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A Tippee's Duty to Disclose Under Rule 10B-5: Dirks v. S.E.C.

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NOTES

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INTRODUCTION

In recent years, the Supreme Court has attempted to restrict application of Section 10(b)[1] of the Security Exchange Act of 1934 and Rule 10b-5[2] with regard to tipper[3] and tippee[4] liability for trading on material, nonpublic corporate information. Most recently, in *Dirks v. S.E.C.*,[5] the Court preserved this pattern when it delineated

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1. Section 10(b) and Rule 10b-5 of the 1934 Securities Exchange Act have become the primary tools in preventing fraud in insider trading. The pertinent part of § 10(b), 15 U.S.C. § 78(j) (1976), reads:

> 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: . . . 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.

2. Rule 10b-5, 17 C.F.R. § 240.10b-5 (1984), states:

> 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 statement made, in 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.

Section 10(b) and Rule 10b-5 have become the kernels of all antifraud actions brought either privately or by the SEC. Glickman, *"Tippee" Liability Under Section 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934*, 20 KAN. L. REV. 47 n.4 (1971). They are broad remedial provisions which are designed "to protect the investing public and to secure fair dealing in the securities markets by promoting full disclosure of inside information so that an informed judgment can be made by all investors who trade in such markets." Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228, 235 (2d Cir. 1974); *In re* Cady Roberts & Co., 40 S.E.C. 907, 910 (1961).

3. Tippers are persons who possess material inside information and also selectively disclose it. Tarasi v. Pittsburg Nat'l Bank, 555 F.2d 1152, 1154 n.1 (3d Cir. 1977), *cert. denied*, 434 U.S. 965 (1977). Courts regularly substitute the term insider for tipper. Insiders have knowledge of facts not available to the general public. 15 U.S.C. § 78p(a). Upon conveying it to a tippee, the insider becomes a tipper. For simplicity, this Note will use the term insider as it is more inclusive.

4. A tippee can be characterized as a person who receives material inside information from a corporate insider or from another tippee. 5A A. JACOBS, THE IMPACT OF RULE 10B-5 § 66.02 (rev. ed. 1980).

5. 103 S. Ct. 3255 (1983).

a new, restricted standard for tippee liability. The Court held that a tippee becomes obligated by a duty to publicly disclose the inside information,[6] only when two events have occurred. First, the insider who disclosed the information to the tippee, must have breached a pre-existing fiduciary duty owed to the corporation. This duty is not breached unless the insider derived a personal benefit from his disclosure. Second, the tippee must have known or have had constructive knowledge of the insider's breach.[7] This Note will retrace the history of the cases which collectively created the standard for tippee liability prior to *Dirks*. It will then analyze the resulting standards under *Dirks* and identify two issues left unresolved by the Supreme Court. Finally, an alternative solution to the *Dirks* holding will be presented.

I. HISTORY OF TIPPEE LIABILITY UNDER RULE 10B-5

A. *In Re Cady, Roberts & Company*

One of the primary contributions to the expansion of Rule 10b-5 liability to persons traditionally not considered insiders was *Cady, Roberts & Co.*.[8] The SEC[9] in *Cady* held that insiders have an affirmative duty to disclose material facts prior to trading, which are known to them by virtue of their position, but which are unknown to persons with whom they deal. In the alternative, the Commission asserted that the insider may simply refrain from trading.[10] The Commission found, however, that this duty to "disclose or refrain" was not limited to traditional insiders.[11] Since the duty is a result of the unfairness which exists when one trader has information obtained through his relationship with the corporation, which he uses to his advantage, the duty to disclose or refrain will be imposed on all persons who are in a special relationship with the

6. Inside or insider information is a common term used for nonpublic corporate information.
7. 103 S. Ct. at 3264.
8. *In re* Cady, Roberts & Co., 40 S.E.C. 907 (1961).
9. SEC refers to the Securities Exchange Commission.
10. 40 S.E.C. at 911.
11. *Id.* Although the court used the term "insider" in its formulation of a rule, it asserted that corporate insiders, (e.g., officers, directors, and controlling stockholders) did not exhaust the class of persons upon whom the duty was placed. "Analytically, the obligation rests on two principal elements; first, the existence of a relationship giving access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone, and second, the inherent unfairness involved where a party takes advantage of such information knowing it is unavailable to those with whom he is dealing." *Id.* at 912. Under the pre-*Chiarella* case law, anyone having access to material inside information assumed the status of an insider and the accompanying duty of disclosure. Glickman, *"Tippee" Liability Under Section 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934*, 20 KAN. L. REV. 47, 48 (1971).

corporation.[12]

In *Cady*, the SEC imposed this duty on Robert Gintel, a partner of a registered broker-dealer, for trading on information received from his partner, J. Cheever Cowdin, a director of the Curtis-Wright Corporation.[13] The SEC found that since Gintel's partner, Cowdin, was a director of Curtis-Wright, his relationship with the company clearly prevented him from trading on the undisclosed information.[14] Gintel, in contrast, had no independent relationship with Curtis-Wright; however, his association with Cowdin as a partner provided him with access to the company's internal affairs. As a consequence, the Commission held that Cowdin's relationship with Curtis-Wright also prohibited Gintel from trading on the company's nonpublic information.[15] Although Gintel was labeled neither an insider nor a tippee, the Commission found that he had acquired an insider's duty to disclose or refrain. Since he failed to disclose the information regarding the Curtis-Wright dividend reduction before trading, he violated Rule 10b-5.[16]

Cady has become famous essentially for having laid down the disclose or refrain duty mentioned above. However, the application of a duty to fraudulent trading by non-insiders, such as tippees, was still uncertain after *Cady* since the Commission failed to identify the precise status of Gintel.[17] Although the issue of tippee liability was not before it, the Second Circuit Court of Appeals in *Texas Gulf Sulphur*,[18] nevertheless took the opportunity to voice its opinion as to the applicability of the *Cady* duty to tippees. The Court noted

12. The relationship which the Commission asserts gives rise to a duty is "a special relationship with a company" in which the insider is "privy to its internal affairs," *Cady*, 40 S.E.C. at 912. This element was essentially ignored by subsequent courts until the United States Supreme Court firmly implanted it in its standard in Chiarella v. United States, 445 U.S. 222 (1980). *See infra* notes 44-75 and accompanying text.

13. *Cady*, 40 S.E.C. at 912. The "tip" consisted of information that the directors of Curtis-Wright were about to publicly announce their decision to reduce the company's quarterly dividend. Upon being informed of the dividend reduction, Gintel, the broker, sold on behalf of his clients, 2,000 shares of Curtis-Wright stock and sold short an additional 5,000 shares. *Id.*

14. *Id.*

15. *Id.*

16. *Id.*

17. *Id.* The Commission only noted that the facts of the case "imposed on Gintel the responsibilities of those commonly refered to as 'insiders.' " *Id.*

18. 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969). In *Texas Gulf*, several officers and directors of the Texas Gulf Sulphur Corporation purchased options and calls on the Corporation's stock after the company had discovered a sizeable copper and zinc ore formation. In addition, a Texas Gulf geologist tipped outside individuals, telling the tippees that the company's stock "was a good buy." The court found that over 8,000 shares of Texas Gulf common stock and 4,700 call options were placed by Texas Gulf insiders. The tippees traded stock and call options totaling 10,500 shares. *Id.* at 847-52. In this proceeding, only the insiders were sued, thus, the issue of tippee liability was addressed only in the court's dictum. *Id.* at 848.

that if tippees have actual or constructive knowledge that material information they possess is undisclosed, their conduct can be equally violative of Rule 10b-5 as is the conduct of insiders who trade. Thus, *Texas Gulf Sulphur* recognized that the courts should be willing to find 10b-5 liability for both insiders and tippees who trade on material, nonpublic information. Since the question of tippee liability was addressed only within the court's dicta, there remained a question of precisely when the duty to disclose or refrain arose in regard to tippee trading. Subsequent proceedings against the brokerage firm of Merrill Lynch provided an answer to this question.

B. *The Merrill Lynch Cases: Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc. and In Re Investors Management Company*

Shapiro[19] and its predecessor *Investors Management*,[20] exemplify the courts' determination to extend Rule 10b-5 liability for fraudulent trading on nonpublic information to tippees of corporate insiders. Where both *Cady* and *Texas Gulf Sulphur* alluded to tippee liability under Rule 10b-5, *Investors Management* went further by firmly delineating the circumstances which give rise to a tippee's duty to disclose or refrain. The Commission held that a duty will be imposed on a tippee when the following elements exist: (a) possession of information by the tippee which is material and nonpublic;[21] (b) the tippee knew or had reason to know that the information was "nonpublic and had been obtained improperly by selective revelation or otherwise";[22] and (c) "that the information

19. Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228 (2d Cir. 1974). *Shapiro* was a private civil suit by former shareholders of Douglas Aircraft Co. against Merrill Lynch and certain of its officers, directors and employees. The plaintiffs sought damages and an accounting of profits realized by the defendants.

20. *In Re* Investors Management Co., Inc., 44 S.E.C. 633 (1971). *Investors Management* was an action commenced by the SEC against several clients of Merrill Lynch who were tipped by Merrill Lynch employees. The SEC sought to censure each of the defendants. Both *Shapiro* and *Investors Management* derive from the same transactions.

21. Material information has been described as information of such importance that there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to act. TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976). *See also* Little v. Valley Nat'l Bank of Ariz., 650 F.2d 218 (9th Cir. 1981); Vaugh v. Teledyne, Inc., 628 F.2d 1214 (9th Cir. 1980); S.E.C. v. Blatt 583 F.2d 1325 (5th Cir. 1978); *In re* Merrill Lynch, Pierce, Fenner & Smith, Inc., 43 S.E.C. 933, 937 (1968). Factors to be considered in order to determine whether the information is material are: a) the degree of specificity of the information; b) the extent to which it differs from information previously disseminated to the public; c) its reliability in light of its nature and source and the circumstances under which it was received. *Investors Management*, 44 S.E.C. at 642.

22. *Investors Management*, 44 S.E.C. at 641.

be a factor in his decision to effect the transaction."[23] Three years later, the Second Circuit Court of Appeals in *Shapiro* pronounced that tippees who have possession of material, nonpublic information which they know or should know came from a corporate insider, become obligated under the disclose or refrain duty.[24]

In the above cases, Merrill Lynch was acting as a lead underwriter for a proposed offering of convertible debentures of Douglas Aircraft Company. In order to prepare Douglas' registration statements, Merrill Lynch was given Douglas projections of the company's reduced earnings for the first six months of 1966. This information was disclosed to several investment companies which eventually traded Douglas stock.[25]

The Securities and Exchange Commission in *Investors Management* applied its three-part test to determine if Merrill Lynch's clients, the tippee investment companies, had acquired a duty to disclose or refrain. The Commission held that the tippees acquired the *Cady* duty to refrain or disclose since they had possession of nonpublic information which they knew had been selectively and improperly revealed to them by Merrill Lynch and which was used in trading their Douglas holdings.[26] Thus, by trading Douglas stock, the tippees breached this duty.[27]

The Commission explicitly rejected an assertion by the defendants that a tippee cannot be obligated by a duty to disclose or refrain unless it was shown that either, 1) the recipient had some type of special relationship with the issuer or corporate insider giving him access to nonpublic information, or that in the absence of such a showing; 2) that he had actual knowledge that the insider breached his fiduciary duty.[28] The Commission asserted that a tippee becomes obligated with the duty to disclose or refrain when he has possession of information which, by its nature, places the tippee in a position superior to other investors. Actual tippee knowledge of a fiduciary breach by the tipping insider is unnecessary. Rather,

23. *Id.*
24. *Shapiro*, 495 F.2d at 238.
25. *Id.* at 231-34. Originally given to a Merrill Lynch vice president, the information was relayed by him to the company's senior aerospace analyst who in turn relayed it to two salesmen in the Merrill Lynch New York institutional sales office. Ultimately, the information was disclosed to several investment companies by Merrill Lynch employees in the New York sales office. Upon receiving this information, the tippees proceeded to sell from a long and short position, over 154,000 Douglas shares valued at $13,300,000.

The stock in question was sold between June 21 and June 23 of 1966. On June 21, Douglas stock sold for 90 1/2, it declined to a low of 30 in October of 1966. *Investors Management*, 44 S.E.C. at 636.

26. *Investors Management*, 44 S.E.C. at 642-47.
27. *Id.*
28. *Id.* at 643-44.

the duty arises when the tippee has reason to know that his tip emanates from a corporate source.[29] This standard reflects a decision by the Commission to obligate a tippee to disclose or refrain when he has mere possession of material, nonpublic information. Thus, the focus was on policing the possession of information which creates an unfair advantage in the securities market.[30]

Applying its new standard, the Commission held that the respondent tippees were obligated to disclose or refrain. By trading on the Merrill Lynch tip, the Commission found that the tippees violated 10b-5.[31] The Commission then affirmed the hearing examiner's decision to censure the defendants.[32]

In his concurring opinion, Commissioner Smith warned that 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."[33] In addition, Commissioner Smith voiced his opinion that what creates the tippee's duty is the special relationship between the insider and his source and that this relationship must be known to the tippee in order to find him liable. Thus, said Smith, it is necessary to find "the tippee knew the information was given to him in a breach of a duty by a person having a special relationship to the issuer not to disclose the information."[34]

In *Shapiro*, the Second Circuit Court of Appeals began by noting that the objective behind Rule 10b-5 is to protect the investing public and to secure fair dealing within the securities market. This would be accomplished by promoting full disclosure of inside information, thus, preventing insiders and tippees from taking unfair advantage of the uninformed outsiders with whom they trade.[35] Citing its decision in *Texas Gulf Sulphur*,[36] the court held that the duty to disclose or refrain applied to all persons, whether insiders or tippees.[37] The duty arose when the defendants were in possession of

29. *Id.*
30. *Id.* at 644.
31. *Id.* at 645.
32. *Id.* at 648.
33. *Id.* Commissioner Smith felt that it was important not to over generalize by policing information *per se* and its possession. The result, he warned, would be the penalization of market analysts who search for new knowledge regarding corporate developments. *Id.* at 649. This argument was used extensively in Dirks v. S.E.C., 103 S. Ct. 3255 (1983).
34. *Investors Management*, 44 S.E.C. at 651. Commissioner Smith's insistence that a relationship must exist between the insider and the issuer became the basis of the Supreme Court's argument in *Chiarella*, 455 U.S. 222 (1980). *See infra* notes 44-75 and accompanying text.
35. *Shapiro*, 495 F.2d 228, 235 (2d Cir. 1974).
36. 401 F.2d at 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969).
37. *Shapiro*, 495 F.2d at 238. The court rejected the tippees' contention that as tippees they were not able to make effective public disclosure of information concerning

material nonpublic information which they knew or should have known derived from a corporate source.[38] The court found that all of the defendants were obligated by this duty and that each had breached it. The court then found that the defendants were thus liable for civil damages[39] to all persons who sold Douglas stock during the period in which the transactions in question were made.[40]

After *Texas Gulf*, *Shapiro* and *Investors Management*, it was clear that the lower courts had accepted the expanded standard of 10b-5 liability for insider trading.[41] The standard was expanded in two ways. First, not only were insiders liable for trading on nonpublic information, but the recipients of this information—their tippees, were also liable if they traded on such information. As a result, persons who received nonpublic information from insiders should be treated as if they were insiders. Second, the class of insiders and tippees who became obligated by the disclose or refrain duty was substantially expanded. The Commission in *Cady* appeared to require the finding of a relationship between the corporate source and the recipient of the information before a duty arose.[42] In contrast, the courts in *Shapiro* and *Investors Management* rejected the necessity of such a finding.[43] Rather, all persons including insiders and tippees, who had possession of material, nonpublic information which emanated from a corporate source, inherited a duty to disclose or refrain from trading. Thus, the *Cady* duty was extended to those who merely had possession of material nonpublic information. It was this rapid expansion which inevitably resulted in the Supreme Court's decision to redefine the duty to disclose or refrain under Rule 10b-5. The opportunity presented itself in *Chiarella v. United States*.[44]

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a corporation with which they were not associated. The court found that the defendants knew or should have known the source of the nonpublic information and that if disclosure was not possible, they had a duty to abstain from trading. *Id.* at 237-38.

38. *Id.*

39. *Id.* at 241. Defendants argued that the *Texas Gulf* holding was inapplicable since the remedy sought there was an injunction, whereas in *Shapiro* the plaintiffs sought civil damages. The court rejected this distinction, asserting that the same public policy reasons which existed in *Texas Gulf* were present in the case at bar. *Id.* at 236. Therefore, *Shapiro* is consistent with both *Texas Gulf* and *Investors Management*, yet, it goes further in that it holds tippees liable for civil damages. *Id.* at 241.

40. *Id.* at 237.

41. Falls v. Fickling, 621 F.2d 1362, 1370 n.22 (5th Cir. 1980); *In re* Haven Industries, Inc., 462 F. Supp. 172, 178 (S.D.N.Y. 1978); Green v. Hamilton Int'l Corp., 437 F. Supp. 723, 728 (S.D.N.Y. 1977); Jackson v. Oppenheim, 411 F. Supp. 659, 665 (S.D.N.Y. 1974), *modified*, 533 F.2d 826 (2d Cir. 1976); *In re* Merrill Lynch, Pierce, Fenner & Smith, Inc., 43 S.E.C. 933, 936-37 (1968).

42. *Cady*, 40 S.E.C. 907, 912 (1961).

43. *Investors Management*, 44 S.E.C. 633, 643 (1971). *See supra* notes 28-30 and accompanying text.

44. 445 U.S. 222 (1980).

C. *Chiarella v. United States*

The Supreme Court's discontent with the Rule surfaced in 1980 when the Court heard a criminal prosecution against Vincent Chiarella. Primarily, the Court was dissatisfied that a federal statute carrying such severe criminal and civil liability, provided little or no indication of what type of activities gave rise to a duty to disclose or refrain.[45] As a result, the Court held that an insider's duty to disclose or refrain does not arise merely from possession of material, nonpublic information. Rather, the duty attaches only when there is a pre-existing fiduciary or quasi-fiduciary relationship between the insider and the corporation.[46]

The petitioner worked in 1975 and 1976 as a markup man[47] for Pandick Press, a New York financial printer. His duties included the handling of corporate takeover bid announcements. Although Pandick Press took steps to conceal the names of the acquiring and target companies on such announcements, Chiarella was able to deduce the true identities of many of the companies. He did so even though his employer's policy strictly forbade such conduct. Without disclosing his knowledge, Chiarella began purchasing shares of the target companies' stock and subsequently sold it immediately after the takeover attempts were made public.[48]

Justice Powell, who delivered the majority's opinion, began by noting that neither the statutory language of Section 10(b) nor Rule 10b-5 provide any explicit indication whether silence[49] can be re-

45. Langevoort, *Insider Trading and the Fiduciary Principle: A Post-Chiarella Restatement*, 70 CALIF. L. REV. 1, 17 (1982).

46. *Chiarella*, 445 U.S. at 228. This Note uses the term quasi-fiduciary to represent those situations in which an individual has "entered into a special confidential relationship in the conduct of the business of the enterprise and is given access to information solely for corporate purposes." Dirks v. S.E.C., 103 S. Ct. 3255, 3261 n.14 (1983). Such a relationship would arise where the individual is working for the corporation as an underwriter, accountant, lawyer or consultant. *Id.*

47. As a markup man for Pandrick Press, Chiarella handled various documents such as annual reports, proxy statements and most importantly, takeover bids. Chiarella selected type fonts and page layouts on the documents before passing them on to be set into type. *Chiarella*, 588 F.2d 1358, 1363 (2d Cir. 1978), *rev'd*, 455 U.S. 222 (1980).

48. *Id.*, 445 U.S. at 224. Over a period of fourteen months, Chiarella realized a profit of more than $30,000. However, in January 1978, he was indicted on seventeen counts of violating § 10(b) and Rule 10b-5. *Id.* at 224-25.

After agreeing to forfeit his profits, the petitioner was convicted a year later of a criminal violation of both § 10b and Rule 10b-5. United States v. Chiarella, 450 F. Supp. 95 (S.D.N.Y. 1978). Later that year, the Court of Appeals for the Second Circuit affirmed Chiarella's conviction. United States v. Chiarella, 588 F.2d 1358 (2d Cir. 1978), *rev'd*, 455 U.S. 222 (1980). The court of appeals held that the duty to disclose is imposed upon "anyone—corporate insider or not—who regularly receives material nonpublic information." *Id.* at 1365.

49. Silence in this sense is the failure to disclose nonpublic information. *Chiarella*, 445 U.S. at 226.

garded as violative of the securities fraud provisions. He recognized that because of this omission, the SEC took an important step when it held that a broker-dealer had an affirmative duty to disclose or refrain when his failure to do so would result in an unfair advantage for him in the market place.[50] The Court pointed out that the insider's advantage derived from his relationship with the corporation and its stockholders.[51] The nature of this relationship is that it is built on trust and confidence between the parties and it provides the insider with access to material nonpublic information. Thus, the duty to disclose or refrain will arise only when the insider has information which the stockholders are entitled to know because of a pre-existing relationship.[52] Application of this duty "guarantees that corporate insiders, who have an obligation to place the shareholder's welfare before their own, will not benefit personally through fraudulent use of material, nonpublic information."[53] In addition, the Court recited its willingness to extend the duty beyond insider liability.[54] The Court recognized that tippees have been held liable under 10b-5 since they too, "have a duty not to profit from the use of insider information that they know is confidential."[55] Further, the Court noted, this duty arises from the tippee's role as a "participant after the fact in the insider's breach of a fiduciary duty."[56] This footnote acquired its importance three years later when the majority in *Dirks v. S.E.C.*[57] cited it as authority for their position that a tippee's duty is a derivative of the insider's obligation.[58]

The *Chiarella* Court then rejected the theory employed by the court of appeals that a duty arises solely because an individual has

50. *Id.* at 226-27.

51. The Court cites the RESTATEMENT (SECOND) OF TORTS § 551(2)(a) (1976). Section 551(2) lists a number of relationships in which the common law imposes an affirmative duty to disclose upon the parties to a transaction. Of note are subsections 2(a) and 2(e). 2(a) compels a party to disclose "matters known to him that the other is entitled to know because of a fiduciary or other similar relation of trust and confidence between them." Subsection 2(e) includes a duty when "facts basic to the transaction" are not known to the other party and "because of the relationship between them, the customs of the trade or other objective circumstances, would reasonably expect a disclosure of those facts." RESTATEMENT (SECOND) OF TORTS § 551(2)(e) (1976).

52. *Chiarella*, 445 U.S. at 228. The stockholders and the trading public are entitled to know all material nonpublic information before the insider trades on his knowledge of such information. *In re* Cady, Roberts & Co., 40 S.E.C. 907, 912, (1961); *In re* Investors Management Co., Inc., 44 S.E.C. 633, 642 (1971). *See supra* note 21.

53. *Chiarella*, 445 U.S. at 230.

54. *Id.* at 230 n.12.

55. *Id.* (*citing* Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228, 237-38 (2d Cir. 1974)).

56. *Chiarella*, 445 U.S. at 230, n.12.

57. 103 S. Ct. 3255 (1983).

58. *Id.* at 3264. *See infra* notes 95-98 and accompanying text.

possession of material nonpublic information.[59] The majority found that both of the lower courts failed to identify a relationship between Chiarella and the selling shareholders which would impose a duty on the petitioner.[60] As a result, the Court held that Chiarella did not violate the fraud provisions since "he was not their [the sellers] agent, he was not a fiduciary, he was not a person with whom the sellers had placed their trust and confidence."[61]

It appears that the purpose of the Court in *Chiarella* was to limit the recent expansion of 10b-5 interpretation and to create a framework for future litigation under the Rule.[62] The holding of the Court reflects this objective: mere possession of material, nonpublic information does not create a duty to disclose or refrain.[63] Rather, an insider who is in possession of strategic information must have a pre-existing fiduciary duty or other form of relationship based on trust and confidence with the corporation and its stockholders.[64]

In most pre-*Chiarella* cases, this requirement would have posed little problem for the courts, since the majority of the insiders prosecuted were directors, officers or employees who knew secret information. Such persons have a fiduciary duty to their employers and thus, they fall within the *Chiarella* standard of liability.[65] However, there are situations such as the one in *Chiarella*, where individuals who do not fall within the traditional agency definition or appear to have no association with the corporation, nevertheless acquire secret information. This problem is most apparent when tippees trade on confidential information.

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59. *Chiarella*, 445 U.S. at 231-32, 235.

60. *Id.* at 231-32.

61. *Id.* at 232. In his dissenting opinion, Chief Justice Burger argued essentially that the duty to disclose or refrain is owed to the public not just to the issuer of the information. Thus, its application is not solely dependent upon a pre-existing fiduciary relationship with the issuer. Rather, it derives its foundation from the principle that "a person who has misappropriated nonpublic information has an absolute duty to disclose that information or refrain from trading." *Id.* at 240. The Chief Justice would focus on a finding that the accused, whether corporate insider or not, used deception or some other fraudulent scheme to obtain the information. *Id.* at 240-41. Thus, an investor who purchases securities by exploiting misappropriated nonpublic information would be liable under the Burger approach.

In his dissent, Justice Blackmun joined by Justice Marshall, would have imposed a much broader basis of liability than either the relationship test or the misappropriation theory. Under the Blackmun standard, persons having access to material, nonpublic information, "not legally available to others [would be prohibited from engaging] in schemes to exploit their structural informational advantage . . . ." *Chiarella*, 445 U.S. at 251.

62. *Id.* at 234-35.

63. 445 U.S. at 235.

64. *Id.* at 230.

65. RESTATEMENT (SECOND) OF AGENCY § 379 (1958); Langvoort, *Insider Trading and the Fiduciary Principle: A Post-Chiarella Restatement*, 70 CALIF. L. REV. 1, 20 n.75.

Typically, a tippee has no fiduciary or quasi-fiduciary[66] association with the corporate source of his information. Prior to *Chiarella*, it was established that tippees could be treated as if they were insiders if they had possession of nonpublic, material corporate information and the tippee knew or had reason to know that the information was derived from the corporation.[67] Thus, the focus was on the tippee and his wrongful trading. By disregarding the need of finding a fiduciary or quasi-fiduciary relationship between the tippee and his corporate source, the courts policed the possession of material, nonpublic information. Possession of such information created an unfair advantage for a tippee who used it in the securities markets.[68] Therefore, the courts obligated the tippee with a duty to disclose or refrain.[69] In essence, the insider's duty passed to the tippee when the above mentioned conditions were met.[70] Moreover, this duty could pass even if the tip was not a breach of the insider's duty.[71] Thus, it was evident that an insider breach was not a necessary condition of obligating the tippee with a duty to disclose or refrain.

Footnote 12 in *Chiarella*[72] created a new sense of doubt over traditional tippee liability. The Court noted that a tippees' obligation has been viewed as arising from his role as a participant after the fact in the insider's breach of fiduciary duty.[73] If read literally, the Court could have suggested that it was not only ready to narrow the scope of insider liability under 10b-5, but also that of tippees to situations in which the insider and his tippee worked in a co-venture.[74] The Court in *Chiarella*, had thus set the stage for its decision in *Dirks v. S.E.C.*.[75]

III. *DIRKS V. SECURITIES AND EXCHANGE COMMISSION*

The Supreme Court heard the SEC's argument against a New York broker, Raymond Dirks, in July of 1983. The case represents the second of two recent attempts by the Court to restrict application of 10b-5 in regard to insider trading. In *Chiarella*, the circum-

66. *See supra* note 46.
67. *Investors Management Co., Inc.*, 44 S.E.C. 633, 641 (1971).
68. *Id.* at 644.
69. *Id.*
70. *See*, Loss, *The Fiduciary Concept as Applied to Trading by Corporate Insiders in the United States*, 33 MOD. L. REV. 34, 40 (1970).
71. *Cady, Roberts & Co.*, 40 S.E.C. 903, 912 (1961).
72. 445 U.S. 222, 230 n.12 (1980).
73. *Id.*
74. For example, where an insider agrees to "sell" his tip to the tippee, or where the tippee agrees to split his profits with the insider which the tippee derived from using the tip in a stock transaction.
75. 103 S. Ct. 3255 (1983).

stances which triggered an insider's duty to disclose or refrain were limited to those in which a fiduciary or quasi-fiduciary relationship existed. In *Dirks*, the Court seized the opportunity to address the liability of tippees under the Rule. Relying in part on its decision in *Chiarella*, the Court held that a tippee assumes a fiduciary duty to disclose or refrain only when there has been a showing that the insider has breached his own duty by deriving a personal benefit from his disclosure and where the tippee knows or should know that the breach occurred.[76]

A. *Facts of Dirks*

In March of 1973, Raymond Dirks was an officer with Delafield Childs, Inc.,[77] a New York broker-dealer. On March 6 of 1973, Dirks received information from Ronald Secrist, a former employee of Equity Funding Corporation of America (Equity Funding).[78] Secrist alleged that Equity Fundings' assets were greatly overstated as the result of fraudulent practices by several of Equity Funding's past and present employees.[79] Secrist claimed that other Equity Funding employees had made similar accusations to various regulatory agencies, but to no avail. He suggested that Dirks verify the allegations and disclose them publicly. In response, Dirks decided to investigate by visiting Equity Funding's corporate headquarters in Los Angeles. While there, he interviewed key officers and employees of the company as well as several of its former employees.[80]

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76. *Id.* at 3264-65.

77. Delafield Childs, Inc., specialized in providing investment analysis information of insurance company securities. 21 S.E.C. Docket 1401, 1402-06 (1981).

78. Equity Funding of America was a diversified corporation, primarily in the business of selling life insurance and mutual funds. It was the parent of Equity Funding Life Insurance Corporation and Bankers National Life Insurance Company. *Dirks*, 103 S. Ct. 3255, 3258 (1983).

79. Specifically, Secrist charged that one of Equity Funding's subsidiaries had created fictitious insurance policies and records in order to inflate the company's sales figures to show impressive growth. In addition, Dirks was told that the company was selling partnership interests in real estate which were nonexistent, that its top officers had Mafia connections which it used to intimidate employees who objected to the fabrications and finally, that Equity Funding's accounting firm, Deloite, Haskins & Sells had dropped the Equity Funding account because of disagreement over the company's business practices. Dirks v. S.E.C., 681 F.2d 824, 829-30 (D.C. Cir. 1982), *rev'd*, 103 S. Ct. 3255 (1983).

80. On March 20, the day after his arrival, Dirks spoke for several hours with Patrick Hopper, a former vice president of Equity Funding who had recently retired. Hopper admitted that he had no direct knowledge nor proof of the fraud alleged by Secrist. However, he confirmed that he had noticed certain irregularities in the company's 1971 sales figures. *Id.*

Later that day Dirks spoke with Frank Majerus, a former comptroller of Equity Funding. Majerus admitted to Dirks that he had participated in falsifications of the company's ledgers. *Id.*

On March 21, Dirks spoke with members of Equity Funding's top management, each officer firmly denied the existence of fraud at Equity Funding. Over the next two days, While investigating, Dirks freely communicated his evidence with various market analysts as well as with a number of his clients whom he knew had an interest in Equity Funding. Subsequently, each sold most if not all of their holdings in the company.[81]

The price of Equity Funding stock fell from $26 per share to less than $15 per share during the two weeks in which Dirks made his investigation.[82] On March 27, the New York Stock Exchange suspended trading in Equity Funding stock and on April 2, the Securities and Exchange Commission filed a complaint against Equity Funding. The company filed a petition in bankruptcy three days later.[83]

B. The Lower Courts' Decisions

The SEC took action against Dirks as well as five of his institutional clients who sold Equity Funding securities. After a hearing by an administrative law judge, the SEC held that Dirks and four of his clients[84] had violated Rule 10b-5. Applying the *Shapiro* stan-

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Dirks continued his investigation as he interviewed four other persons. Two of these persons had worked as computer technicians for Equity Funding and another was still employed at the company. All four of the men came to conclusions that Equity Funding's computer files contained fictitious insurance policies. *Id.*

81. On March 20, Dirks spoke with officers of the Boston Company Institutional Investors, Inc., over the telephone. The next day, the Boston Company sold its entire holding of Equity Funding stock and debentures for over $7 million. *Dirks*, 681 F.2d at 831 n.4. Dirks was explicitly told by the Boston Company that he would receive a $25,000 commission from the Company. *In re* Raymond L. Dirks, 21 S.E.C. Docket 1401, 1404 (1981). Apparently, Dirks never received this. *Id.* at 1404 n.10. Dirks also spoke to the Dreyfus Corporation on March 23, which sold its holdings of Equity Funding stock on March 26. *Dirks*, 681 F.2d at 831 n.4 (1982).

Finally, on March 26, Dirks discussed the Equity Funding scheme with representatives of John W. Bristol & Co.; Tomlin, Zimmerman & Parmalee, Inc.; and Manning & Napier. By the end of that day, all three had sold all or substantially all of their holdings in Equity Funding. John W. Bristol & Co. alone, sold more than $8 million worth of Equity Funding stock. *Id.*

During his investigations at Equity Funding, Dirks made two attempts to contact outside authorities and notify them of the fraud scheme. On March 23, Dirks learned that Equity Funding's auditors were about to release certified financial statements for the Company. The auditors met with Dirks on the following day and he appraised them of his findings in hope that they would withhold the release of their report. The auditors did not heed this warning. *In re* Raymond L. Dirks, 21 S.E.C. Docket at 1404 n.12.

In addition, Dirks was in contact with William Blundell, the *Wall Street Journal's* Los Angeles bureau chief. Dirks urged Blundell to write a story on the allegations of fraud at Equity Funding. Blundell was skeptical about the fraud and refused to write a story for fear of his own personal liability. *Dirks*, 681 F.2d at 831-32. Blundell doubted that a fraud of such magnitude could exist without detection. He considered the evidence presented by Dirks nothing more than hearsay and was afraid that publishing the rumors on such scanty evidence might be libelous. *Id.*

82. *Dirks*, 103 S. Ct. at 3258.

83. *Dirks*, 681 F.2d at 832.

84. The Boston Institutional Investors, Inc.; John W. Bristol & Co.; Tomlin, Zim-

dard of tippee liability,[85] the SEC concluded that "where 'tippees'—regardless of their motivation or occupation—come into possession of material 'information that they know is confidential and know or should know came from a corporate insider,' they must either publicly disclose that information or refrain from trading."[86] Noting that Dirk's investigation was pivotal in exposing the Equity Funding fraud, the SEC only censured him.[87]

Dirks then sought review of the SEC decision in the Court of Appeals for the District of Columbia.[88] His defense relied upon the holding of *Chiarella*. In essence, it was Dirks' assertion that he could not be liable under Rule 10b-5 since he had no legal duty to Equity Funding. He claimed that after *Chiarella*, such duty could not be imposed without a finding of a pre-existing fiduciary duty or other relationship.[89] In addition, Dirks claimed under *Chiarella* his actions did not violate Rule 10b-5 unless his corporate sources (insiders) also violated the Rule. He argued that such was not the case because California law did not compel a fiduciary to abstain from disclosing information regarding a corporate fraud.[90] The court of appeals rejected this argument. *Chiarella*, the court asserted, "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."[91] Granting to Dirks the assumption that his corporate insiders did not breach their fiduciary duties, the court found that under *Shapiro* and *Investors Management*, the insiders obligation passed to Dirks when they disseminated the information to him. By then passing this information on to investors who would likely trade, Dirks breached his inherited duty.[92] The Supreme Court granted a writ of certiorari to Dirks in 1982.[93]

C. The Supreme Court's Majority Opinion

Justice Powell delivered the majority's opinion. After reaffirming the *Chiarella* requirement that a relationship exist between an in-

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merman & Parmalee, Inc.; and Manning & Napier were all censured by the SEC, *In re* Raymond L. Dirks, 21 S.E.C. Docket at 1412.

85. Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228, 237-38 (2d Cir. 1974).

86. *In re* Raymond L. Dirks, 21 S.E.C. Docket 1401, 1407 (1981) (quoting Chiarella v. United States, 445 U.S. 222, 230 n.12 (1980)).

87. *Id.* at 1412.

88. Dirks v. S.E.C., 681 F.2d 824 (D.C. Cir. 1982), *rev'd*, 103 S. Ct. 3255 (1983).

89. *Id.*, 681 F.2d at 828.

90. *Id.*

91. *Id.* at 838-39. The court later reemphasized this interpretation of the *Chiarella* holding. *Id.* at 839 n.16.

92. *Id.* at 837-39.

93. *Dirks*, 103 S. Ct. 371 (1982).

sider and the corporation, the Court next addressed the lower court holdings. The SEC's finding that Dirks had inherited his fiduciary duty from Secrist was rejected by Justice Powell.[94] This position, Justice Powell asserted, differed little from the theory the Court had rejected in *Chiarella* since it based liability on mere possession of nonpublic market information.[95] The tippee does not inherit the insider's fiduciary duty; rather, the recipient's obligation to disclose or refrain is more properly viewed as a derivative of the insider's duty.[96] Therefore, a tippee will assume his insider's obligation not because he has possession of nonpublic information, but rather, because he has received it from the insider "improperly."[97] The Court defined "improperly" as those instances when the insider breached the duty defined in *Cady*. Under these principles, the Court articulated its standard for tippee liability under Rule 10b-5: "a tippee assumes a fiduciary duty to the shareholders of a corporation not to trade on material nonpublic information only when the insider has breached his fiduciary duty to the shareholders by disclosing the information to the tippee and the tippee knows or should know that there has been a breach."[98] Having created a standard of tippee liability which conditioned its application upon the insider's breach, the Court then proceeded to identify the circumstances which constitute an insider breach.

The Court noted that because not all disclosures of corporate information are inconsistent with the fiduciary duty,[99] it was necessary to identify the element which triggered the insider's duty to disclose or refrain. The Court concluded that whether the disclosure is a breach of the *Cady* duty depends on the insider's purpose in disseminating the information. Thus, since a purpose of the securities laws was to eliminate "use of inside information [for] per-

94. *Dirks*, 103 S. Ct. 3255, 3262 (1983).

95. *Id.* Justice Powell notes that the SEC's theory appeared to be based on the presumption that Congress had intended the anti-fraud provisions to insure equal information among all investors in the market. The Court pointed out that this position contradicted the *Chiarella* holding that mere possession of nonpublic information is not an adequate basis for Rule 10b-5 violation. *Dirks*, 103 S. Ct. at 3261-62 n.16. Had the Court accepted the SEC's theory, its standard would have been "inherently imprecise." Thus, neither corporate insiders nor market analysts would be able to distinguish between permissible and impermissible disclosures and use of nonpublic information. *Id.* at 3263 n.17.

96. *Id.* at 3264. The Court cited its decision in *Chiarella* and the fact that it viewed the tippee's obligation as arising from his role as a "participant after the fact in the insider's breach." *Chiarella*, 445 U.S. 222, 230 n.12 (1980).

97. *Dirks*, 103 S. Ct. at 3264.

98. *Id.*

99. Examples of such innocent disclosures would exist when either the insider or the tippee was unclear as to the importance (materiality) of the disclosure. In addition, the Court would pardon corporate officials if they mistakenly thought the information was immaterial or already public. *Id.* at 3265.

sonal advantage,"[100] the test was "whether the insider personally will benefit, directly or indirectly, from his disclosure."[101]

Applying this standard, the Court found that since Dirks had no pre-existing duty to Equity Funding's shareholders, his obligation was contingent upon a finding that Secrist breached his own duty.[102] Neither Secrist nor the other Equity Funding employees breached their *Cady* duty since they "received no monetary or personal benefit" for their disclosure.[103] Therefore, the Court concluded, Dirks did not assume a duty. Thus, there was no violation of Rule 10b-5.[104]

D. The Supreme Court's Minority Opinion

Noting that the majority's new standard was based on motivation, Justice Blackmun criticized the result as frustrating the purpose of the SEC antifraud provisions.[105] He claimed that by

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100. *Id.* (quoting *In re* Cady, Roberts & Co., 40 S.E.C. 907, 912 n.15 (1961)). The Commission in *Cady* noted that "A significant purpose of the [Securities] Exchange Act was to eliminate the idea that the use of inside information for personal advantage was a normal emolument of corporate office." *In re* Cady, Roberts & Co., 40 S.E.C. 907, 912 n.15 (1961).

101. *Dirks*, 103 S. Ct. at 3265. The Court comments that a court's determination of an insider breach must focus on "objective criteria, i.e., whether the insider receives a direct or indirect personal benefit from the disclosure, such as a pecuniary gain or reputational benefit that will translate into future earnings." *Id.* at 3266. The SEC expressed its fears that an insider could always "fabricate some ostensibly legitimate business justification for transmitting the information." *Id.* at 3265. The Court chided the SEC for being "unduly concerned." *Id.* The Court suggested that scienter is relevant in some cases to determine whether an insider deceived, defrauded or manipulated shareholders. *Id.* at 3265 n.23. But regardless, a court must examine objective criteria in order to detect a breach. *See supra* note 100.

The Court admitted that this task will not always be easy for the courts. *Dirks*, 103 S. Ct. at 3266. However, it was necessary to provide "a guiding principle" for investors, analysts and insiders whose "daily activities must be limited and instructed by the SEC's inside-trading rules." *Id.* Without such instructions, the Court felt that persons affected by the Rule would be "forced to rely on the reasonableness of the SEC's litigation strategy" which the court stated would "be hazardous." *Id.* at 3266 n.24. Thus, the majority felt that their new restricted standard for tippee liability would provide the investing public with a clearer picture as to what conduct constitutes illegal insider trading. In addition, the Court felt that their holding would limit the SEC's ability to pick and choose the violaters it seeks to prosecute. *Id.* at 3266 n.24.

102. *Id.* at 3267.

103. *Id.* at 3267-68.

104. *Id.* at 3268. The Court noted that the court of appeals found as an additional basis of liability that Dirks acquired a fiduciary duty by virtue of his position as an employee of a broker-dealer. *Dirks*, 681 F.2d 824, 842 (D.C. Cir. 1982). However, the SEC did not allege such a breach to the Supreme Court, therefore, it was not considered. *Dirks*, 103 S. Ct. at 3267 n.26. *See* Comment, *Dirks v. S.E.C.: Increased Exposure to Rule 10b-5 Liability for Broker-Dealers*, 51 U. CIN. L. REV. 849, 853 (1983).

105. *Dirks*, 103 S. Ct. 3255, 3268 (1982) (Blackmun, J., dissenting). Justice Blackmun noted that the majority's "innovation excuses a knowing and intentional violation of an insider's duty to shareholders if the insider does not act from a motive of personal gain." *Id.* Justices Brennan and Marshall joined in the Blackmun dissent.

including private gain as an element of the insider's breach, the majority erroneously addressed the insiders' motives rather than his actions and their consequences.[106] Citing *Mosser v. Darrow*,[107] Justice Blackmun claimed that the insider's motives are irrelevant. Rather, the breach consisted of taking action that was disadvantageous to the person to whom he owed the duty.[108] The dissenting justices would have found Secrist in violation of 10b-5 since he disclosed material, nonpublic information to Dirks with the intention that Dirks would cause his clients to trade on the information. Subsequently, since Secrist breached his fiduciary duty, Dirks assumed Secrist's duty to disclose or refrain. By causing his clients to trade, he too violated Rule 10b-5.[109]

IV. Discussion

The Court's two-part holding in *Dirks* is relatively narrow and straightforward: 1) a tippee assumes a fiduciary duty to the shareholders of a corporation to refrain from trading on material, nonpublic information only when the insider has breached his fiduciary duty to the shareholders by disclosing the information to the tippee and the tippee thereby knows or should know that the insider has breached his duty.[110] 2) A corporate insider breaches his fiduciary duty to disclose or refrain when he discloses material, nonpublic information to an outsider and the insider thereby derives a personal gain from such disclosure.[111] This standard reflects the Court's determination, since its decision in *Chiarella*, to narrow the scope of both insider and tippee liability under Rule 10b-5. Under *Chiarella*, an insider was obligated to disclose or refrain only when a pre-existing fiduciary or quasi-fiduciary relationship had been identified.[112] Generally, this rule was limited to actions against insiders since it was typically impossible to find a fiduciary type relationship between a tippee and a corporation.[113] Thus, most courts

106. *Id.* at 3271.
107. Mosser v. Darrow, 341 U.S. 267 (1951).
108. *Dirks*, 103 S. Ct. 3255, 3272 (1983) (Blackmun, J., dissenting).
109. *Id.* at 3274.
110. *Id.* at 3264.
111. *Id.* at 3265.
112. *Chiarella*, 445 U.S. 222, 232 (1980).
113. In order to meet the *Chiarella* fiduciary or quasi-fiduciary relationship test, the defendant must be an agent, a fiduciary or a person with whom the sellers of the stock (or the corporation) have placed their confidence and trust. *Id.* Tippees, in contrast, are generally outsiders of the corporation who typically are complete strangers to the plaintiffs. *See supra* note 46.

In S.E.C. v. Lund, 570 F. Supp. 1397 (C.D. Cal. 1983), a federal district court judge ordered Lavere Gilbert Lund to disgorge profits he had acquired while trading P & F Industries stock. Lund, who had no pre-existing relationship with P & F, was labeled a temporary insider by the judge. Citing footnote 14 in *Dirks*, the judge found that Lund applied the standard articulated in *Investors Management*, a tippee assumed the insider's *Cady* duty when he knowingly received confidential corporate information from the insider. This theory was rejected by the *Dirks* court in an attempt to further restrict liability under 10b-5 for trading on nonpublic information. *Dirks* restricted tippee liability in two ways: First, a tippee does not become obligated by the duty to disclose or refrain unless the insider first breached his own duty by disclosing information; second, the disclosure will not amount to a breach by the insider unless he gains a personal benefit from his disclosure.[114] This discussion will identify two issues raised by the *Dirks* decision, and point out the problems which are likely to arise as a result of the Court's holding.

A. Issues Left Unresolved

The first issue raised is whether the *Dirks* standard for obligating a tippee to disclose or refrain will provide a workable framework for litigation under Rule 10b-5. Although the Court's intention was to restrict the application of Rule 10b-5, the means it employed may prove to be impracticable. Justice Blackmun warned in *Chiarella*, that the Court had pursued "a course, chartered in recent decisions, designed to transform Section 10(b) from an intentionally elastic 'catchall' provision to one that catches relatively little of the misbehavior that all too often make investment in securities a needlessly risky business for the uninitiated investor."[115] Both the *Dirks* minority and the SEC expressed fears as to a court's ability in many cases to identify the existence of an insider's personal benefit. Without such a finding, the tippee does not inherit the insider's duty to disclose or refrain.[116]

This task may prove to be impracticable because *Dirks* does not limit its classification of personal benefits merely to pecuniary advantages. Rather, the majority asserts that a finding of any direct or *indirect* personal benefit is sufficient evidence of an insider gain.[117] Although direct benefits are easy to identify, indirect bene-

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became a temporary insider of P & F because his insider source was a close friend who did not expect Lund to use the information for a personal gain. In footnote 14, the *Dirks* court recognized that under some circumstances, underwriters, accountants, lawyers and consultants working for the corporation can acquire a fiduciary status if the corporation expects the outsiders to keep confidential, corporate information they learn because of their relationship with the corporation. *Dirks*, 103 S. Ct. 3255, 3261 n.14 (1983). Although the term "temporary insider" has been used by scholars, it had never been used by a court. It will be interesting to see if the Supreme Court allows this interpretation of footnote 14, since the footnote appears to refer to a precise and narrow category of professional relationships.

114. *Dirks*, 103 S. Ct. at 3264-66.
115. Chiarella v. United States, 445 U.S. 222, 246 (1980).
116. *Dirks*, 103 S. Ct. at 3265.
117. *Id.*

fits are not. Direct benefits would presumably be advantages such as a pecuniary gain.[118] This could be identified through discovery procedures. In addition, the nature of direct benefits such as money and other tangible tokens of value is that they provide the receiver with a *recognizable* gain in wealth. In contrast, the court's classification of indirect benefits is more troublesome. This category could include such gains as reputational benefits, and the satisfaction realized when the insider gives a "gift of information" to the tippee.[119] The majority maintains that a court should focus on objective criteria and objective facts and circumstances which infer the existence of a personal benefit.[120] However, the nature of an indirect benefit, as the majority uses the term, is that its identification requires one to focus on subjective criteria. For example, a disclosure to a tippee friend will result in an intrinsic gift-giving pleasure for the insider. The identification of "pleasure" will certainly require a court to rely on a subjective analysis of the insider's state of mind since the criteria for such an analysis would be generosity, affection and other emotion.[121] This problem was present in *Dirks* itself.

It seems reasonable to conclude that by exposing the fraud scheme of Equity Funding, Secrist gained reputational benefits in the form of public admiration. Yet, how could a court identify the "pleasure" Secrist received as a result of public admiration? Clearly, it would require the court to *infer* that Secrist experienced such a benefit. Unless the existence of a direct benefit can be established, the courts will find objective criteria to be of little use in the personal benefit analysis. As a result, the courts will be hampered by the difficult task of identifying an indirect benefit through a subjective analysis of the insider's motive.

A second issue raised by *Dirks* is whether the Supreme Court will feel compelled to restrict its holding to the unique facts of *Dirks*. In most fraudulent trading cases where the insider intends for his tippee to trade, the insider has an improper motive. In *Dirks*, Secrist clearly intended to reveal the Equity Funding fraud scheme to Dirks in hopes that the latter would expose the hoax to the public.[122] Yet, according to the majority, this motive was proper. The Court saw the need to encourage exposure of fraudulent schemes. It appears as if in order to find Secrist and Dirks not liable, the majority designed a rule to achieve the result they deemed proper.

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118. *Id.* at 3266.
119. *Id.*
120. *Id.*
121. The Supreme Court defines "gift" for income tax purposes as a transfer made out of detached and disinterested generosity and motivated by respect, admiration, charity or like impulses. Commissioner v. Duberstein, 363 U.S. 278 (1960).
122. *Dirks*, at 3268 (1982) (J. Blackmun dissenting).

This tailored standard may prove to be impractical for application to other factual situations.[123] If this is the result, the Court's initial objective to retrench the application of 10b-5 in regard to tippee trading, will remain unaccomplished.

B. An Alternative Solution to the Dirks Holding

Essentially, the *Dirks* holding restricted the application of 10b-5 in regard to tippee liability in two ways. First, a tippee assumes the *Cady* duty only when the insider has breached his duty. Second, the insider breaches his duty only when he has derived a benefit from his disclosure. The entire Supreme Court appears to favor the first element of the *Dirks* holding which was originally expressed by Commissioner Smith in *Investors Management.*[124] This rule follows consistently with the *Chiarella* mandate that the *Cady* duty to disclose or refrain does not arise merely from the possession of insider information.[125] The second element is novel and as such, has little, if any, support from case law on the subject.[126] As mentioned above, this element creates several practical problems for the courts and it is the focus of the dissent's blistering attack on the majority opinion.[127] Therefore, the alternative solution presented by this Note would discard this element from the tippee duty to disclose or refrain.

This alternative solution would obligate a tippee with the *Cady*

123. For example, had Secrist been motivated purely by a desire to injure the management at Equity Funding, application of the *Dirks* rule would result in an absurd outcome. In this hypothetical, Secrist would have an improper motive, but he nevertheless failed to derive a benefit and thus, would not have breached his duty.

The Court's holding seems to reflect the dilemma posed by the unique facts of this case. Equity Funding shareholders were clearly hurt by the conduct of Dirks. In addition, his clients saved millions of dollars, yet they suffered only an administrative slap on the wrist. *In re* Raymond L. Dirks, 21 S.E.C. Docket 1401, 1412-13 (1981). *See supra* note 84. However, Dirks did play an important role in bringing Equity Funding's fraud scheme to a halt, and as the SEC observed, he reported the fraud allegation to the Company's auditors and sought to have the information published in the *Wall Street Journal.* Raymond L. Dirks, 21 S.E.C. Docket at 1404. Apparently, the majority concluded that the benefit to society from exposure of such fraud schemes, outweighs the harm caused to corporate shareholders. The dissent found this policy argument to be an improper justification for the Court's holding. *Dirks*, 103 S. Ct. 3255, 3272-73 (1983).

124. 44 S.E.C. 633, 650 (1971). *See supra* notes 32-34 and accompanying text.

125. Under this rule, a tippee can be obligated by the *Cady* duty only where his insider source has made the information available to the tippee improperly. *Dirks*, 103 S. Ct. at 3264. However, what constitutes an improper disclosure requires an examination of the second element in the *Dirks* holding: the necessity of finding that the insider gained a benefit. *Id.* at 3265.

126. As the minority recognizes, the only support cited by the majority is a reference to *Cady* and a law review article by Professor Brudney. *In re* Cady, Roberts & Co., 40 S.E.C. 907, 912 n.15 (1961); Brudney, *Insiders, Outsiders, and Informational Advantages Under the Federal Securities Laws*, 93 HARV. L. REV. 322, 345-48 (1979).

127. *Dirks*, 103 S. Ct. 3255, 3268 (1983) (Blackmun, J., dissenting).

duty to disclose or refrain when the tippee knows or has reason to know that material, nonpublic information has become available to him as the result of a breach of duty by the insider. The insider owes his duty to the corporation not to use or disclose the information for non-corporate purposes. One way an insider would breach this duty, is by disclosing the information to a tippee whom he knew would trade or was likely to trade on the basis of that information. Essentially, this solution is a hybrid of the standards used in *Investors Management* and *Dirks.*[128]

The advantage of this alternative is twofold. First, it retains the initial element of the *Dirks* holding, namely, that the tippee is viewed as a participant after the fact of the insider's breach. Unless the insider breaches his duty, the tippee is not obligated to disclose or refrain. As a result, the application of Rule 10b-5 is restricted to an extent, but not to the extreme which results from the *Dirks* holding.[129] Second, the alternative solution focuses the insider's duty on the conduct Congress sought to prevent, specifically, the fraudulent and manipulative use of nonpublic information to the detriment of the investing public.[130] Under the *Dirks'* rule, the insider's conduct is forbidden only when the insider gains a benefit from his disclosure. This premise ignores the fact that shareholders are injured regardless of whether the insider derives a benefit from his disclosure. Their injury transpires whenever the insider or his tippee trade on nonpublic corporate information, which if known to the shareholder, would have affected his decision to trade.[131] Certainly, a primary purpose of Rule 10b-5 is to prevent unjust enrichment of the insider. However, this is only one of the results the duty seeks to prevent.[132] This alternative solution ignores the personal benefit analysis and instead focuses on the conduct which is likely to lead to shareholder injury.[133]

Secrist clearly knew that Dirks would exploit the information

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128. Dirks v. S.E.C., 103 S. Ct. 3255 (1983); *In re* Investors Management Co., Inc., 44 S.E.C. 633 (1971). *See infra* note 133.

129. This alternative solution would not restrict application of Rule 10b-5 to the extent that the *Dirks* holding did since the second element of *Dirks* is discarded—the requirement that the insider gain a personal benefit.

130. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 195 (1976).

131. Indeed, this is the nature of material, nonpublic information. *See supra* note 21. It seems obvious that the shareholders who purchased the Equity Funding stock from Dirks' clients, would not have acquired the stock had they known of the fraud scheme. Yet, the fact that Secrist was not paid a cash bonus in consideration for his tip did not reduce the extent of the stockholder's injury.

132. *Dirks*, 103 S. Ct. 3255, 3271 n.9 (1983) (Blackmun, J., dissenting).

133. This alternative solution is not profound nor startling. It is in essence, an incorporation of first element of the *Dirks* holding with the standard for tippee liability as laid down by *Investors Management*. *See supra* note 20-32 and accompanying text. It merely restricts the application of the duty to disclose or refrain in regard to tippee trading, to those situations in which the insider has breached his own duty and the

that he had been tipped. Thus, under the alternative solution, Secrist would have breached his duty by tipping Dirks. Consequently, Dirks would have been obligated by the duty to disclose or refrain. Since Dirks did not publicly disclose the information before causing his clients to trade, he too breached his duty.[134]

CONCLUSION

Ever since the SEC heard the case of *Cady, Roberts & Co.*, the doctrine which it then expressed, the disclose or refrain rule, has been redefined and reinterpretated repeatedly. This effort reflects the inherently ambiguous nature of Section 10b and Rule 10b-5, to which the *Cady* doctrine applied. Section 10(b) and Rule 10b-5 were drafted in such a manner that judicial interpretation was essential. Because of this, the courts eventually expanded the rule to cover a variety of fraudulent activities in the securities market.

Attempting to define the scope of tippee liability, the courts in *Investors Management* and *Shapiro* exercised this role of expanding the scope of Rule 10b-5 liability. Their decisions reflected a belief that breaches by tippees were equally as scandalous as those of corporate insiders. A fundamental problem surfaced, however, when the Supreme Court in *Chiarella*, held that the duty to disclose or refrain arises only when an insider has a fiduciary or quasi-fiduciary relationship with the corporation from which the information derived. Thus, mere possession of inside information did not obligate a party to disclose or refrain.[135] However, the courts experienced difficulty in applying the *Chiarella* rule to tippees, since they typically were not fiduciaries or quasi-fiduciaries of the corporation. If the *Chiarella* rule were applied, most tippees would not become obligated by the *Cady* disclose or refrain duty. The Supreme Court, in *Dirks* attempted to rectify this inconsistency.

In *Dirks*, the Court restricted application of the *Cady* duty in regard to tippee trading to those instances when the insider breached his own fiduciary duty by deriving a personal gain from his disclosure. A tippee became obligated by a duty to disclose or refrain only when the insider breached his duty by acquiring a di-

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tippee knows of the breach. Dirks v. S.E.C., 103 S. Ct. 3255, 3264 (1983); *In re* Investors Management Co., Inc., 44 S.E.C. 633, 641 (1971).

134. The fact that this result is contradictory to the Court's apparent desire to *find* Secrist and Dirks not liable, manifests the problem mentioned above in *supra* notes 118-19 and accompanying text. The *Dirks* court seems to have designed a rule to fit the unique facts of the case. Under previous case law, Dirks and Secrist would have certainly violated Rule 10b-5. *See* Dirks v. S.E.C., 681 F.2d 824 (D.C. Cir. 1982), *rev'd*, 103 S. Ct. 3255 (1983); Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228 (2d Cir. 1974).

135. 445 U.S. 222, 232-35 (1980).

rect or indirect personal benefit. By adding the personal gain element to the insider's breach, the Court thereby substantially constricted tippee liability under Rule 10b-5. As this Note reveals, the Court has created a standard which may prove to be impracticable, thereby limiting its application to only those factual situations similar to *Dirks*.

As an alternative to the *Dirks* holding, this Note has suggested a standard which would avoid the pitfalls of the *Dirks* rule and yet, would still meet the Court's objective, to narrow the application of Rule 10b-5. By discarding the necessity of finding a personal benefit in the insider's breach, the alternative focuses on the insider's conduct and forbids those acts which would lead to shareholder injury.

This solution is essentially a compromise between the *Dirks* holding and the standard applied by the courts prior to this intriguing case. It represents a step, rather than a leap, towards restricting the application of Rule 10b-5 to tippee trading. Regardless whether the Court adopts a similar rule in the future, it seems certain that the Supreme Court will find it necessary to articulate a new standard which will narrow the scope of tippee liability, yet which will be sufficiently broad to "catch" the fraud Congress intended Section 10b to embrace.

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