

100. *America's Largest Private Companies*, FORBES; *Bloomberg*, BLOOMBERG FINANCE L.P., https://www.bloomberg.com/company/?utm_source=bloomberg-menu&utm_medium=blp [https://perma.cc/566P-QZF9].

101. *Lists of Current MLPs & MLP Funds*, MASTER LIMITED P'SHIP ASS'N, https://www.mlpassociation.org/mlp-101/list-of-current-mlps/ [https://perma.cc/336Z-7NQK].

102. *About Us*, ENTERPRISE PRODS. PARTNERS L.P., https://www.enterpriseproducts.com/about-us [https://perma.cc/DC75-BHJK].

103. *Who We Are*, BLACKSTONE, https://www.blackstone.com/the-firm/overview [https://perma.cc/TEQ5-42TZ].

104. Molk, *supra* note 14, at 505.

the governance flexibility that they provide.[105] Most states give LLCs and LPs more flexibility to set their internal governance relationships by contract than corporations or general partnerships, with few if any mandatory provisions imposed.[106] Delaware has emerged as the leader of this movement, designing its statutes to give "maximum effect to the principle of freedom of contract and to the enforceability of [companies' governance provisions]."[107] For Delaware LLCs and LPs, only contract law's implied covenant of good faith and fair dealing—which is not a fiduciary duty—is mandatory; other traditional protections from corporate and partnership law apply at most merely by default.[108]

In particular, Delaware LLCs and LPs can, if they so desire, entirely eliminate any fiduciary or other duties that managers or officers would otherwise owe to the company or its owners.[109] These duties are mandatory for partnerships and corporations, but they apply merely by default to alternative entities. The LLC statute explicitly allows that:

> To the extent that, at law or in equity, a member or manager or other person has duties (including fiduciary duties) to a[n LLC] or to another member . . . the member's or manager's or other person's duties may be expanded or restricted or eliminated by provisions in the [LLC] agreement . . . .[110]

Delaware's LP statute provides functionally equivalent language.[111] Therefore, while traditional fiduciary duties upon which insider trading liability has rested are mandatory for

105. *Id.*

106. *See, e.g.*, LARRY E. RIBSTEIN & ROBERT R. KEATINGE, RIBSTEIN AND KEATINGE ON LIMITED LIABILITY COMPANIES, app. 9:6 (2016) (summarizing state LLC law provisions on fiduciary duty waivers).

107. DEL. CODE ANN. tit. 6, §§ 17-1101(c) (LPs), 18-1101(b) (LLCs).

108. *Id.* § 17-1101(d) (LPs); *id.* § 18-1101(c) (LLCs).

109. *Id.* Delaware statutes purport to allow eliminating any duties owed either at law or in equity, but some have questioned the constitutionality of limiting equitable powers of Delaware's Chancery Court. Lyman Johnson, *Delaware's Non-Waivable Duties*, 91 B.U. L. REV. 701 (2011). *See generally* Mohsen Manesh, *Equity in LLC Law?*, 44 FLA. ST. U. L. REV. 93, 106–17 (2016) (reviewing this argument and relevant Delaware court development). In any event, Delaware courts have yet to raise this argument to limit fiduciary duty waivers, instead pointing to it only for waivers of the right to seek equitable judicial dissolution. *In re* Carlisle Etcetera LLC, 114 A.3d 592 (Del. Ch. 2015); Huatuco v. Satellite Healthcare & Satellite Dialysis of Tracy, LLC, C.A. No. 8465-VCG, 2013 WL 6460898 (Del. Ch. Dec. 9, 2013).

110. DEL. CODE ANN. tit. 6, § 18-1101(c).

111. *Id.* § 17-1101(d).

corporations and general partnerships, they apply only by default to Delaware alternative entities. LLCs and LPs can entirely eliminate those fiduciary duties by organizing in Delaware and adopting appropriate language in their governance documents.

Delaware LLCs and LPs have not been shy about waiving fiduciary duties. In an empirical study of publicly traded Delaware LLCs and LPs, Mohsen Manesh found that almost half—49%—waived all three fiduciary duties of loyalty, care, and good faith.[112] Other studies have shown that privately held alternative entities evince similar fiduciary duty eliminations, although at more modest rates.[113]

Language from the publicly traded LLC MGM Growth Properties is illustrative. Its operating agreement provides:

> [T]o the fullest extent permitted by law, no [manager, managing member, officer, director, agent, tax matters partner, fiduciary or trustee] shall have any duties or Liabilities, including any fiduciary duties, to the Company, any Member, any other Person who acquires an interest in a Share or any other Person who is bound by this Agreement. . . .[114]

The agreement further provides that management of the company

> shall, to the fullest extent permitted by law, make [a] decision in its sole and absolute discretion . . . and shall be entitled to consider only such interests and factors as it desires, including its own interests, and shall have no duty or obligation (fiduciary or otherwise) to give any consideration to any interest of or factors affecting the Company or the Members. . . .[115]

The agreement also provides for a complete waiver of the analogue to the corporate opportunity doctrine, noting that no person

> who acquires knowledge of a potential transaction, agreement, arrangement or other matter that may be an opportunity for the

112. Manesh, *supra* note 7, at 575.

113. *See, e.g.*, Suren Gomtsian, *Contractual Mechanisms of Investor Protection in Non-Listed Limited Liability Companies*, 60 VILL. L. REV. 955, 987, 991 (2015) (finding elimination or modification of fiduciary duties of loyalty, care, and good faith in approximately one quarter of examined companies); Molk, *supra* note 14, at 528 (showing waivers of fiduciary duties of loyalty, care, and good faith in privately held LLCs are present, although uncommon). Fiduciary duties are not the sole standard business law protection that LLCs modify. For analysis of additional waivers, see Molk, *supra* note 14; Peter Molk & Verity Winship, *LLCs and the Private Ordering of Dispute Resolution*, 41 J. CORP. L. 795 (2016).

114. Form of Amended and Restated Limited Liability Company Agreement of MGM Growth Properties LLC, (Form 10-K, Ex. 3.1) §§ 1.1, 7.9(a) (2016).

115. *Id.* § 7.9(c).

> Company, shall have any duty to communicate or offer such opportunity to the Company, and such [person] shall not be liable to [any LLC member] for breach of this Agreement or any duty otherwise existing at law, in equity or otherwise or obligation of any type whatsoever, by reason of the fact that such [person] pursues or acquires such opportunity for itself, directs such opportunity to another Person or does not communicate such opportunity or information to the Company.[116]

MGM Growth Property LLC's language is hardly unique; similar waiver language is not difficult to find among publicly traded LLCs and LPs.[117] For example, the partnership agreement of CVR Partners, a publicly traded Delaware LP that operates a nitrogen fertilizer business, provides:

> Except as expressly set forth in this Agreement, neither the General Partners nor any other [person] shall have any duties or liabilities, including fiduciary duties, to the Partnership or any Partner and the provisions of this Agreement, to the extent that they restrict, eliminate or otherwise modify the duties and liabilities, including fiduciary duties, of the General Partner or any other [person] otherwise existing at law or in equity, are agreed by the Partners to replace such other duties and liabilities of the General Partner or such other [person].[118]

Despite some seeming reluctance,[119] Delaware courts enforce these broad fiduciary duty waivers.[120] For example, in

116. *Id.* § 7.5(b).

117. *See, e.g.*, Manesh, *supra* note 7, at 757 (finding similar expansive language used among the 49% of publicly traded uncorporate entities that waived traditional fiduciary duties).

118. Form of Second Amended and Restated Agreement of Limited Partnership of CVR Partners, LP (Form S-1) § 7.9(e) (2008). This language is generally taken by Delaware courts to eliminate all default fiduciary duties. Lonergan v. EPE Holdings LLC, 5 A.3d 1008, 1017 (Del. Ch. 2010) (involving an LP agreement with substantially identical language); *In re* Atlas Energy Res. LLC, No. 4589, 2010 WL 4273122, at *12 (Del. Ch. Oct. 28, 2010) (involving an LLC agreement with nearly identical language).

119. *See, e.g.*, *In re* Carlisle Etcetera, 114 A.3d 592 (Del. Ch. Apr. 30, 2015) (providing equitable judicial dissolution remedy in the face of an apparent contradictory governance provision); Leo E. Strine, Jr. & J. Travis Laster, *The Siren Song of Unlimited Contractual Freedom*, *in* RESEARCH HANDBOOK ON PARTNERSHIPS, LLCS AND ALTERNATIVE FORMS OF BUSINESS ORGANIZATIONS 11, 25–26 (Robert W. Hillman & Mark J. Lowenstein eds., 2015) ("[C]ontractual liability standards have generated judicial decisions that leave investors with no remedy because of the court's need to be faithful to the contract, even in circumstances when the court itself harbored serious doubt that the alternative entity had gotten a fair shake.").

120. To further the Delaware statute's commitment to contractual freedom, Delaware courts have enforced waivers of a variety of fundamental governance protections. *See, e.g.*, Elf Atochem N. Am., Inc. v. Jaffari, 727 A.2d 286 (Del. 1999) (enforcing Delaware LLC agreement requiring all disputes to be decided

Kahn v. Icahn, the Delaware Chancery Court enforced a broad business opportunity waiver in dismissing a complaint alleging investor-manager Carl Icahn took for himself profitable real estate opportunities that were directly within the line of business of the LP he was managing.[121] In *Zimmerman v. Crothall*, the Delaware Chancery Court enforced an LLC's fiduciary duty of loyalty waiver that allowed managers to be on both sides of a challenged business transaction.[122] And in *In re Atlas Energy Resources*, the Delaware Chancery Court refused to allow claims to proceed against directors who approved a merger between their publicly traded LLC and its controlling shareholder at an allegedly unfair price.[123] The Court pointed to the LLC's blanket waiver of fiduciary duties that precluded what might otherwise have been "a colorable claim for the breach of the traditional fiduciary duties of care and loyalty . . . ."[124]

Enforcing these waivers is perhaps not surprising given the attitude that expressly appears in the Delaware LLC and LPs statutes: giving maximum effect to the principle of freedom of contract.[125] As Chancellor Chandler has noted, "for a Delaware limited liability company, *the contract's the thing*."[126] Similar sentiments have echoed throughout Delaware opinions.[127]

by either arbitration or by California courts); *In re* Seneca Inv. LLC, 970 A.2d 259 (Del. Ch. 2008) (allowing LLC to change line of business because operating agreement specified company could pursue "any lawful act"); R & R Capital, LLC v. Buck & Doe Run Valley Farms, LLC, No. C.A. 3803, 2008 WL 3846318 (Del. Ch. Aug. 19, 2008) (enforcing waiver of ability to seek judicial dissolution); Minnesota Invco of RSA No. 7 v. Midwest Wireless Holdings LLC, 903 A.2d 786 (Del. Ch. 2006) (enforcing operating agreement's amendment process that allowed majority member to amend agreement unilaterally).;

121. Kahn v. Icahn, No. C.A. 15916, 1998 WL 832629 (Del. Ch. Nov. 12, 1998).

122. Zimmerman v. Crothall, 62 A.3d 676 (Del. Ch. 2013).

123. *In re* Atlas Energy Resources, LLC, No. C.A. 4589, 2010 WL 4273122 (Del. Ch. Oct. 28, 2010).

124. *Id.* at *14; *cf.* Sonet v. Timber Co., L.P., 722 A.2d 319 (Del. Ch. 1998) (pointing to L.P. agreement's waiver of fiduciary duties to dismiss claim alleging unfair merger terms).

125. DEL. CODE ANN. tit. 6, §§ 17-1101(c) (LPs), 18-1101(b) (LLCs).

126. *R & R Capital, LLC v. Buck & Doe Run Valley Farms, LLC*, No. C.A. 308, 2008 WL 3846318, at *1 (Del Ch. Aug. 19, 2008).

127. *See, e.g.*, Henson v. Sousa, No. C.A. 8057, 2015 WL 4640415, at *1 (Del. Ch. Aug. 4, 2015) ("LLCs, as this Court has repeatedly pointed out, are creatures of contract."); Touch of It. Salumeria & Pasticceria, LLC v. Bascio, No. C.A. 8602, 2014 WL 108895, at *4 (Del. Ch. Jan. 13, 2014) ("[R]ecognizing that LLCs are creatures of contract, I must enforce LLC agreements as written."); Costantini v. Swiss Farm Stores Acquisition LLC, No. C.A. 8613, 2013 WL 4758228, at

Of course, Delaware is not the sole state for LLC and LP formations. Nevertheless, highlighting Delaware's stance on fiduciary duty waivers is important for two reasons. First, Delaware has leapt to the fore in attracting unincorporated business entities, leading all other states in out-of-state formations. Empirical studies confirm that when large[128] or small[129] privately held alternative entities choose to locate outside their home state, they most often choose Delaware. Publicly traded alternative entities show an overwhelming Delaware preference.[130]

Second, Delaware law exerts an "almost gravitational pull" on other states' alternative entity law, often causing those states to mimic Delaware's approach.[131] Fourteen states, including Delaware, have statutes adopting Delaware's contractual freedom model, allowing for complete elimination of fiduciary duties.[132] Their courts consequently hew closely to the Delaware approach.[133]

A significant slice of LLCs and LPs therefore organize in states that permit, with courts that enforce, wholesale waivers of traditional business law fiduciary duties. And since insider

*1 (Del. Ch. Sept. 5, 2013) ("[O]ur law provides broad latitude for LLCs to allocate the rights and responsibilities of its members."); Fisk Ventures, LLC v. Segal, No. C.A. 3017, 2008 WL 1961156, at *8 (Del. Ch. May 7, 2008) ("In the context of limited liability companies, which are creatures not of the state but of contract, . . . duties or obligations must be found in the LLC Agreement or some other contract."); Haley v. Talcott, 864 A.2d 86, 88 (Del. Ch. 2004) ("A princip[al] attraction of the LLC form of entity is the statutory freedom granted to members to shape, by contract, their own approach to common business 'relationship' problems."); *see also* Manesh, *supra* note 95, at 399–401 (summarizing judicial references to "freedom of contract" among LLCs).

128. Dammann & Schündeln, *supra* note 11.

129. Bruce H. Kobayashi & Larry E. Ribstein, *Delaware for Small Fry: Jurisdictional Competition for Limited Liability Companies*, 2011 U. ILL. L. REV. 91 (2011).

130. *See, e.g.*, Manesh, *supra* note 7, at 598 (finding only one publicly traded LP organized outside of Delaware, and no publicly traded LLCs).

131. BISHOP & KLEINBERGER, *supra* note 11, at ¶ 14.01[2].

132. The states are Alabama, Arkansas, Kansas, Maine, Maryland, Massachusetts, Michigan, Missouri, Nevada, New Hampshire, New Mexico, Texas, and Wisconsin. H. Justin Pace, *Contracting Out of Fiduciary Duties in LLCs: Delaware Will Lead, but Will Anyone Follow?*, 16 NEV. L.J. 1085, 1093–94 (2016) The list encompasses categories one through four of the Article.

133. *See, e.g.*, JP Morgan Chase Bank, N.A. v. KB Home, 632 F. Supp. 2d 1013 (D. Nev. 2009); Lynch Multimedia Corp. v. Carson Commc'ns, L.L.C., 102 F. Supp. 2d 1261 (D. Kan. 2000); Alimenta (USA), Inc. v. Oil Seed S., LLC, 622 S.E.2d 363 (Ga. Ct. App. 2005); Allen v. Devon Energy Holdings, L.L.C., 367 S.W.3d 355, 396 (Tex. App. 2012).

trading liability rests on the existence of breached fiduciary duties, when fiduciary duties vanish, seemingly so too does core insider trading liability. Company executives will be unconstrained in their ability to trade in the stock of their companies and others based on material, nonpublic information they acquire through their executive roles.[134] To determine whether this is a problem, and to set up the later discussion on potential solutions, the next Part surveys policy justifications for and against insider trading liability.

III. INSIDER TRADING LIABILITY'S POLICY JUSTIFICATIONS

Insider trading liability has existed for over a century. The merits of this liability have been extensively discussed in the literature. This Part reviews the policy justifications in favor of insider trading liability, as well as traditional arguments against imposing insider trading liability. In doing so, I also assess whether there is reason to treat alternative entities differently from standard general partnerships and corporations whose mandatory fiduciary duties already subject them to mandatory insider trading restrictions, setting up the policy discussion that follows in Part IV.

A. PROTECTING INVESTORS

One of the main purposes of the 1934 Securities and Exchange Act and its Section 10(b) antifraud provisions is to protect investors.[135] Indeed, Section 10(b) expressly directs the SEC to promulgate rules and regulations "as necessary or appropriate in the public interest *or for the protection of investors*."[136] Insider trading restrictions are commonly viewed as a means of protecting investors.

First, when a regular investor sells to, or buys from, an insider with superior information, the insider's later profits may be seen as coming at the expense of the regular investor.[137] Suppose, for example, our investor holds 100 shares in a company trading at $100 per share. The company's CEO, aware of an

134. Indeed, the problem can extend past the executive level, although currently most alternative entity fiduciary duty waivers focus on directors and officers, rather than rank-and-file employees.

135. *See, e.g.*, Brudney, *supra* note 2, at 334, 357.

136. 15 U.S.C. § 78(j) (2018) (emphasis added).

137. *See, e.g.*, Brudney, *supra* note 2, at 360–62.

impending announcement that will boost the company's stock to $120 per share, buys shares (including our investor's) at the current market price. When the CEO later sells the shares at $120 per share, the incremental $20 per share profit, or $2000, from our investor's shares might be seen as belonging to our investor. By preventing insider trading, the law keeps this profit out of the insider's hands.[138]

A closer look, however, shows that most of the time the insider's incremental profits actually do not come at our investor's expense. Since our investor had already decided to sell at the market price of $100, then the incremental $2000 profit from the later increase in value would never have been realized by our investor, but instead would have gone to the party that bought our investor's shares. In that case, our investor would have missed the extra $2000 profit regardless of the insider's activity.[139]

This discussion brings up another way that regular investors might be harmed from insider trading. If our investor would not have sold *but for* the insider's presence, then the insider might cause our investor to suffer foregone profits. Perhaps, for example, the insider's purchases have increased the market price to a point where our investor has now decided to sell. Absent the insider's presence, prices would not have risen to the point that induces our investor to sell at that time. Or perhaps the insider's purchases provide the volume needed to execute trades that otherwise would not consummate, as when shares are thinly traded, or if they are not publicly traded at all.[140] Again, absent the insider's presence, our investor would not have sold at that price at that time. In these cases, preventing insider trading means our investor holds her shares instead of selling

138. *Id.*

139. LANGEVOORT, *supra* note 1, § 1.3. In fact, our investor might actually *benefit* from insider trading in this circumstance, if she had already decided to sell and if the trader's activity pushed up the market price at which she sold.

140. *See, e.g.*, William K.S. Wang, *Trading on Material Nonpublic Information on Impersonal Stock Markets: Who Is Harmed, and Who Can Sue Whom Under SEC Rule 10b-5?*, 54 S. CAL. L. REV. 1217, 1236 (1981). Gilson and Kraakman have argued that even here, the insider may have little effect when measured against the entire pool of similar securities, although they have since moderated this position. Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 630–31 (1984); Ronald J. Gilson & Reinier Kraakman, *The Mechanisms of Market Efficiency Twenty Years Later: Hindsight Bias*, 28 J. CORP. L. 715 (2003).

them, potentially realizing the gains from the later price increase.

Insider trading restrictions can be an effective investor protection tool in this situation. Insider trading proponents have noted, however, that the firm itself may also have appropriate incentives to prohibit insider trading, making regulatory intervention less necessary. Rational investors who anticipate potential harm from insider trading will be less likely to buy into the firm in the first place. Assuming the firm wants to attract investors, not drive them away, the firm prohibits insider trading in its securities.[141] Of course, if there is a deviation between investors' and the firm's wishes, as when investors poorly monitor the firm and inadequately protect themselves, regulatory intervention can still be valuable.

How does this policy justification apply to alternative entities? In many ways, the case for insider trading liability may be *stronger* for LLCs and LPs than for traditional corporations. These uncorporate forms are particularly popular among privately held firms.[142] Private companies are not exempt from insider trading law,[143] and the SEC pursues actions against privately held companies for suspected insider trading violations.[144] The thin markets of privately held firms provide a higher potential for insider trading to harm investors, in turn providing a greater argument for subjecting these entities to *increased*, rather than diminished, insider trading restrictions.

Moreover, some LLCs are chosen by a group of comparatively unsophisticated investors who are attracted by the firms' tax advantages, rather than their governance flexibility. These investors are no more likely to protect themselves from the potential for insider trading than is the average investor in a corporation, and thus could benefit at least as much from regulatory intervention. As discussed above, a regulatory intervention makes more sense in those circumstances.

On the other hand, some alternative entities are organized exclusively by sophisticated investors who are attracted to these forms' governance flexibility, rather than their tax advantages. These investors are much more likely to protect themselves,

141. *See, e.g.*, Dennis W. Carlton & Daniel R. Fischel, *The Regulation of Insider Trading*, 35 STAN. L. REV. 857, 862–63 (1983).

142. Chrisman, *supra* note 6.

143. Section 10(b) explicitly applies to both registered as well as unregistered (private) securities. 15 U.S.C. § 78j(b) (2018).

144. *See supra* note 18.

leading to a *reduced* need for regulation to provide insider trading protections for them.

B. PREVENTING MANAGERIAL MORAL HAZARD

Another objection to insider trading is that it may incentivize management to destroy, rather than enhance, company value.[145] Typically, we want management to have reasons to improve company value. Incentive-based compensation mechanisms, reputational markets, the threat of firing, and legal rules all help align management and company incentives. Unsanctioned insider trading, however, potentially defeats these mechanisms. Unexpectedly decreasing company value is generally easier to do than unexpectedly increasing it.[146] Therefore, if an insider could trade freely on her private information, some worry that she might take a short position in her company stock, take steps to destroy company value, and reduce the stock price, leading her to profit at society's expense.[147] She might lose her job at the company in the process; but if she takes a large enough short position, then her one-time gains can more than compensate for the lost future earnings from her job. Insider trading restrictions prohibit insiders from profiting in this way, and provide a disincentive to destroying company value.

Yet, in addition to the somewhat fantastical assumptions needed for this justification,[148] the problem comes from insider' trading on share price *declines*, rather than insider trading more generally. This concern could be solved simply by prohibiting insiders from taking negative positions in their stocks. And, in fact, the law already does exactly this. Section 16 of the Securities and Exchange Act prohibits statutory insiders of public companies from uncovered shorting in their company stock.[149] And since the main way to profit off stock price declines is through

145. *See, e.g.*, Saul Levmore, *Securities and Secrets: Insider Trading and the Law of Contracts*, 68 VA. L. REV. 117, 149 (1982).

146. Carlton & Fischel, *supra* note 141, at 873–74.

147. This more general phenomenon of "negative activism" is developed more completely elsewhere. Barbara A. Bliss, Peter Molk, & Frank Partnoy, *Negative Activism*, 97 WASH. U. L. REV. (forthcoming).

148. *See* MANNE, *supra* note 20, at 155; Carlton & Fischel, *supra* note 141, at 873–74.

149. Securities Exchange Act § 16(c), 15 U.S.C. § 78p(c) (2018). Statutory insiders are defined as directors, officers, and beneficial owners of more than 10% of the company's shares. *Id.* § 78p(a). Uncovered shorting occurs when the investor shorts shares without holding an offsetting long position, *i.e.* bets on a company stock decline.

uncovered short positions (or the derivative equivalent), this avenue is essentially already shut off without having to apply the insider trading laws more broadly.

However, just because the main way that insiders profit from stock declines is already removed does not mean the *only* way of profiting from stock declines has been removed. Insider trading restrictions are still potentially useful. There are a variety of indirect ways an insider might profit. For instance, instead of shorting her own company, an insider might take a long position in a direct competitor, with the expectation that negative actions within her own company might increase that competitor's share price. This alternative approach would not be prohibited by Section 16's statutory insider section, which applies to short, not long, positions.[150] This practice does not yet seem widely used, perhaps because of its comparative riskiness—it requires one company's negative news to positively impact another, which is not guaranteed. But that is not to say the practice would not be used in the future, as regulatory changes push investors to seek profits in underexplored ways.

Perhaps, then, insider trading liability could be justified as prohibiting these alternative profit mechanisms that reduce company value. Unfortunately, insider trading theories do not reach this situation. Under the classical theory, the insider owes no fiduciary duties to other companies and those companies' shareholders, so she breaches no classical fiduciary duties when trading in those other companies.[151] Under the misappropriation theory, the insider owes no fiduciary duty of loyalty to her company, shareholders, or the information's source when that duty has been waived, so she feigns no loyalty, engages in no deception, and commits no securities fraud when she converts that information to her own use.[152]

Moreover, the negative effects from managerial moral hazard should be fully internalized by the firm, making an external legal restriction less useful. A rational management team that is responsive to shareholder interests should already be adopting voluntary insider trading restrictions if it would benefit investors. A legal prohibition against insider trading is best justified

150. Moreover, our company insider would generally not be a statutory insider of the competitor unless she owned 10% of the shares in the competitor. *See generally* Ayres & Bankman, *supra* note 66 (analyzing several variations of this alternative approach).

151. *See supra* Part I.B.

152. *See supra* Part I.B.

if investors only poorly monitor management, allowing management to pursue its own self-interest instead of the firm's.

There is little reason to treat alternative entities differently from corporations and general partnerships when applying this policy concern. Agency concerns of a poorly monitored management are present irrespective of organizational form. At the same time, some investors choose LLCs and LPs precisely because they substitute private incentives for corporate-style protections and the need to monitor management;[153] mandatory insider trading restrictions may have little value for them.

C. ENCOURAGING VOLUNTARY RELEASE OF INFORMATION

Some have argued that insider trading leads to delayed release of information into the securities markets. Since insiders may need time to take a position in their company stock before trading, they may delay information releases to accumulate their stake first,[154] leading to distorted allocations of capital during the delay.[155] These distortions have negative ramifications for capital markets as a whole, so firms will have inadequately low private incentives to adopt efficient levels of trading restrictions. By eliminating insiders' profit incentive with an insider trading ban, these informational delays and resulting capital distortions would be minimized.

Skeptics argue that while the worry is theoretically valid, its practical significance is minimal.[156] Many companies' securities have liquid markets, so insiders can quickly accumulate significant positions.[157] Derivatives and the use of leverage also allow insiders to take outsized positions with comparatively little capital, minimizing any delays from the insider's having to acquire funds.[158] Public companies also face periodic, mandatory disclosure requirements, the timing of which they have little

153. Larry E. Ribstein, *Partnership Governance of Large Firms*, 76 U. CHI. L. REV. 289, 289–90 (2009).

154. *See, e.g.*, Roy A. Schotland, *Unsafe at Any Price: A Reply to Manne,* Insider Trading and the Stock Market, 53 VA. L. REV. 1425, 1448–49 (1967).

155. *See, e.g.*, Marcel Kahan, *Securities Laws and the Social Costs of "Inaccurate" Stock Prices*, 41 DUKE L.J. 977, 1005–08 (1992).

156. Carlton & Fischel, *supra* note 141, at 879 (noting this concern "is a logical possibility, but has little empirical basis").

157. This is most obviously true among publicly traded companies on national exchanges.

158. Shaun Martin & Frank Partnoy, *Encumbered Shares*, 2005 U. ILL. L. REV. 775, 787–92.

capacity to manipulate, which constrains insiders' ability to delay releases of certain information.[159] Moreover, too much delay postpones the profits the insider hopes to earn as well as risks losing the profit-making opportunity if the information becomes public through other means; any delays, therefore, will be relatively small.

Particularly for publicly traded companies with liquid markets and periodic disclosure requirements, insider trading prohibitions may do little to help with the release of information. On the other hand, private companies present a greater theoretical concern for informational delay from insider trading. These companies are not actively traded, and the insider might require additional time to accumulate her desired position before disclosing information. These companies may also not have any derivative financial instruments, leading the insider to take time to stockpile large amounts of capital needed to take large effective positions. For these companies, insider trading restrictions might be particularly useful for encouraging informational releases.

If that is so, then this policy argument weighs in favor of insider trading restrictions among alternative entities. LLCs are especially popular among privately held companies and have emerged as the form of choice for new businesses.[160] Insider trading might therefore lead to the most severe comparative informational delays among these entities; mitigating these delays through a mandatory prohibition might provide comparatively high returns.

D. PROTECTING THE PERIODIC DISCLOSURE SYSTEM

James Park has argued that insider trading prohibitions are required to protect the integrity of the periodic disclosure system with which public companies must comply.[161] Periodic (not continuous) disclosure requirements give rise to a gap between

159. The Exchange Act of 1934 gives the requirements for disclosures: Companies must disclose if they are listed on national securities exchanges, if they are large with a large number of shareholders, or if they have made a public offering of their securities under the Securities Act of 1933. Securities Exchange Act § 13, 15 U.S.C. § 78m (requiring periodic filings); § 12(a), 15 U.S.C. § 78l(a) (requiring filing for companies listed on a national securities exchange); § 12(g), 15 U.S.C. § 78l(g) (size); § 15(d)(1), 15 U.S.C. § 78o(d)(1) (public offering).

160. *See* Chrisman, *supra* note 6.

161. James J. Park, *Insider Trading and the Integrity of Mandatory Disclosure*, 2018 WIS. L. REV. 1133, 1135.

when information is discovered and when it must be periodically communicated to the public. Park argues that, since the basic purpose of the mandatory disclosure system is to "provide [investors] equal access to the company's most important information," insider trading in advance of that information's disclosure needs to be restricted.[162] If, instead, insider trading on as-yet-undisclosed financial information were allowed, then securities prices would begin to incorporate that financial information in advance of the later mandatory disclosure.[163] Park argues that ordinary investors would begin to lose trust in the mandatory disclosure system's effectiveness, which undermines the basic purpose of the system's existence.[164]

Park's argument is best suited to companies governed by public company periodic disclosure requirements. These requirements apply to companies listed on national exchanges as well as sufficiently large and widely held non-listed companies.[165] While most alternative entities do not fall into these categories, many do. A search of the SEC's EDGAR system, which consolidates disclosures made pursuant to the mandatory disclosure system, reveals some 600 LLCs alone making disclosures; once limited partnerships are added in, the number is significantly greater.[166] Protecting the mandatory disclosure system's integrity would suggest insider trading liability should be extended at least to these uncorporate entities.

E. PROVIDING EXTRA-CONTRACTUAL COMPENSATION

Zachary Gubler argues that insider trading liability is best understood as a means of providing super-contractual damages in the event parties breach agreements not to trade on information.[167] Because the probability of detecting these breaches is small, extra-compensatory damages provided under securities law are needed to provide an adequate deterrent to breach.[168] In

162. *Id*. at 1136.

163. *Id*.

164. *Id*.

165. Securities Exchange Act §§ 12(a), (g)(1), 15 U.S.C §§ 78l(a), (g)(1) (2018).

166. SEC. & EXCH. COMM'N, EDGAR INVESTOR INFORMATION DATABASE, https://www.sec.gov/edgar/searchedgar/companysearch.html [https://perma.cc/AS89-V3VA].

167. Zachary J. Gubler, *Insider Trading As Fraud*, N.C. L. REV. (forthcoming).

168. *Id*.

effect, then, insider trading liability allows parties to contract for fraud liability.[169]

Under this theory, the need for additional deterrence rests on parties' probabilities of engaging in undetected insider trading. Gubler sees this need as most pressing among traditional insiders, where it is otherwise difficult to restrict their access to firm-specific information, and he uses this as a basis to support existing insider trading liability's application to traditional intra-firm relationships.[170] But unless it is easier to detect insider trading breaches in uncorporate entities, this argument suggests imposing restrictions on all firms rather than differentiating by organizational form as the fiduciary duty-based approach currently does.

F. LOWERING CAPITAL COSTS

Another argument raised for restricting insider trading is the positive effect these restrictions have on firms' capital costs. First, investors may have more trust in the individual companies that are subject to insider trading restrictions, making investors willing to invest in those companies on more favorable terms.[171] This might be because, for example, the managerial moral hazard costs discussed above are minimized when managers face insider trading restrictions, making these firms more likely to maximize shareholder value.[172] Or, it might be because investors, when they buy and sell, are less likely to face someone on the other side of the transaction with superior information when insider trading is restricted. Since investors need not worry as much that their trading partner has superior information, investors will raise the price at which they will buy and lower the price at which they sell, because they face a reduced need to compensate for a comparative informational disadvantage.[173] This narrows the bid-ask spread for the firm's securities, reduces costs for investors, and reduces the firm's cost of capital.[174]

169. *Id.*

170. *Id.*

171. *See, e.g.*, Mervyn King & Ailsa Roell, *Insider Trading*, 3 ECON. POL'Y 163, 170 (1988) ("Investor confidence is weakened as savers feel that the dice are loaded against them in stock market investment.").

172. *See supra* Part III.B.

173. *See, e.g.*, King & Roell, *supra* note 171, at 170.

174. *See, e.g.*, Lawrence R. Glosten & Paul R. Milgrom, *Bid, Ask and Transaction Prices in a Specialist Market with Heterogeneously Informed Traders*, 14 J. FIN. ECON. 71 (1985). *But see* Pierre Collin-Dufresne & Vyacheslav Fos, *Do*

Critics have pointed out that this argument relies on financial incentives that should be fully internalized by the firm; the firm should therefore already have optimal incentives to prohibit insider trading on its own.[175] In that case, there is no reason for a regulatory insider trading restriction that could be supplied by the private actors themselves if appropriate.

Regulatory proponents also argue that insider trading restrictions might lower firms' capital costs because investors will have more trust in markets, making investors willing to invest in companies across the board on more favorable terms.[176] This argument provides a stronger justification for regulatory intervention. When an individual firm allows insider trading, investors will lose confidence not just in that company but also in the markets as a whole.[177] In that case, the individual firm no longer fully internalizes the reasons to deter insider trading. Instead, we are left with a classic externalities problem. When there are many firms, private attempts at self-regulation and self-policing may not fully solve the problem. This failure makes external regulation an effective means at correcting for externality effects.[178] Given the SEC's goal of "promot[ing] a securities market that is worthy of the public's trust and characterized by transparency

Prices Reveal the Presence of Informed Trading?, 70 J. FIN. 1555 (2015) (finding that for certain long-lived, private information, insider trading may help moderate bid-ask spreads).

175. Carlton & Fischel, *supra* note 141, at 858–59.

176. *See, e.g.*, King & Roell, *supra* note 171, at 170.

177. *See, e.g.*, United States v. O'Hagan, 521 U.S. 642, 658 (1997) ("Although informational disparity is inevitable in the securities markets, investors likely would hesitate to venture their capital in a market where trading based on misappropriated nonpublic information is unchecked by law."). *See generally* Donald C. Langevoort, *Rereading* Cady, Roberts*: The Ideology and Practice of Insider Trading Regulation*, 99 COLUM. L. REV. 1319, 1325–28 (1999) (discussing the investor confidence rationale of insider trading restrictions).

178. Some aspects of corporate governance have been successfully addressed through self-regulation. Securities exchanges, for example, impose independent director requirements on listed companies—despite no external regulatory requirement to do so—as a means of increasing the trustworthiness of listed companies. N.Y. STOCK EXCH., LISTED COMPANY MANUAL § 303A.01. *See generally* Paul G. Mahoney, *The Exchange as Regulator*, 83 VA. L. REV. 1453 (1997) (advocating for an increased role for securities exchanges in the regulation of securities markets). However, especially for private LLCs and LPs, private-led efforts are likely to be insufficient. For discussion of this issue in the context of LLCs, see Peter Molk, *More Ways to Protect LLC Owners and Preserve LLC Flexibility*, 51 U.C. DAVIS L. REV. ONLINE 181 (2018).

and integrity,"[179] an insider trading prohibition may fit well within the SEC's purview.

This justification for regulatory intervention ultimately depends on how the public responds to the presence of insider trading. While survey evidence indicates the public is deeply disturbed by this practice,[180] revealed preferences showed a hearty willingness by the public to participate in capital markets even before insider trading had any meaningful regulation.[181] Some therefore argue that there would be little market-wide impact from an individual firm's decision to allow insider trading.[182] To the extent insider trading restrictions promote participation in the securities markets, insider trading restrictions of companies—whether corporations, partnerships, LLCs, or LPs—could be warranted.

G. PROMOTING INVESTMENT IN INFORMATION

Another argument for insider trading restrictions is the protection these restrictions give to firms' production of information. Briefly put, certain types of information can be expensive to generate but difficult to preserve for the firm's private use.[183] Suppose, for example, that a company is working on a takeover bid for another firm. Putting together this bid and generating a valuation of the target company involves considerable, costly investment, yet the resulting information—the potential takeover—is difficult to keep secret. Anyone working on the deal will know this information. If these individuals can then act on the

179. SEC. & EXCH. COMM'N., AGENCY FINANCIAL REPORT 6 (2013), https://www.sec.gov/files/sec-strategic-plan-2014-2018.pdf [https://perma.cc/7KNK-NJ4P].

180. *See, e.g.*, Stuart P. Green & Matthew B. Kugler, *When Is It Wrong to Trade Stocks on the Basis of Non-Public Information? Public Views of the Morality of Insider Trading*, 39 FORDHAM URB. L.J. 445 (2011).

181. The first federal laws on insider trading were not passed until 1933 and 1934, after exchanges had already operated for many years. Even then, these laws were not pursued with significant vigor until 1961's *In re* Cady, Roberts & Co., 40 SEC 907 (1961). *See* United States v. Chestman, 947 F.2d 551, 572–76 (2d Cir. 1991) (Winter, J., concurring) (summarizing the statutory and caselaw history on insider trading enforcement).

182. *See, e.g.*, Carlton & Fischel, *supra* note 141, at 880 n.76. Of course, the relevant question is whether there is now *greater* participation with regulation, and reliable evidence on this question is difficult to find.

183. For development of this argument, see *Chestman*, 947 F.2d at 576–78; Bainbridge, *supra* note 20, at 1252–57; Frank H. Easterbrook, *Insider Trading Secret Agents, Evidentiary Privileges, and the Production of Information*, 1981 SUP. CT. REV. 309.

information by purchasing shares in the target ahead of the takeover bid, the acquisition becomes more costly, decreasing the firm's returns, thereby making the firm less likely to invest in generating the information in the first place. Insider trading restrictions preserve the firm's returns on information and its incentives to invest in producing this useful information by prohibiting insiders from acting on it.

Although this argument may justify insider trading restrictions for certain types of information, the potential difficulty is that it does not present a clear picture for regulatory intervention. Similar to the prior arguments, the firm should already have optimal private incentives to prohibit the practice voluntarily since the costs of insider trading are shouldered solely by the firm.[184] If owners are only ineffective monitors, regulation makes more sense. Because alternative entities appeal to some of the most sophisticated and least sophisticated investors, this argument weighs in favor of restrictions for at least some alternative entities.

H. PROMOTING FAIRNESS

Finally, some justify insider trading restrictions based on fairness considerations. It is difficult for many to tolerate the idea of company management, entrusted with running the firm, earning profits that might otherwise accrue to shareholders by trading on the information they learn through their management position. Survey results suggest significant dissatisfaction among the public with this practice.[185] This dissatisfaction, to the extent it carries over into decreased participation by the public in securities markets,[186] may have some efficiency costs, but some insider trading regulatory advocates argue for banning the practice even independent of any efficiency effects, on fairness grounds.[187] And, since these fairness considerations by definition

184. Carlton & Fischel, *supra* note 141, at 878–79.

185. Green & Kugler, *supra* note 180, at 484.

186. Indeed, some have explicitly tied fairness considerations to the worry about decreased participation in capital markets. Kimberly D. Krawiec, *Fairness, Efficiency, and Insider Trading: Deconstructing the Coin of the Realm in the Information Age*, 95 NW. U. L. REV. 443, 470 (2001).

187. *See, e.g.*, Charles C. Cox & Kevin S. Fogarty, *Bases of Insider Trading Law*, 49 OHIO ST. L.J. 353, 353 (1988) (recognizing that "[a]rguments against insider trading tend either to have an economic emphasis or a moral one . . . [but that] [t]he more important argument against insider trading is that it is unfair, either in the sense that it is dishonest or in the sense that it simply does not allow everyone an equal opportunity to profit"). *But cf.* D. Daniel Sokol,

are independent of efficiency considerations, they will not be fully internalized by individual firms, making regulation justified.

Critics of regulation rationally point out the difficulty this fairness stance faces when one considers, as discussed above, that insider trading often does not harm investors, and in fact may even help some.[188] Moreover, if companies authorize insider trading, or there are no restrictions, then logically there should be nothing "unfair" about the practice: it is as permissible as any other legal act.[189]

In spite of these responses, the fairness objection has not disappeared during the decades that insider trading restrictions have been in force and publicly debated. It is not difficult[190] to find modern references to insider trading's perceived unfairness, despite over fifty years of debate since Henry Manne offered one of the first comprehensive defenses of the practice.[191] If the public *perceives* the practice to be unfair, despite rational arguments

Rethinking the Efficiency of the Common Law, 95 NOTRE DAME L. REV. (forthcoming 2020) (arguing that the use of a purely economic goal can potentially lead to greater efficiency). Recently, this dissatisfaction expressed itself in the push for members of Congress to be prohibited from insider trading. For analysis of the fairness issue in this context, see Stephen M. Bainbridge, *Insider Trading Inside the Beltway*, 36 J. CORP. L. 281, 300–01 (2011). For general analysis of insider trading restrictions for members of Congress, see Matthew Barbabella et al., *Insider Trading in Congress: The Need for Regulation*, 9 J. BUS. & SEC. L. 199 (2009).

188. *See supra* Part III.A.

189. *See* Carlton & Fischel, *supra* note 141, at 881–82 (arguing that if shareholders voluntarily authorized insider trading, then they have no reason to raise fairness objections); Merritt B. Fox, et al., *Informed Trading and Its Regulation*, 43 J. CORP. L. 817, 841–42 (2018) (arguing that "[o]verall, it is hard to argue that fundamental value informed trading creates unfairness").

190. *See, e.g.*, Brief for the United States at 13, Salman v. United States, 137 S. Ct. 420 (2016) (noting that reducing insider trading restrictions "would seriously harm investors and damage confidence in the fairness of the nation's securities markets"); Madelyn La France et al., *Securities Fraud*, 55 AM. CRIM. L. REV. 1677, 1712 n.243 (2018); Joan MacLeod Heminway, *Tipper/Tippee Insider Trading as Unlawful Deceptive Conduct: Insider Gifts of Material Nonpublic Information to Strangers*, 56 WASH. U. J.L. & POL'Y 65, 96 (2018) ("[R]easonable minds can disagree about whether (and, if so, under what circumstances) tipping by insiders . . . makes public securities markets unfair."); *see also* Editorial, *Dark Clouds Loom Over Chris Collins*, BUFFALO NEWS (Aug. 10, 2018), https://buffalonews.com/2018/08/09/editorial-dark-clouds-loom-over-chris-collins [https://perma.cc/X9XH-8QCB] ("Insider trading cheats other stock buyers by creating an unfair playing field.").

191. MANNE, *supra* note 20.

to the contrary, then that perception can still translate to increases in market-wide capital costs that could justify regulation.[192] Non-economic considerations might also justify regulation independent of traditional economic justifications.

If fairness justifies regulating insider trading among general partnerships and corporations, it is difficult to see why circumstances differ for alternative entities. On the one hand, some LLCs and LPs have investor bases indistinguishable from the typical corporation or general partnership. The same fairness considerations that support regulation should therefore apply. On the other hand, as already noted, LLCs and LPs also may feature some of the most sophisticated investors who are concerned more with financials and less with fairness.[193] Fairness considerations may not be appropriate for those entities.

I. ARGUMENTS AGAINST INSIDER TRADING LIABILITY

The prior subparts have laid out the arguments in favor of insider trading liability and showed how these arguments are at least as applicable to certain alternative entities as they are to traditional corporations and general partnerships. In doing so, I have also highlighted how insider trading advocates have responded to these arguments.

However, proponents of legalized insider trading do not confine themselves merely to identifying weaknesses in traditional regulatory justifications. They also have arguments about why insider trading may be desirable on its own merits. These arguments are generally along the lines that insider trading can improve economic efficiency, although the manner in which this efficiency is improved takes several forms. I summarize them below and assess their application to alternative entities.

1. Encouraging Release of Information

One way that proponents argue insider trading can improve efficiency is through increasing the flow of information that reaches the public marketplace. Ironically, this is also an argument against legalized insider trading.[194] Yet in some ways insider trading has the potential to bring nonpublic information to

192. *See, e.g.*, Heminway, *supra* note 190, at 97 (noting that "the perception of unfairness or harm may be more important than the reality").

193. *See supra* note 105 and accompanying text.

194. *See supra* Part III.C.

light more quickly, and more often, than a system where this trading is prohibited.

Companies and management have strong existing incentives to publicize positive information about their operations. Positive information increases companies' share prices, which the company and its management have several reasons to do. Managers who receive performance-based compensation have a self-interested reason to increase share prices.[195] Managers may also invest in their employer firms' securities, giving them more reason to produce positive information that boosts share prices.[196] Disclosing positive information, and raising share prices, may also ensure managers keep their jobs, or develop positive reputations to land better jobs, as the stewards of firms with high share prices. Or, since higher share prices make it easier for the company to raise future financing, there is still another reason to release positive news voluntarily.

However, these forces that push for voluntary disclosure of positive information also push for withholding negative information. Voluntarily disclosing negative information tends to undermine managers' and their company's interests; consequently, we can expect voluntary disclosure of disproportionately positive news. The resulting biased picture of a firm's operations can result in share mispricing and a misallocation of capital.

Analysts and investors might discover and disclose this negative information to correct the biased picture, but the process is costly, and the incentives are often incomplete due to limits on many institutional investors' shorting activity.[197] The SEC's whistleblower program provides another means of incentivizing negative information disclosure, but the program has been only modestly successful so far.[198] Legalized insider trading can help

195. For evidence on the widespread use of performance-based pay, see Alex Edmans, et al., *Executive Compensation: A Survey of Theory and Evidence* fig. 6 (CESifo, Working Paper No. 6585, July 2017).

196. Indeed, these additional holdings can counteract to some degree the effectiveness of incentive-based compensation. Eli Ofek & David Yermack, *Taking Stock: Equity-Based Compensation and the Evolution of Managerial Ownership*, 55 J. FIN. 1367 (2000).

197. For additional discussion on this issue, see Peter Molk & Frank Partnoy, *Institutional Investors as Short Sellers?*, 99 B.U. L. REV. 837 (2019).

198. Although the SEC paid a record total amount of whistleblower rewards in fiscal year 2017–18, those awards were paid to only thirteen individuals. *See* Mengqi Sun, *SEC Whistleblower Program Has Record-Breaking Year*, WALL STREET J. Nov. 16, 2018, https://www.wsj.com/articles/sec-whistleblower

correct this biased picture. By taking short positions in stocks, insiders can profit from releasing negative information, encouraging them to release negative information that otherwise would not be released, or that would be released after delay.[199] Because this negative information moves securities prices towards their fundamental values, insider trading can promote efficiency of the capital markets.[200]

In principle, it should make no difference for this argument whether the entities whose insiders trade are corporations, general partnerships, LLCs, or LPs. Accurate pricing of capital is an important advantage of both privately held companies and publicly traded ones, and alternative entities, just like corporations and general partnerships, encompass both groups.[201]

2. Efficient Management Compensation

Another theoretical justification for legalized insider trading is its usefulness as a management compensation device. This argument has multiple components. First, some have argued that paying management through legalized insider trading serves a useful sorting function, identifying the best, least risk-averse managers.[202] Others have argued that insider trading is a particularly direct and effective method of performance-based

-program-has-record-breaking-year-1542413518?ns=prod/accounts-wsj [https://perma.cc/H9BK-UQLK].

199. These disclosures might occur later because they are mandated by periodic disclosure requirements or because independent analysts discover the information after costly searching (which introduces additional market-wide costs). *See, e.g.*, Carlton & Fischel, *supra* note 141, at 867.

200. Of course, the insider might have reason to release information solely to induce a stock price movement, whether or not that information is accurate. Fortunately, general antifraud and anti-manipulation laws prohibit this activity independent of fiduciary relationships. Securities Exchange Act § 10(b), 15 U.S.C. § 78j (2018) (prohibiting both manipulation and fraud); *see also* Basic, Inc. v. Levinson, 485 U.S. 244 (1988) (discussing components of general securities fraud claims); ATSI Commc'ns, Inc. v. Shaar Fund, Ltd., 493 F.3d 87, 101 (2d Cir. 2007) (discussing components of securities manipulation claims).

201. It is worth noting that insider trading encourages releasing negative information only when the insider can profit from that disclosure, principally by taking a short position in her company. While shorting is easy for most publicly traded companies, it is not an option for many privately held ones. So, this potential advantage of legalized insider trading largely does not apply to most alternative entities, which are privately held. Of course, the same is true for most partnerships and corporations as well.

202. Carlton & Fischel, *supra* note 141, at 871–72.

compensation, rewarding managers for producing unexpected gains for the firm.[203]

Others have questioned these advantages. Gains from insider trading may be determined by the insider's financial leverage and luck in coming across information rather than the value of information produced, leading to a haphazard relationship between value-added and personal payoff.[204] In fact, most of the high-profile Supreme Court cases that developed insider trading law dealt with insider traders who were not responsible for adding value to the company.[205] Compensating based on randomness, rather than the value provided by the insider as measured by stock prices, provides questionable incentives.

Another objection to insider trading as compensation is the excessive risk that this compensation imposes on management. Because insider trading returns will vary significantly over time, depending on whether material, nonpublic information has been produced, this type of compensation is analogous to paying management with lottery tickets.[206] Risk-averse management will significantly discount the value of this compensation, but the firm pays the higher expected value, leading to an inefficient compensation arrangement.[207]

Finally, critics have pointed to the rise of new methods of incentive-based compensation that provide some of the compensatory advantages from insider trading, without the downsides. A wide array of individualized compensation agreements, stock options, and profit-sharing plans provide most of the direct incentive benefits that insider trading could provide, while ensuring that people are paid based on the value they provide, rather than based on an arbitrary link to access to material, nonpublic information.[208]

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203. *Id.* at 871; MANNE, *supra* note 20, at 110–20; Henry G. Manne, *In Defense of Insider Trading*, HARV. BUS. REV., Nov–Dec. 1966, at 113, 117–19.

204. *See generally* Robert B. Thompson, *Insider Trading, Investor Harm, and Executive Compensation*, 50 CASE WESTERN RES. L. REV. 291, 302 (1999) (noting the arbitrary relationship between traders on inside information and the parties responsible for producing that information).

205. *Id.*

206. Easterbrook, *supra* note 183, at 332. However, because these effects should be fully internalized among the firm, its management, and its investors, they provide a comparatively weak reason to impose regulatory restrictions.

207. *Id. See generally* STEPHEN M. BAINBRIDGE, CORPORATION LAW AND ECONOMICS 605 (2002) ("[I]nsider trading is an inefficient compensation scheme.").

208. *See, e.g.*, Thompson, *supra* note 204, at 302–03.

These objections have been powerful. Today's consensus seems to be that insider trading is a poor means of executive compensation.[209] Because the arguments are independent of the firm's ownership characteristics or whether shares are publicly or privately traded, this suggests the same outcome for alternative entities as for general partnerships and corporations. If anything, since LLCs and LPs already frequently feature tailored compensation arrangements to align management incentives with those of investors,[210] any additional efficiencies from authorizing insider trading might therefore be comparatively small for them.

3. Avoiding Costs from Incorrect Prosecutions

Finally, although not traditionally raised as an advantage,[211] legalized trading potentially frees the firm and its management from the costs (financial and otherwise) of defending against insider trading suits. As with any source of liability, insider trading liability has some identification error,[212] and its targets can be chosen somewhat arbitrarily.[213] While the problem is no doubt less severe[214] than the nonmeritorious duty of

209. *See, e.g.*, BAINBRIDGE, *supra* note 207, at 591–92 (summarizing arguments against insider trading as a compensation mechanism); George W. Dent, Jr., *Why Legalized Insider Trading Would Be a Disaster*, 38 DEL. J. CORP. L. 247, 251–56 (2013); Easterbrook, *supra* note 183, at 332.

210. *See, e.g.*, Ribstein, *supra* note 153, at 290–98.

211. For example, Manne's classic works do not explicitly consider the issue, although he examines related disadvantages to those who have to bring suit (rather than to the targets of those suits). MANNE, *supra* note 20, at 159–69; Manne, *supra* note 203. *See generally* Carlton & Fischel, *supra* note 141, at 866–72 (not including this potential advantage in their arguments for legalizing insider trading).

212. Prosecution of insider trading is imperfect even when brought by comparatively neutral public regulators, as opposed to private parties. These suits not only impose financial defense costs, much of which may be borne by external insurers, but also distract insiders from their work. Mark Cuban's prosecution by the SEC provides a recent example of a high-profile public prosecution that failed to yield a conviction. Jury Charge/Verdict at 7:156–8:165, SEC v. Cuban, No. 08-cv-2050-D (N.D. Tex. Oct. 16, 2013).

213. Those critical of insider trading liability have charitably described the practice as "arbitrary." MANNE, *supra* note 20, at 161.

214. Although we might hope that insider trading prosecutions are targeted with greater precision than duty-of-care suits, another reason to be less concerned about overly broad insider trading targeting is that these "false positives" impose primarily financial and distraction costs. On the other hand, pursuing duty-of-care claims against managers that made risky, yet desirable, business decisions imposes the same categories of costs, and in addition might

care cases that evoked Delaware's 102(b)(7) exculpation response,[215] the basic principle is the same. Rational investors that fully trust management to refrain from insider trading, or who are unconcerned by the potential, may be better off if they know company resources and management's attention would not be diverted by defending these suits.

This potential advantage might be particularly compelling for alternative entities with very financially sophisticated investors, who choose the forms precisely because of their ability to jettison traditional corporate law protections for tailored contractual alternatives.[216] When these tight private ordering solutions already closely align manager and investor interests, there is less reason to worry about any distortionary effects from managerial insider trading. A fiduciary duty waiver (and, by extension, insider trading waivers) in that context could make sense when the threat of insider trading prosecutions imposes more costs than benefits.[217]

On the other hand, some LLCs and LPs closely resemble the circumstances where insider trading liability's benefits and potential for imperfect targeting nevertheless outweigh the costs. Some companies have less sophisticated owners who are poorly positioned to monitor management; others have widely dispersed ownership bases who lack the incentive to monitor management; others fail to adopt tailored restrictions to align manager-owner incentives. In these situations, insider trading liability might, on average, reasonably provide more benefits than costs from occasionally targeting innocent managers.

IV. APPLYING INSIDER TRADING RESTRICTIONS

As the prior Part reveals, indiscriminately allowing alternative entities to eliminate insider trading liability, while still imposing liability on general partnerships and corporations, does not produce an ideal policy outcome. Many LLCs and LPs are indistinguishable from their partnership and corporate counterparts in their need to protect investors, so policy arguments for regulating general partnerships and corporations also apply to

deter these managers from taking those desirable risks in the future. *See, e.g.*, William T. Allen, et al., *Realigning the Standard of Review of Director Due Care with Delaware Public Policy: A Critique of* Van Gorkom *and Its Progeny as a Standard of Review Problem*, 96 NW. U. L. REV. 449, 462–63 (2002).

215. DEL. CODE ANN. tit. 8, § 102(b)(7) (2013).

216. *See, e.g.*, Molk, *supra* note 14, at 505.

217. *Id.* at 513–15.

regulating at least these LLCs and LPs. Whether justified as correcting for externalities, as protecting investors, as protecting the periodic disclosure system, or as protecting fairness, so long as insider trading liability remains justified for traditional organizational forms, it should apply to at least some alternative entities.

However, some LLCs and LPs are different from general partnerships and corporations. These uncorporate entities represent a maximal commitment to governance flexibility that attracts particularly sophisticated investors, and saddling this group with mandatory protections may not only be unnecessary, but also could reduce welfare.[218]

The task that naturally follows is to figure out what to do about this situation. Here, I consider techniques to reattach insider trading liability to LLCs and LPs. I seek to place these proposals within the existing framework of insider trading law, disturbing that framework as little as possible to maximize the likelihood of implementation. If we were designing insider trading liability afresh, we might well prefer something that deviates dramatically from these approaches;[219] but that is not the situation in which we find ourselves.

I first consider whether focusing on alternative entities' lone mandatory governance protection, the implied covenant of good faith and fair dealing, might provide a viable option. I show that although this option might be easy to implement, it is unsatisfying from an enforcement perspective, and its application would be overly broad.

218. *See supra* Part III.I for a discussion of these costs.

219. *See, e.g.*, Jill E. Fisch, *Start Making Sense: An Analysis and Proposal for Insider Trading Regulation*, 26 GA. L. REV. 179, 226–28 (1991) (proposing that insider trading liability be based on an insider's status, rather than an insider's fiduciary duties); Michael D. Guttentag, *Selective Disclosure and Insider Trading*, 69 FLA. L. REV. 519, 565–69 (2017) (suggesting reforms for determining when selective disclosure by tippers will invoke insider trading liability); Roberta S. Karmel, *The Fiduciary Principle of Insider Trading Needs Revision*, 56 WASH. U. L.J. & POL'Y 121, 134 (2018) (proposing a statutory definition for insider trading); Nagy, *supra* note 67, at 48 (proposing tipper-tippee liability be linked to the duty of loyalty—which would be effective only if the duty of loyalty were mandatory as it is for corporations and general partnerships—or that insider trading instead be reconceptualized as using information that was wrongfully obtained); Yesha Yadav, *Insider Trading and Market Structure*, 63 UCLA L. REV. 968, 1026–30 (2016) (proposing reforms to insider trading doctrine to address high frequency traders).

Ultimately, I argue that imposing a mandatory fiduciary duty upon LLCs and LPs offers the most promise. There is substantial room for reasonable minds to debate the scope and application of this duty, but the duty would provide a reliable means of reconnecting insider trading liability to alternative entities. I offer thoughts on where the debate should be focused and two ways in which the debate could be resolved.

A. IMPOSE LIABILITY THROUGH THE IMPLIED COVENANT OF GOOD FAITH AND FAIR DEALING

One reform possibility is to impose liability through the single mandatory governance protection demanded of alternative entities: the implied covenant of good faith and fair dealing.[220] The implied covenant is not an independent fiduciary duty; instead, it is a doctrine from contract law designed primarily to fill contract gaps consistent with parties' expectations,[221] deterring unreasonable conduct that "frustrat[es] the fruits of the bargain."[222] The implied covenant of good faith and fair dealing thus ensures that silences in LLC and LP governance agreements, which are just a type of contract, are interpreted to reflect the general intentions of the parties.[223] Perhaps, therefore, the implied covenant could hold insiders liable for trading on inside information. After all, do investors buy into a company expecting management to engage in insider trading if the agreement does not explicitly allow the practice? Without express authorization in the governance agreement, perhaps this argument would have some force.

There are several significant hurdles to overcome for this argument to work. First, courts have been careful to point out the restraint with which they apply the implied covenant to alternative entity governance agreements. Delaware courts characterize it as a "cautious enterprise,"[224] designed only to address "developments or contractual gaps that the asserting party pleads neither party anticipated."[225] If there is indeed such a

220. DEL. CODE ANN. tit. 6, §§ 17-1101(d), 18-1101(c) (West 2010) (imposing liability to LPs and LLCs respectively).

221. *See, e.g.*, Nationwide Emerging Managers, LLC v. Northpointe Holdings, LLC, 112 A.3d 878, 897 (Del. 2015); Nemec v. Shrader, 991 A.2d 1120, 1125 (Del. 2010).

222. *Nemec*, 991 A.2d at 1126.

223. *Id.*

224. *Id.* at 1125.

225. *Id.*

gap, courts apply the implied covenant to fill the gap to match the parties' presumed intent if those parties had "considered the issue in their original bargaining positions at the time of contracting,"[226] rather than in the way the court thinks is fair or equitable.[227] But, when an alternative entity agreement eliminates all fiduciary duties in its governance agreement, courts have signaled they will be "all the more hesitant to resort to the implied covenant" for *any* purpose, let alone for analyzing fiduciary duties, because eliminating all fiduciary duties "implies an agreement that losses should remain where they fall."[228] Aggrieved investors would have to overcome this skepticism when pleading that insider trading should be restricted despite the governance agreement's waiver of all fiduciary duties.

Courts are similarly reluctant to use the implied covenant to provide protection "when the contract could easily have been drafted to expressly provide for it."[229] It is easy to draft language expressly governing insider trading: specify that insiders either owe a fiduciary duty, or that insiders are prohibited from trading while in possession of material, nonpublic information about their company.

A party bringing insider trading within the implied covenant must therefore argue that despite completely waiving fiduciary duties of loyalty, care, and good faith towards both the company and its owners, and despite failing to have language that reimposes insider trading liability, insiders nevertheless act in a way the owners would not have sanctioned when they trade on inside information.[230] This argument is difficult to make. The fact that owners have waived fiduciary duties across the board suggests at least indirect permission for insider trading from investors. And, since owners could have expressly provided for

226. Gerber v. Enter. Prods. Holdings, LLC, 67 A.3d 400, 418 (Del. 2013).

227. NAMA Holdings, LLC v. Related WMC LLC, C.A. No. 7934, 2014 WL 6436647, at *17 (Del. Ch. Nov. 17, 2014); *accord* Miller v. HCP & Co., C.A. No. 2017-0291, 2018 WL 656378, at *9 (Del. Ch. Feb. 1, 2018).

228. Lonergan v. EPE Holdings, LLC, 5 A.3d 1008, 1018 (Del. Ch. 2010).

229. *Nationwide Emerging Managers, LLC v. Northpointe Holdings, LLC*, 112 A.3d 878, 897 (Del. 2015). For additional discussion of the implied covenant of good faith and fair dealing in the LLC and LP context, see generally Mohsen Manesh, *Express Contract Terms and the Implied Contractual Covenant of Delaware Law*, 38 DEL. J. CORP. L. 1 (2013).

230. *See* Manesh, *supra* note 229, at 34 (stating that the legal standard used in this situation is "good faith and reason").

protection in their governance agreements, court dictum suggests a reluctance to intervene.[231]

On the other hand, one might plausibly argue that investors who waive fiduciary duties do not realize the implication these waivers will have on insider trading liability. At the very least, aggrieved investors might argue that explicit waivers of fiduciary duties were not intended to imply an explicit waiver of insider trading liability, particularly given the scant attention most courts have paid to insider trading's fiduciary duty requirement to date.[232] Thus, while the implied covenant might not supplant a governance agreement that explicitly authorized insider trading, perhaps it could be stretched to cover the situation when the agreement is silent on insider trading but explicit on fiduciary duties.

Even if this argument is successful, it presents a second-best solution. While private investors might be able to sue on the implied covenant theory, it is difficult to see how the SEC or any public entity could prosecute insider trading this way. Breaching the implied covenant corresponds to breaching a contract, not breaching a fiduciary duty.[233] Thus, while investors in the company might bring private actions against management, an implied covenant breach would not provide the SEC with the fiduciary hook necessary for public prosecution. Nor could the SEC sue for the breach of contract unless it somehow constituted an intended third-party beneficiary of the contract, since it is not a party to governance contracts, which are agreements among investors and management. With the SEC's comparative advantages in identifying and pursuing suspected insider trading cases,[234] relying exclusively on private investors to police this

231. *Nationwide Emerging Managers*, 112 A.3d at 897.

232. As discussed earlier, little attention has been necessary because, until recently, the principal means of doing business all retained mandatory fiduciary duties. *See supra* notes 83–88 and accompanying text.

233. *See, e.g.*, Manesh, *supra* note 83, at 93–95 (discussing case law, statutes, and uniform act evidence to this effect).

234. Bainbridge, *supra* note 20, at 1263 ("That the Commission has a comparative advantage is fairly easy to demonstrate."); Stephen M. Bainbridge, *Insider Trading Regulation: The Path Dependent Choice Between Property Rights and Securities Fraud*, 52 S.M.U. L. REV. 1589, 1644 (1999) (noting the SEC's "comparative advantage in detecting and prosecuting insider trading" although characterizing the prohibition's "location in the federal securities laws as a historical accident"). This is not to say that there is widespread agreement that the SEC would have been the natural enforcement apparatus if we had to rebuild insider trading enforcement from scratch. *See, e.g.*, ROBERTA ROMANO, THE

behavior seems a distant second best solution. Consequently, I recommend another solution: to reimpose fiduciary duties on alternative entities.

B. MANDATE FIDUCIARY DUTIES

Another way to extend insider trading liability is to focus on the fiduciary relationship between core insiders and investors in their companies, and use this relationship to establish a mandatory fiduciary duty whose breach results in classical and misappropriation insider trading liability. Even when fiduciary duties have been waived, courts in states like Delaware still categorize core insiders as fiduciaries. Writing about LLCs, then-Chancellor Strine noted:

> It seems obvious that, under traditional principles of equity, a manager of an LLC would qualify as a fiduciary of that LLC and its members . . . . The manager of an LLC—which is in plain words a limited liability "company" having many of the features of a corporation—easily fits the definition of a fiduciary. The manager of an LLC has more than an arms-length, contractual relationship with the members of the LLC. Rather, the manager is vested with discretionary power to manage the business of the LLC. . . . Thus, our cases have to date come to the following place based on the statute. The statute incorporates equitable principles. Those principles view the manager of an LLC as a fiduciary and subject the manager as a default principle to the core fiduciary duties of loyalty and care. But, the statute allows the parties to an LLC agreement to entirely supplant those default principles or to modify them in part. Where the parties have clearly supplanted default principles in full, we give effect to the parties' contract choice.[235]

If management remains the fiduciary of the company and its investors even when traditional fiduciary duties are waived,[236] it

GENIUS OF AMERICAN CORPORATE LAW 103 (1993) (questioning if the burden to police insider trading is lessened by moving to the public sector); David D. Haddock & Jonathan R. Macey, *A Coasian Model of Insider Trading*, 80 NW. U. L. REV. 1449, 1451 (1986) (arguing the SEC may be unnecessary).

235. Auriga Capital Corp v. Gatz Props., LLC, 40 A.3d 839, 850–52 (Del. Ch. 2012) (citations omitted).

236. Determining when a fiduciary relationship exists, while often doctrinally clear in enumerated circumstances, is itself a topic of academic debate. For examples, see Evan J. Criddle, *Liberty in Loyalty: A Republican Theory of Fiduciary Law*, 95 TEX. L. REV. 993, 1000 (2017) (arguing that fiduciary relationships should be recognized "whenever a party has been entrusted with power over another's legal or practical interests"); Paul B. Miller, *Justifying Fiduciary Duties*, 58 MCGILL L.J. 969, 1010–11 (2013) (noting difficulties that scholarship has had in defining fiduciary relationships, and advocating a relationship as one "in which one party (the fiduciary) exercises discretionary power over the significant practical interests of another (the beneficiary)"). Often, fiduciary duty analysis starts by finding a fiduciary relationship and then

becomes a comparatively easy step for the law to institute a mandatory fiduciary duty—the fiduciary role is already established—whose breach constitutes the means necessary for insider trading liability.

A fiduciary duty solution comes with three main issues that I address below. First, should the duty be imposed through state law, or through federal law? Second, what should be the scope of this new duty? Finally, should this duty (and therefore insider trading liability) be a mandatory duty, a default duty, or a mixture: mandatory for some, and default for others?

1. Source of the Duty

We must first decide whether the fiduciary duty should be determined by federal or by state law. This is a separate issue from whether federal actors (like the SEC) or state actors should be enforcing the law;[237] the SEC's history and expertise in this area suggests that relying exclusively on nonfederal actors would not make sense at this point.[238] Instead, the issue is whether the fiduciary duty that triggers federal insider trading liability should be a product of uniform federal law, or instead state law subject to variation across states.

Federally-defined liability in this area is often justified as promoting principles of uniformity, making it easier to police liability and easing investors' burden of determining their governance protections.[239] Roberta Karmel has further argued that uniform federalization is necessary to realize the broader disclosure regime of federal securities law.[240] For those who justify insider trading liability as promoting nationwide investment in securities markets, imposing uniform liability through a mandatory federal fiduciary duty would be entirely appropriate.

But state law is another source. In considering the source of fiduciary duties that give rise to insider trading liability,

considering what fiduciary duties follow, rather than the other way around; a waiver of traditional fiduciary duties would therefore not, by itself, imply a lack of fiduciary relationship.

237. *See, e.g.*, Bainbridge, *supra* note 20, at 1266–68 (noting the appropriateness of having the SEC enforce insider trading even if based on state-defined fiduciary rights).

238. *See* Bainbridge, *supra* note 234.

239. *See, e.g.*, Steginsky v. Xcelera, Inc., 741 F.3d 365, 371 (2d Cir. 2014) (arguing in favor of a federal system).

240. Karmel, *supra* note 219, at 125; Roberta S. Karmel, *Outsider Trading on Confidential Information – A Breach in Search of a Duty*, 20 CARDOZO L. REV. 83, 111–12 (1998).

Stephen Bainbridge has championed a state-based approach, recommending that insider trading policy goals could best be realized if the states, rather than the federal government, defined the relevant fiduciary relationships.[241] He argues that principles of federalism caution against intruding on areas such as fiduciary duties that have traditionally been left to the states to define.[242] In addition, since Bainbridge views insider trading liability as justified as a private property protection regime, he argues the federal government has little public interest to be promoted from a uniform federal standard.[243] Fiduciary duties imposed by the state of organization provide another option for reforming alternative entity insider trading liability because fiduciary duties typically fall within the domain of state regulation and courts already look to state law fiduciary duty breaches to trigger insider trading liability.[244]

With policy arguments in favor of either federal or state-based definitions of fiduciary duties, perhaps doctrine might determine the choice. Precedent reveals a strong *suggestion* that the fiduciary duty arises out of state law by linking fiduciary discussions to traditional state fiduciary duties, particularly in the misappropriation theory context, but not a binding prohibition against federal law defining the duty. There appears to be room for the fiduciary duty to arise out of either state or federal law. Because the Supreme Court has not ruled definitively on the issue, there are, in Stephen Bainbridge's words, two possibilities: either "a unique rule of federal common law that applies uniformly throughout the nation" or "state law as the federal rule."[245] So while many have assumed the requisite fiduciary duty for insider trading liability comes from state law, one could also argue for a federal fiduciary duty.

The Second Circuit took precisely this approach in its recent *Steginsky v. Xcelera Inc.* opinion, imposing a new federal

241. Bainbridge, *supra* note 20, at 1201–12; Bainbridge, *supra* note 234, at 1626–27. Bainbridge is not the only prominent academic to advocate a state-centric approach to defining insider trading liability. *See, e.g.*, ROMANO, *supra* note 234, at 112–17; Larry E. Ribstein, *Federalism and Insider Trading*, 6 SUP. CT. ECON. REV. 123, 154–58 (1998).

242. Bainbridge, *supra* note 20, at 1266–68.

243. *Id.*

244. *See supra* Part I.

245. Bainbridge, *supra* note 20, at 1208.

common law fiduciary duty on company insiders.[246] By adopting this duty against insider trading, the court noted that "looking to idiosyncratic differences in state law would thwart the goal of promoting national uniformity in securities markets."[247] While perhaps true, this single conclusory sentence constitutes the bulk of the court's engagement with the fiduciary duty topic, leaving unanswered key issues like the scope of the duty, the precise nature of the duty, to whom the duty should apply, and why the advantages of a uniform federal approach outweigh potential advantages from a state-based one.

If the goal is to impose a single federal uniform liability, Congress and the SEC are additional options beyond federal courts. The SEC has already done so, in another context, through Rule 10b5-2, enumerating circumstances where a duty of trust or confidence for misappropriation theory liability is presumed to arise.[248] Congress has supplied fiduciary duties in other circumstances, such as the duties of loyalty and prudence required of investment advisors governed by ERISA.[249] Federal law also already shapes, directly and indirectly, various areas of traditionally state-based corporate law, including the law of insider trading.[250] But the Department of Labor's recent failed attempt to do the same among investment advisors shows the resistance that these efforts can face.[251]

246. 741 F.3d 365, 371 (2d Cir. 2014); *accord* United States v. Whitman, 555 Fed. App'x 98, 107 (2d Cir. 2014).

247. *Steginsky*, 741 F.3d at 371.

248. 17 C.F.R. § 240.10b5-2 (2018). Not all have embraced the SEC's rulemaking here, however, believing it stretches the bounds of judicially-defined liability. United States v. Falcone, 257 F.3d 226, 234–35 (2d Cir. 2001); United States v. Chestman, 947 F.2d 551, 567 (2d Cir. 1991) ("[A] fiduciary duty cannot be imposed unilaterally by entrusting a person with confidential information."); Gubler, *supra* note 167, at 62 ("[W]hile the rule is valid, it is probably at the limit of the SEC's authority . . . ."); Donna M. Nagy, *Insider Trading and the Gradual Demise of Fiduciary Principles*, 94 IOWA L. REV. 1315, 1323–24 (2009) (arguing that SEC authority is limited when there is no fiduciary relationship).

249. Employee Retirement Income Security Act of 1974 § 404(a)(1)(A), 29 U.S.C. § 1104(a)(1)(A) (2018).

250. *See, e.g.*, Mark J. Roe, *Delaware's Competition*, 117 HARV. L. REV. 588, 614 (2003) (discussing the interplay between Delaware law and federal law on corporate issues generally, and insider trading in particular).

251. *See, e.g.*, Tara Siegel Bernard, *Court Overturns Obama-Era Rule on Retirement Planners*, N.Y. TIMES (Mar. 16, 2018), https://www.nytimes.com/2018/03/16/business/fiduciary-rule-retirement-planning.html [https://perma.cc/2ML3-6FKA].

It is not my goal to rehash completely all the arguments for federal or state liability that have already received extended attention elsewhere.[252] The comparative advantages of federal versus state are likely dwarfed by the benefits of having a fiduciary duty in place to deter insider trading liability, regardless of that duty's source. In other words, reinstating insider trading liability among alternative entities should be the primary goal, whether done through the federal or state level.

That being said, there are some potential advantages to a uniform minimal federal standard, particularly among companies traded on national exchanges. In addition to easier enforcement by the SEC and other national regulators, and avoiding the difficulty of getting many states all to revise their individual alternative entity statutes, insider trading liability may be necessary to protect the integrity of the federal disclosure regime.[253] Mandatory insider trading liability for all public companies would therefore be a good place to start,[254] and that liability could be imposed most expeditiously by federal law.

Beyond this limited category, however, there seems to be less federal policy interest in a uniform standard; additional liability could therefore be defined through state law fiduciary duties of loyalty. As I discuss shortly, and as the prior discussion has suggested, there is a good argument for making insider trading liability a mere default liability for at least some alternative entities that are not publicly traded: those alternative entities with the most sophisticated investors who choose the form precisely because of the resulting governance flexibility. State-based liability not only allows states to tailor liability to state-by-state differences in investor circumstances through their own definition of fiduciary duties, but also allows room for

252. See sources cited *supra* in notes 240–41 for the debate among scholars about federal and state roles.

253. *See supra* Part III.D.

254. It is surely also the case that public companies have comparatively unsophisticated owners who would benefit from mandatory fiduciary duties, which may provide one explanation for the continued endurance of corporations among public companies. *See, e.g.*, Henry Hansmann & Reinier Kraakman, *Reflections on the End of History for Corporate Law*, *in* THE CONVERGENCE OF CORPORATE GOVERNANCE 44 n.9 (Abdul A. Rasheed & Toru Yoshikawa eds., 2012) ("Only a madman, it seems, would allow a business partner to contract out of the duty of good faith. We suspect [uncorporate entities'] extraordinary latitude to sidestep fiduciary obligations is meant to appeal to sophisticated and heavily lawyered agreements creating closely-held entities, and for this reason do not require standard form structures or fiduciary duties.").

informative experimentation across states.[255] A mixture of federally imposed liability for public companies and state-defined liability for the rest therefore could provide an improved scenario.[256]

Before addressing the issue of when liability should apply and whether that application should be mandatory for all, I briefly consider the scope of the fiduciary duty to be imposed.

2. Scope of the Duty

The scope of the duty, and when it arises, is an issue about which reasonable minds can differ. If, as many have argued,[257] as a policy matter insider trading liability would be best conceptualized as protecting investments by the firm in information, then the duty should be tailored around this property rights goal. In that case, the duty should encompass a disclosure-specific fiduciary duty to refrain from using nonpublic information belonging to the firm for the insider's advantage,[258] rather than looking to the more traditional broader fiduciary duties of loyalty and care, which encompass far more than protecting property. This approach probably makes the most sense for any federally imposed fiduciary duty, as it does intrude minimally on the contours of fiduciary duties that are traditionally defined through state law.

255. Several papers have recently suggested pursuing the general informational value from experimental legal regimes. *See, e.g.*, Yoon-Ho Alex Lee, *An Options Approach to Agency Rulemaking*, 65 ADMIN. L. REV. 881, 938–39 (2013); Zachary J. Gubler, *Experimental Rules*, 55 B.C. L. REV. 129, 136–39 (2014); Peter Molk & Arden Rowell, *Reregulation and the Regulatory Timeline*, 101 IOWA L. REV. 1497, 1525–30 (2016).

256. It would, however, perhaps be the most difficult to implement, requiring both federal and state action. However, since the states already indirectly have defined when insider trading liability applies through their existing duty of loyalty caselaw, the primary new action would have to be only from the federal side. And, if states acted on their own to introduce liability for public companies, federal action would not be required. If states wish to maintain their traditional jurisdiction over fiduciary duty law, it would be in their interest to take this action voluntarily. Roe, *supra* note 250, at 599–600 (identifying how states may feel pressure to regulate to save federal regulation from intervening).

257. *See supra* Part III.G.

258. *See, e.g.*, Stephen M. Bainbridge, *Regulating Insider Trading in the Post-Fiduciary Duty Era: Equal Access or Property Rights?*, *in* RESEARCH HANDBOOK ON INSIDER TRADING 80 (Stephen M. Bainbridge ed., 2013); Bainbridge, *supra* note 20, at 1267; Easterbrook, *supra* note 183, at 320–23.

Instead, we might want to move insider trading law in an entirely new direction, as some have argued.[259] In that case, the fiduciary duty could be designed to alter more fundamentally the way insider trading liability attaches. If, for example, we wished to embrace the goal of equal access to information, the fiduciary duty could be crafted to require disclosure whenever a core insider trades in company stock, regardless of whether the insider does so to profit at the company's expense. These more fundamental shifts would then best be applied not just to alternative entities, but also traditional partnerships and corporations.

Finally, a policymaker might be more interested in crafting a fiduciary duty that attempts to replicate existing case law. This fiduciary duty is often (but not always) viewed as a species of the duty of loyalty to the insider's company and investors that results in an obligation to disclose private information or refrain from trading.[260] In that case, all that must be done is to extend state law duties of loyalty, on a mandatory basis, to those uncorporate entities upon which we would impose insider trading liability. This approach likely makes the most sense for any state-based expansion of insider trading liability, since states already define the scope of the duty of loyalty. Moreover, as I have argued elsewhere, there are compelling policy reasons to impose a mandatory duty of loyalty on alternative entities in many contexts beyond the benefits of imposing insider trading liability;[261] insider trading liability provides an additional bonus.

Finally, I turn to a consideration of which alternative entities—some, or all—should face this expansion in fiduciary duties and thereby face mandatory insider trading liability.

3. Applying the Duty

The final issue is whether insider trading liability should be a default form of liability for at least some alternative entities, or rather mandatory for all. There are policy arguments for making insider trading liability mandatory, at least for some alternative entities. The earlier discussion revealed how some advantages from restricting insider trading accrue to the capital markets as a whole, such as those aimed at increasing trust in capital markets and the integrity of the mandatory disclosure

259. For a discussion of the potential solutions others have put forth, see *supra* note 219.

260. *See supra* notes 63–66 and accompanying text.

261. Peter Molk, *Protecting LLC Owners While Preserving LLC Flexibility*, 51 U.C. DAVIS L. REV. 2129, 2148–49 (2018).

system.[262] Mandatory insider trading liability would correct for externalities that would otherwise result when firms choose their own rules. Other insider trading justifications that are traditionally fully internalized by the firm, such as the protection of investors or confidential information, might also justify mandatory rules if investors cannot be relied upon to protect themselves.[263]

But mandatory liability is not costless, as Part III demonstrated. Restrictions sacrifice insider trading's ability to publicize negative information that would otherwise never become public.[264] Restrictions also impose litigation expenses and distraction costs when insider trading liability is litigated; these costs may outweigh any benefits.[265] Since many of the benefits from regulated insider trading accrue exclusively to the firm and its shareholders, allowing those firms and shareholders to set their own rule may most often produce the efficient solution.[266]

From a policy perspective, then, it may make sense to exempt some uncorporate entities from mandatory liability. Initially, it may seem strange to even consider a default but nonmandatory form of insider trading liability. In the partnership and corporate context, federal insider trading prohibitions are assumed to be mandatory.[267] Moreover, the Exchange Act contains an anti-waiver provision, noting that "[a]ny condition, stipulation, or provision binding any person to waive compliance with any provision of [the Act] or of any rule or regulation thereunder, or of any rule of a self-regulatory organization, shall be void."[268] The anti-waiver provision might plausibly be seen as preventing waiver of insider trading liability, which is imposed

262. *See supra* Parts III.D, F.

263. *See supra* Part III.A.

264. *See supra* Part III.I.1.

265. *See supra* Part III.I.3.

266. Fox et al., *supra* note 189, at 856 ("[A]n argument can be made that each issuer should be able to adopt a policy publicly allowing its insiders to trade as long as the policy is publicly announced.") Fox, Glosten, and Rauterberg ultimately conclude that insider trading restrictions should be mandatory for all firms, in part because of the economies of scale from enforcement. Yet, unless subjecting more firms to insider trading prohibitions and oversight reduced *aggregate* enforcement costs (rather than enforcement costs per firm), social welfare could be improved by allowing firms to opt out of the prohibition when doing so benefits the firm. *Id.* at 856–59.

267. *See, e.g.*, ROMANO, *supra* note 234, at 91.

268. Securities Exchange Act § 29(a), 15 U.S.C. § 78cc(a) (2018).

through the Exchange Act's Section 10(b). How could mere default liability then be possible?

It turns out that even beyond insider trading in alternative entities, the conventional wisdom of mandatory insider trading restrictions already fails in practice. There are at least three distinct areas where parties engage in private ordering of insider trading restrictions. First, the misappropriation theory of insider trading liability is, at least theoretically, subject to the private control of the trader. Unlike the classical theory of insider trading focused on earlier, the misappropriation theory imposes liability when traders "misappropriate[] confidential information for securities trading purposes, in breach of a duty owed to the source of the information."[269] Yet this liability would not apply, according to the Supreme Court, "if the fiduciary discloses to the source that he plans to trade on the nonpublic information," as there would no longer be deception required for insider trading fraud liability.[270] Traders facing liability under the misappropriation theory can therefore tailor liability by deciding whether to disclose their intentions to trade prior to making the trade.[271] In other words, they can avoid the consequences of "mandatory" insider trading prohibitions through their own private efforts, making the misappropriation theory essentially a default form of insider trading liability, not a mandatory one.[272]

Second, the SEC's Rule 10b5-2 establishes enumerated situations where a "duty of trust and confidence" arises, whose breach gives rise to misappropriation theory liability. But whether these situations are triggered is also, to some degree, within the control of traders, making this insider trading liability also a default liability. The first case arises "[w]henever a person agrees to maintain information in confidence" and agrees not to trade on that information.[273] To avoid liability here, the recipient of information need merely refrain from promising to

269. United States v. O'Hagan, 521 U.S. 642, 652 (1997).

270. *Id*. at 655.

271. Bainbridge, *supra* note 234 at 1633–34 (using the phrase "brazen misappropriator" to describe this situation). In *SEC v. Rocklage*, the First Circuit held that this technique applied, if at all, only when the misappropriator has acquired the information legitimately, rather than through additional deception. 470 F.3d 1, 12 (1st Cir. 2006).

272. Gubler, *supra* note 67, at 1253 ("[T]he misappropriation theory gives rise to an insider trading prohibition that is in reality a type of default rule, allowing the source of the information and the trader to contract around the prohibition.").

273. 17 C.F.R. § 240.10b5-2(b)(1) (2018).

keep it in confidence or refrain from promising not to trade; to trigger liability, the recipient can merely agree to keep it confidential and not trade.[274] Mark Cuban's unsuccessful prosecution by the SEC provides a vivid example of how parties can tailor "mandatory" insider trading liability in this way.[275] The second enumerated case arises when people who share information "have a history, pattern, or practice of sharing confidences, such as the recipient of the information knows or reasonably should know that the person communicating the material nonpublic information expects that the recipient will maintain its confidentiality."[276] Again, parties have the ability to adjust "mandatory" insider trading liability based on whether the provider of information makes clear that the information is not provided in confidence. Rule 10b5-2's last enumerated case arises when family members share information, but it too can be adjusted based on whether there was an "agreement or understanding to maintain the confidentiality of the information."[277]

The final way that private parties already tailor "mandatory" insider trading liability is through the use of "big boy letters." Big boy letters are agreements between buyers and sellers of securities that stipulate the parties are sophisticated; that the parties may have private information about the securities that are to be traded; that the parties are not relying upon each other's nondisclosure of that information; and that the parties waive the right to sue one another for that nondisclosure, in essence, that they are "big boys" who can protect themselves.[278] Big boy letters are an attempt by private parties to determine, through their own private means, whether they will face insider

274. Of course, if the provider of information breaches a duty to the information's source by passing information not in confidence, the recipient may inherit tippee liability through the *Dirks* framework discussed earlier. But if the provider is an insider who owes no fiduciary duties, we are back to the problem of seemingly no liability for the tippee to inherit.

275. SEC v. Cuban, No. 3:08-CV-2050-D (N.D. Tex. Oct. 16, 2013).

276. 17 C.F.R. § 240.10b5-2(b)(2) (2018).

277. *Id.* § 240.10b5-2(b)(3).

278. For a helpful analysis of big boy letters, see Edwin D. Eshmoili, Note, *Big Boy Letters: Trading on Inside Information*, 94 CORNELL L. REV. 133, 135 (2008). There is some question about whether big boy letters are directly enforceable between private parties because of Section 29(a)'s anti-waiver provision, but the letters might still eliminate any claim to reasonable reliance that the trader might otherwise have, which is a necessary component of establishing a private insider trading action. *Id.* at 136–37, 153–56; *see also* Harborview Master Fund, LP v. Lightpath Tech., Inc., 601 F. Supp. 2d 537, 547 n.8 (S.D.N.Y. 2009).

trading liability for a specific transaction. The lack of private suits regarding big boy letters suggests some success at achieving this objective.[279]

Therefore, at least in some circumstances, insider trading liability is already merely a default liability, subject to the private tailoring of parties. Applying default liability to some alternative entities, and mandatory liability to others, is therefore not such a foreign concept as might initially appear.

Still, policymakers might instead favor a simpler solution that merely imposes mandatory insider trading liability on executives across all alternative entities, mimicking traditional partnerships, corporations, and those uncorporate entities organized in jurisdictions with mandatory fiduciary duties.[280] This is certainly a workable solution, and it may even be optimal if the market-wide externalities of authorized insider trading are large.

On the other hand, mandatory liability for all uncorporate entities may be overly broad. In states like Delaware, alternative entities are undeniably different from general partnerships and corporations. They reflect a commitment to freedom of contract, with the assumption that sophisticated parties choose alternative entities precisely for that reason and know best how to structure their protections.[281] Insider trading liability can be viewed

279. Eshmoili, *supra* note 278, at 137. The SEC, however, has not determined that big boy letters would prevent the SEC from pursuing insider trading liability. *Id*. at 136–37.

280. *See supra* note 240 and accompanying text.

281. *See, e.g.*, Mohsen Manesh, *Legal Asymmetry and the End of Corporate Law*, 34 DEL. J. CORP. L. 465, 479 (2009) ("[N]oncorporate investors are more likely to be financially sophisticated and more likely to seek legal advice in connection with their investment." (citations omitted)); Larry E. Ribstein, *The Evolving Partnership*, 26 J. CORP. L. 819, 848 (2001) ("LLCs . . . are usually [formed] with the advice of counsel."); Robert H. Sitkoff, *An Economic Theory of Fiduciary Law*, *in* PHILOSOPHICAL FOUNDATIONS OF FIDUCIARY LAW 197, 206 (Andrew S. Gold & Paul B. Miller eds., 2014) ("[T]he parties [to LLCs] are more likely to be fully informed and sophisticated."); Steele, *supra* note 14, at 237 ("[I]t is important to note that sophisticated parties bargain for the obligations and duties provided in an LLC agreement. The choice of the LLC form was an intentional form, chosen by sophisticated parties because that form provides the contracting parties with the maximum ability to customize their relationship."); Myron T. Steele, *Judicial Scrutiny of Fiduciary Duties in Delaware Limited Partnership and Limited Liability Companies*, 32 DEL. J. CORP. L. 1, 9 (2007) ("Absent evidence to the contrary, it must be assumed that passive investors who authorize, in the unincorporated business entities' enabling documents, the elimination or restriction of one or more fiduciary duties are fully informed of

as just one particular example of these protections that should be subject to sophisticated parties' individual tailoring. If we could reliably identify these companies with sophisticated owners, which might also be the companies least subject to generating negative market-wide externalities from authorized insider trading, then mandatory liability for those companies would be inappropriate.

Therefore, another solution would be to impose mandatory insider trading liability on alternative entities without exclusively sophisticated investors, but not on other alternative entities. When all owners are sophisticated, insider trading liability would apply merely by default,[282] subject to waiver by the parties in their governance agreements.[283] Mandatory regulation is

the risks and benefits."); Myron T. Steele, *The Moral Underpinnings of Delaware's Modern Corporate Fiduciary Duties*, 26 NOTRE DAME J.L. ETHICS & PUB. POL'Y 3, 22 (2012) ("[C]orporations and alternative business entities are different. By law, at least in Delaware, members of alternative business entities have significantly more contractual power to define their relationships with their managers. . . . Consequently, in my view, members of alternative business entities can negotiate for precisely those protections that they want and ignore those that they do not want."); *see also* Abry Partners V, L.P. v. F&W Acquisition LLC, 891 A.2d 1032, 1063 (Del. Ch. 2006) ("In the alternative entity context, . . . it is more likely that sophisticated parties have carefully negotiated the operating agreement.").

282. Given the significant consequences that might result from contracting around this default, it would likely be wise to make the default fairly sticky, with a fairly conspicuous attempt needed to contract around it. LLC and LP agreements currently are able to contract out of default fiduciary duties without much transparency, varying the language in dense pages of micetype or, perhaps most egregiously, specifying that the parties' protections are limited solely to those within the agreement and then merely refraining from specifying fiduciary duty protections within the agreement. *See, e.g.*, Huatuco v. Satellite Healthcare, C.A. No. 8465, 2013 WL 6460898, *3 (Del. Ch. Dec. 9, 2013) (limiting rights to those in the governance agreement that stated, "Except as otherwise required by applicable law, the Members shall only have the power to exercise any and all rights expressly granted to the Members pursuant to the terms of this Agreement"); Strine & Laster, *supra* note 119, at 13 ("[A]lternative entity agreements typically contain ninety-plus pages of dense, complex, and heavily cross-referenced legalese . . ."). Therefore, insider trading might be allowed if, for example, the governance agreement explicitly authorized insider trading, but not if the agreement merely waived all fiduciary duties without highlighting the effects this waiver would have on insider trading liability.

283. Some might wonder how this default liability regime could exist alongside the Securities Exchange Act's prohibition against liability waivers. Securities Exchange Act § 29(a), 15 U.S.C. § 78cc(a) (2018). As Judge Easterbrook noted, without the existence of a fiduciary duty, there is no liability to waive, so the doctrinal argument could be simply that the parties were waiving the

least compelling when owners are sophisticated. First, these parties are the ones most capable of protecting themselves; rules that protect them from management opportunism are therefore less necessary. Second, these parties seem least subject to the negative externalities that might otherwise result from insider trading. Mandatory insider trading restrictions, for example, have been justified by promoting trust in the capital markets that reduces overall capital costs.[284] But sophisticated parties are most likely to understand the implications from authorizing insider trading and are the least likely to exit the capital markets after experiencing an insider trading event, rendering their trust in the capital markets little affected by insider trading.[285] Similarly, insider trading restrictions might increase the speed of voluntary company disclosures,[286] but sophisticated owners are the ones most likely to require speedy disclosure already or otherwise have access to it.

The challenge, of course, is to identify those investors who are "sophisticated" and who potentially might have only default insider trading liability protection. This is a challenge that I have dealt with extensively elsewhere in the alternative entity context, so I merely summarize it here.[287] The difficulty lies in identifying, at fairly low cost, those investors who are likely to recognize and price the consequences from authorized insider trading into their investment decision. Investors who price governance provisions are the ones most likely to authorize insider trading only when doing so benefits the company as a whole,

fiduciary duty. Jordan v. Duff & Phelps, Inc., 815 F.2d 429, 436 (7th Cir. 1987) ("Section 29(a) of the Securities Exchange Act . . . forbids waivers of the provisions of the Act. . . . But a provision must be applicable to be 'waived,' and the existence of a requirement to speak is a condition of the application of § 10(b) to a person's silence during a securities trade. The obligation to break silence is itself based on state law, and so may be redefined to the extent state law permits.").

284. *See supra* Part III.F.

285. Perhaps, however, there might be spillover effects: ordinary investors might lose trust in capital markets because they know that some companies, in which they cannot invest, authorize insider trading. Policy choices elsewhere suggest this concern is small: offerings exempt under Rule 506 provide just one example. See *infra* notes 291–92 and accompanying text for discussion.

286. *See supra* Part III.C.

287. This is a challenge that I have dealt with extensively elsewhere, when considering how to apply corporate-like protections (including fiduciary duties) to alternative entities. Molk, *supra* note 261, at 1259–68. The basics of the exercise are similar, although the particular application and conclusions are slightly different.

maximizing the value from mere default liability. These investors also protect against the potential opportunism and mispricing of capital that might otherwise occur when investors assume they have one set of protections, only to realize later they have another, weaker set.[288]

This requirement yields several possibilities. We might look to the uncorporate entity's state of formation, assuming that parties investing in non-domestic companies are comparatively sophisticated.[289] We might require investors to pass financial sophistication tests before allowing them to invest in "risky" companies with mere default insider trading liability.[290]

Perhaps the most workable solution, however, would be to look to financial measures, as does securities law's accredited investor framework.[291] This framework uses investors' wealth and income as a proxy for the sophistication needed to price unregistered investments and shoulder the consequences of a failed risky venture.[292] There is significant overlap between the desirable characteristics of an insider trading separation tool and the characteristics that the accredited investor framework is designed to identify; both effectively identify investors who can price governance protections, or at least would not be too turned off by a failed risky venture to have negative spillover effects in the market. Of course, a wealth-based sorting mechanism is far from a perfect means of distinguishing investors who meet the substantive standard, but it has at least some predictive power, and it is easy to administer.

Any sorting mechanism, whether wealth-based or otherwise, and whether state-law or federal, should make sure that publicly traded alternative entities face mandatory insider trading restrictions. Doing so is worthwhile at least to preserve the integrity of the periodic disclosure system.[293] Moreover, the investor base of publicly traded companies may only poorly protect itself by monitoring management, and insider trading in publicly traded companies may be most likely to produce negative spillovers of mispriced capital and higher capital costs from investor

288. *Id*. at 2133.

289. *Id.* at 2165–66. With LLCs' and LPs' growing acceptance by more traditional investors focused merely on limited liability and not the concomitant governance flexibility, this proxy has become increasingly noisy over time.

290. *Id.* at 2159–68.

291. 17 C.F.R. § 230.506 (2018).

292. Molk, *supra* note 261, at 2156.

293. *See supra* Part III.D.

distrust.[294] If a wealth measure were chosen as a proxy for sophistication, this outcome is already ensured. Since publicly traded entities (whether corporations or alternative entities) will have many low-wealth investors, those companies will fail the investor sophistication screen, and insider trading liability will be mandatory for them.

The preceding discussion therefore reveals two paths. One path would impose a mandatory insider trading restriction on all alternative entities. This approach, while potentially overinclusive, is justified by a need for either uniform standards or for aggressive protection against negative externalities from core executive insider trading. The other path would impose mandatory insider trading liability on alternative entities with investors unlikely to protect themselves, and mere default liability on the rest. This approach, assuming uncorporate entities could be accurately sorted without much difficulty, could allow for more optimal governance agreements without significant costs.

CONCLUSION

Insider trading law and its reliance on fiduciary duties has functioned reasonably well for decades, with case law patching holes in liability as those holes develop. This system that rests on fiduciary duties for liability now has yet another problem: new types of alternative entities that waive any fiduciary duties among managers, investors, and the firms under state law. Policy arguments show that at least some alternative entities should be subject to the same liability as corporations and general partnerships. However, these new organizational forms' dedication to contractual flexibility suggests value from making insider trading liability merely a default for some alternative entities. It is time for the law of insider trading to respond with a careful consideration of when and how to extend insider trading law to these entities that currently operate outside the bounds of restrictions.

294. *See supra* Parts III.C, F.