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The Second Circuit Chips Away at the "Hot News" Misappropriation Doctrine

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On June 20, 2011, in *Barclays Capital Inc. v. TheFlyontheWall.com, Inc.* (Fly), a three-judge panel of the U.S. Court of Appeals for the Second Circuit clipped the wings of the "hot news" misappropriation doctrine, holding that financial news aggregator Fly was not liable for reporting "buy" and "sell" stock Recommendations made by plaintiff financial firms (the Firms), including Merrill Lynch and Morgan Stanley, to their clients. Plaintiffs' claim was preempted by copyright law because defendants' conduct did not fall within the scope of the misappropriation "hot news" tort, as originally recognized by the Supreme Court in 1918 and upheld by an earlier Second Circuit panel in 1997. The Court expressly noted, but declined to address, the "wide variety of interesting legal and policy issues" raised by the parties and amici, because it was bound by existing Second Circuit law, and was "without authority" to repudiate the tort wholesale as some amici had urged it to do. At the same time, the majority opinion strained to define the existing law as narrowly as possible in order to reposition New York State's hot news misappropriation tort into a much-reduced role.

Case background

The Firms offer daily stock analyst reports to their institutional and individual clients before each morning's opening of the U.S. securities markets. The Firms' primary source of profit on the reports is commissions they collect on client stock trades in response to the information contained in the reports. (There is also a small market for later sales of the reports, but this is a negligible source of revenue for the Firms.) The Recommendations in these reports can themselves be market movers in the short term, so recipients of the reports and Recommendations can profit from trading on them before they are available to other investors.

Defendant Fly offered its paying subscribers advance notice of the information contained in the Firms' daily reports. In some cases, Fly reported the information before the reports had been delivered to all of the Firms' clients. Fly's initial business model involved obtaining the reports from the Firms' own employees and publishing portions of them on Fly's website. More recently, Fly obtained the reports from other sources, and disseminated only the analysts' Recommendations (such as "buy," "sell," or "hold," and price targets). After trial, Judge Denise Cote of the District Court for the Southern District of New York found that Fly's publication of excerpts from the reports infringed the Firms' copyrights, a finding that Fly did not appeal. The only issue on this appeal was the validity of the lower court's additional finding that Fly's publication of the Recommendations constituted misappropriation of hot news.

The hot news doctrine stems from the U.S. Supreme Court's holding in *International News Service (INS) v. Associated Press*, 248 U.S. 215 (1918), where the International News Service, unable to report World War I news from Europe over Allied telegraph lines, gained access to uncopyrighted Associated Press stories, rewrote them, and published the news as its own. The Court held that given the resources AP had invested in gathering the news, it held a quasi-property right in the news while it was still timely, and a competitor could not "reap where it has not sown" by appropriating it. While *INS* is no longer good law (because it relied on the now-defunct concept of federal common law), the tort it described survives as a state law cause of action in New York and elsewhere, albeit in somewhat different iterations.

Specifically, in *National Basketball Association (NBA) v. Motorola, Inc.*, 105 F.3d 841 (2d Cir. 1997), a case involving updates of NBA basketball games delivered to subscribers via pager, the Second Circuit found that New York's misappropriation tort was preempted by federal copyright law unless plaintiffs could establish that:

(i) a plaintiff generates or gathers information at a cost; (ii) the information is time-sensitive; (iii) a defendant's use of the information constitutes free riding on the plaintiff's efforts; (iv) the defendant is in

direct competition with a product or service offered by the plaintiffs; and (v) the ability of other parties to free-ride on the efforts of the plaintiff or others would so reduce the incentive to produce the product or service that its existence or quality would be substantially threatened.

Applying this five-factor test (which all parties below agreed governed), Judge Cote found that Fly was free-riding on the Firms' efforts and creating a disincentive for the Firms to continue to create their research reports, which she characterized as a valuable social good. She found Fly liable for misappropriation and enjoined it from publishing pre-market Recommendations until half an hour after the market opened or 10:00 a.m., whichever came later; and from publishing post-market Recommendations until two hours after the Firms' publication.

On appeal, Fly made a number of arguments, including that the Firms had failed to prove the second through fifth factors of the *NBA* test, and that the district court's injunction was inconsistent with the First Amendment. The Firms argued that their business model depended on clients' paying for access to, and then placing trades with the Firms based on, the Recommendations in their reports. If the clients could obtain the same information from free-riders, they would then make their trades elsewhere, and the Firms would have no incentive to continue to maintain their expensive research departments or to create the reports. A number of entities submitted amicus briefs, including traditional news organizations who argued that the hot news tort was an important protection for the press; news aggregators such as Google and Yahoo! who asked the Court to repudiate the hot news tort entirely; and various First Amendment advocacy groups who argued that that the hot news doctrine needed a First Amendment safety valve.

The decision

In a 71-page majority opinion written by Judge Robert Sack, the Second Circuit considered whether the hot news claim should be preempted on the grounds that it dealt with state law rights that "are equivalent to any of the exclusive rights within the general scope of copyright." 17 U.S.C. §301. Sack noted that the rationale for copyright preemption is the importance of maintaining a national, uniform copyright law (though Judge Reena Raggi, in her rather sharp 17-page concurrence, stated that she did not share the majority's "pressing concern" that states might adopt a patchwork of differing approaches to the hot news question). The Court determined that the Firms' claim fell within the general scope of copyright and involved the type of works protected by the Copyright Act, so the claim would be preempted unless it fit into the narrow exception for hot news misappropriation carved out by the Second Circuit in the *NBA* case.

The Court quite clearly struggled with the *NBA* precedent and ultimately determined that the five-factor test articulated in that case—although propounded in a sentence beginning with the words "We hold"—was *not* the holding but rather *dicta*, because it posited a hypothetical situation in which the hot news tort might exist, but was not based on facts actually before the Court. In support of that proposition, Judge Sack pointed out that the *NBA* decision included three different, inconsistent iterations of the relevant factors (including one that listed only three factors), and described the factors as "sophisticated observations" that aided in the *NBA* court's analysis, not "equivalent to a statutory command" to which the Court was required to adhere.

Having thus eliminated the need to either embrace the *NBA* standard or overturn it, Judge Sack reverted to the Supreme Court's underlying rationale in the *INS* case, which he described as "a ghostly presence as a description of a tort theory, not [a] precedential establishment of a tort cause of action." Under the *INS* rationale, Sack found, Fly's conduct was not the type of "free riding" that the hot news tort was designed to prevent. Unlike the defendant in INS, Fly was not taking material acquired by plaintiffs at their expense and selling it as Fly's own content. Instead, Fly was taking material *created* by the plaintiffs and reporting to customers the fact that Firm X had made a particular recommendation, while giving full credit to the creators—an act that he analogized to reporting facts such as scores of basketball games or newspapers' reporting other newspapers' endorsements of political candidates.

Judge Sack drew a sharp line between the Firms as "making" the news and Fly as "breaking" that news, a distinction that Judge Raggi, in her concurrence, seemed to view as a false dichotomy that could cause problems in future cases with different facts. The majority opinion also noted that unlike the type of free-rider described in *INS*, Fly was not trying to minimize costs by piggybacking on others' efforts, but employed its own staff to collect, summarize, and disseminate the news. Furthermore, any profits lost by the Firms were redirected not to Fly, but to other brokers. Judge Sack seemed unmoved by the Firms' argument that Fly's conduct would reduce their incentive to create research reports. While acknowledging that it was in the public interest to encourage the Firms to research and report generally on companies, industries, and stocks, Judge Sack focused on other methods available to the Firms to safeguard their information, including the contractual terms that the Firms impose on their clients and technological measures that allow the Firms to track down the sources of leaks. Given Fly's representation that it no longer obtains the reports from employees of the Firms, it seems likely that at least some of the leaks now come from the Firms' clients.

The opinion seems laced with market-fairness concerns, so much so that we must wonder how much the underlying free-market concerns formed the majority's analysis. Sack expressly noted several times in his opinion that the Firms' clients have a trading advantage over others without access, since the Recommendations themselves often move the market before the Recommendations are publicly known. Indeed, he called the Recommendations "self-fulfilling prophecies" because investors trade on their mere existence. Sack thus found the Recommendations to be newsworthy facts in themselves, and his conclusion specifically references the likelihood that the Recommendations will affect stock market prices.

In her concurring opinion, Judge Raggi likewise concluded that the Firms' misappropriation claim was preempted, but for a completely different reason. Although she too took issue with the formulation of the five factor *NBA* test, she did not believe that it could be summarily dismissed as *dicta* and therefore ignored, because the test was necessary to the holding of the *NBA* opinion. Instead, Judge Raggi applied that test and found that the Firms had failed to satisfy the "direct competition" factor. While both Fly and the Firms make Recommendations on which their customers can base investment decisions, that similarity alone was insufficient to establish direct competition. Rather, the parties' business models are very different: unlike the Firms, which send clients only their own Recommendations, Fly sends the Recommendations of every financial firm, and does not create its own Recommendations or reports or seek commissions. Judge Raggi believed that Fly was free-riding on the Firms' efforts, but ultimately agreed with the majority that the apparent unfairness was not enough in itself to overcome preemption.

Both Judge Sack and Judge Raggi—as did the *NBA* court—posited hypothetical situations in which hot news misappropriation might be found. Judge Sack suggests in a footnote that Fly could raise a credible argument of copyright infringement if a competing news service copied facts from Fly. He also suggested that if a financial firm collected facts about other firms' Recommendations as well as its own and Fly were to copy those facts, Fly might be liable on a hot news theory. Judge Raggi agreed with that scenario, and suggested another involving a Fly-like service that reported only one firm's Recommendations. She also said that she would not foreclose the possibility that an entity that both created and disseminated the information could have a hot news claim—as long as the plaintiff's and defendant's products directly competed.

Because the court's ruling disposes of the injunction, neither the majority nor the concurrence addressed the First Amendment and other concerns raised by the unusual injunction below (including the provision that Fly could move to modify or vacate the injunction if the Firms failed to take action against other misappropriators).

Takeaways

- The hot news misappropriation tort is not dead, but certainly seems to be moribund. The central question going forward is whether, practically speaking, there is *any* set of real-world circumstances that will lead to a finding of hot news misappropriation, short of head to head

competition between competing aggregators.

- A critical question is how much of the Court's analysis is formed by the factual context (Judge Sack's perception of unfairness in the securities market), how much is formed by underlying First Amendment concerns, and how far the decision will be applied outside the particular facts presented.

- For traditional media companies and other content providers, the fact that the court did not repudiate the hot news doctrine altogether (as amici on behalf of aggregators had asked them to do) may be of some comfort. But the judges' cabining of the doctrine, confinement of it to narrow circumstances, and wholesale rejection of unfairness, commercial immorality, or unethical behavior as sufficient basis to survive preemption, suggests that hot news misappropriation will not be a particularly useful tool against aggregators going forward.

- For aggregators, the narrowing of the hot news doctrine can only be good news. While they still must avoid actual copying of expression beyond what can be justified as a fair use, aggregators and bloggers who do not gather or create their own news can take considerable comfort from this holding. The decision may however lead to increased use by content providers of technological and other methods to prevent their information from being used by competitors and to trace leaks. And, as Judge Raggi pointed out, claims for breach of confidence, contract and/or fiduciary duty, or theft of trade secrets against those who pirate and transit the "purloined" information are likely not preempted, and may be a somewhat effective tool to stem the flow of information to aggregators.

- The public at large may benefit from the increased availability of the kind of information Fly and other aggregators distribute. On the other hand, if the rationale underlying the hot news doctrine is correct—that free-riding leads to a loss of incentives to create or gather news—the general public could ultimately be the loser.

- Finally, because the Second Circuit declined to answer the First Amendment issues raised by Fly and several of the amici, it remains unclear whether the hot-news misappropriation tort runs afoul of a defendant's First Amendment right to publish information that it obtained by lawful means, even if others might have acted unlawfully in providing the information. Issues as to whether this First Amendment argument was waived below may preclude any ultimate consideration of that issue in this case, even if certiorari is sought and granted.

Meantime, stay tuned ...