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Whistle Blowing as a Rule 10b-5 Violation: *Dirks v. SEC*

Wendy Ehrenkranz

Whistle Blowing as a Rule 10b-5 Violation: *Dirks v. SEC*

A diligent securities analyst who in the normal course of his work ferrets out evidence of fraudulent activity within a corporation may not disseminate such information to his clients, despite his numerous attempts to have regulatory agencies and the *Wall Street Journal* disclose the news of the corporate corruption to the general public. Rather, he must refrain from advising his clients to sell their stock until it loses most or all of its value.

This remarkable rule of law is currently being urged by the Securities and Exchange Commission, albeit in a more ingenuous formulation, upon the United States Supreme Court in *Dirks v. SEC*.[1] If the Supreme Court adopts this position, it will represent a complete departure from the prevailing law of liability for insider trading under rule 10b-5[2] of the Securities Exchange Act of 1934.[3]

I. The Factual Setting of *Dirks*

On March 7, 1973, Raymond Dirks, a highly regarded analyst of insurance company securities, was contacted by a former executive of the Equity Funding Corporation of America ("Equity Fund-

1. 681 F.2d 824 (D.C. Cir. 1982), *aff'g* [1981 Transfer Binder] Fed. Sec. L. Rep. ¶ 82,812 (SEC Jan. 22, 1981), *cert. granted*, 103 S. Ct. 371 (1982).

2. 17 C.F.R. § 240.10b-5 (1981). Rule 10b-5 provides,

> 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,
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> (a) To employ any device, scheme, or artifice to defraud,
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> (b) To make any untrue statement of any material fact or to omit to state a material fact necessary in order to make the statement made, in the light of the circumstances under which they were made, not misleading,
>
> (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.

3. Section 10(b) of the Securities Exchange Act of 1934 provides,

> 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—
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> (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 manipulation 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.

15 U.S.C. § 78j(b) (1976).

ing"), an insurance holding company listed on the New York Stock Exchange.[4] The executive told Dirks an incredible story of massive fraud involving, among other things, the creation and booking of fictitious insurance policies by Equity Funding.[5] The informant had also approached a New York State regulatory agency earlier that day to report his knowledge of the alleged fraud.[6] The executive did not contact the SEC, assuming that such an approach would be fruitless because of the Commission's failure to investigate several earlier complaints by Equity Funding employees regarding the allegedly fraudulent practices.[7]

When the informant departed after his three-and-a-half hour recital of the allegedly criminal practices at Equity Funding,[8] Dirks decided to investigate. After his initial inquiries directed to members of the Wall Street investment community failed to elicit any explanation of the alleged fraud, Dirks flew to Los Angeles, where he interviewed some members of the senior management of Equity Funding and additional former employees during the week of March 19, 1973. Despite the denial by Equity Funding management of any wrongdoing and the purported ignorance of its auditors, Dirks obtained substantial corroboration of the initial allegations from former Equity Funding employees.[9] Between March 21 and 24, Dirks repeatedly tried to persuade the *Wall Street Journal* to print a story about the alleged Equity Funding fraud. The Los Angeles bureau chief refused to publish such a story because he thought that the publication of the former employee's hearsay evidence would be libelous. The bureau chief urged Dirks, however, to brief the SEC on the allegations.[10] Dirks contacted the SEC on March 27 and spent two days presenting his information to the Commission.[11]

Throughout his three-week investigation, Dirks contacted a number of Wall Street analysts and investors to substantiate ru-

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4. 681 F.2d at 829.

5. *Id.* at 829-31.

6. The former executive met with the New York Insurance Department and alleged that false, nonexistent insurance policies on the books of Equity Funding were being sold to reinsurers. Dirks was not aware of this communication for nearly two weeks, well after he began investigating the fraud. *Id.* at 832 n.6.

7. *Id.*

8. *See In re* Boston Co. Institutional Investors, Inc., [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 81,705, at 80,838 (SEC, Sept. 1, 1978).

9. 681 F.2d at 830-31.

10. *Id.* at 831-32; *In re* Boston Co. Institutional Investors, Inc., [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 81,705, at 80,844-45 (SEC Sept. 1, 1978).

11. 681 F.2d at 832.

mors, to provide information to clients or potential clients, and to respond to others inquiring about the possible fraud. Five of the investment advisors contacted by Dirks liquidated their holdings in Equity Funding, while other investors purchased stock or maintained their positions.[12] Within little more than two weeks after the securities analyst began his investigation, the price of Equity Funding stock fell by almost half its pre-investigation market price. The New York Stock Exchange halted trading in Equity Funding stock on March 27, 1973. The following day, the SEC followed suit and suspended trading in the stock for a ten-day period.[13] Within a few days, a state insurance regulatory authority, alerted by the New York agency to which Dirks's initial informant had first spoken, uncovered evidence of asset manipulation in Illinois.[14] The *Wall Street Journal* finally published a story concerning the scandal, which earned the author a nomination for a Pulitzer Prize.[15] Three days later, Equity Funding filed for bankruptcy.[16] After public revelation of the fraudulent scheme, twenty-two Equity Funding defendants were ultimately convicted on various criminal charges.[17]

The Division of Enforcement of the SEC charged Dirks with violating rule 10b-5 and aiding and abetting violations of section 10(b), rule 10b-5, and section 17(a)[18] of the federal securities laws because he had repeated the allegations of fraud to the five institu-

12. *Id.* at 831 & n.4.

13. *Id.* at 832.

14. The New York State Insurance Commission informed the California Insurance Department of the former executive's allegations because the California agency had jurisdiction over Equity Funding. The California insurance authority then contacted the Illinois Insurance Department, which uncovered the first hard evidence of fraud. *Id.* at 832 n.6.

15. Blundell, *A Scandal Unfolds: Some Assets Missing, Insurance Called Bogus At Equity Funding Life*, Wall St. J., Apr. 2, 1973, at 1, col. 6.

16. 681 F.2d at 832.

17. Wright, *22 Indicted by U.S. in Equity Scandal*, N.Y. Times, Nov. 22, 1973, at 1, col. 1.

18. Section 17(a) of the Securities Act of 1933 provides,

> It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly—
>
> (1) to employ any device, scheme, or artifice to defraud, or
>
> (2) to obtain money or property by means of any untrue statement of a material fact or any omission 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
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> (3) to engage in any transaction, practice or course of business which operates or would operate as a fraud or deceit upon the purchaser.

15 U.S.C. § 77q(a) (1976).

tional investors who liquidated their Equity Funding holdings before public disclosure of the fraud.[19] The administrative law judge found that Dirks had violated the federal securities laws as alleged by the Division of Enforcement and suspended him from associating with any broker or dealer for sixty days.[20] On review, the Commission affirmed the administrative finding that the securities analyst was a tippee of confidential corporate information[21] who had aided and abetted violations of the federal securities laws by his investor clients.[22] In view of the significant contribution made by the securities analyst to the discovery of the fraud and his attempts to effect public disclosure, the SEC reduced the sanction to a censure.[23]

II. The Tippee's Disclose-or-Refrain Duty

On appeal, a divided panel of the United States Court of Appeals for the District of Columbia Circuit affirmed the SEC decision.[24] The court held that Dirks aided and abetted his clients' violations of rule 10b-5 when he informed them of the alleged fraud without disclosing such knowledge to the public and the SEC.[25] Writing for the court, Judge Wright conceded that Dirks was responsible for exposing "one of the most infamous frauds in recent memory," which "the SEC repeatedly missed opportunities to investigate."[26] The court rejected Dirks's contention that he had no fiduciary obligation to uninformed shareholders to keep his knowledge of the fraud to himself. Judge Wright recognized that the fiduciary framework of *Chiarella v. United States*[27] imposed a disclose-or-refrain duty only on those parties bound by relationships

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19. *In re* Boston Co. Institutional Investors, Inc., [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 81,705 (SEC Sept. 1, 1978).

20. *Id.* at 80,846-67. Four of the five investors who sold Equity Funding stock after learning of the fraud from Dirks were also found to have violated the securities laws.

21. *Id.* at 83,947-49.

22. *In re* Dirks, SEC Exchange Act Release No. 17,480, [1981 Transfer Binder] Fed. Sec. L. Rep. ¶ 82,812 (Jan. 22, 1981), *aff'd*, 681 F.2d 824 (D.C. Cir.), *cert. granted*, 103 S. Ct. 371 (1982). The investors censured in the administrative proceeding did not seek review of the administrative law judge's initial decision. The Commission only addressed the liability of Dirks for aiding and abetting the various violations of his investor clients. Implicitly rejected was the administrative finding that the securities analyst directly violated rule 10b-5.

23. *Id.* at 83,950-51.

24. Dirks v. SEC, 681 F.2d 824 (D.C. Cir. 1982), *aff'g* [1981 Transfer Binder] Fed. Sec. L. Rep. ¶ 82,812 (SEC Jan. 22, 1981), *cert. granted*, 103 S. Ct. 371 (1982).

25. 681 F.2d at 837-42, 844-46.

26. *Id.* at 829.

27. 445 U.S. 222 (1980).

of trust or confidence to potentially injured shareholders.[28] Judge Wright maintained that Dirks inherited such a duty when he received information about the possible fraud, even though under California corporation law his informants breached no confidential duty to the corporation or its shareholders by disclosing their allegations of corporate corruption.[29] Stating that the state law of fiduciary relations was not coextensive with the duty to disclose under rule 10b-5, Judge Wright reasoned that *Chiarella* merely required the existence of fiduciary obligations, not the breach thereof;[30] Dirks's informants, in Judge Wright's view, could not legally have traded on their knowledge of fraud because they remained fiduciaries of Equity Funding and its shareholders.[31] Therefore, reasoned Judge Wright, the securities analyst and his investor clients had a duty not to profit as tippees of the information, even though they received the information lawfully.[32] Despite his explicit acknowledgment of Dirks's various attempts to effect public disclosure and the securities analyst's critical role in uncovering the massive fraud, Judge Wright concluded that the securities analyst aided and abetted violations of rule 10b-5 by disseminating the allegations of fraud to investors likely to trade on the information.[33]

III. The Fiduciary Rationale Before *Dirks*

The circumstances in which an individual possessing material nonpublic information is deemed an insider subject to the disclosure requirement of rule 10b-5 have evoked considerable debate.[34]

28. 681 F.2d at 837.

29. *Id.* at 838-39.

30. *Id.* at 837-38.

31. *Id.* at 839. The opinion assumed that Dirks's informants retained a fiduciary obligation not to trade on their knowledge of the fraud even though their dissemination of the information to Dirks was lawful. The question whether secret trading by the corporate insiders themselves would have been illegal remains unresolved. *See id.* at 838 n.15.

32. *See id.* at 838-39.

33. *Id.* at 842, 844-46. Judge Wright advanced an alternative theory of liability by finding that Dirks had an ethical duty to disclose that was "implicit in the scheme of broker-dealer registration under the federal securities laws . . . even if we would not impose it on his sources at Equity Funding." *Id.* at 840. The doctrinal support for the broker-dealer registration laws as a source of a duty not to disclose seems questionable. The theory is unlikely to receive serious consideration by the Supreme Court because the SEC never pressed this argument throughout the proceedings.

34. *See* Barry, *The Economics of Outside Information and Rule 10b-5,* 129 U. PA. L. REV. 1308 (1981); Brudney, *Insiders, Outsiders, and Informational Advantages under the Federal Securities Laws,* 93 HARV. L. REV. 322 (1979); Fleischer, Mundheim & Murphy, *An Initial Inquiry into the Responsibility to Disclose Market Information,* 121 U. PA. L. REV.

Although rule 10b-5 has its origins in the fiduciary principles embedded in common law fraud and state corporation codes, the scope of the duty to disclose has been broadened to include persons other than corporate directors, executives, and controlling shareholders.[35] This development is attributable principally to the SEC's grafting of the goal of equalizing the availability of market information onto the twin legislative objectives of the federal securities laws: promoting investor confidence and the efficient functioning of capital markets.[36]

In the landmark case of *In re Cady, Roberts & Co.,*[37] the SEC interpreted rule 10b-5 as prohibiting corporate insiders from trading on inside information without public disclosure. The Commission set forth two rationales for the disclose-or-refrain rule: (1) Corporate insiders have access to information intended to be used only for corporate purposes and not for personal benefit, and (2) the use by insiders of legally unavailable information is inherently unfair to investors without access to such information.[38] *Cady, Roberts* involved an individual who was both a director of a corporation and a partner in a brokerage firm and who used undisclosed corporate information to benefit the brokerage firm's clients. The director-broker could have been held liable under rule 10b-5 on the narrower ground of a breach of fiduciary duty. The language of the SEC decision, however, supported a broader interpretation of rule 10b-5 under a fairness rationale.[39] In *SEC v. Texas Gulf Sulphur Co.,*[40] the United States Court of Appeals for the Second Circuit, employing a rationale similar to that of the Commission in *Cady, Roberts,* held that various corporate insiders had violated rule 10b-5 by trading on news certain to increase the worth of company stock when publicly disclosed. The Second Circuit found the harm to uninformed investors to be the inherent unfairness of the defendants' informational advantage. It did not condition the shareholders' right to information solely on the insiders' fiduciary ties to the

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798 (1973); Langevoort, *Insider Trading and the Fiduciary Principle: A Post-*Chiarella *Restatement,* 70 CALIF. L. REV. 1 (1982); *see also* Morgan, *The Insider Trading Rules After* Chiarella: *Are They Consistent with Statutory Policy?,* 33 HASTINGS L.J. 1407 (1982).

35. For a summary of the relationship between common law doctrines of fiduciary responsibility and the development of the law under rule 10b-5, see 3 L. LOSS, SECURITIES REGULATION 1445-56 (2d ed. 1961); 6 *id.* at 3556-72 (2d ed. Supp. 1969).

36. *See generally* Brudney, *supra* note 34, at 333-39.

37. 40 S.E.C. 907 (1961).

38. *Id.* at 912.

39. *See id.*

40. 401 F.2d 833 (2d Cir. 1968), *cert. denied,* 394 U.S. 976 (1969).

corporation and its shareholders.[41]

Consistent with its expansive interpretation of rule 10b-5, the Commission determined in *In re Investors Management, Inc.*[42] that tippees of corporate insiders were also subject to rule 10b-5.[43] Although unrelated by any relationship of trust to the corporation or its shareholders, the Commission considered the tippee to have inherited a duty to disclose or refrain from trading on confidential corporate information that the tippee should have known was improperly obtained. Because the nontrading informant could not lawfully profit from the information, his tippee was similarly prohibited from trading on the insider's tip.[44]

In most cases, the dissemination of corporate information by an insider to a tippee is an actual breach of the insider's fiduciary duty to the corporation or its shareholders. In some cases, however, tippee liability has been thought to result even when the communication of confidential information by a corporate insider is legitimate. The rationale for this variant theory of tippee liability is that the mere receipt of corporate confidential information imposes on the tippee a constructive fiduciary duty not to trade on the information without public disclosure. The validity of this alternative theory of tippee liability is open to doubt given the fiduciary principle adopted by the Supreme Court in *Chiarella*.[45]

In *Chiarella* the Supreme Court rejected the argument that rule 10b-5 was violated merely because a person obtained information not legally available to other diligent investors. The Court restricted the scope of rule 10b-5 to those persons owing fiduciary obligations to the corporation or its shareholders. The mere possession of nonpublic material market information, in the absence of any special relationship of trust or confidence, did not trigger a duty to disclose or refrain from trading on the information.[46]

Chiarella has had significant implications for all kinds of informational exchanges.[47] Any allegation of insider status or rule

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41. *See id.* at 848.

42. 44 S.E.C. 633 (1971).

43. The Second Circuit adopted the concept of tippee liability in Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, 495 F.2d 228 (2d Cir. 1974). *Shapiro* involved a civil action for damages brought by uninformed purchasers of stock.

44. 44 S.E.C. at 645-46.

45. *See infra* text accompanying notes 79-88.

46. 445 U.S. 222, 231-35 (1980).

47. *See* Staffin v. Greenberg, 672 F.2d 1196 (3d Cir. 1982); United States v. Newman, 664 F.2d 12 (2d Cir. 1981); State Teachers Retirement Bd. v. Fluor Corp., 654 F.2d 843 (2d Cir. 1981); Elkind v. Ligget & Myers, Inc., 635 F.2d 156 (2d Cir. 1980); Walton v. Morgan Stanley & Co., 623 F.2d 796 (2d Cir. 1980); SEC v. Lund, [1981-1982 Transfer Binder] FED.

10b-5 violations must be framed in terms of the fiduciary principle adopted by the Court in that case. Given the various concurring and dissenting opinions filed by the Justices, the parameters of the decision are unclear.[48] Subsequent lower court decisions, however, have consistently interpreted *Chiarella* as predicating liability for insider trading on the existence of a fiduciary relationship between the trader and the corporation from which the information was originally obtained.[49]

By restricting the scope of the disclose-or-refrain rule to parties bound by fiduciary relationships, the majority in *Chiarella* clouded[50] the precise cirumstances in which tippee communications result in liability for insider trading under rule 10b-5.[51] Writing for the Court in *Chiarella,* Justice Powell seemed to tolerate the inherent tension between the fiduciary rationale for the prohibition on insider trading and the disclosure duty of the tippee, unrelated to the corporation. In a footnote, Justice Powell alluded to a justification for tippee liability within the fiduciary framework by viewing a tippee "as a participant after the fact in the insider's breach of a fiduciary duty."[52] *Dirks* squarely presents the question of tippee liability within the fiduciary structure of *Chiarella* for review by the Supreme Court.[53]

SEC. L. REP. (CCH) ¶ 98,428 (C.D. Cal. Jan. 22, 1982); O'Connor & Assocs. v. Dean Witter Reynolds, Inc., [1981-1982 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 98,443 (S.D.N.Y. Dec. 30, 1981); SEC v. Finamerica Corp., SEC. REG. & L. REP. (BNA) No. 594, at A-5 (D.D.C. Mar. 11, 1981); Feldman v. Simkins Indus., 492 F. Supp. 839 (N.D. Cal. 1980), *aff'd,* 679 F.2d 1299 (9th Cir. 1982).

The decision in *Chiarella* has also received a great deal of scholarly comment. *See, e.g.,* Cann, *A Duty to Disclose? An Analysis of* Chiarella v. United States, 85 DICK. L. REV. 249 (1981); Deutsch, Chiarella v. United States: *A Study in Legal Style,* 56 TEX. L. REV. 1291 (1980); Langevoort, *supra* note 34; Morgan, *supra* note 34; Wang, *Trading on National Nonpublic Information on Impersonal Stock Markets: Who is Harmed, and Who Can Sue under SEC Rule 10b-5?,* 54 S. CAL. L. REV. 1217 (1981); Note, *The Trend Toward a Strict Construction of Rule 10b-5:* Aaron v. S.E.C. *and* Chiarella v. United States, 13 CONN. L. REV. 549 (1981); *see also* Heller, Chiarella, *SEC Rule 14e-3 and* Dirks: *"Fairness" versus Economic Theory,* 37 BUS. LAW. 517 (1982); Morrison, *Silence Is Golden: Trading on Non-Public Market Information,* 8 SEC. REG. L.J. 211 (1980).

48. *See* Barry, *supra* note 34, at 1313-14; Langevoort, *supra* note 34, at 17.

49. *See* cases cited *supra* note 47.

50. Under the misappropriation theory articulated by Chief Justice Burger, it would be more difficult to assert that Dirks was a tippee because he did not receive stolen information. *Cf.* United States v. Newman, 664 F.2d 12 (2d Cir. 1981).

51. *See* Langevoort, *supra* note 34, at 28-30.

52. 445 U.S. at 230 n.12.

53. The case evoked considerable comment at the agency and appellate levels. *See, e.g.,* Heller, *supra* note 47; Herman, *Equity Funding, Inside Information and the Regulators,* 21 U.C.L.A. L. REV. 1 (1973); Langevoort, *supra* note 34. The proceedings attained new significance when the Supreme Court granted Dirks's petition for certiorari, 103 S. Ct. 371 (1982),

Given the precedent discussed above, the District of Columbia Circuit's conclusion that Dirks had violated rule 10b-5 required one of two findings: (1) Dirks was a corporate insider; or (2) if not a corporate insider or one standing in some fiduciary relationship to the corporation or its shareholders, Dirks inherited a duty to the corporation as a tippee of corporate information. To be liable as a tippee under existing law, he must have acquired confidential corporate information from a corporate insider, directly or indirectly, and he must have known or reasonably should have known that the information was improperly obtained. The courts disagree on whether the initial informant must have actually breached a fiduciary obligation by disclosing the information to the tippee.[54] In the absence of any fiduciary duty not to disclose on the part of Dirks's informants, Dirks could not be deemed to have inherited, as a tippee, his informants' duty not to trade on their knowledge of the fraud.

Judge Wright's conclusion that Dirks became a tippee upon being told of the possible fraud[55] is flawed by the initial assumption that the analyst received inside information. Dirks never inherited a duty to disclose under rule 10b-5 because the allegations of fraud did not constitute inside information. California law exempted the informants from a breach of confidentiality, a fact that the SEC had conceded in the initial proceedings.[56] More important, as evidence of a crime, the allegations of possible fraud were not a corporate asset subject to misappropriation or wrongful withholding under agency or restitution principles.[57] Since the informa-

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and the Department of Justice endorsed the position of the securities analyst rather than that of the Commission.

The SEC was authorized to file a brief in opposition to Dirks's petition for certiorari, but the Solicitor General stated that in his view the opinion of the court of appeals conflicted with all five opinions—majority, concurring, and dissenting—in *Chiarella*. Brief of the SEC in Opposition to Petition for a Writ of Certiorari at 17-18, Dirks v. SEC, 103 S. Ct. 371 (1982). The Court heard oral argument in the case on Mar. 21, 1983. *Court Hears Whistle-Blower Case*, The Wash. Post, Mar. 22, 1983, at C7-C12; Greenhouse, *Dirks Gets His Day in Court*, N.Y. Times, Mar. 22, 1983 at D1, col. 3; *Ray Dirks Gets His Day in Court*, Bus. Wk., Mar. 21, 1983, at 130.

54. *See infra* text accompanying notes 77-86.

55. 681 F.2d at 838 & n.15.

56. *In re* Dirks, SEC Exchange Act Release No. 17,480, [1981 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,812, at 83,948 (SEC Jan. 22, 1981), *aff'd*, 681 F.2d 824 (D.C. Cir.), *cert. granted*, 103 S. Ct. 371 (1982).

57. All the previous cases finding tippee liability for violation of rule 10b-5 involved the dissemination for a noncorporate purpose of confidential information in which the corporation had a property right. By contrast, in *Dirks* information about fraud was criminal evidence, which could not be deemed the private property of Equity Funding or its corporate

tion conveyed by Dirks's informants failed to render the securities analyst a tippee, there was no source from which he could have inherited a fiduciary duty to Equity Funding's shareholders. Thus, the majority's conclusion that Dirks inherited his informants' duty to refrain from trading is wrong because it is premised on the incorrect assumption that Dirks was a tippee.

Judge Wright recognized that *Chiarella* required as a threshold finding that Dirks somehow inherited a fiduciary duty as a tippee since Dirks was not related in any way to Equity Funding's shareholders. Conceding that *Chiarella* did not sanction imposing liability on persons simply because they possessed informational advantages over other investors, the court struggled to find another source of the informants' duty for which Dirks was the conduit. Judge Wright's response was to assert that *Chiarella* did not require a breach of a fiduciary obligation but merely the *existence* of some fiduciary relationship.[58] Moreover, stated Judge Wright, the fiduciary duties of Dirks's informants were not coextensive with those imposed by state fiduciary law.[59]

Judge Wright's alleged distinction between the fiduciary duty itself and the breach of such duty is specious and constitutes no basis for tippee liability. The language of *Chiarella*,[60] when considered in the context of insider trading, necessarily implies that the use of inside information must constitute a breach of a fiduciary obligation to shareholders before rule 10b-5 will apply. A person obliged to act for the benefit of shareholders breaches a fiduciary duty to them when he trades on inside information without making public disclosure. In its brief discussion of tippee liability,[61] the Court in *Chiarella* suggested that an inside informant must have breached his duty by selectively disclosing the information to the tippee. Other federal courts that have interpreted *Chiarella*

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insiders. Under agency principles, Dirks's informant was entitled to disseminate the allegations to the analyst. *See* RESTATEMENT (SECOND) OF AGENCY § 395 comment f (1958). Analysis in terms of agency doctrine seems appropriate, given the fiduciary framework with which the *Chiarella* Court placed rule 10b-5 issues.

58. "The *Chiarella* majority focused on the existence of a set of fiduciary obligations as a prerequisite to the addition of a disclosure-or-refrain duty, but it did not hold that *breach* of the fiduciary obligations was required to bring Rule 10b-5 to bear on a case . . . ." 681 F.2d at 838 (emphasis in original).

59. "While the standards of Rule 10b-5 have always duplicated state fiduciary obligations to a certain extent, courts have never regarded the two as identical." *Id.*

60. "[A] purchaser of stock who has no duty to a prospective seller because he is neither an insider nor a fiduciary has been held to have no obligation to reveal material facts." 445 U.S. at 229.

61. 445 U.S. at 230 n.12.

broadly have done so only when the facts revealed a breach of a fiduciary obligation by the party charged with a rule 10b-5 violation.[62]

The precedents marshalled by Judge Wright in support of his assertion that the fiduciary duties of Dirks's informants need not parallel state fiduciary law provide no support at all. Several of the cited cases concerned outsiders who were fiduciaries of the injured investors by reason of preexisting relationships of trust or as a result of conduct that induced trust. In *SEC v. Capital Gains Research Bureau*,[63] *Affiliated Ute Citizens v. United States*,[64] *Chasins v. Smith, Barney & Co.*,[65] and *Zweig v. Hearst Corp.*,[66] undisclosed trading by investment advisors, market makers, and financial columnists, who were unrelated to the firms in whose stock they traded for their personal benefit, constituted deceptive practices banned by rule 10b-5. Such persons were fiduciaries of the shareholders, and their undisclosed trading violated their duty to provide disinterested financial advice. This basis for a duty to disclose has no analogue in Dirks's case, since the shareholders injured by the Equity Funding scandal were never clients of Dirks as an investment advisor. Furthermore, neither the analyst nor his firm owned any Equity Funding shares at any time.[67]

Most of the decisions cited by Judge Wright that did involve corporate insiders did not concern the application of rule 10b-5 as an enforcement mechanism against insider trading. In *Goldberg v. Meridor*,[68] the shareholders of a subsidiary firm invoked rule 10b-5 as a disclosure mechanism in a derivative action to supplement a state cause of action against the directors of the parent corporation for unfair valuation of assets. The Second Circuit in *Meridor* did not interpret rule 10b-5 as creating a fiduciary obligation or as mandating disclosure of information in the absence of a fiduciary duty. *Staffin v. Greenberg*,[69] which involved the purchase of stock by an outsider contemplating a corporate merger, merely restated the *Chiarella* rule that a party unrelated to the target corporation,

62. *See, e.g.*, United States v. Newman, 664 F.2d 12 (2d Cir. 1981); O'Connor & Assocs. v. Dean Witter Reynolds, Inc., [1981-1982 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 98,443 (S.D.N.Y. Dec. 30, 1981).

63. 375 U.S. 180 (1963).

64. 406 U.S. 128 (1972).

65. 438 F.2d 1167 (2d Cir. 1970).

66. 594 F.2d 1261 (9th Cir. 1979).

67. Greenhouse, *supra* note 53, at D2, col. 2.

68. 567 F.2d 209 (2d Cir. 1977), *cert. denied*, 434 U.S. 1069 (1978).

69. 672 F.2d 1196 (3d Cir. 1981).

whether as an insider, fiduciary, or tippee, need not disclose his reason for purchasing the corporation's stock.[70] In *United States v. Newman*,[71] the Second Circuit held former employees of an investment bank and a stockbroker liable for violating rule 10b-5 by stealing and then trading on information entrusted to the bank by its corporate clients. As agents of the employer bank, the employees breached their fiduciary obligation not to disseminate confidential information that the bank had received by virtue of its special trust relationship with its corporate clients.[72]

Judge Wright failed to establish that Dirks's informants were legally required, by virtue of some duty independent of state corporation law, to withhold the allegations of fraud. As a result, Dirks did not inherit a duty to refrain from disseminating the nonconfidential allegations. The SEC failed to establish the threshold requirement under *Chiarella*: that the securities analyst had a fiduciary duty to disclose to the public the Equity Funding fraud before advising his clients of the allegations. Accordingly, the Supreme Court should reverse the judgment below that Dirks aided and abetted violations of the federal securities laws.

IV. THE *Dirks* VARIATION—LIABILITY WITHOUT A BREACH OF DUTY

Judge Wright's opinion highlights the current uncertainty in the federal courts regarding the circumstances in which a tippee who legitimately received confidential information has a duty under rule 10b-5 to disclose the information or refrain from trading.[73] Since *Dirks* should turn on the threshold issue of whether Dirks's receipt of information about the fraud subjected him to tippee liablity,[74] the application of the fiduciary principle adopted in *Chiarella* to the theory of tippee liability may remain unresolved. If, however, the Supreme Court regards the information received by the securities analyst as confidential inside information disseminated to him by legitimate means, affirmance of the court of appeals would require the Supreme Court to adopt a constructive breach theory of tippee liability—thereby nullifying the re-

70. *Id.* at 1202.

71. 664 F.2d 12 (2d Cir. 1981).

72. *Id.* at 17, 19.

73. *Compare* SEC v. Lund, [1981-1982 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 98,428 (C.D. Cal. Jan. 22, 1982) *with* Walton v. Morgan Stanley & Co., 623 F.2d 796 (2d Cir. 1980).

74. *See supra* text accompanying notes 56-57.

quirement of a special relationship of trust or confidence between a corporation and a tippee.

Although the theory of tippee liability is necessary to prevent insiders from avoiding rule 10b-5 liability by trading secretly in concert with outsiders, such a theory is conceptually at odds with the *Chiarella* fiduciary principle.[75] This tension is reduced by viewing the tippee as a participant after the fact in his informant's breach of duty, assuming that the tipper's communication with the tippee in fact constituted a breach of some duty not to disclose the particular information. The court in *Dirks* instead adopted a constructive breach theory of tippee liability under which Dirks was deemed a quasi-fiduciary of Equity Funding's shareholders.[76]

The constructive breach theory is derived from restitution and trust law principles of unjust enrichment and has been approved by only one federal court of appeals, the District of Columbia Circuit in *Dirks*.[77] The Second Circuit has explicitly rejected the constructive breach theory.[78] The precedent for such a theory is particularly dubious in light of *Chiarella*. The seminal tippee liability decisions, *Investors Management*[79] and *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith*,[80] involved persons who acquired confidential information as a result of an insider's breach of his fiduciary duty. These cases do not provide adequate support for the constructive breach theory. Although the requirement of an actual breach is not specified, there was no reason for the SEC to have done so. In both decisions, tippees received confidential information from a corporate insider. The majority opinion in *Investors Management* articulated a test that, loosely stated, can certainly be read to require an actual breach by the tipper.[81] *Investors Management* requires that the tippee's information be improperly obtained and "emanate" from a corporate source.[82] The concurring opinion urged more specifically the requirement that tippee liabil-

75. *See* Langevoort, *supra* note 34, at 28-32.

76. The court implicitly adopted this theory by rejecting the actual breach requirement and relying on general trust doctrines as well as authorities supporting a constructive breach theory of tippee liability. *See* 681 F.2d at 839 & n.16.

77. The D.C. Circuit in *Dirks* joined a California federal district court that had adopted a constructive breach theory in SEC v. Lund, [1981-1982 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 98,428 (C.D. Cal. Jan. 22, 1982).

78. Walton v. Morgan Stanley & Co., 623 F.2d 796 (2d Cir. 1980).

79. 44 S.E.C. 633 (1971).

80. 495 F.2d 228 (2d Cir. 1974); *see supra* text accompanying notes 42-44.

81. *See* Fleischer, *supra* note 34, at 806-07.

82. *Investors Management*, 44 S.E.C. at 644.

ity hinge on the corporate insider's breach of duty.[83] Because Justice Powell's explanation in *Chiarella* of tippee liability tracks the language of the *Investors Management* concurring opinion more nearly than it follows the majority opinion in *Investors Management* or the Second Circuit decision in *Shapiro*,[84] Judge Wright's dismissal of *Chiarella* as support for the actual breach theory of tippee liability is ingenuous.

After *Chiarella* the continued validity of the constructive breach theory of rule 10b-5 liability is questionable because that theory replaces the *Chiarella* requirement of a preexisting fiduciary relationship with a concept of liability based on the tippee's relative informational advantage in an arm's-length context.[85] Under the constructive breach theory, the receipt of confidential information renders the recipient the shareholders' constructive trustee, who may not profit from the information despite the absence of a relationship between the tippee and the shareholders or any wrongdoing on the informant's part. The Court in *Chiarella* refused to transform the informational advantage gained by the mere receipt of information in a legitimate manner into a duty to disclose or refrain from trading on the information.[86] The constructive breach theory thus undermines the Supreme Court's rejection of the use of rule 10b-5 as a "parity-of-information"[87] tool.

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83. Commissioner Smith stated,

> It is important in this type of case to focus on policing insiders and what they do, which I think appropriate, rather than on policing information *per se* and its possession, which I think impracticable. I believe the emphasis in the law should continue to be upon the conduct of corporate insiders and their privies . . . rather than upon a concept—too vague for me to apply with any consistency—of relative informational advantages in the marketplace.
>
> . . . .
>
> [T]ippee responsibility must be related back to insider responsibility by a necessary finding that the tippee knew the information was given to him in breach of a duty by a person having a special relationship to the issuer not to disclose the information . . . .

Id. at 651 (Smith, Comm'r, concurring).

84. *Investors Management* and *Shapiro* arose from the same occurrence in which a financial analyst with Merrill Lynch, the prospective managing underwriter for Douglas Aircraft Company, tipped investor clients as to an as-yet unannounced reduction in Douglas's earnings. The Second Circuit adopted the broader view of the SEC majority opinion in *Investors Management.*

85. The constructive breach theory may be viewed as an attempt to achieve the policy goals of the "information" theory while employing the "fiduciary" language of *Chiarella. Cf. Dirks,* 681 F.2d at 835 n.4 (discussing inherent tension between the two theories).

86. *See* 445 U.S. at 231 n.14.

87. *See id.* at 233.

V. THE DETECTION OF SECURITIES FRAUD AFTER *Dirks*

From a policy standpoint, the *Dirks* decision adversely affects investor confidence and the efficient allocation of capital. The result in *Dirks* would inhibit informational exchanges between securities analysts and corporate sources, thus diminishing the ability of investors to make informed decisions based on investment advice. Investors would then be forced to rely solely on the investigative efforts of the SEC for detection of fraudulent securities transactions. The proceedings against Dirks highlight the dangers inherent in relying on the SEC to uncover securities fraud and illustrate the critical role of private initiative as a supplement to federal criminal investigation. *Dirks* raises the question of how best to investigate massive, skillfully orchestrated fraud at the smallest social cost and with the least unfairness to uninformed shareholders.

The social costs of large-scale securities fraud are substantial, whether measured against the risk of a libel suit following publication of allegations of possible fraud, increased budgetary allocations to state and federal enforcement agencies, or the expense of private investigations by unremunerated parties. The cost of permitting private individuals, such as the securities analyst in *Dirks*, to disseminate the results of their investigations of large-scale fraud undiscovered by the SEC is justified by the benefit to society of early detection of the fraud.

Another goal of the securities laws, of course, is the promotion of fairness in securities transactions. This objective is not disserved by allowing private individuals to profit from their efforts at uncovering fraud by disseminating the information as investment advice. First, the speed with which the information is disseminated permits securities to reach their true market value quickly, avoiding unnecessary outlays of funds by uninformed investors.[88] Second, the large institutional investors that benefit from professional investment advice indirectly represent the pooled interests of millions of small investors holding stock in mutual funds, pension plans, or insurance companies. To the extent that uninformed individual investors with small holdings invest in the same companies as do their informed investment or portfolio managers, they are not harmed by the absence of public disclosure. In this circumstance, the windfall gain of the institutional investor passes indirectly to the individual investor who does not personally receive

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88. This assumes the validity of some form of the efficient capital markets hypothesis. For a discussion of the variants of this theory, see Barry, *supra* note 34, at 1330-59.

the advice of a securities analyst. This proposition is difficult to establish as a justification for future private investigations such as the one in *Dirks*. This rationale is, however, appropriate in view of the current market, which is dominated by a few large institutional investors.[89]

Dirks illustrates several ways in which a rule encouraging extragovernmental investigation of securities fraud would foster investor confidence. First, the securities analyst uncovered the fraudulent scheme much sooner than did the SEC.[90] Second, Dirks's efforts led eventually to the public revelation of the scandal and the conviction and punishment of the criminals at Equity Funding.[91] In terms of social gain, Dirks's discovery of the fraud fulfilled the goal of punishing miscreants who waste scarce resources by causing uninformed investors to buy worthless securities. It is also conceivable that similar investigations, motivated by the prospect of financial gain, will deter those who might otherwise concoct schemes such as the Equity Funding fraud. The result should be fewer frauds, or at least more rapid detection. Removing the financial incentive to private individuals to investigate securities fraud would discourage persons from undertaking costly private investigations. This would undermine significantly the federal criminal enforcement effort against securities fraud.

The censure of Dirks deals a serious blow to the right of investors to substitute insurance, in the form of professional investment advice, for the risk of making uninformed investment decisions.[92] The right to insure against such risks is inherent in our legal system, which gives property owners the right to protect their interests from injury caused by wasteful behavior as well as from loss caused by property destruction or theft. Seeking professional securities advice is analogous to using private security guards as a supplement to state and federal police; it provides information to investors who wish to avoid quantifiable, probable losses and wasteful use of their resources. Until *Dirks*, not even the SEC has argued that securities analysts, or their clients who pay for the analysts' expert advice, must disclose lawfully acquired information to other investors who are unable or unwilling to pay for the

89. *Id.* at 1309 n.9.

90. *See* 681 F.2d at 832 n.6.

91. *See supra* text accompanying notes 11-17.

92. The individual purchase of privately produced securities information is often justified by the significant social benefit the information provides. *See, e.g.*, Barry, *supra* note 34, at 1323-28.

advice.[93]

VI. Conclusion

The decision of the District of Columbia Circuit in *Dirks* is incorrect because Dirks neither owed nor breached a fiduciary duty to Equity Funding or its shareholders. *Chiarella* suggests that even if Dirks did inherit a duty as a tippee, he still should not have been found liable under rule 10b-5, since no wrongdoing by Dirks's informants was effected in connection with his receipt of the information.

Although the securities analyst in *Dirks* attempted to effect public disclosure, he violated no duty in relating the information to his own clients before the general public learned of the fraud. Dirks had no relationship of trust or confidence with Equity Funding shareholders, no duty to them, and never received confidential inside information. Whistle-blowing is a necessary function of securities analysts, permitting the rapid valuation of securities and supplementing the woefully inadequate regulation of securities fraud by federal enforcement agencies.[94]

Wendy Ehrenkranz

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93. *See* SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968), *cert. denied,* 404 U.S. 1005 (1971); *In re* Cady, Roberts & Co., 40 S.E.C. 907 (1961); *see also* Brudney, *supra* note 34, at 361-62.

94. For a discussion of the history of SEC enforcement actions, see J. Seligman, The Transformation: The History of the Securities and Exchange Commission and Corporate Finance (1981).

Editor's Note—

On July 1, 1983, during the printing of this issue, the United States Supreme Court held that Raymond Dirks "had no duty to abstain from use of the inside information that he obtained." *Dirks v. SEC*, 51 U.S.L.W. 5123, 5129 (U.S. July 1, 1983) (No. 82-276). The Court reasoned, as did the author of this casenote, that

> Dirks himself was a stranger to Equity Funding, with no preexisting fiduciary duty to its shareholders. He took no action, directly or indirectly, that induced the shareholders or officers of Equity Funding to repose trust or confidence in him. There was no expectation by Dirk's [sic] sources that he would keep their information in confidence.

Id. at 5128.