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DUTIES OF DISCLOSURE OF CORPORATE INSIDERS WHO PURCHASE SHARES*

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The question treated here is whether a corporate officer or director who purchases outstanding shares in his firm has an affirmative fiduciary duty of disclosure to the selling shareholder.[1] The trend in the common law of a growing minority of states and under section 10(b) of the Securities Exchange Act of 1934 is to extend insiders' corporate fiduciary duty to the individual shareholder from whom he purchases shares.[2] Even in the absence of active fraud by misrepresentation, by the half-truth in response to inquiry, or by concealment, the insider will be held liable for failure to come forth and disclose unusual material facts which he knows will affect the share price and which are unavailable in the corporation's books or financial reports. A correlative common law rule holds that the insider is usually not required to account to his corporation for profits made from using corporate inside information to speculate in its stock.

It will be argued that both of these legal rules and the reasons offered to support them are in error. It is submitted that they are based on a misapprehension of the market relations involved and tend to misdirect, rather than strengthen, the fiduciary duties which are the legal foundation of the corporate system of enterprise.

This study examines the factual basis of the corporate insider's fiduciary duties and the arguments for extending the duty of disclosure to the individual stockholder. The market uncertainties involved in trading in corporate shares are examined against the background of the burden of proving good faith by a corporate fiduciary accused of doing wrong.

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† See contributors' section, masthead p. 138, for biographical data.

1 See Berle, "Publicity of Accounts and Directors' Purchases of Stock," 25 Mich. L. Rev. 827 (1927); Laylin, "The Duty of a Director Purchasing Shares of Stock," 27 Yale L.J. 731 (1918); Smith, "Purchase of Shares of a Corporation by a Director from a Shareholder," 19 Mich. L. Rev. 698 (1921); Walker, "The Duty of Disclosure by a Director Purchasing Stock from his Stockholders," 32 Yale L.J. 637 (1923); Weisbrod, "Trading in Business Ownership," 1954 U. Ill. L.F. 465; Wilgus, "Purchase of Shares of Corporation by a Director from a Shareholder," 8 Mich. L. Rev. 267 (1910). Notes, 29 Calif. L. Rev. 67 (1940); 47 Harv. L. Rev. 353 (1933); 43 Iowa L. Rev. 109 (1957); 51 Mich. L. Rev. 290 (1952); 32 Mich. L. Rev. 678 (1934); 14 Minn. L. Rev. 530 (1930); 5 Syracuse L. Rev. 71 (1954); 11 Wis. L. Rev. 547 (1936).

2 Ballantine, Corporations 212-16 (rev. ed. 1946); 1 Hornstein, Corporation Law & Practice §§ 443-44 (1959); Loss, Securities Regulation 825 (1951). Northern Trust Co. v. Essaness Theatres Corp., 348 Ill. App. 134, 108 N.E.2d 493 (1952), 1953 U. Ill. L.F. 144; Dawson v. National Life Ins. Co., 176 Iowa 362, 157 N.W. 929 (1916); Jacquith v. Mason, 99 Neb. 509, 156 N.W. 1041 (1916).

A survey of the recent cases concerning insiders' purchases of shares is made in order to establish the magnitude of the purported trend toward increasing corporate fiduciaries' duties in this area. Finally, an argument is made to support the theory that the fiduciary duty in this situation, as in all of the insider's other corporate activities, is owed to the corporation, not to the selling shareholder.

It should be noted that this study does not cover the separate, but sometimes related problems of the sale of the corporate control by a majority insider or group.[3] In such cases the questions treated here—duties of disclosure when the insider is merely purchasing shares of his firm—if they arise, become secondary and not the controlling law of the case.

The Majority Rule

Almost all of the cases litigating the insider's duties of disclosure to stockholders from whom he buys shares have arisen in close corporations.[4] Only here is it physically feasible to make such disclosures. The question usually has arisen when, because of his inside position in the firm, the officer or director knows of an impending assured sale by the corporation of its assets, a merger, or other business fact that is very likely to cause a sharp increase in the price of the firm's stock. Absent active fraud, the majority of decisions have held that the insider has no fiduciary duty to come forth and make affirmative disclosures of the special facts he knows about the firm that will soon affect the price of the stock.[5]

The courts adhering to the majority rule, that the insider has no affirmative duties of disclosure to the selling shareholder, reason that this follows directly from the nature of the fiduciary duty. The rules here are

[3] This problem received extensive comment in the journals following the decision of Perlman v. Feldmann, 219 F.2d 173 (2d Cir.), cert. denied, 349 U.S. 952 (1955), 22 U. Chi. L. Rev. 895, 68 Harv. L. Rev. 1274. See Berle, "'Control' in Corporate Law," 58 Colum. L. Rev. 1212, 1220 (1958); Hill, "The Sale of Controlling Shares," 70 Harv. L. Rev. 986 (1957); Jennings, "Trading in Corporate Control," 44 Calif. L. Rev. 1 (1956); Leech, "Transactions in Corporate Control," 104 U. Pa. L. Rev. 725 (1956).

When corporate insiders purchase outstanding shares as part of an overall scheme to transfer corporate control, the special area of fiduciary law relating to transfer of control receives the dominant treatment. Commonwealth Title Ins. & Trust Co. v. Seltzer, 227 Pa. 410, 76 Atl. 77 (1910); Westwood v. Continental Can Co., 80 F.2d 494 (5th Cir. 1935).

[4] The analogy between the close corporation and the partnership is important to this subject. When purchasing a co-partner's interest, the purchasing partner is under a duty to make disclosure of facts having a bearing on value which are not open to the other partner. Crane, Law of Partnership 360 (2d ed. 1952), and cases cited. If it can be shown that the stockholder in the close corporation places the same trust in his corporate officers or directors when selling his shares to them as the law presumes partners place in each other, the majority rule is clearly wrong. For a general discussion of the partnership analogy, see Hornstein, "Judicial Tolerance of the Incorporated Partnership," 18 Law & Contemp. Prob. 435 (1953). Compare 1 O'Neal, Close Corporations 17-22 (1958).

[5] Cases adopting the majority rule in twenty states are cited in Chenery Corp. v. S.E.C., 128 F.2d 303, 307 (D.C. Cir. 1942), remanded on other grounds, 318 U.S. 80 (1943); 3 Fletcher, Private Corporations § 1168.1 (1947); Annot., 84 A.L.R. 615 (1933).

adopted from the law of trusts. The officer or director is not a strict trustee, since he does not take legal title to the corporate property. He is a fiduciary (quasi-trustee) to the corporation, however, because he is trusted by the corporation to manage its business.[6] He is trusted to deal with the corporate property and business opportunities for the beneficiary of the trust, the corporation and its stockholders as a group. Since he is in a position of trust, the insider has a fiduciary duty of absolute good faith and undivided loyalty to his corporation. He must act to maximize the corporation's profits. Other than his contractual salary, he is precluded from making personal profits at the expense of the corporation. It follows directly from this that he is precluded from usurping the corporation's business opportunities. And, when the insider deals with his own corporation, personal transactions with the corpus of his trust, he has an affirmative duty to disclose to his beneficiary (represented by the board of directors) every material fact he knows about the transactions.

Courts following the majority rule hold that there is no logical reason to extend the insiders' corporate fiduciary duty to the individual shareholders and require affirmative disclosures to them.[7] In the law of trusts, the fiduciary duty attaches when the trustee deals with the corpus of his trust. The corpus here is the corporate management, its property and its business opportunities. But the insider is not dealing with the corpus of his trust when he purchases outstanding shares in the corporation. The outstanding shares are not within the control of the corporate insider and for this reason can not be considered part of the corpus of his trust.[8] Furthermore, it is the corporation which has employed the insider and placed the trust in him. Consequently, the insider has an unlimited duty of trust to the corporation, the stockholders as a group, which binds him and takes precedence in his private business dealings with an individual stockholder. If, for example, the corporation is in the market to purchase its own shares or the insider is directed to purchase shares as agent for the corporation, his fiduciary duty is to the corporation to minimize its cost, not to the selling shareholder.[9] Since failure to come forward and make affirmative disclosures to the selling shareholder will in no way

[6] 3 Fletcher, Private Corporations § 838 (1947), and cases cited.

[7] "There is no legal privity, relation, or immediate connection, between holders of shares in a bank, in their individual capacity, on the one side, and the directors of the bank on the other. The directors are not the bailees, the factors, agents or trustees of such individual stockholders." Smith v. Hurd, 53 Mass. (12 Met.) 371, 384 (1847).

[8] Chatz v. Midco Oil Corp., 152 F.2d 153, 155 (7th Cir. 1945); Hooker v. Midland Steel Co., 215 Ill. 444, 74 N.E. 445, 447 (1905); Adams v. Mid-West Chevrolet Corp., 198 Okla. 461, 179 P.2d 147, 156 (1947). Cf. Board of Comm'rs v. Reynolds, 44 Ind. 509, 515 (1873); Crowell v. Jackson, 53 N.J.L. 656, 23 Atl. 426, 427 (1891).

[9] Gladstone v. Murray Co., 314 Mass. 584, 50 N.E.2d 958 (1943). See Note, 59 Harv. L. Rev. 769, 776 (1946). It is fundamental that a servant can serve only one master at a time. 3 Bogert, Trusts and Trustees 492, at 154 (1946).

injure the corpus of his trust, the majority of courts hold that the insider need not make them.

The majority rule courts hold also that the mere relation of officer or director to stockholder is not sufficient to raise an implied trust analogous to that of financial advisor and client.[10] A business relation between two parties involving a single contract is not of itself sufficient to create a confidential relation between the parties and thereby become a basis for imposing a constructive trust.[11] Unless there is a past history of the insider's giving financial advice to the stockholder now selling him shares, there is no factual basis for a confidential relation creating a special duty of disclosure to the selling stockholder. In fact, the reaction of a shareholder when approached by an insider who offers to purchase his shares will likely be one of suspicion that the insider has a scheme to make a quick speculation, not one of trust. The majority rule courts hold that the expectation in a reasonable shareholder, engaging in a single transaction with a corporate insider, is no different here than in other ordinary transactions of the market.[12] The shareholder should thus expect to deal at arm's length and not expect the insider to volunteer information he has learned by virtue of his corporate position.

The mere fact of superior knowledge on the part of the corporate insider buying shares is held by the majority of courts not to create duties of affirmative disclosure.[13] Unequal knowledge is a common characteristic of contract negotiations in an enterprise economy. In a large pro-

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10 Goodwin v. Agassiz, 283 Mass. 358, 186 N.E. 659, 660 (1933); Blabon v. Hay, 269 Mass. 401, 169 N.E. 268, 271 (1929); Schuur v. Berry, 285 Mich. 654, 281 N.W. 393, 395 (1938); Binns v. Copper Range Co., 335 Pa. 257, 6 A.2d 895, 898 (1939).

11 "A 'confidential relation' arises by reason of kinship between the parties, or professional, business or social relations that would reasonably lead an ordinarily prudent person in the management of his business affairs to repose that degree of confidence in the defendant which largely results in the substitution of the will of the defendant for that of the plaintiff in the material matters involved in the transaction." Mahan v. Dunkleman, 205 Okla. 54, 58, 234, P.2d 366, 370 (1951), quoting from a headnote to Derdyn v. Low, 94 Okla. 41, 220 Pac. 945 (1923). See 3 Bogert, Trusts and Trustees § 482 (1946).

"No matter what the relationship is or may be termed, it has never been held that the director is accountable for the proceeds of his purchase where the stockholder did not rely on the director in making the sale." Fisher v. Guaranty Trust Co., 259 App. Div. 176, 182 N.Y.S.2d 328, 334 (1940), aff'd per curiam, 285 N.Y. 679, 34 N.E.2d 379 (1941).

12 Leech argues that the expectations of selling shareholders about what affirmative disclosures they can expect, even though they make no inquiries, depends in part on whether the law of their state has followed the majority rule or the counter-rule. Leech, "Transactions in Corporate Control," 104 U. Pa. L. Rev. 725, 746 (1956). It is hard to believe that shareholders have the grasp of law that Leech presumes them to have. It is also unlikely that they will seek legal advice about the nature of bargaining in special situations.

13 "Fiduciary obligations of directors ought not to be made so onerous that men of experience and ability will be deterred from accepting such office. Law in its sanctions is not coextensive with morality. It cannot undertake to put all parties to every contract on an equality as to knowledge, experience, skill and shrewdness. It cannot undertake to relieve against hard bargains made between competent parties without fraud." Goodwin v. Agassiz, 283 Mass. 358, 362-63, 186 N.E. 659, 661 (1933). See Seitz v. Frey, 152 Minn. 170, 188 N.W. 266, 268 (1922).

portion of business negotiations, one party, who has great knowledge from many years of experience dealing in a specific product or service, deals with another person who only occasionally buys or sells the item in question. The usual contract rule is that, absent inquiry by the other party, the party who has superior information about the product and its market has no duty to make affirmative disclosures.[14] The party who has been diligent in reducing some of the market uncertainties to fact is not required to come forth and offer this information to the less diligent. Thus, the purchaser of land does not have to inform the seller that he has found out that a street will be put through the area, greatly increasing land values.[15] And the seller of an old, used truck, who is not asked, need not volunteer the information that the truck has been in a wreck and carefully repaired.[16] The land speculator could be called an "insider," since he has inside information about the land market, and the truck seller could likewise be called an "insider" concerning the history of his truck. Both had inside information which made their market positions superior. The law required neither to make affirmative disclosures.

In the free market, the less informed party to the sale of a tangible item may inspect and ask questions. If the item sold is an intangible, he may ask questions. If he does not bother to inspect or ask questions, he has assumed the uncertainty that the other party may bargain with superior information. The corporate stockholder selling his shares to an officer or director is in such a position. The insider is likely to have more information about the corporation's prospects than the ordinary shareholder. The shareholder is free to ask the insider for a summary of facts on which he bases his purchase. In this case, the law of fraud requires a complete answer by the insider, for speaking a half-truth under the circumstances would be equivalent to misrepresentation. If the shareholder does not bother to ask questions, he assumes the uncertainty that the insider may deal with superior knowledge.

The majority rule is further supported by the fact that when the insider purchases the shares on an exchange, making disclosures to unknown sellers before they sell would be extremely costly and perhaps impossible.[17] The policy of brokers of listed and over-the-counter securities

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[14] Peek v. Gurney, L.R. 6 H.L. 377, 403 (1873). See Restatement, Contracts § 472 (1932); Restatement, Torts § 551 (1938); Bower, Actionable Non-Disclosure 134 (1915). Compare Prosser, Torts § 87 (2d ed. 1955).

[15] James v. Anderson, 149 Va. 113, 140 S.E. 264 (1927), 56 A.L.R. 429 (1928). See generally Goldfarb, "Fraud and Nondisclosure in the Vendor-Purchaser Relation," 8 W. Res. L. Rev. 5, 26 (1956); Keeton, "Fraud—Concealment and Non-Disclosure," 15 Texas L. Rev. 1, 21 (1936).

[16] Carter v. Seaboard Fin. Co., 33 Cal. 2d 564, 569, 203 P.2d 758, 762 (1949).

[17] Goodwin v. Agassiz, 283 Mass. 358, 186 N.E. 659, 661 (1933).

to guard the secrecy of their customer lists would probably result in prospective sellers' brokers refusing to reveal sellers' names. A rule requiring disclosures would effectively bar stock purchases by officers and directors except from their corporations. This would conflict with the recognized business policy that stock ownership by officers and directors should be encouraged, since an ownership interest is an added incentive to managerial efficiency.

One final point in support of the majority rule concerns the market uncertainties undertaken by the insider in the transaction. The officer or director purchases shares with the superior knowledge of a forthcoming merger, assured sale of assets, issuance of a valuable patent to the corporation or some similar event. Some months or years later, after the venture has proven profitable to the insider, the selling shareholder learns of this and brings suit. Under trust law rules, he asks the insider to carry the burden of showing that he acted in good faith by making disclosures before he bought the shares. Should the selling shareholder be allowed to impose this burden on an officer or director and upon failure of the proof be allowed to recover the insider's profit, even though he, the shareholder, undertook no market uncertainties? A minority of courts say 'yes' because this is a material fact available only to the insider. But the event about which the insider knew could have failed to materialize and the stock price could have moved down instead of up. The difficulty here is to determine just how certain the special event was at the time the insider purchased the shares. It could range from a contract with a guaranteed profit already signed by the corporation to highly uncertain business negotiations which, if they did eventuate into contract, could, after a year or two, result either in large profits or large losses. The less certain the expected profit or loss and the smaller its size, the less would be the likelihood of the insider's mentioning it, even if he was informed that he had a special duty to disclose. The further away the special event was from realization when the insider bought the shares, the more likely he would be to think of it as a market uncertainty and the less likely he would be to think of it as a material "fact" which must be disclosed. Could an insider be required to detail every transaction his firm was negotiating before he purchased outstanding shares? If he is ordered by the board of directors not to disclose inside information or knows such disclosure would injure the firm, a legal duty of disclosure would effectively prohibit him from buying shares a large portion of the time.[18]

[18] Percival v. Wright, [1902] 2 Ch. 421, 426.

THE COUNTER-RULE

The counter-rule, imposing duties of disclosure on an officer or director purchasing outstanding shares, is characterized by the courts under two different labels. These are the "minority" rule and the "special circumstances" or "special facts" rules. The minority rule courts state that the officer and director is a fiduciary of each individual stockholder and must disclose every material fact he knows about the corporation's activities to the shareholder who is about to sell shares to him. Courts following the special-circumstances rule state that, while the officer or director is not usually a fiduciary to the individual shareholder, he must make affirmative disclosures to the selling shareholder of all special facts he knows about the corporation's activities that may or will soon have a material effect on the value of the stock and that are not available in its books or financial reports. The cases reveal that these rules are really the same.[19] No minority rule case has held an insider liable for merely failing to come forth and offer to explain the meaning of books of account and company reports. All of the cases imposing liability under either of these rules have involved knowledge of special facts by the insider not available in the firm's books. The insider's use of, and personal profit from, his superior knowledge of these special facts, which the shareholder could not find in the company's books, has been the basis of imposing on him a duty of disclosure.

The cases originating the counter-rule have been analyzed in detail by Mr. Wilgus.[20] His amazing but verified conclusion was that every case to 1910 which enunciated an equitable duty of disclosure on the purchasing insider as a basis for liability also contained facts proving common law fraud. Thus, in the leading case cited as authority for the so-called minority rule, *Oliver v. Oliver*,[21] the failure of the president purchasing shares at $110 to disclose an assured sale of the plant which made the shares worth $185 was accompanied by a fraudulent company report which omitted certain assets of the firm. *Stewart v. Harris*,[22] the other foundation case of the minority rule, involved a half-truth in response to inquiry by the selling shareholder, which is also active fraud. The defendant

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19 Cf. Note, 40 Minn. L. Rev. 62, 64 (1955).

20 Wilgus, op. cit. supra note 1.

21 118 Ga. 362, 45 S.E. 232 (1903). Here the court also found that the fiduciary relation came from another source. The president, in taking the option on the shares, gave the stockholders the impression he would get them the highest possible price. He was thus found to be an agent of the stockholders for the sale of their shares.

The statement of a fiduciary duty to the individual was based on the questionable authority of Jackson v. Ludeling, 88 U.S. (21 Wall.) 616 (1874). This case involved the foreclosure of a mortgage by corporate insiders to the detriment of the firm and other bondholders. Stock purchase was not involved. See Note, 51 Mich. L. Rev. 290 (1952).

22 69 Kan. 498, 77 Pac. 277 (1904).

insider stated to the plaintiff that the firm was in bad condition and pointed out that a large amount of property had been charged off when he knew the property had since become valuable. *Strong v. Repide,*[23] the leading case adopting the special-circumstances rule, relies primarily on the above two cases stating the minority rule. Here the failure to disclose an assured sale of assets was accomplished by concealment of identity by the purchasing director in order to avert inquiry concerning the facts underlying the value of the shares. This, too, is active fraud. It appears that all three of these founding cases for the counter-rule could have been grounded on common law fraud instead of using equitable doctrines of trust and constructive fraud to support liability.

Most of the more recent cases supporting special duties of disclosure on insiders purchasing shares have also contained facts showing the decision could have rested on common law fraud. In *Humphrey v. Baron,*[24] the purchasers made fraudulent misrepresentations about the audited value of the stock. *Buckley v. Buckley,*[25] was a case where the selling shareholder indicated he was placing trust in the purchasing officer by asking questions about the value of the shares, and the insider responded with only part of the facts. Half-truths or misrepresentations of value on which selling shareholders reasonably relied were also the primary bases for liability in five other cases.[26] In this type of case, a misrepresentation of opinion concerning value is fraud, for when an insider does render affirmative statements concerning the value of shares in a close corporation, it is reasonable for the ordinary shareholder to treat such expert opinion as fact and rely on it. In *Schroeder v. Carroll,*[27] the selling shareholder asked the purchasing officer if there was "anything in sight where the stockholders will receive a benefit" and received a negative answer even though the officer knew of the coming sale of the entire assets. *Nichol v. Sensenbrenner,*[28] involved the same type of concealment of identity to avert inquiry as was found in *Strong v. Repide.*[29]

In other cases declaring a fiduciary duty of affirmative disclosure on the insider to the shareholder in purchasing shares, the decision could

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23 213 U.S. 419 (1909).

24 223 Iowa 735, 273 N.W. 856, 861 (1937). Similar fraudulent misrepresentations were present in Poole v. Camden, 79 W. Va. 310, 92 S.E. 454, 458 (1917), and McMynn v. Richardson-Phenix Co., 186 Wis. 442, 201 N.W. 272, 280 (1924).

25 230 Mich. 504, 202 N.W. 955 (1925).

26 Blazer v. Black, 196 F.2d 139 (10th Cir. 1952); Hohart v. Hobart Estate Co., 26 Cal. 2d 412, 159 P.2d 958, 969 (1945); Fox v. Cosgriff, 66 Idaho 371, 159 P.2d 224, 228 (1945); Dalton v. Hill, 169 Kan. 388, 219 P.2d 710 (1950); Lightner v. W. H. Hill Co., 258 Mich. 50, 242 N.W. 218 (1932).

27 192 Wis. 460, 212 N.W. 299 (1927). A similar active fraud was found in Staker v. Reese, 82 W. Va. 764, 97 S.E. 641, 645 (1918).

28 220 Wis. 165, 263 N.W. 650 (1935). Similar concealment of identity was found in Taylor v. Wright, 69 Cal. App. 2d 371, 159 P.2d 980, 983 (1945).

29 Supra note 23.

have been rested on a fiduciary duty arising from another source. In *Voellmeck v. Harding*,[30] the purchasing officer bought shares from a junior official in the firm who placed trust in his superior officer for financial advice. In *Bettendorf v. Bettendorf*,[31] the insider purchasing shares was administrator of an estate and purchased his shares from his own beneficiary. In *Hotchkiss v. Fischer*,[32] a widow, ignorant of business affairs, asked the ~~officer purchasing~~ her shares the meaning of the financial statements. He refused to answer this question but did mention certain negative aspects about the condition of the firm. The widow was found to have placed trust in the officer and relied on these half-truths. In *Jaynes v. Jaynes*,[33] another widow sold her shares to her brother-in-law, officer in the firm. Evidence showed she relied on him as her financial adviser. In *Holty v. Landauer*,[34] an uncle held stock in trust for his nephew and purchased the stock from his nephew, the beneficiary of the trust.

One must conclude that most of the opinions declaring a fiduciary duty on an insider purchasing shares to come forth and disclose facts, even though the seller does not bother to ask, could have been founded on common law fraud or on a duty of trust arising from another source. These decisions do not, however, make their statements about fiduciary duties of disclosure on officers or directors purchasing shares obiter dicta. They are judicial dicta at least. Since the courts adopt this rule as one of the bases of decision, it does become precedent for later cases. Hence, it is not surprising to find it becoming an established rule of law in a minority of states.

A few cases holding insiders liable for non-disclosure in purchasing shares contain no active fraud and hence do rest their decision entirely on a fiduciary duty of the insider to come forth and disclose special facts learned within the firm. The rule in its pure form is found in *Jacquith v. Mason*[35] and *Dawson v. National Life Ins. Co.*[36] The rule also appears as the sole basis of decision in two lower appellate cases in Illinois.[37] The most recent holding that corporate insiders are fiduciaries to individual shareholders is found in *Mansfield Hardwood Lumber Co. v. Johnson.*[38]

[30] 166 Wash. 93, 6 P.2d 373 (1931).
[31] 190 Iowa 83, 179 N.W. 444 (1920).
[32] 136 Kan. 530, 16 P.2d 531 (1932).
[33] 98 Cal. App. 2d 447, 220 P.2d 598 (1950).
[34] 270 Wis. 203, 70 N.W.2d 633 (1955).
[35] 99 Neb. 509, 156 N.W. 1041 (1916).
[36] 176 Iowa 362, 157 N.W. 929 (1916). Critical comments on the Jacquith and Dawson cases appear in Walker, op. cit. supra note 1, at 642.
[37] Agatucci v. Corradi, 327 Ill. App. 153, 63 N.E.2d 630 (1945); Northern Trust Co. v. Essaness Theatres Corp., 348 Ill. App. 134, 108 N.E. 2d 493 (1952), 1953 U. Ill. L. F. 144.
[38] 263 F.2d 748 (5th Cir. 1959). This first Court of Appeals opinion, based on common law fiduciary and constructive fraud concepts, was supplemented by an opinion based on

The Court of Appeals in this case was applying Louisiana law. The control group of six persons caused the corporation to purchase plaintiff minority shareholder's stock and allegedly induced the sale by fraudulent misrepresentations that they did not intend to dispose of the corporation's assets and liquidate it. The District Court found that defendants had committed fraud.[39] The Court of Appeals held the finding of active fraud to be erroneous because the fraudulent intent was not proven. It held the defendant was still liable, however, but on the ground of constructive fraud. In doing so the court explicitly stated that the insiders had a fiduciary duty to the individual minority stockholder to supply him with all information relating to pending negotiations to sell the assets of the firm.

Since almost all of the recorded decisions finding wrongful acts by corporate insiders when purchasing outstanding shares have involved active fraud, why have so many courts resorted to equitable doctrines of fiduciary duty to find liability? One writer suggests that subsequent to the fusion of law and equity some courts confused common law and equitable causes of action and thereby made unnecessary, unwarranted and illogical extensions of the fiduciary doctrine.[40] The two reasons for this confusion both seem to this writer to stem from the courts' efforts to give greater protection in this situation to the victims of common law fraud than found in the traditional remedies.

The first effect of invoking the equitable remedy was to shift the burden of proof to the insider purchasing the shares to prove he had acted in good faith and had made full disclosures. Thus, the seller-plaintiff with inadequate evidence did not have to carry the usual burden of proving the fraud which he alleged had occurred. Feeling pity for his unequal knowledge, the courts allowed the seller to assert the incomplete disclosures by the insider and make the insider carry the key burden of persuasion.

The second reason for extending the equitable fiduciary concept into this type of transaction probably arises from a misunderstanding of the correct measure of damages. The usual common-law fraud damages would be the difference between contract price and market value on date of sale. This limited measure might in some cases allow a fraudulent party to keep part of the fruits of his fraud. This would be true if the market value of the stock on date of purchase, had there been no fraud,

civil law. Since constructive fraud is unknown in Louisiana civil law, the court modified its opinion to hold that there was the necessary intent to constitute actionable fraud, as fraud is broadly defined in the Louisiana Code. Mansfield Hardwood Lumber Co. v. Johnson, 268 F.2d 317 (5th Cir.), cert. denied, 361 U.S. 885 (1959).

39 Johnson v. Mansfield Hardwood Lumber Co., 159 F. Supp. 104 (W.D. La. 1958).

40 Walker, op cit. supra note 1, at 639.

was less than the resale price received by the fraudulent purchaser. For this reason, some of the courts may have converted this from a common law cause of action into an equitable action of constructive trust so that plaintiff could be awarded the equitable damages of all profits made from the fraud by the defendant. This reasoning, that there must be violation of an equitable duty to get equitable relief, was erroneous and unnecessary. The measure of damages for restitution to a victim of common law fraud in a case of this type would always be the entire profits made by the fraudulent party.[41] The law of restitution, especially when the cause of action is consciously tortious conduct, will operate to prevent unjust enrichment. In this case the damages would be the entire fruits of the fraud received by the defendant, his profit from buying and reselling the shares. Such result can and should be reached without resort to any theory of trust or constructive trust.

FIDUCIARY DUTY IS OWED TO CORPORATION

The prime complaint of the courts which reject the majority rule is that when officers or directors use corporate inside information to speculate in the stock of their corporation, they are using a corporate asset for their personal profit when such profit legally belongs to all the shareholders.[42] From this basic premise, the minority courts argue that the fiduciary duty of the corporate insider should bar a private gain to him by advance use of corporate inside information. But neither of these premises provide a logical basis for deciding to whom the fiduciary duty is owed. The mere existence of fiduciary responsibility in the corporate insider does not determine that the law should extend special treatment to stockholders who sell their shares between the time the corporate opportunity arises and the time it affects the stock price due to public announcement by the corporation that it has been offered or has entered into the transaction. On the contrary, basic trust law would put no special rights of recovery in the selling shareholder just because his purchaser

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[41] Staker v. Reese, 82 W. Va., 764, 97 S.E. 641, 645-46 (1919); Barnes v. Eastern & Western Lumber Co., 205 Ore. 553, 287 P.2d 929, 947 (1955). See Restatement, Restitution, §§ 151 & 154 (1937).

[42] The so-called majority rule is predicated on the theory that the corporation—the collective stockholders—is a separate and distinct legal entity, an artificial personality, to whom the director owes his duty. The legal writers above referred to and the more recent cases adopting the minority view, have pointed out the fallacy of this reasoning. These authorities logically point out that the detailed information a director has of corporate affairs is in a very real sense property of the corporation, and that no director should be permitted to use such information for his own benefit at the expense of his stockholders. The so-called majority rule permits a director to secure for himself profits rightfully belonging to all. Such a rule offends the moral sense, and is contrary to our modern concept of the duty of a director towards those he represents.

Taylor v. Wright, 69 Cal. App.2d 371, 381, 159 P.2d 980, 984-85 (1945). See Wilgus, op. cit. supra note 1, at 297; Ballantine, Corporations 213 (rev. ed. 1946).

was a director or officer of the corporation instead of another stranger. Rather, trust law should hold that since the insider used a corporate asset, corporate inside information, for his own private gain, he has *ipso facto* violated his fiduciary duty to the corporation.[43] Yet in this situation the courts have held otherwise. A growing minority has created a fiduciary duty of disclosure to the selling shareholder but none rules that a fiduciary duty to account for such profits is owed to the corporation.

The courts have held that directors or officers not in dominant control of a solvent corporation may buy and sell stock in their corporation at will, and that such speculation is not within the usual scope of their fiduciary duties to the corporation.[44] This rule is based on a theory that a corporation as such has no interest in its outstanding shares. As pointed out in the first section of this article, the outstanding shares are not assets of the corporation and are thus not part of the corpus of the insider's trust. But the corporation's inside information is one of its assets, and there is no apparent reason to treat it differently from other corporate assets as far as fiduciary responsibility of insiders is concerned. Officers and directors should be held to account to the corporation for all profits gained from personal use of corporate inside information. One must conclude that the corporate title to the special knowledge within the firm and the basic trust relation of insiders to their firm create fiduciary duties to the corporation in this situation, not to the selling shareholders.

Two exceptions to the rule being questioned here should be noted. If the board of directors instructs a director or officer to purchase outstanding shares for the corporation, purchasing for himself would usurp a corporate opportunity. The other exception is illustrated by the *Brophy*

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[43] If they [directors and officers] make a personal profit through the use of corporate assets, they must account for it to the stockholders. It is immaterial that their dealings may not have caused a loss or been harmful to the corporation; the test of liability is whether they have unjustly gained enrichment.

Bailey v. Jacobs, 325 Pa. 187, 194, 189 Atl. 320, 324 (1937). See generally Bromschwig v. Carthage Marble & White Lime Co., 334 Mo. 319, 66 S.W.2d 889, 892 (1933); 3 Fletcher, Private Corporations § 898 (1947). The use by a director of corporate funds to buy stock in another corporation was both a conversion and violation of a fiduciary duty allowing corporate recovery of the director's profits. Marcus v. Otis, 168 F.2d 649, 654 (2d Cir. 1948), modified, 169 F.2d 148 (2d Cir. 1948). Use of corporate assets by an officer or director to engage in transactions for personal profit is held a material factor in declaring a usurption of corporate opportunity in Higgins v. Shenango Pottery Co., 256 F.2d 504, 508 (3d Cir. 1958); Central Ry. Signal Co. v. Longden, 194 F.2d 310, 318-19 (7th Cir. 1952); Guth v. Loft, Inc., 23 Del. Ch. 255, 5 A.2d 503, 515 (1939). See generally 3 Fletcher, Private Corporations § 884, 274-75 (1947); Ballantine, Corporations 206 (rev. ed. 1946).

[44] Du Pont v. Du Pont, 256 Fed. 129 (3d Cir.), cert. denied, 250 U.S. 642 (1919); Bisbee v. Midland Linseed Prods. Co., 19 F.2d 24, 27 (8th Cir.), cert. denied, 275 U.S. 564 (1927); Llewellyn v. Queen City Dairy, Inc., 187 Md. 49, 48 A.2d 322 (1946); Keely v. Black, 91 N.J. Eq. 520, 111 Atl. 22 (1920); Adams v. Mid-West Chevrolet Corp., 198 Okla. 461, 179 P.2d 147, 156 (1947); 3 Fletcher, Private Corporations § 900 (1947). Corporate insiders were held not accountable for profits from speculation in shares of a subsidiary of their corporation in Kaufman v. Wolfson, 153 F. Supp. 253 (S.D.N.Y. 1957)

case.[45] The board of directors secretly adopted a policy to start buying outstanding shares in the market. The insider (confidential secretary to a director), who had no duties relating to the corporation's purchases, knew of the corporation's policy and that it would probably bid up the market price of the shares. He purchased some of the corporation's outstanding shares himself. This personal use of secret corporate information was a breach of a confidential relation by an employee, and the complaint was held to state a cause of action against the defendant for an account to the corporation for his profits. The court specifically ruled that no harm to the corporation need be shown. The court did not go as far as the policy advocated here; it did not hold the insider liable merely for using a corporate asset, corporate inside information, for personal profit.

The rule advocated here of holding insiders liable to their corporations for personal profits from using corporate information does not solve the related problem of speculation by corporations in their own shares. The basic relation of corporation to shareholder is contractual.[46] The corporation is bound to represent the shareholders as a group when dealing in the market with one shareholder. For this reason, restrictions on purchases of their own shares by corporations cannot be found in the law of trusts. They have been and must be adopted by statute as the working of the securities markets indicates is necessary.[47] Section 10(b)

[45] Brophy v. Cities Service Co., 31 Del. Ch. 241, 70 A.2d 5 (1949), 63 Harv. L. Rev. 1446 (1950).

[46] 1 Bogert, Trusts and Trustees § 16, at 81 (1951). A corporation is not a fiduciary toward its shareholders individually and, therefore, there is no duty on the officer buying shares for the firm to make disclosures to the shareholder. Anchor Realty & Inv. Co. v. Rafferty, 308 Ill. App. 484, 32 N.E. 2d 394, 401 (1941).

One recent case appears to support the contrary argument, that a corporaton purchasing its own shares is liable to the selling stockholder for the non-disclosure by its purchasing officers of material facts they know may affect the value of the shares, which facts are not recorded in the corporate books of account or financial statements. Northern Trust Co. v. Essaness Theatres Corp., 348 Ill. App. 134, 108 N.E.2d 493 (1952). The holding there, that the complaint stated a cause of action in equity for violation of fiduciary duty by the defendant president for which the defendant corporation was liable, can, however, be explained on the much more conventional fiduciary theory of the corporate-opportunity doctrine. Defendant president of the corporation was negotiating the Oriental theatre transaction before plaintiffs sold the corporation their shares. Defendant allegedly failed to reveal this to the corporation's other board members, who included plaintiff's representative and the third shareholder, Stern. He was thus alleged to have usurped a corporate opportunity by keeping secret the Oriental theatre negotiations from the other board members (the corporation) until he could buy out their shares and remove them from the board. He then could (and did choose to) consummate the usurping transaction in the corporate name, since he had become sole stockholder. Furthermore, corporate alter ego doctrines come into play here. Allowing suit against the corporation to whom plaintiffs sold their shares is equivalent to allowing suit against defendant president, the sole stockholder, in circumstances where suit against him alone might fail, thereby sanctioning constructive fraud. See Imperial Paper & Color Corp. v. Sampsell, 114 F.2d. 49, 52 (9th Cir. 1940); 3 Fletcher, Private Corporations § 851 (1947). For requirements for application of the alter ego doctrine, see Frank McCleary Cattle Co. v. Sewell, 73 Nev. 279, 317 P.2d 957, 959 (1957).

[47] Corporations' purchases of their own stock are of course restricted by the common

of the Securities Exchange Act of 1934, an example which is discussed below, has been held to treat the duties of disclosure in purchasing shares, whether by an individual or by a corporation.

SECURITIES EXCHANGE ACT, SECTION 16(b)

Section 16(b) of the Securities Exchange Act of 1934 makes profits of insiders from short-swing purchase and resale of shares of their own corporations recoverable by the corporations.[48] This section applies only to securities registered on a national exchange. It applies to officers, directors and beneficial owners of more than 10 per cent of any class of any equity security other than those exempted by the statute and the rules promulgated pursuant thereto. The issuing corporation is given the right to recover all profits made from short-swing speculation of six months or less, regardless of the period the insider intended to hold the stock at the time he bought it.

The congressional hearings indicate that section 16(b) specifically was designed to protect "outside" stockholders against at least short-swing speculation by insiders with advance information.[49] The effect of the statute was to make such profits inure to the benefit of the corporation.[50] The rule is based on the trust relationship of officers, directors and beneficial owners of 10 per cent of a company's shares to their corporation, that of the last of the three being enacted for the limited purpose of this statute.[51] It was designed to prevent not only the personal use of advance corporate information by insiders but also to discourage them from per-

law and by statutes for the protection of corporate creditors and the stockholders as a group. 1 Hornstein, Corporation Law & Practice 612-28 (1959); Rohrlich, Law & Practice in Corporate Control 123-27 (1933). If a dominant or majority stockholder should manipulate corporate financial policy for the purpose of corporate speculation in its own stock, this would undoubtedly be a violation of a fiduciary duty to the minority stockholders. 13 Fletcher, Private Corporations § 5811 (1943).

[48] For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer, any profit realized by him from any purchase and sale, or sale and purchase, of any equity security of such issuer (other than an exempted security) within any period of less than six months, unless such security was acquired in good faith in connection with a debt previously contracted, shall inure to and be recoverable by the issuer, irrespective of any intention on the part of such beneficial owner, director, or officer in entering such transaction of holding the security purchased or of not repurchasing the security sold for a period exceeding six months. . . .

48 Stat. 896 (1934), 15 U.S.C. § 78p(b) (1958). See Annot., 40 A.L.R.2d 1346 (1955).

[49] Smolowe v. Delendo Corp., 136 F.2d 231, (2d Cir.), cert. denied, 320 U.S. 751 (1943), citing Hearings before Committee on Interstate and Foreign Commerce on H.R. 7852 and H.R. 8720, 73d Cong., 2d Sess. 85 (1934); Hearings before Committee on Currency and Banking on S. 84, 72d Cong., 2d Sess. (1933); and S. 56 & S. 97, 73d Cong., 1st & 2d Sess. 6557-59 (1934). See Rubin and Feldman, "Statutory Inhibitions upon Unfair Use of Corporate Information by Insiders," 95 U. Pa. L. Rev. 468 (1947).

[50] Shaw v. Dreyfus, 172 F.2d 140 (2d Cir.), cert. denied, 337 U.S. 907 (1949); Park & Tilford, Inc. v. Schulte, 160 F.2d 984 (2d Cir.), cert. denied, 332 U.S. 761 (1947).

[51] Gratz v. Claughton, 187 F.2d 46, 49 (2d Cir.), cert. denied, 341 U.S. 920 (1951); Kogan v. Schulte, 61 F. Supp. 604, 608 (S.D.N.Y. 1945). See Ellerin v. Massachusetts Mut. Life Ins. Co., 270 F.2d 259 (2d Cir. 1959).

verting corporate financial policies, such as the timing of dividends, for their own speculative gains.[52] The widespread practice of "sure thing" speculation by corporate control groups and managers was to be terminated.

The method chosen to stop short-swing speculation in stock of listed corporations by insiders was to make all profits from such speculation recoverable by the corporations. Absolute prohibition of share trading would have penalized the manager who had enough confidence in his ability to make good faith investments in stock of his own corporation. It would also have impaired the use of stock option plans as a form of compensation. Allowing recovery only where there was proof of misuse of confidential information was considered to put too great burdens of proof on the issuer corporation in a situation where evidence was mostly circumstantial and difficult to assemble.[53] The compromise was to make all short-swing profits recoverable by the issuer corporation without the necessity of proving bad faith on the part of the insider.[54] Recovery by the corporation is thus not dependent on proof of actual or unfair use of information, but only that the profit was made by the insider.[55] In the unusual case, when someone else manages his investments, the insider can find himself liable to his corporation for short-swing profits even though he was unaware that he had bought or sold shares in his corporation.[56]

A chairman of the Securities and Exchange Commission has pointed out unofficially that section 16(b) "appears to proceed on the principle that the confidential information which a corporate insider automatically obtains by virtue of his position belongs to the corporation."[57] As to listed securities, the statute was designed to plug the hole in fiduciary law discussed in the previous section, which allowed the insider to make personal profits from using corporate information. One court has thus held

52 S. Rep. No. 792, 73d Cong., 2d Sess. 9 (1934). For descriptions of other abuses by insiders, see S. Rep. No. 1455, 73d Cong. 2d Sess. 47, 55-68 (1934). See also H.R. Rep. Nos. 1383, 1838, 73d Cong., 2d Sess. (1934); Loss, Securities Regulation 883-84 (1951).

53 Smolowe v. Delendo Corp., 136 F.2d 231, 235-36 (2d Cir.), cert. denied, 320 U.S. 751 (1943).

54 Walet v. Jefferson Lake Sulphur Co., 202 F.2d 433, 434 (5th Cir.), cert. denied, 346 U.S. 820 (1953); Stella v. Graham-Paige Motors Corp., 132 F. Supp. 100, 102 (S.D.N.Y. 1955), cause remanded on other grounds, 232 F.2d 299 (2d Cir.), cert. denied, 352 U.S. 831 (1956); Carr-Consolidated Biscuit Co. v. Moore, 125 F. Supp. 423, 427 (M.D. Pa. 1954); Arkansas Louisiana Gas Co. v. W. R. Stephens Inv. Co., 141 F. Supp. 841, 845 (W.D. Ark. 1956); Magida v. Continental Can Co., 12 F.R.D. 74, 78 (S.D.N.Y. 1951). See generally Yourd, "Trading in Securities by Directors, Officers and Stockholders: Section 16 of the Securities Exchange Act," 38 Mich. L. Rev. 133, 139-52 (1939).

55 Lockheed Aircraft Corp. v. Campbell, 110 F. Supp. 282, 284 (S.D. Cal. 1953); Truncale v. Blumberg, 80 F. Supp. 387, 392 (S.D.N.Y. 1948).

56 Rattner v. Lehman, 193 F.2d 564 (2d Cir. 1952). In this case the director was a member of a partnership that engaged in stock speculation but did not personally take part in the decision to speculate in the stock of his corporation.

57 Cook and Feldman, "Insider Trading under the Securities Exchange Act," 66 Harv. L. Rev. 385, 408 (1953).

that section 16(b) is not penal, but is remedial in that its purpose is to deter "what was reasonably thought to be a widespread abuse of a fiduciary relationship."[58]

Section 16(b) takes the position that the fiduciary duty of the insider when dealing in shares of his corporation is owed to the corporation and not to the "outside" shareholders with whom he deals. This is in contrast to the expanding minority group of states where common law requires fiduciary disclosures by the insider, not to his corporation but to the shareholders from whom he purchases shares. As stated in the preceding section, the writer believes that the fiduciary responsibility in this type of transaction is solely to the corporation. The logic of section 16(b) is thus the same as that of all other fiduciary law. It is derived from corporate title to its own confidential information and the basic trust relation of officers and directors to their corporations.

It should be noted that there is a possibility of double liability for the officer or director of a listed corporation who makes a private purchase of outstanding shares in his firm. If he resells them within six months, there may be corporate recovery of his profits under section 16(b). There may also be recovery by the selling shareholder for failure of the insider to make full disclosure to him under the common law in a minority-rule or special-circumstances rule state or under section 10(b) of the Securities Exchange Act of 1934, which is discussed in the next section. The arguments submitted here would support corporate recovery under section 16(b) or under the general corporate fiduciary duty of insiders. Absent active fraud by the purchasing insider, another recovery by the selling shareholder should be denied. But if there is active fraud by the purchasing insider, a strong argument in favor of double recovery can be made on the basis that the single purchase involved wrongs against both the corporation and the selling shareholder.[59]

Section 16(b) is more strict than common law fiduciary duties in that it creates liability to the corporations for profits even though the insider acted in good faith. The statute is, however, less pervasive than common law duties. The mechanistic six month limitation means that section 16(b) fails to cover the situation where the insider in bad faith does use confidential information in deciding to purchase shares in his corporation but sells no shares in the corporation for more than six months there-

58 Adler v. Klawans, 267 F.2d 840, 844 (2d Cir. 1959). Only one court has said that the statute was only punitive because speculation by an insider causes no damage to the remaining stock. Commissioner v. Obear-Nester Glass Co., 217 F.2d 56, 58 (7th Cir. 1954), cert. denied, 348 U.S. 982 (1955) (dictum).

59 For arguments supporting double recovery, see Comment, 59 Yale L.J. 1120, 1140-42 (1950). Compare Stevens, Corporations 701-02 (2d ed. 1949).

after.[60] For this reason, section 16(b) is not a substitute for a common law fiduciary duty to the corporation when an insider uses corporate information for his own profit. The recommendation of the preceding section that the general fiduciary duty of officers and directors to their corporations should apply to stock transactions is timely even though section 16(b) covers some of this area for listed securities.

Another limitation of section 16(b) is that it covers only listed securities and not all security transactions where there is federal jurisdiction. It does not apply to unlisted securities which are traded over-the-counter in interstate commerce.[61] It can not apply to securities in closed corporations where interstate commerce is not concerned. The language of the act further limits liability solely to the officers, directors, and beneficial owners there designated. It makes the insider liable only for profits realized by him, not for those earned by his friends with whom he shared his inside corporate information.[62] The rigid objective standards of this statute may enable insiders to make gifts of inside information to outsiders and under the statute not become liable to the corporation for the profits made by donees of the information.

SECURITIES EXCHANGE ACT, SECTION 10(b)

Section 10(b) of the Securities Exchange Act of 1934 has been interpreted to take the other approach to the problem of the purchase of outstanding shares by corporate insiders.[63] Instead of duty to the corporation and recovery by the corporation as in section 16(b), section 10(b)

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60 Since all shares are alike, matching of certificates is not required for liability under § 16(b). Hence, a purchase of shares by an insider who already owns some shares must be followed by no sales from either group of shares for six months in order to avoid liability to the corporation for profits. Walet v. Jefferson Lake Sulphur Co., 202 F.2d 433, 434 (5th Cir.), cert. denied, 346 U.S. 820 (1953). A director who purchased shares in the corporation before he became an officer but sold them after assuming his post, the purchase and sale being within a six-month period, was held liable to his corporation for the profits earned. Adler v. Klawans, 267 F.2d 840 (2d Cir. 1959).

61 For a summary of proposals to expand the classes of securities covered by § 16(b), see Senate Committee on Banking and Currency, Report on Unlisted Securities, S. Rep. No. 700, 85th Cong., 1st Sess. (1957); Senate Committee on Banking and Currency, Hearings on SEC Legislation, 85th Cong., 1st Sess. (1957); Senate Committee on Banking and Currency, Stock Market Study, S. Rep. No. 376, 84th Cong., 1st Sess. (1955). See Report of SEC on S. 2054 to the Senate Committee on Banking and Currency, 84th Cong., 2d Sess. (Comm. Print 1956).

62 Rattner v. Lehman, 193 F.2d 564 (2d Cir. 1952), 25 So. Cal. L. Rev. 475.

63 It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails or of any facility or any national securities exchange—

(a) . . .

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

48 Stat. 891 (1934), 15 U.S.C. § 78j (1958).

and SEC rule X-10B-5[64] prohibit fraudulent schemes against selling shareholders. Although this section does not provide a civil remedy, the courts have consistently held that one is implied.[65] Many more classes of transactions are covered by section 10(b) than section 16(b), which latter section applies only to equity securities listed on a national exchange. The language of section 10(b) indicates that it applies to any security and that it is not limited to transactions on a national securities exchange or even to over-the-counter markets where interstate commerce is involved. This section also applies to any securities transaction which has been carried on "by the use of any means or instrumentality of interstate commerce or the mails." It has been interpreted liberally so that the fraudulent misrepresentation or deceptive device need not have been carried by the mails; jurisdiction is found if there was any use of the mails in connection with the purchase or sale.[66]

What is the scope of the remedy in the selling stockholder under section 10(b) and rule X-10B-5 for false or deceptive practices by a purchasing insider? The history of rule X-10B-5 has been summarized by Judge A. Hand.[67] He points out that the rule is almost a verbatim adoption of the language in section 17(a) of the Securities Act of 1933,[68] which prohibits fraud in the sale of securities, such as by the holder of outstanding shares who is about to sell them. Rule X-10B-5 was adopted to close this " . . . loophole in the protections against fraud administered

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[64] It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud.

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

17 C.F.R. 240.10b-5 (1949).

For an excellent analysis of the scope of this rule, see Comment, 59 Yale L.J. 1120 (1950).

[65] Fratt v. Robinson, 203 F.2d 627, 632 (9th Cir. 1953); Fischman v. Raytheon Mfg. Co., 188 F.2d 783, 787 (2d Cir. 1951); Mills v. Sarjem Corp., 133 F. Supp. 753, 762 (D.N.J. 1955). See generally Comment, 59 Yale L.J. 1120, 1133 (1950); Note, 61 Harv. L. Rev. 858 (1948); Annot., 37 A.L.R.2d 649 (1954).

For an excellent survey of this problem under the 1933 Securities Act, see Shulman, "Civil Liability and the Securities Act," 43 Yale L.J. 227 (1933).

[66] Errion v. Connell, 236 F2d 447, 455 (9th Cir. 1956); Fratt v. Robinson, 203 F.2d 627, 634 (9th Cir. 1953); Northern Trust Co. v. Essaness Theatres Corp., 103 F. Supp. 954, 964 (N.D. Ill. 1952).

[67] Birnbaum v. Newport Steel Corp., 193 F.2d 461, 463 (2d Cir.), cert. denied, 343 U.S. 956 (1952). Promulgation of rule X-10B-5 was held not to be an invalid usurpation of legislative power by the SEC in United States v. Shindler, 173 F. Supp. 393 (S.D. N.Y. 1959).

[68] 48 Stat. 84 § 17(a) (1933), 15 U.S.C. § 77q(a) (1958). See Latty, "The Aggrieved Buyer or Seller or Holder of Shares in a Close Corporation Under the S.E.C. Statutes," 18 Law & Contemp. Prob. 505, 508 (1953).

by the Commission by prohibiting individuals or companies from buying securities if they engage in fraud in their purchase."[69]

It is clear from the cases that common law fraud in the purchase of securities by a corporate insider violates section 10(b) and rule X-10B-5.[70] In *Kardon v. National Gypsum Co.*,[71] the purchasing insider knowingly misrepresented that he had made no agreement for the sale of the corporation's assets. A complaint alleging fraudulent misrepresentations by a control group was held to state a cause of action under section 10(b) in *Robinson v. Difford*,[72] and in the related case of *Fratt v. Robinson*.[73] It is notable that in interpreting section 10(b) as a basis of remedy for common law fraud in security transactions, the common law requirement that the plaintiff purchaser or seller be one that defendant intended to defraud has been retained.[74]

A party who has been a victim of common law fraud in a securities transaction has two main advantages in suing under section 10(b) instead of suing under common law in the state courts. He has the benefit of extraterritorial service of process, and he is relieved of some of the narrow, technical limitations of the fraud concept under common law.[75] The case of *Errion v. Connell*,[76] though not concerned with purchase by a corporate insider, is clearly illustrative of the utility of section 10(b). The fraud was committed in the State of Washington, after which the seven defendants retired to Oregon. They left in Washington only a corporation, which would also be a necessary defendant. It was unwise for

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69 SEC Release No. 3230, May 21, 1942. This release announced the adoption of rule X-10B-5.

70 There is only one recorded opinion in which a district court dismissed an action by holding that rule X-10B-5 does not cover common-law fraud. Beury v. Beury, 127 F. Supp. 786 (S.D.W. Va. 1954). On appeal, the dismissal was upheld on other grounds, the court of appeals noting that it did not concur with the district court's opinion on the limited scope of rue X-10B-5. Beury v. Beury, 222 F.2d 464 (4th Cir. 1955). See Notes, 68 Harv. L. Rev. 1290 (1955); 54 Mich. L. Rev. 149 (1955); 103 U.Pa. L. Rev. 1098 (1955).

71 73 F. Supp. 798 (E.D. Pa.), supplemented, 83 F. Supp. 613 (E.D. Pa. 1947).

72 92 F. Supp. 145 (E.D. Pa. 1950), 64 Harv. L. Rev. 1018 (1951). See similar ruling in Northern Trust Co. v. Essaness Theatres Corp., 103 F. Supp. 954 (N.D.Ill. 1952).

73 203 F.2d 627 (9th Cir. 1953).

74 Joseph v. Farnsworth Radio & Television Corp., 99 F. Supp. 701 (S.D.N.Y. 1951), aff'd per curiam, 198 F.2d 883 (2d Cir. 1952), 4 Stanford L. Rev. 308. In this case, plaintiffs purchased shares on a national exchange subsequent to the issuance of an allegedly false financial statement by defendant directors, who had sold their shares on the exchange. The district court dismissed the complaint because there was not "a semblance of privity between the vendor and purchaser." See Loss, Securities Regulation 1064 (1951) & (Supp. 1955, at 371-72). See also Birnbaum v. Newport Steel Corp. 193 F.2d 461 (2d Cir.), cert. denied, 343 U.S. 956 (1952).

75 For comparisons of common-law and SEC fraud concepts, see Loss, Securities Regulation 812-23 (1951), and Latty, op. cit. supra note 68, at 525-34. For a summary of procedural advantages of a § 10(b) action, see Comment, 59 Yale L.J. 1120, 1130-33 (1950). See Judge Clark's comments on the expanded fraud concept in the SEC Act in a case holding a broker liable for non-disclosure of his large profits from selling shares to a customer. Charles Hughes & Co. v. SEC, 139 F.2d 434 (2d Cir. 1943), cert. denied, 321 U.S. 786 (1944).

76 236 F.2d 447 (9th Cir. 1956), 9 Stanford L. Rev. 589 (1957).

plaintiff to sue in Oregon because its two-year statute of limitations had probably run. She could not sue in the Federal Court in Washington on the basis of diversity of citizenship because the Washington corporation had to be made a defendant. Only section 10(b) and rule X-10B-5 gave jurisdictional basis for suit. The alleged misrepresentations in the case were all on the borderline between fact and predictive opinion. They were that certain land would be condemned by a municipality and that its reasonable worth was $1,200 per acre. Nevertheless, under the comprehensive language of rule X-10B-5, the court was able to find a fraudulent scheme. Decision for plaintiff was affirmed.

Assuming that an insider when purchasing outstanding shares does not commit active fraud, can he be held liable under section 10(b) and rule X-10B-5 for mere failure to disclose facts he knows about the corporation that are unavailable to outside stockholders?[77] It is fairly clear that the commission does consider rule X-10B-5 to put affirmative duties of disclosure on purchasing insiders, that under this rule the insiders are to be held liable as fiduciaries toward the stockholders from whom they buy shares. The commission view was stated in the *Ward La France* investigation.[78] The president and the treasurer of the company, who owned 74 per cent of its outstanding shares, had almost completed negotiations to sell their shares for about $45 each. They ordered a broker to buy other outstanding shares for the corporation in the open market, which he did at prices from $3.25 to $5.75 per share. Selling shareholders were not told that Ward La France was the purchaser, that the two officers were about to sell their controlling shares for about $45, that the amount to be paid on liquidation was about $25 per share, and that earnings since the last published report had risen from $2.73 per year to $15.75 for the more recent 11 months. The commission concluded that this failure to disclose material facts violated rule X-10B-5. No formal action was taken as voluntary restitution was made to the minority shareholders. This same view, that rule X-10B-5 requires affirmative disclosures, was taken by the commission in over ten injunction actions, all of which resulted in consent decrees or dismissals following voluntary restitution.[79]

There have been few court opinions on whether section 10(b) and rule X-10B-5 create liability for mere non-disclosure of special facts to the shareholder from whom the insider purchases shares. It can be argued that earlier federal cases applying the common law to stock pur-

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[77] See Loss, Securities Regulation 828-38 (1951); Comment, 59 Yale L.J. 1120, 1142-49 (1950).

[78] Ward La France Truck Corp., 13 S.E.C. 373 (1943).

[79] These cases are discussed in Loss, Securities Regulation 827 (1951); Comment, 59 Yale L.J. 1120, 1145-46 (1950); Note, 59 Harv. L. Rev. 769, 772 (1946).

chases by insiders would control the interpretation of the language in section 10(b). In such case, the special circumstances rule as applied in *Strong v. Repide*[80] would require affirmative disclosures to selling stockholders. There is a dictum in the *Kardon* case to this effect.[81]

The case in which the problem has received the most thorough discussion is *Speed v. Transamerica Corp.*[82] This case concerned the purchase of outstanding shares of Axton-Fisher Tobacco Company, not by an officer or director, but by a controlling shareholder, Transamerica Corporation. Plaintiffs sold their Class A and Class B shares at $40 and $12 per share respectively, when they were allegedly worth $200 and $100 per share respectively. There is a question whether this was a mere non-disclosure case or one containing common law fraud. The trial court first dismissed a count for common law fraud and then reinstated it. It further held that the parent, Transamerica, by reason of its control over the board of directors of the subsidiary, Axton-Fisher, was under a fiduciary obligation to the minority shareholders of Axton-Fisher.[83]

The plaintiffs alleged a fraudulent act in the *Speed* case in that Transamerica had caused a 1941 Annual Report of Axton-Fisher to be distributed to Axton-Fisher shareholders, showing the average inventory cost of Axton-Fisher to be $7.5 million while it had a real value of $17 million. There was a finding that this statement was released at a time when the defendant had a secret, undisclosed intent to liquidate Axton-Fisher and realize the profit on the tobacco inventory. For this reason, the statements made were found to be misleading. Such misleading statements, half-truths, were found to be a case of fraud and deceit at common law and under subparagraph (b) of rule X-10B-5 which makes it illegal "to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading.[84]

The court went on, however, to point out that the mere non-disclosure of the intent to liquidate Axton-Fisher to capture the inventory appreciation violated subparagraphs (a) and (c) of rule X-10B-5. The non-disclosures were considered a scheme to defraud. It is clear from Judge Leahy's statements that he considers rule X-10B-5 to create af-

80 Supra note 23.
81 Kardon v. National Gypsum Co., 73 F. Supp. 798, 800 (E.D. Pa. 1947).
82 99 F. Supp. 808 (D. Del. 1951), supplemented, 100 F. Supp. 461, rehearing denied at 463 (D. Del. 1951), motion denied, 103 F. Supp. 47 (D. Del. 1952). For opinion on motion for summary judgment, see 71 F. Supp. 457 (D. Del. 1947). For opinion on damages, see 135 F. Supp. 176 (D. Del. 1955), modified and affirmed, 235 F.2d 369 (3d Cir. 1956).
83 99 F. Supp. 808, 849.
84 Id. at 828, 829.

firmative duties of disclosure on corporate insiders when purchasing shares.[85]

Further authority that rule X-10B-5 puts a fiduciary duty of disclosure on corporate insiders purchasing outstanding shares is found in the recent case of *Reed v. Riddle Airlines*.[86] Riddle, the president of the corporation, purchased stock from Reed, a minority shareholder, and allegedly induced the sale by the fraudulent misrepresentation that there was no market for the stock. The trial court found for defendant, holding that the misrepresentation had not occurred and that Reed had learned prior to his selling that a third party, Davis, was interested in purchasing control of the firm. The Court of Appeals affirmed, but held that Riddle was excused from his affirmative duty to disclose to Reed that Davis was interested in purchasing it only because Reed was found to have known this fact already. The appeals court thus held that the insider had a fiduciary duty to disclose all material facts he knew about the value of the stock. It held that rule X-10B-5 incorporates this duty, which the same court had previously held to be the law of Louisiana in the *Mansfield* case.[87]

SUMMARY

Unquestionably, the law relating to the duties of disclosure on corporate insiders when purchasing outstanding shares has long been and still is in an unsettled state. The majority of state courts continue to hold that the corporate insider has no fiduciary duties of disclosure to individual shareholders from whom he purchases shares. A growing minority of state courts, however, hold that, because of his superior access to information, the corporate insider does have a fiduciary duty here to make affirmative disclosures to the selling sharcholder. Although most of these cases have involved active fraud by corporate insiders, the courts have chosen to rest their decisions primarily on an equitable duty of dis-

[85] It is unlawful for an insider, such as a majority stockholder, to purchase the stock of minority stockholders without disclosing material facts affecting the value of the stock, known to the majority stockholders by virtue of their inside position but not known to the selling minority stockholders, which information would have affected the judgment of the sellers. The duty of disclosure stems from the necessity of preventing a corporate insider from utilizing his position to take unfair advantage of the uninformed minority stockholders. It is an attempt to provide some degree of equalization of bargaining position in order that the minority may exercise an informed judgment in any such transaction. Some courts have called this a fiduciary duty while others state it is a duty imposed by the "special circumstances". One of the primary purposes of the Securities Exchange Act of 1934, 15 U.S.C. § 78a et. seq., was to outlaw the use of inside information by corporate officers and principal stockholders for their own financial advantage to the detriment of uninformed public security holders. Speed v. Transamerica Corp., 99 F. Supp. 808, 828-29.

[86] 266 F.2d 314 (5th Cir. 1959).

[87] Mansfield Hardwood Lumber Co. v. Johnson, 263 F.2d 748 (5th Cir. 1959). See page 61, supra, for a discussion of this case.

closure that puts the main burden of persuasion on the corporate insider. The SEC and some federal courts have interpreted the anti-fraud provisions of section 10(b) of the Securities Exchange Act and SEC rule X-10B-5 to create a federal cause of action in selling shareholders against corporate insiders who purchase their shares without disclosing special facts they have learned by virtue of their inside position. One must conclude that both state and federal courts have established a trend toward extending the fiduciary duties of disclosure on corporate insiders to individual stockholders from whom they buy shares.

The aspect of fiduciary law that seems most logically applicable in this situation is the one that has been most neglected in the cases. The argument is that since the insider uses a corporate asset, corporate inside information, to speculate for his personal profit, he violates his fiduciary duty to the corporation. Nevertheless, the few courts that have dealt with the problem have denied corporate recovery, reasoning that speculation in its own stock is not a corporate function. It is submitted that this reasoning obscures the real issue. An agent's use of his principal's assets for his own personal gain *ipso facto* creates unjust enrichment and constitutes a violation of fiduciary responsibility. One can only conclude that the courts have erred in denying corporate recovery of profits made by officers and directors by speculating in the stock of their corporation without consent of the board of directors.

Section 16(b) of the Securities Exchange Act, which allows corporate recovery of an insider's profits, is based on a theory that corporate inside information is corporate property and that it is subject to the traditional fiduciary duty. Its limited application to stock traded on a national exchange and held for less than six months makes section 16(b) no substitute for a general fiduciary duty to the corporation in this area.

The related problems of purchases of outstanding shares by corporations themselves or by insiders with consent of their corporations cannot be satisfactorily treated under established fiduciary law. To the extent that an exceptional opportunity for security manipulation exists in such transactions, they should be controlled by state and federal statutes aimed at the specific wrongs. It is submitted that the purchase of shares by corporations or insiders usually does not involve the placing of trust by the selling shareholder. For this reason, extensions of equitable fiduciary doctrines or expanded application of federal anti-fraud statutes are not appropriate remedies.