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Dirks v. SEC's Footnote Fourteen: Horizontal and Vertical Reach

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NOTES

DIRKS v. SEC's FOOTNOTE FOURTEEN: HORIZONTAL AND VERTICAL REACH

In *Dirks v. SEC*,[1] the Supreme Court significantly narrowed the scope of tippee liability under the federal securities laws.[2] The Court held that a tippee[3] comes within the "disclose-or-abstain"[4] prohibition of rule 10b-5[5] only when the tipper breaches a fiduciary duty[6] to the

1. 103 S. Ct. 3255 (1983).

2. *See* Phillips, *Insider Trading Liability After* Dirks, 16 REV. SEC. REG. (S & P) 841, 844 (1983). The victor in the case, Raymond Dirks, believes the decision will "help securities analysts perform their job without fear of getting into trouble." H. BAKER, R. BARRON & H. HAVELES, JR., REGULATION OF BROKERS, DEALERS AND SECURITIES MARKETS ¶ 2.14[2], at S2-77 (Supp. 1983). *See also infra* notes 58-69 and accompanying text.

3. A "tipper" is a person who discloses material inside information. A "tippee" is the recipient of such information. *E.g.*, Grumet v. Shearson/American Express, Inc., 564 F. Supp. 336, 340 (D.N.J. 1983); 5A A. JACOBS, THE IMPACT OF RULE 10b-5 § 164 (1980).

4. The Second Circuit originated the "disclose-or-abstain" rule in SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 848 (2d Cir. 1968) (en banc), *cert. denied*, 394 U.S. 976 (1969). The defendants argued that legitimate corporate objectives prohibited them from publicly disclosing certain information prior to trading. The court replied that "anyone in possession of material inside information must either disclose it to the investing public, or, if he is disabled from disclosing it in order to protect a corporate confidence . . . must abstain from trading in or recommending the securities concerned while such information remains undisclosed." *Id. See infra* notes 33-40 and accompanying text.

5. Section 10(b) of the Securities Act of 1934 provides in pertinent part:

> 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.

15 U.S.C. § 78(j) (1976). The statute is a general provision prohibiting fraudulent practices. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 202-06 (1976). *See also* Miller v. Sebastian Gold Mines, Inc., 540 F.2d 807, 809 (5th Cir. 1976) (cause-of-action under section 10(b) requires showing of "fraud or deceit").

Rule 10b-5 promulgated pursuant to section 10(b), provides as follows:

> 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,

issuer's shareholders.[7] The Court further stated that an insider-tipper breaches this fiduciary duty only when he selectively discloses inside information for an improper purpose.[8] The tippee becomes secondarily liable only if he knew or should have known that the insider breached his fiduciary duty to the company's shareholders.[9]

The Court's decision closely follows the framework of analysis set forth in *Chiarella v. United States,*[10] in which the Court described the tippee as a "participant after the fact" in the tipper's breach of duty.[11] In footnote fourteen of its *Dirks* opinion,[12] the Court recognized that certain recipients of confidential corporate information might directly incur liability as "tippers,"[13] rather than as "tippees,"[14] pursuant to

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

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

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

17 C.F.R. § 240.10b-5 (1983).

6. A fiduciary must preserve the confidentiality of information obtained from the beneficiary. RESTATEMENT OF RESTITUTION § 200 (1937). *See also* RESTATEMENT (SECOND) OF AGENCY § 395 (1958) (agent under same duty to principal). Two corollaries follow from this rule. First, the fiduciary cannot use confidential information for his personal advantage. RESTATEMENT OF RESTITUTION, *supra,* at § 200 comment a. Second, the fiduciary must not "sell" confidential information to a third person. *Id.* comment b. *See* RESTATEMENT (SECOND) OF TRUSTS § 2 comment b (1959) (fiduciary cannot profit at beneficiary's expense). These principles form the basis of the Court's assertion in *Dirks* that a tipper does not violate rule 10b-5 unless he derives some personal advantage from the disclosure. *See infra* text accompanying notes 67-68.

7. Dirks v. SEC, 103 S. Ct. 3255, 3261-62 (1983).

8. *Id.* at 3265. The Court's determination of the tipper's purpose rests on objective criteria. The most important consideration is whether the insider personally benefits from the disclosure. *Id.* at 3266.

9. *Id.* at 3264.

10. 445 U.S. 222 (1980).

11. *Id.* at 230 n.12. *See infra* note 57 and accompanying text.

12. 103 S. Ct. at 3261 n.14. Footnote fourteen states in pertinent part:

> Under certain circumstances, such as where corporate information is revealed legitimately to an underwriter, accountant, lawyer, or consultant working for the corporation, these outsiders may become fiduciaries of the shareholders. The basis for recognizing this fiduciary duty is not simply that such persons acquired nonpublic corporate information, but rather that they have entered into a special confidential relationship in the conduct of the business of the enterprise and are given access to information solely for corporate purposes . . . . When such a person breaches his fiduciary relationship, he may be treated more properly as a tipper than a tippee . . . . For such a duty to be imposed, however, the corporation must expect the outsider to keep the disclosed nonpublic information confidential, and the relationship at least must imply such a duty.

13. *Id.*

14. *See supra* note 3 and accompanying text.

Chiarella's "after the fact" theory.[15] These "tippers" acquire a duty to abstain from trading[16] even though they receive nonpublic information for a legitimate purpose.[17]

The SEC contends that footnote fourteen undercuts the *Chiarella-Dirks* emphasis on fiduciary duty.[18] The Commission maintains that footnote fourteen presents a powerful mechanism for placing a duty to disclose on tippers and tippees.[19]

The SEC overstates the scope of footnote fourteen. Properly considered the footnote reaches only those persons with a preexisting contractual or ethical obligation to protect the confidentiality of inside information. This Note proposes that traditional concepts of agency law and fiduciary duty compel a limited reading of footnote fourteen that is consistent with the Supreme Court's development of 10b-5 doctrine in *Chiarella* and *Dirks.* Part One of this Note traces the historical origins of footnote fourteen.[20] Part Two considers the classes of persons characterized as "constructive insiders" that come within footnote fourteen's "horizontal scope."[21] Part Three examines the "vertical scope" of footnote fourteen, using the law firm as a model to determine whether courts should treat employees of "constructive insiders" as "tippers."[22] This Note concludes that footnote fourteen extends liability only to the extent necessary to prevent unreasonable results when an outsider[23] exploits confidential information.

15. 103 S. Ct. at 3261 n.14.

16. *See supra* note 4.

17. 103 S. Ct. at 3261 n.14.

18. *See infra* notes 50-57 and accompanying text.

19. *See, e.g.,* 15 SEC. REG. & L. REP (BNA), No. 38, 1820 (Sept. 30, 1983) ("valuable new tool"); Legal Times, Nov. 7, 1983, at 64, col. 4, n.51 ("salvation" for the SEC); *id.* at 28, col. 1 ("potent new theory"). The Commission has not articulated the boundaries of footnote fourteen. Telephone interview with Phillip Parker, Associate Director, SEC Enforcement Division (Feb. 8, 1984).

20. *See infra* notes 24-76 and accompanying text.

21. *See infra* notes 77-142 and accompanying text.

22. *See infra* notes 143-85 and accompanying text.

23. The term "outsider" refers to persons other than directors, officers, and controlling shareholders of the issuer. *See, e.g.,* S. REP. No. 792, 73d Cong., 2d Sess. 9 (1934) (persons covered by 15 U.S.C. § 78p(b) (1976)).

I. HISTORICAL ORIGINS OF FOOTNOTE FOURTEEN

A. *The Relational Theory*

In *Cady, Roberts & Co.*[24] a partner of a brokerage firm received information of a dividend reduction from a business associate[25] who was a director of the issuer.[26] The broker then sold shares of the affected company's stock for his customers and wife before the information became public.[27] When the SEC instituted a rule 10b-5 action against the broker, he argued that he had no fiduciary duty to a nonshareholder-purchaser.[28] The Commission rejected this argument, stating that common law principles of fiduciary relationships are not coextensive with the duty to disclose under rule 10b-5.[29]

In imposing "insider" status on the broker, the Commission established a two-part test to determine when a duty to disclose nonpublic information exists under rule 10b-5.[30] First, the person must have a relationship to a company that gives him access to information intended to be available only for a legitimate corporate purpose.[31] Second, private use of this information must be "inherently unfair."[32]

B. *The Equal Access Theory*

In *SEC v. Texas Gulf Sulphur Co.*[33] the Second Circuit extended the

24. 40 S.E.C. 907 (1961).
25. *Id.* at 909.
26. *Id.*
27. *Id.*
28. *Id.* at 913.
29. *Id.*
30. The Commission emphasized the remedial nature of the federal laws. *Id.* at 910.
31. *Id.* at 913-14. The Commission stated:

> Whatever distinctions may have existed at common law based on the view that an officer or director may stand in a fiduciary relationship to existing stockholders from whom he purchases but not to members of the public to whom he sells, it is clearly not appropriate to introduce these [distinctions] into the broader anti-fraud concepts embodied in the securities acts.

Id. at 913-14 (footnote omitted).

32. *Id.* at 912. In *Cady, Roberts* the SEC treated the broker as an insider because he had gained inside information through a special business contact. *Id.* The Commission stated: "[O]ur task here is to identify those persons who are in a special relationship with a company and privy to its internal affairs, and thereby suffer correlative duties in trading in its securities. Intimacy demands restraint lest the uninformed be exploited." *Id.*

33. 401 F.2d 833 (2d Cir. 1968), *cert. denied,* 394 U.S. 976 (1969). In *Texas Gulf Sulphur,* several officers and directors purchased additional shares in their company's stock based on confidential information concerning a possible mineral strike. In addition, the defendants selectively disclosed the information to a number of individuals who also purchased shares. *Id.* at 839-43.

scope of rule 10b-5 to cover any person in possession of inside information.[34] Although the Commission named only traditional insiders as defendants,[35] the Second Circuit shifted away from the relational focus of *Cady, Roberts*[36] to enunciate a broad "equal access" theory.[37] This theory provides that all investors trading on impersonal exchanges should have relatively equal access to material[38] information.[39] Under the court's analysis, an outsider in receipt of confidential information acquires a duty to "disclose or abstain" from trading.[40]

The Second Circuit again applied the equal access theory in *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*[41] Merrill Lynch agreed to underwrite a Douglas Aircraft Company debenture offering.[42] In its underwriting capacity, Merrill Lynch learned that Douglas' earnings had declined.[43] Before the information became public, Merrill Lynch

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34. *Id.* at 848.

35. *Id.* at 852-53. In dicta the court suggested that the defendants' tippees may be liable for trading on inside information. *Id.*

36. The court purported to apply the *Cady, Roberts* test. In quoting the test, however, the *Texas Gulf* court deleted the requirement of a "relationship" to the corporation. *See id.* at 848 (citing Cady, Roberts & Co., 40 S.E.C. 907, 912 (1961)).

37. The equal access theory has generated considerable controversy. *Compare* Brudney, *Insiders, Outsiders and Informational Advantages Under the Federal Securities Laws,* 93 HARV. L. REV. 322, 346 (1976) (informational advantages deprive investors of ability to compete) *with* Koeltl & Kubek, Chiarella *and Market Information,* 13 REV. SEC. REG. (S & P) 903, 905 (1980) ("equal access" theory ignores *Cady, Roberts* requirement of relationship to company).

38. Rule 10b-5 covers only *material* inside information. *See, e.g.,* SEC v. MacDonald, 699 F.2d 47, 49 (1st Cir. 1983). The test for materiality is whether there is "a substantial likelihood that, under all the circumstances, the omitted fact would have assumed actual significance in the deliberations of a reasonable shareholder." TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976).

The proposed Federal Securities Code would change the test to one focusing on whether a fact is of "special significance." FEDERAL SEC. CODE § 1603(a) (Proposed Official Draft 1978). The Code defines such a fact as one which, "in addition to being material, would be likely, if made available, to affect the market price of a security to a significant extent." *Id.* § 202(56).

39. 401 F.2d at 848. The court noted that rule 10b-5 is based "on the justifiable expectation of the securities marketplace that all investors trading on impersonal exchanges have relatively equal access to material information . . . ." *Id.*

40. *See supra* note 4 and accompanying text.

41. 495 F.2d 228 (2d Cir. 1974). Shortly after *Texas Gulf Sulphur,* the Second Circuit appeared to repudiate the equal access principle in General Time Corp. v. Talley Indus., Inc., 403 F.2d 159 (2d Cir. 1968), *cert. denied,* 393 U.S. 1026 (1969). The court stated: "We know of no rule of law . . . that a purchaser of stock, who was not an 'insider' and had no fiduciary relation to a prospective seller, had any obligation to reveal circumstances that might raise a seller's demands and thus abort the sale." *Id.* at 164. In *Merrill Lynch,* however, the Second Circuit clearly embraced the *Texas Gulf Sulphur* approach. *See infra* text accompanying note 49.

42. 495 F.2d at 232.

43. *Id.*

tipped certain institutional investors.[44] The tippees then sold their Douglas securities, thereby avoiding a loss that uninformed members of the public suffered.[45] The Second Circuit held, in part, that the "disclose-or-abstain" prohibition of rule 10b-5 applied to Merrill Lynch.[46] The court stated that Merrill Lynch breached its 10b-5 duty by selectively disclosing inside information.[47] Moreover, because Merrill Lynch's tippees enjoyed special access to inside information, they violated the rule by trading prior to public disclosure.[48] Under the equal access test, the court found the *Shapiro* insiders liable although they had disclosed inside information only for legitimate business reasons.[49]

C. *The Supreme Court's Emphasis on the Existence of a Fiduciary Duty and the Rejection of the Equal Access Theory*

The Supreme Court rejected the *Texas Gulf-Shapiro* equal access theory in *Chiarella v. United States.*[50] In *Chiarella* the Court reversed the conviction of a printer's employee who allegedly had violated section 10(b) and rule 10b-5.[51] The printer's corporate clients had deleted the names of the aggressors and targets on announcements of takeover bids to protect the confidentiality of the bids.[52] On five occasions, however, the defendant deduced the identities of the target companies and purchased shares before the bids were disclosed to the public.[53] The Court held that the "disclose-or-abstain" rule of 10b-5 applies only to individuals under an independent duty to disclose such information.[54] This duty arises only through the existence of a fiduciary[55] relationship

44. *Id.*
45. *Id.*
46. *Id.* at 238.
47. *Id.*
48. *Id.* The court held both the Merrill Lynch tippers and their tippees liable in damages to those who purchased Douglas securities prior to public disclosure of the adverse earnings information. *Id.*
49. *Id.* at 232, 238.
50. 445 U.S. 222 (1980).
51. *Id.* at 224.
52. *Id.* In the course of his employment, the printer received the names on the night of the final printing. *Id.*
53. *Id.*
54. *Id.* at 235.
55. The term "fiduciary" eludes precise definition. In the broadest sense, it refers "to any person who occupies a position of peculiar confidence toward another. It refers to integrity and fidelity." Kinzbach Tool Co. v. Corbett-Wallace Corp., 138 Tex. 565, 571, 160 S.W. 2d 509, 512 (1942).

between the person possessing inside information and the issuer.[56] The Court made only a passing reference to tippee liability, asserting that a tippee who traded on material, nonpublic information would be a "participant after the fact" in the tipper-insider's violation of rule 10b-5.[57]

The Court directly confronted the issue of tippee liability three years later in *Dirks v. SEC*.[58] In *Dirks*, a former employee[59] of Equity Fund-

56. Chiarella v. United States, 445 U.S. 222, 228 (1980) (quoting RESTATEMENT (SECOND) OF TORTS § 551(2)(a) (1976)).

57. 445 U.S. 222, 230 n.12 (1980). Pre-*Chiarella* courts divided on the theoretical justification for tippee liability. *See* Block & Solovy, *Developments Under Rules 10b-5 and 14e-3*, 2 FOURTEENTH ANN. INST. ON SEC. REG. 387-88 (1982). Those courts that did not predicate liability on a fiduciary duty to the issuer often viewed tippees as primary actors. *See, e.g.*, Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228, 237-38 (2d Cir. 1974) (no distinction between liability for tipping and trading); Investors Management Co., 44 S.E.C. 633, 644 (1971) (tippee's duty based on unequal access to corporate information). These courts tended to treat the tipper as an aider and abettor of the tippee's breach of duty. *See generally* Levine, Ferrigno, Watters & Mann, *Insider Trading: A Forty-Eight Year Assessment*, 2 FOURTEENTH ANN. INST. ON SEC. REG. 451 (1982) (summarizes theoretical basis for holding tippees liable under 10b-5). A number of courts and commentators, however, viewed the insider-tipper's breach as primary. *See, e.g.*, SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 853 (2d Cir. 1968) (en banc) (tippee's trading may be as "reprehensible" as insider's violation), *cert. denied*, 394 U.S. 976 (1969). For example, the SEC contended that an outsider's failure to trade did not absolve the tipper of liability. *See, e.g.*, Faberge, Inc., 45 S.E.C. 249, 257 (1973) (tipping alone violates rule 10b-5); Langevoort, *Insider Trading and the Fiduciary Principle: A Post* Chiarella *Restatement*, 70 CALIF. L. REV. 1, 28 n.111 (1982) ("better view is that selective disclosure is itself a breach"). *See also* 5A A. JACOBS, THE IMPACT OF RULE 10b-5 § 167, at 7-5 (1980) (summarizes Commission's pre-*Chiarella* position). The Commission would impose liability even though the tipper's fraud is unconnected with the "purchase or sale of a security." *See id.* (criticizes SEC's position). Of course, the theory cannot create a private cause of action, for without trading no damages arise. Elkind v. Liggitt & Meyers, Inc., 635 F.2d 156, 165 (2d Cir. 1980).

Most courts have followed *Chiarella*'s "after the fact" language in indicating that tippee liability is secondary. *See, e.g.*, Xaphes v. Shearson, Hayden, Stone, Inc., 508 F. Supp. 882, 886 (S.D. Fla. 1981) (tippees liable as participants after the fact); Kulla v. E.F. Hutton & Co., 426 So. 2d 1055, 1058 (Fla. Dist. Ct. App. 1983) (same). Some courts, however, have continued to treat tippees as primarily liable despite the absence of an independent duty. Block & Solovy, *supra*, at 389-90. *See, e.g.*, State Teachers Retirement Bd. v. Fluor Corp., 654 F.2d 843, 854-55 (2d Cir. 1981) (held tipper and tippee liable without mention of *Chiarella*).

Dirks follows *Chiarella* in asserting that the tippee's fiduciary duty to the issuer is secondary. 103 S. Ct. 3255, 3261 (1983). *See generally* Block & Solovy, *supra*, at 390-91 (discussing competing theoretical views of tippee liability).

58. 103 S. Ct. 3255 (1983).

59. The Court assumed, without discussion, that Ronald Secrist, the *former* employee, was an insider of Equity Funding. Traditional principles of agency law provide only superficial support for the Court's assumption. After the termination of an agency relationship, the agent cannot exploit confidential information previously acquired. RESTATEMENT (SECOND) OF AGENCY § 396(c),(d) (1959). *See also* H. REUSCHLEIN & W. GREGORY, THE LAW OF AGENCY AND PARTNERSHIP § 68, at 123 (1979) (former employee prohibited from using trade secrets). An agent's unauthorized use of confidential information creates a cause of action in favor of the former em-

ing, Inc. (EFCA), Ronald Secrist, passed inside information to Raymond Dirks, an investment adviser, to expose a massive criminal fraud.[60] Dirks investigated the allegations, verified the fraud's existence, and promptly advised his institutional clients of his findings.[61] Five clients consequently liquidated their EFCA holdings.[62] After public exposure of the EFCA fraud, the SEC brought a criminal action against Dirks, alleging that his selective disclosure of confidential information violated rule 10b-5.[63] The SEC found Dirks guilty, but only censured him[64] because of his role in bringing the EFCA fraud to light.[65]

The Supreme Court absolved Dirks of liability because he was not a fiduciary of EFCA's shareholders.[66] The Court reasoned that Dirks' informant had not acted improperly[67] because the informant had made no "secret profit" from the tip.[68] The Court found no derivative breach by Dirks because the insider-tipper had breached no duty to EFCA's

ployer. *See* RESTATEMENT (SECOND) OF AGENCY § 396(c) & comment g (1959) (use of trade secrets provides basis for restitution claim). In *Dirks*, the Court should have distinguished between insiders in criminal and civil cases. Secrist was an insider to the extent that he was under a duty to account to Equity Funding for profits obtained from his tip. The Court's extension of Secrist's duty to account for a criminal prosecution is not supportable. *See* Legal Times, July 11, 1983, at 1, col. 1 (suggests Court's assumption of insider status is mistaken).

60. 103 S. Ct. at 3258, 3268. The majority contended that Secrist advised Dirks to announce the fraud publicly. *Id.* Justice Blackmun, however, believed that Secrist tipped Dirks, hoping that Dirks would selectively disclose the information to his clients whose heavy selling would cause a dramatic drop in EFCA's market price and thus cause public attention to focus on EFCA. *Id.* at 3268 (Blackmun, J., dissenting). Even under Justice Blackmun's interpretation of the record, however, the insider received no personal gain from the disclosure. *Id.*

61. *Id.* at 3258. Dirks also urged *The Wall Street Journal* to expose the scheme. The newspaper, however, declined Dirks' request. *Id.*

62. *Id.*

63. *Id.* at 3259.

64. *Id.* at 3259. The Commission also found that Dirks had aided and abetted violations of § 17(a) of the Securities Act of 1933, which contains language virtually identical to that of rule 10b-5. *See* 15 U.S.C. § 77(q)(a) (1982). Section 17(a), however, does not apply to purchasers of securities. *See id.*

65. The Supreme Court disagreed on the importance of Dirks' role in exposing the Equity Funding fraud. The majority described Dirks' role as "important," 103 S. Ct. at 3259 & nn. 8, 18, while Justice Blackmun suggested that Dirks' contribution was minor. *Id.* at 3273 & n.15 (Blackmun, J., dissenting).

66. *Id.* at 3266-67.

67. *Id.* at 3267-68.

68. *Id.* The Court held that an insider's tip is improper only if he benefits personally. *Id.* at 3265. The benefit may be to the tippee's finances or reputation. *Id.* In dissent, Justice Blackmun criticized the test, but conceded that Dirks' informant did not benefit from the tip. *Id.* at 3270-71 (Blackmun, J., dissenting).

shareholders.[69] In footnote fourteen to the *Dirks'* opinion, however, the Court noted that certain individuals occupying a special relationship with a corporation may be considered as tippers, rather than as tippees, for purposes of determining the existence of a duty to disclose under rule 10b-5.[70]

Under *Chiarella* and *Dirks*, if an individual does not owe a direct or derivative duty to a corporation, he cannot be liable under rule 10b-5 for trading on material, nonpublic information.[71] The *Chiarella* characterization of a tippee as a "participant after the fact" in an insider's violation[72] would have led to absurd consequences in the absence of footnote fourteen.[73] No derivative breach occurs when a tippee receives confidential information for a legitimate purpose, as in *Dirks*.[74] In most situations, however, a tippee should not be free to exploit such information for his own personal benefit.[75] Footnote fourteen, however, provides a workable framework for analyzing such conduct.[76]

69. *Id.*

70. *Id.* at 3261 n.14, 3264. *See also* 5A A. JACOBS, THE IMPACT OF RULE 10b-5, § 167, at 7-4 (1975) (tippee liable only if he knew insider's disclosure constituted breach of trust). Justice Powell suggested that selective disclosure of confidential information promotes efficiency in the stock market. 103 S. Ct. at 3263 n.17. The argument, however, has its critics. *Compare* H. MANNE, INSIDER TRADING AND THE STOCK MARKET (1966) (insider trading promotes efficiency in the market) *with* W. PAINTER, THE FEDERAL SECURITIES CODE AND CORPORATE DISCLOSURE § 5.10 (1979) (prompt disclosure of confidential information promotes efficiency in the market).

71. *See supra* notes 54-57 & 66-70 and accompanying text.

72. Chiarella v. United States, 445 U.S. 222, 230 n.12 (1980). *See supra* text accompanying note 57.

73. *But see* Nat'l L.J., Sept. 19, 1983, at 64 n. 54, col. 2 (footnote fourteen is corollary of "participant after fact" theory). The article confuses the distinction between primary and secondary liability. *See* cases cited *supra* note 57.

74. *See supra* note 60 and accompanying text.

75. *See* Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, 495 F.2d 228, 235 (2d Cir. 1974) (rule 10b-5 designed to promote informed judgments by all investors); Radiation Dynamics, Inc. v. Goldmuntz, 464 F.2d 876, 890 (2d Cir. 1972) (10b-5 prevents tippees from abusing informational privileges).

76. After *Chiarella*, courts tended to ignore the "participant after the fact" theory in order to hold "constructive insiders" liable under 10b-5. *See generally* W. KNEPPER, LIABILITY OF CORPORATE OFFICERS AND DIRECTORS § 11.06, at 54 (3d ed. Supp. 1982) (pre-*Dirks* liability of constructive fiduciaries). For cases holding attorneys liable under rule 10b-5, decided between *Chiarella* and *Dirks*, see SEC v. Martin Cooper, No. 82-3462 (C.D. Cal. July 15, 1982) (consent) (attorney traded on information received from banker); SEC v. O'Connell, No. 80-6183 (S.D.N.Y. Oct. 30, 1980) (consent) (attorney traded in securities of target company after learning that it approved takeover bid).

After *Dirks*, the Southern District of New York upheld the guilty plea of Carlos Florentino, an attorney. He allegedly purchased stock in nine companies based on confidential information. SEC v. Florentino, [1983-1984 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 99, 465 (S.D.N.Y.

II. HORIZONTAL SCOPE OF FOOTNOTE FOURTEEN

A. Introduction

The language of footnote fourteen suggests that it applies to a limited class of professionals. The footnote states in part: "Under certain circumstances, such as where corporate information is revealed legitimately to an underwriter, accountant, lawyer, or consultant working for the corporation, these outsiders may become fiduciaries of the shareholders."[77] Because the Court undoubtedly did not intend this list to be exhaustive,[78] considerable controversy has arisen concerning the footnote's scope. Officials in the SEC, for example, have hailed the footnote as a powerful device to deter insider trading,[79] while others have argued that *Dirks* as a whole presents a serious threat to the Commission's enforcement efforts.[80]

B. The Fiduciary Framework

Footnote fourteen recognizes the fiduciary duties of certain classes of outsiders to an issuer. In doing so, the *Dirks* Court logically extends the *Cady, Roberts-Chiarella* requirement of a special relationship providing access to corporate information.[81] Traditional insiders, such as

Sept. 7, 1983). For a discussion of the safeguards subsequently implemented by Florentino's firm, see Nat'l L.J., Jan. 23, 1984, at 25, cols. 1 & 2.

Post-*Chiarella* courts also prohibited accountants from trading on inside information. *See, e.g.*, SEC v. Martin, No. C82-381 (W.D. Wash. April 7, 1982) (consent) (traded in targets of takeover bids on information obtained by clients); SEC v. Davidowitz, No. 81-4857 (S.D.N.Y. Aug. 6, 1981) (consent) (same). For cases holding broker-dealers liable under 10b-5, see SEC v. Fabregas, No. 82-3440 (C.D. Cal. July 14, 1982) (consent) (tipper); SEC V. Roussel, 1980 FED. SEC. L. REP. (CCH) ¶ 97,531 (D. Kan. 1980) (consent) (manager of tender offeror purchased target's shares).

77. *Dirks v. SEC*, 103 S. Ct. 3255, 3261 n.14.

78. *See* Comment, *Tippee Liability Under Rule 10b-5 Predicated On Whether Tipper Tips to Secure Personal Gain,* Dirks v. SEC, 62 WASH. U.L.Q. 165, 173 n.46 (1984).

79. *See supra* note 19 and accompanying text. Phillip Parker, an associate director of the SEC Enforcement Division, concedes that the misappropriation theory remains a more powerful theory than the "constructive insider" principle. Telephone interview with Phillip Parker (Feb. 8, 1984). *See infra* notes 164-85 and accompanying text (discussing the misappropriation theory).

80. *See, e.g.*, Phillips, *Insider Trading Liability After Dirks,* 16 REV. SEC. REG. (S & P) 841, 841 (1983) (*Dirks* "sharply limited" SEC's regulation of tippees); Wall St. J., July 5, 1983, at 5, col. 1 (*Dirks* "will make it harder for the SEC"). Because of concern over the *Dirks* decision, the House Energy & Commerce Committee directed the SEC to provide a report, including "(1) the number of insider trading cases brought, settled, and tried; (2) the propositions for which counsel cited *Dirks* in representing clients accused of insider trading; and (3) a summary and analysis of lower court decisions citing and interpreting *Dirks*." H.R. REP. No. 355, 98th Cong., 1st Sess. 1 (1983).

81. *See supra* notes 24-32 & 50-57 and accompanying text.

corporate officers and directors, are agents[82] of the corporation.[83] As agents, they owe duties of loyalty[84] and care[85] to the corporate entity and derivatively to its shareholders.[86] Certain outsiders, such as attorneys and underwriters, serve the issuer in a capacity that creates the same relationship of trust and confidence with the company.[87] These persons, by virtue of their preexisting fiduciary relationships with the issuer, cannot exploit corporate opportunities for their personal advantage.[88] Hence, footnote fourteen also prohibits these individuals from trading on confidential corporate information.[89]

The footnote does not expand the class of persons considered to be corporate fiduciaries.[90] Footnote fourteen merely recognizes that certain outsiders have a sufficiently close nexus to the corporation that

82. An "agent" is a person authorized to execute contracts on behalf of the principal. H. REUSCHLEIN & W. GREGORY, THE LAW OF AGENCY AND PARTNERSHIP § 49 (1979).

83. *E.g.,* G. BOGERT & G. BOGERT, THE LAW OF TRUSTS AND TRUSTEES § 16, at 94, 98 (2d ed. 1965); H. HENN & J. ALEXANDER, LAWS OF CORPORATIONS § 224, at 593 (3d ed. 1983). *See, e.g.,* Miller v. Miller, 301 Minn. 207, 219-20, 222 N.W. 2d 71, 78 (1974) (agency relationship underlies corporate opportunity doctrine); New York Trust Co. v. American Realty Co., 244 N.Y. 209, 216-17, 155 N.E. 102, 104 (1926) (agency relationship underlies prohibition against self-dealing). *But see* RESTATEMENT (SECOND) OF AGENCY § 14C (1958) (individual director not agent of corporation).

84. *See, e.g.,* New York Trust Co. v. American Realty Co., 244 N.Y. 209, 216, 155 N.E. 102, 104 (1926) (liability for self-dealing determined by common law agency principles). *See also* MODEL BUSINESS CORP. ACT § 41 (1980) ("Director Conflicts of Interest").

85. *See, e.g.,* Litwin v. Allen, 25 N.Y.S.2d 667, 699 (1940) (bank directors negligent in approving repurchase option pursuant to sale of securities). *Compare id. with* Schlensky v. Wrigley, 95 Ill. App. 2d 173, 182-83, 237 N.E.2d 776, 781 (1968) (directors not negligent in refusing to install lights in baseball stadium). *See generally* W. SEAVEY, STUDIES IN AGENCY § 401 (1949) (agent's obligation to exercise due care).

86. Langevoort, *supra* note 57, at 20. This list does not exhaust the duties owed by corporate agents. For example, common-law principles prohibit directors from favoring one class of stockholders at the expense of another. *See, e.g.,* Zahn v. Transamerica Corp., 162 F.2d 36, 46-47 (3d Cir. 1947) (corporation redeemed one class of equity securities at expense of another class).

87. Langevoort, *supra* note 57, at 19-20.

88. *See, e.g.,* Miller v. Miller, 301 Minn. 207, 219, 222 N.W.2d 71, 78 (1974). The court in *Miller* stated: "[O]ne entrusted with the active management of a corporation, such as an officer or director, occupies a fiduciary relationship to the corporation and may not exploit his position as an 'insider' by appropriating to himself a business opportunity properly belonging to the corporation." *Id.*

89. *See* ABA Comment Letter on Material, Non-Public Information (Oct. 15, 1973), *reprinted in* 233 SEC. REG. & L. REP. (BNA) D-2 & D5-D6 (outsiders' exploitation of inside information constitutes disregard of "legitimate business expectations of confidentiality").

90. *See* H. BAKER, R. BARRON, & H. HAVELAS JR., REGULATION OF BROKERS, DEALERS AND SECURITIES MARKETS ¶ 2.14 [2], at S2-76 (Supp. 1983) (footnote fourteen "useful guide" to determining presence of fiduciary duty).

they acquire fiduciary responsibilities.[91] The scope of footnote fourteen thus depends on the nature of fiduciary relationships. Under traditional agency principles, an agency relationship arises only on the mutual assent of the principal and agent.[92] This concept is the cornerstone of all consensual fiduciary relationships.[93] The *Dirks* footnote implicitly endorses the mutual assent requirement in two ways. First, the footnote requires that the issuer justifiably expect the information to remain confidential.[94] Second, the footnote's requirement of a "special confidential relationship" between the outsider and the corporation supplies this justification.[95]

This "special confidential relationship" requires the fiduciary's consent[96] and an implicit agreement to serve the beneficiary with utmost loyalty.[97] The fiduciary, moreover, must occupy a position of dominance over the principal.[98] The relationship between a corporation and an outsider satisfies these requirements only if the latter is under a preexisting duty to protect the confidentiality of corporate information. The duty exists only if the outsider actually or constructively consents to it. Actual consent arises through the existence of a contractual rela-

91. *See* ABA Comment Letter on Material, Non-Public Information, *supra* note 89, at D-6 (advisors have "required nexus" to corporation to preclude exploitation of confidential information).

92. *E.g.,* M. FERSON, PRINCIPLES OF AGENCY § 13 (1954); RESTATEMENT (SECOND) OF AGENCY § 15 (1959). *See, e.g.,* Valley View Cattle Co. v. Iowa Beef Processors, Inc., 548 F.2d 1219, 1221 (5th Cir.), *cert. denied,* 434 U.S. 855 (1977) (agency status created by contract or operation of law); Eitel v. Schmidlapp, 459 F.2d 609, 614 (4th Cir. 1972) (intention of parties "significant element" in determining whether agency relationship exists).

93. *See, e.g.,* Smith v. Merck, 206 Ga. 361, 368-69, 57 S.E.2d 326, 332 (1950) (agent is fiduciary of principal). *See generally* H. REUSCHLEIN & W. GREGORY, THE LAW OF AGENCY AND PARTNERSHIP § 67 (1979) ("The Agent as Fiduciary").

94. Footnote fourteen states in part: "For such a duty to be imposed, however, the corporation must expect the outsider to keep the disclosed nonpublic information confidential, *and the relationship at least must imply such a duty.*" 103 S. Ct. 3255, 3261 n.14 (1983) (emphasis added).

95. The footnote provides: "The basis for recognizing this fiduciary duty is not simply that such person acquired nonpublic information, but rather that they have entered into a *special confidential relationship* in the conduct of the business of the enterprise and are given access to information solely for corporate purposes." *Id.* (emphasis added).

96. *See* RESTATEMENT (SECOND) OF AGENCY § 15 comment b (1959) (person becomes fiduciary only if he consents).

97. *See* G. BOGERT & G. BOGERT, LAW OF TRUSTS § 86, at 315 (5th ed. 1973) (fiduciary owes duty of loyalty to beneficiary). *See also* RESTATEMENT (SECOND) OF AGENCY § 395 comment a (1959) (agent cannot profit by using confidential information); RESTATEMENT OF RESTITUTION § 200 (1937); (same prohibition applies to all fiduciaries); RESTATEMENT (SECOND) OF TRUSTS § 2 comment b (1959) (fiduciary under duty to act for principal's benefit).

98. G. BOGERT & G. BOGERT, LAW OF TRUSTS § 86, at 315 (5th ed. 1973).

tionship.[99] Constructive consent occurs by virtue of the outsider's pre-existing ethical duties to his corporate client.[100]

Typically a contract is insufficient to create a fiduciary relationship.[101] Ordinary business relationships contain no expectations of confidentiality and the parties' rights are freely transferable.[102] Courts, however, have historically attached extraordinary importance to certain types of consensual relationships, such as that existing between an employer and employee. An elementary principle of both agency[103] and securities law[104] provides that an employee possesses fiduciary duties to his superior with respect to confidential information acquired in the course of employment. For example, the *Dirks* Court assumed without discussion that Secrist, a former employee of Equity Funding, was an "insider."[105] Because many outsiders serve corporate clients in a capacity similar to that of an employee, a distinction between "employees" and "independent contractors"[106] can be misleading. For ex-

99. *See, e.g.,* Lord v. Jackman, 206 Kan. 22, 28, 476 P.2d 596, 600-01 (1970) (consent to agency relationship may be express or implied); Busby v. Walker, 84 So. 2d 304, 307 (La. Ct. App. 1955) (same).

100. *Cf.* Kennedy v. Justus, 64 N.M. 131, 134, 325 P.2d 716, 718 (1958) (agency relationship created by mutual consent or operation of law); Twin City Fire Ins. Co. v. Zupnik, 32 Ohio App. 138, 141 (1929) (same). The terms "actual" and "constructive" consent are of the author's own invention.

101. *See, e.g.,* Thomson v. Wheeler Constr. Co., 385 P.2d 111, 114 (Ala. 1963) (no fiduciary relationship between parties to construction contract). *See also* G. BOGERT & G. BOGERT, THE LAW OF TRUSTS AND TRUSTEES § 17, at 107 (2d ed. 1965). The authors state: "While one does not enter into a contract with another unless he trusts and has confidence in him, contract and debt amount to a business and not to a fiduciary relationship." *Id.*

102. G. BOGERT & G. BOGERT, *supra* note 83, § 17, at 107.

103. RESTATEMENT (SECOND) OF AGENCY § 395 (1959). *See, e.g.,* Textile Rubber & Chem. Co. v. Shook, 243 Ga. 587, 590, 255 S.E.2d 705, 708 (1979) (trade secrets); Packard Instrument Co. v. Reich, 89 Ill. App. 3d 908, 917, 412 N.E.2d 617, 623-24 (1980) (same).

104. *See, e.g.,* Memorandum of the SEC in Support of the Insider Trading Sanctions of 1982, *reprinted in* FOURTEENTH ANN. INST. ON SEC. REG. 442 n.4 (1982) ("insiders" includes employees of the issuer).

105. Dirks v. SEC, 103 S. Ct. 3255, 3267 (1983). *See supra* note 59 and accompanying text.

106. The distinction is relevant to the doctrine of *respondeat superior,* which refers to an employer's vicarious liability for torts committed by his "servants." *E.g.,* Dickson v. Graham-Jones Paper Co., 84 So. 2d 309, 310 (Fla. 1955); M. FERSON, PRINCIPLES OF AGENCY § 25 (1954); H. REUSCHLEIN & W. GREGORY, THE LAW OF AGENCY AND PARTNERSHIP § 52, at 101 (1979); W. SEAVEY, STUDIES IN AGENCY 129 (1949). The Restatement (Second) of Agency enumerates a number of factors that distinguish "servants" from "independent contractors." *See* RESTATEMENT (SECOND) OF AGENCY § 220(2) (1959). The most important consideration is the employer's power to control the details of the assignment. *E.g.,* Dickson v. Graham-Jones Paper Co., 84 So. 2d 309, 310 (Fla. 1955). For a historical analysis of the *respondeat superior* doctrine, see M. FERSON, PRINCIPLES OF AGENCY § 6 (1954).

ample, when a consulting analyst acquires access to secret corporate information, he remains an "independent contractor" although he occupies a position of special trust and confidence to the company.[107] The outsider's acceptance of this position justifies the company's expectation of confidentiality.[108]

The company's expectation is equally justified when the outsider is ethically obligated to protect the confidentiality of corporate information.[109] The clearest evidence of an ethical duty is its codification in a professional code.[110] For example, self-regulating organizations im-

107. In this respect, the consulting analyst resembles a number of outside corporate advisers, all of whom should be considered constructive insiders. These advisers include engineers, testing laboratories, underwriters, and public relations consultants. *See, e.g.,* Investors Management Co., 44 S.E.C. 633, 645 (1971), *cited in* Dirks v. SEC, 103 S. Ct. 3255, 3261 n.14 (1983) (prospective underwriter cannot disclose corporate information); C. ABELES, B. PRICE & T. SCHWAB, INSIDE INFORMATION: PREVENTION OF ABUSE A-12 (1979) (pre-*Chiarella* definition of "insiders" includes engineers and testing laboratories); AMERICAN STOCK EXCHANGE DISCLOSURE POLICIES § 402(6) (1970) (public relations consultants treated as insiders). Similarly, the Comptroller of the Currency prohibits banks from exploiting inside information. 12 C.F.R. § 9.7 (d) (1983) provides as follows:

> Every national bank exercising fiduciary powers shall adopt written policies and procedures to ensure that the Federal securities laws are complied with in connection with any decision or recommendation to purchase or sell any security. Such policies and procedures, in particular, shall ensure the national bank trust departments shall not use material inside information in connection with any decision or recommendation to purchase or sell any security.

See also Fed. Reserve Bd., *Policy Statement Concerning Use of Inside Information,* 64 FED. RESERVE BULL. 339, 340 (1978) (use of inside information to trade in securities is "an unsafe and unsound banking practice").

108. The outsider's access to confidential information creates an agency relationship with the principal. In this respect, the duties of employees and analysts are the same. The Restatement of Agency states:

> [M]ost of the persons known as agents, that is, brokers, factors, attorneys, collection agencies, and selling agencies are independent contractors . . . since they are contractors but, although employed to perform services, are not subject to the control or right to control of the principal with respect to their physical conduct in the performance of the services. However, they fall within the category of agents. *They are fiduciaries; they owe to the principal the basic obligations of agency loyalty and obedience.*

RESTATEMENT (SECOND) OF AGENCY § 14N comment a (1958) (emphasis added).

109. *See supra* note 100 and accompanying text; *see also* Levine, Ferrigno, Watters & Mann, *Insider Trading: A Forty-Eight Year Assessment,* in 2 FOURTEENTH ANN. INST. ON SEC. REG. 451, 541 (1982). The article states: "[T]he high ethical standards . . . of law, accounting and acceptable business practices and policies all mandate that the confidentiality of non-public information be preserved and that such information not be used as the basis for trading in securities." *Id.*

110. Professional codes serve a dual function. First, they provide guidance as to what constitutes acceptable conduct. *See, e.g.,* Patterson, *Wanted: A New Code of Professional Responsibility,* in T. MORGAN & R. ROTUNDA, PROFESSIONAL RESPONSIBILITY 21 (2d ed. 1981) (ABA Code "not for bad lawyers but for good lawyers"). Second, the codes serve as objective standards for measuring ethical violations. For example, the ABA Code of Professional Responsibility "points the

pose a duty on attorneys[111] and certified public accountants[112] to protect the confidentiality of client communications. The ABA's Code of Judicial Conduct similarly prohibits judges from exploiting information acquired in an official capacity.[113]

The same result should occur outside these self-regulated professions when the nature of the outsider's activities implies an ethical duty of confidentiality. In such cases, the absence of a professional code makes necessary a clear showing that public policy or societal expectations require the recipients of information to protect its confidentiality.[114]

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way to the aspiring and provides standards by which to judge the transgressor." MODEL CODE OF PROFESSIONAL RESPONSIBILITY Preamble (1981). *But cf.* MODEL RULES OF PROFESSIONAL CONDUCT Preamble (Final Draft 1983) (violation of ethical rules does not, in itself, create cause of action).

111. The ABA Code of Professional Responsibility provides: "A lawyer should not use information acquired in the course of the representation of a client to the disadvantage of the client and a lawyer should not use, except with the consent of his client after full disclosure, such information for his own purposes." MODEL CODE OF PROFESSIONAL RESPONSIBILITY EC 4-5 (1981), *see also* MODEL CODE OF PROFESSIONAL RESPONSIBILITY DR 4-101(B) (1981) (prohibits disclosure of confidential client information in most circumstances); *cf.* CANONS OF PROFESSIONAL ETHICS Canon 37 (superseded 1970) (pre-Code duty to preserve client's confidences).

112. J. CAREY & W. DOHERTY, ETHICAL STANDARDS OF THE ACCOUNTING PROFESSION 134 (1966). The American Institute of Certified Public Accounts (AICPA) codified this rule. Accountants cannot disclose confidential information about their clients except (1) when necessary to avoid violation of accounting standards, (2) when necessary to comply with a valid subpoena or summons, or (3) in connection with a voluntary AICPA or state investigation. AICPA PROFESSIONAL STANDARDS ET 301.01 (1981); *cf.* RULES OF PROFESSIONAL CONDUCT Rule 16 (1950) (members "shall not violate the confidential [client] relationship"). Nineteen states have created an accountant-client privilege by statute. D. CAUSEY, JR., DUTIES AND LIABILITIES OF PUBLIC ACCOUNTANTS 60 (1982).

113. CODE OF JUDICIAL CONDUCT Canon 5(C)(7) (1979) provides: "Information acquired by a judge in his judicial capacity should not be used or disclosed by him in financial dealings or for any other purpose not related to his judicial duties." *Id.* The rule originated in the judge's fiduciary capacity. R. WISE, LEGAL ETHICS 653 n.9 (Supp. 1979).

114. *Cf.* Rodgers v. Arapahoe Pipe Line Co., 185 Kan. 424, 430, 345 P.2d 702, 707 (1959) (party claiming benefit of agency relationship must demonstrate its existence by "clear and satisfactory evidence"). Courts should require such a showing because privileges of confidentiality occasionally impede the administration of justice. *See, e.g.,* THE AMERICAN LAWYER'S CODE OF CONDUCT Preface (Rev. Draft 1982) (lawyer's duty of confidentiality sometimes impedes justice).

Professional codes provide objective standards to determine acceptable behavior. Without such a rule, measurement of ethical conduct becomes a rather esoteric enterprise. In the context of legal ethics, one commentator states:

> The problems of legal ethics are those between right and right, not between right and wrong, for genuine ethical problems always create a dilemma for the lawyer. The basic duties—loyalty, candor, and fairness—all conflict with each other if carried to their logical extremes, and the question of the right thing to do in a particular situation is a matter of degree. This means that the solution to the problem is a matter of sound judgment.

Patterson, *Wanted: A New Code of Professional Responsibility,* in T. MORGAN & R. ROTUNDA, For example, to allow government officials to trade on inside information could seriously undermine public confidence in those officials.[115] Furthermore, imposition of a fiduciary duty encourages corporate compliance with governmental investigations.[116] Courts should thus treat government officials as trustees of information they acquire in the course of public service.[117] This ethical duty of confidentiality translates into a duty to abstain from trading pursuant to footnote fourteen.[118]

C. The Boundaries of Fiduciary Duty

The class of "constructive insiders" should not extend beyond those persons who contractually or constructively agree to enter a "special confidential relationship" with the corporation. The court's opinion in *SEC v. Lund*[119] illustrates the danger of a broad interpretation of footnote fourteen. Horowitz and Lund were co-directors of Verit Industries.[120] Horowitz was also the president of P & F Industries, Inc.[121] P & F negotiated with another company concerning a possible joint ven-

PROFESSIONAL RESPONSIBILITY 21 (2d ed. 1981). Moreover, the presence of objective standards promotes enforcement of ethical norms. *See* Fleischer, Mundheim & Murphy, *An Initial Inquiry into the Responsibility to Disclose Market Information,* 121 U. PA. L. REV. 798, 822-23 (1973) (self-regulated professions are easily policed). These considerations support a restrictive reading of footnote fourteen in the absence of easily identifiable ethical standards. Otherwise, an unworkable burden falls on the regulatory authorities charged with enforcement of rule 10b-5. In each case, these authorities would have to identify and weigh policy considerations favoring an ethical duty of confidentiality. *See* SEC v. Monarch Fund, 608 F.2d 938, 942 n.2 (2d Cir. 1979) (insiders under duty to disclose because they "are readily identified and easily policed").

115. The judiciary provides one illustration. The prohibition against judges' trading on confidential information fosters respect for the judicial system. *See supra* note 113 and accompanying text; *cf.* CODE OF JUDICIAL CONDUCT Canon 2(A) (1979) (ethical rules designed to promote public confidence in judiciary).

116. *Cf.* Black v. Sheraton Corp. of America, 564 F.2d 531, 545-46 (D.C. Cir. 1977) (government's evidentiary privilege concerning investigations designed to promote law enforcement).

117. *See* Langevoort, *supra* note 57, at 34-35 (government official owes fiduciary duty to public investors); *see also* 15 U.S.C § 78x (1976) (SEC members prohibited from exploiting information acquired in investigation); 18 U.S.C. § 1905 (1976) (disclosure of confidential information by federal employee is felony). The policy considerations behind judges' ethical duties of confidentiality are equally applicable to all government officials. *See supra* notes 113 & 115 and accompanying text.

118. *See* H.R. REP. No. 355, 98th Cong., 1st Sess. 4 (1983) (footnote fourteen includes government officials). *But see* N.Y.L.J., August 17, 1983, at 2, cols. 4 & 5 (government officials under no fiduciary duty to issuer's shareholders).

119. 570 F. Supp. 1397 (C.D. Cal. 1983).

120. *Id.* at 1399.

121. *Id.*

ture involving the establishment of a gambling casino.[122] Horowitz, on behalf of P & F, asked Lund if his company would help finance the venture.[123] Lund rejected the offer, but purchased shares in P & F on the basis of this information.[124] The SEC sought an injunction and disgorgement of profits, claiming that Lund violated section 10(b) and rule 10b-5 by trading on inside information.[125]

The court quoted footnote fourteen and held that Lund was a constructive insider of P & F.[126] Thus, Lund could not trade in P & F securities on the basis of material, nonpublic information.[127] The court reasoned that the friendship between Lund and Horowitz created a "special relationship" within the meaning of footnote fourteen.[128] Moreover, the court asserted that their personal relationship implied that the information was to be kept confidential.[129] The court concluded that Lund's receipt of the information created a duty to disclose or abstain from trading.[130]

The *Lund* court misconstrued the nature of footnote fourteen.[131] Although Lund and Horowitz may have enjoyed a confidential relationship,[132] the court erroneously fit their relationship within footnote fourteen. First, Lund's relationship was not with P & F, but with Horowitz. Footnote fourteen requires a special confidential relationship between the outsider (Lund) and the issuer (P & F).[133] The entrance of certain outsiders "into a special confidential relationship in

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122. *Id.*

123. *Id.* at 1400.

124. *Id.* Lund purchased 10,000 shares of P & F common stock at $1.25 per share. After P & F publicly announced the merger, Lund sold his P & F stock at a price averaging $2.50 per share. *Id.*

125. *Id.* at 1399. The SEC initiated the action under three independent theories: (i) insider liability, (ii) tippee liability, and (iii) misappropriation. After the Supreme Court decided *Dirks*, the SEC withdrew its allegation of tippee liability, for Horowitz had tipped Lund solely to secure investment capital. The parties submitted supplemental briefs discussing the impact of *Dirks*. *Id.* at 1399 n.1.

126. *Id.* at 1402-03.

127. *Id.* at 1403.

128. *Id.*

129. *Id.*

130. *Id.*

131. The SEC considers *Lund* a "major victory" that illustrates the utility of footnote fourteen. 15 SEC. REG. & L. REP. (BNA) No. 38, 1818 (Sept. 30, 1983).

132. Lund conceded this point. *See* Defendant's Opposition Post-Trial Memorandum of Law at 9.

133. Dirks v. SEC, 103 S. Ct. 3255, 3261 n.14 (1983).

the conduct of the business of the enterprise"[134] constitutes the justification for footnote fourteen. Lund's rejection of Horowitz's invitation to enter a business relationship with P & F[135] did not create the "special confidential relationship" required under footnote fourteen. Lund, moreover, was not a fiduciary of Horowitz,[136] for friendship alone does not create a fiduciary relationship.[137] Although the two friends had a confidential relationship,[138] confidentiality does not create a fiduciary relationship without the recipient's consent.[139]

Lund illustrates the danger of applying footnote fourteen to persons who would not otherwise be corporate fiduciaries. The *Lund* court imposed a duty on the defendant to abstain from trading solely because he had received confidential information. *Chiarella* expressly rejected this theory.[140] *Lund*'s expansive reading of footnote fourteen threatens to revive the *Texas Gulf* equal access theory despite the Court's clear intention to put that theory to rest.[141] The class of constructive insiders properly includes only those outsiders with preexisting contractual or ethical duties to refrain from exploiting confidential corporate information.[142]

III. VERTICAL SCOPE OF FOOTNOTE FOURTEEN

A. Introduction

The duty of confidentiality does not bar constructive insiders from exposing their employees to sensitive client information.[143] The SEC

134. *Id.* (citations omitted).

135. 570 F. Supp. at 1400

136. Defendant's Opposition Post-Trial Memorandum of Law at 10.

137. Recent Decisions, *Applicability of Insider Responsibility to Broker in Possession of Inside Corporate Information,* 60 MICH. L. REV. 651, 654 (1962). *See also* G. BOGERT & G. BOGERT, LAW OF TRUSTS § 86, at 315 (5th ed. 1973) (family relationship creates duty of loyalty if position of dominance and superiority). *But see* Ross v. Licht, 263 F. Supp. 395, 409-10 (S.D.N.Y. 1967) (close friends of controlling stockholders are insiders).

138. *See supra* note 132 and accompanying text.

139. *See supra* notes 96-97 and accompanying text.

140. *See supra* notes 50 & 54-56 and accompanying text.

141. *See* text accompanying notes 54-56 & 66-68.

142. The proposed Federal Securities Code would extend the coverage of rule 10b-5 even further. It covers "a person whose relationship or former relationship to the issuer gives or gave him access to a fact of special significance about the issuer or the security that is not generally available." FED. SEC. CODE § 1603(b)(3) (Proposed Official Draft 1978).

143. The duty of confidentiality does not prohibit the fiduciary from using confidential information for the principal's own benefit. *E.g.,* RESTATEMENT (SECOND) OF TRUSTS § 2 comment b (1959); RESTATEMENT OF RESTITUTION § 200 comment a (1937). The employee's exposure to

contends that such employees inherit from their employers a fiduciary responsibility to keep client information confidential.[144] Under this view, employees become constructive fiduciaries of the client and thereby acquire a duty to abstain from trading in the client's securities.[145] For example, a law firm's fiduciary duties would vertically extend to all its employees.[146] The law firm provides a useful model for exploring the vertical scope of the *Dirks* footnote.[147]

B. The Apparent Paradox

A fiduciary duty extends to all those with a preexisting ethical or contractual relationship with the issuer.[148] An attorney has an ethical duty to maintain the confidences of his firm's corporate clients even though he did not directly receive inside information.[149] The law firm's

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client information should redound to the client's benefit. *See* RESTATEMENT (SECOND) OF AGENCY § 5 comment b (1959) (agent can delegate power, even though he remains primarily responsible toward the principal). For example, the ABA Model Rules expressly permit lawyers to discuss client affairs with other employees of the firm. MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.6 comment (Final Draft 1983).

144. Telephone interview with Phillip Parker, Associate Director, SEC Enforcement Division (Feb. 8, 1984).

145. *See* Dirks v. SEC, 103 S. Ct. 3255, 3261 n.14 (1983).

146. *See* Insider Trading by Law Firm Employees, SEC Securities Exchange Act Release No. 13,437 (Apr. 8, 1977). The release states:

> The antifraud provisions of the Federal securities laws . . . mandate that the confidentiality of non-public information be preserved and in particular that such information not be used as the basis for trading in securities. *This obligation extends not only to partners in the law firm but also to associated lawyers and service personnel employed by the firm.*

Id. (emphasis added). The Commission has recently initiated a major crackdown against insider trading by nonlawyer employees of large firms. N.Y.L.J., Jan. 23, 1984, at 25, col. 1.

147. An analogous "vertical problem" involves multi-service brokerage houses. These institutions typically maintain separate departments involving corporate acquisitions and personal investment advice. *E.g.*, Herzel & Colling, *The Chinese Wall Revisited*, 6 CORP. L. REV. 116 (1983). The acquisitions and underwriting departments regularly receive material inside information. When brokerage houses maintain a fiduciary relationship with an issuer, they become constructive insiders under footnote fourteen. *See, e.g.*, Merrill Lynch, Pierce, Fenner & Smith, 43 S.E.C. 933, 937 (1968) (managing underwriter cannot disclose inside information to other departments). As a result, multiservice securities firms usually erect "Chinese Walls" to restrict the access of most administrative departments to confidential information. *See generally* Harman, *Chinese Wall*, in TWELFTH ANN. INST. ON SEC. REG. 703-14 (1980) (summarizes "Chinese Wall" techniques). The courts have divided on the sufficiency of the Chinese Wall defense in insider trading cases. *Compare* Slade v. Shearson, Hammill & Co., 517 F.2d 398, 403 (2d Cir. 1974) (rejected Chinese Wall defense) *with* O'Brien v. Continental Ill. Nat'l Bank & Trust Co. of Chicago, 431 F. Supp. 292, 297 (N.D. Ill. 1977) (approved Chinese Wall defense).

148. *See supra* notes 99-100 and accompanying text.

149. *See* MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.10 comment (Final Draft 1983) (lawyer having access to client information acquires duty of confidentiality); *see also* New York

fiduciary obligations thus extend vertically to all its attorneys.[150]

Less clear, however, is the question whether the firm's obligations extend to its nonlawyer employees.[151] This category includes paralegals, clerks, and secretaries.[152] Under traditional agency principles, an employee becomes a fiduciary of the employer with respect to information received in the course of employment.[153] For example, when a legal secretary legitimately receives inside information, he owes a duty to his employer to protect its confidentiality.[154] Footnote fourteen, however, requires a fiduciary relationship with the firm's client.[155] The secretary is not a fiduciary of the firm's client for two reasons. First, the secretary has no contractual or apparent authority[156] to affect the client's rights or responsibilities.[157] Second, the employee's contractual relationship with his employer does not constitute actual or constructive consent to serve as the client's fiduciary.[158] Power[159] and mutual assent are essential attributes of agency relationships.[160] Bootstrapping the

City Bar Ass'n Comm. on Professional Ethics and Grievances, Formal Op. 225 (1932) (attorney who overhears another's client cannot exploit information thus acquired); MODEL RULES OF PROFESSIONAL CONDUCT Rules 5.1 & 5.2 (Final Draft 1983) (lawyers bound by ethical rules even though not directly responsible to client); THE AMERICAN LAWYER'S CODE OF CONDUCT Preface (Rev. Draft 1982) (obligation of confidentiality extends beyond lawyer-client relationship).

150. *But see* N.Y.L.J., Sept. 19, 1983, at 22, col. 1 ("not at all clear" that lawyer not assigned to the case acquires fiduciary duty to the client).

151. The Canons of Professional Ethics extended the duty of confidentiality to nonlawyer employees. CANONS OF PROFESSIONAL ETHICS Canon 37 (superseded 1970). Similarly, a few jurisdictions extend the attorney-client privilege to nonlawyer employees. *See, e.g.,* N.J. STAT. ANN. § 2A:158A-12 (West 1971) (attorney-client privilege extends to Public Defender's employees); N.Y. CIV. PRAC. LAW § 4503(a) (Consol. 1963) (mandatory attorney-client privilege extends to attorney's employees).

152. *See* Nat'l L.J., Sept. 19, 1983, at 22, col. 1 (questioning applicability of footnote fourteen to these persons).

153. *See* Brophy v. Cities Servs. Co., 31 Del. Ch. 241, 244, 70 A.2d 5, 7 (1949) (employee in possession of confidential information concerning client becomes fiduciary of employer). *See supra* text accompanying note 103.

154. *See supra* notes 103-04 and accompanying text.

155. Dirks v. SEC, 103 S. Ct. 3255, 3261 n.14 (1983).

156. "Apparent authority" refers to the "power to affect the legal relations of another person by transactions with third persons, professedly as agent for the other, arising from and in accordance with the other's manifestations to such third persons." RESTATEMENT (SECOND) OF AGENCY § 8 (1958).

157. *See* RESTATEMENT (SECOND) OF AGENCY § 18 & comment b (1959) (fiduciary cannot delegate power requiring use of discretion).

158. *See supra* notes 96-100 and accompanying text.

159. "Power" refers to "an ability on the part of a person to produce a change in a given legal relation by doing or not doing a given act." RESTATEMENT (SECOND) OF AGENCY § 6 (1958).

160. *See supra* notes 86 & 102 and accompanying text.

secretary's duties to encompass those of the firm conflicts with the principle that a secretary's obligations extend only to his employer.

Traditional agency principles[161] prohibit the employee from exploiting confidential information acquired in the course of employment.[162] It would be anomalous indeed to permit the legal secretary to use such information while subjecting the firm's attorneys to liability under rule 10b-5.[163] Imputing the firm's obligations to the secretary, without confusing the distinct spheres of the employer-employee and firm-client relationships, requires some middle step.

C. *Misappropriation and the Middle Step*

The misappropriation theory[164] advanced in *United States v. Newman*[165] provides the middle step. The issue of misappropriation arises when an outsider, after legitimately receiving information in the course of his employment, converts that information to his own use.[166] Under this theory a secretary acquires the firm's fiduciary duties if he misuses confidential information.[167] In this context, the secretary's misappropriation violates his fiduciary duties to the firm.[168]

The Second Circuit defined the boundaries of this type of misappro-

161. *See* RESTATEMENT (SECOND) OF AGENCY § 395 (1959) (agent prohibited from using confidential information for his own benefit).

162. RESTATEMENT OF RESTITUTION § 200 (1937).

163. Typically, non-lawyer employees are fully aware of the prohibition against misuse of client information. *See infra* Appendix. For example, many firms require new employees to agree in writing to protect the confidentiality of information obtained in the course of employment. *See, e.g.*, Nat'l L.J., Jan. 23, 1984, at 26, cols. 1-2 (Wachtell, Lipton's safeguards against insider trading); *cf.* Sperry Rand Corp. v. Rothlein, 241 F. Supp. 549, 559 (D. Conn. 1964) (employee contract designed to protect trade secrets). In such circumstances, the codification of the attorney's ethical duties to the firm's clients does not justify distinctions between the ethical responsibilities of a lawyer and a legal secretary. *See* Insider Trading by Law Firm Employees, SEC Securities Exchange Act Release No. 13437 (Apr. 8, 1977) (securities antifraud laws apply to nonlawyer employees). *But cf.* Comment, *The Dutiful Relationships of Section 10(b): The* Chiarella *Decisions*, 42 U. PITT. L. REV. 637, 649-50 (1981) (rule 10b-5 does not cover employee's misuse of information obtained from employer).

164. *See infra* notes 165-85 and accompanying text.

165. 664 F.2d 12 (2d Cir. 1981). *See infra* text accompanying notes 169-74.

166. For instance, Vincent Chiarella's activities constituted such a conversion. *Chiarella v. United States*, 445 U.S. 222, 244-45 (1980) (Burger, C.J., dissenting); *id.* at 245-46 (Blackmun, J., dissenting). A second type of misappropriation occurs when an outsider illegally obtains inside information, such as through the theft of corporate documents. Legal Times, July 11, 1983 at 28, col. 1.

167. *See supra* note 111 and accompanying text.

168. *See supra* note 111 and accompanying text. *But see* Irving Trust Co. v. Deutsch, 73 F.2d 121, 125 (2d Cir. 1934) (employee not fiduciary toward employer).

priation in *United States v. Newman*.[169] In *Newman* the government alleged that two employees of investment banking firms disclosed confidential information about impending takeovers to Newman.[170] Newman then passed the information to two confederates.[171] Based on this information, the three conspirators purchased shares in the target companies.[172] The court held that Newman would be criminally liable if he had aided and abetted the misappropriating tippers,[173] for the investment bankers had acquired the information in their capacity as fiduciaries of the target companies.[174]

Dirks' focus on the relationship of the parties[175] does not foreclose acceptance of the *Newman* theory.[176] *Dirks* simply requires a fiduciary breach against the issuer as an element of outsider liability. *Newman* supplies a means of acquiring this fiduciary responsibility. Imposing the fiduciary duties of an employer upon a misappropriating employee is fully consistent with *Dirks*.[177] For example, if a legal secretary re-

169. 664 F.2d 12 (2d Cir. 1981).

170. *Id.* at 15.

171. *Id.*

172. *Id.*

173. *Id.* at 16. In Moss v. Morgan Stanley, Inc., 719 F.2d 5 (2d Cir. 1983), *cert. denied*, 104 S. Ct. 1240 (1984), the Second Circuit limited *Newman*'s holding to criminal prosecutions. *Id.* at 15-16. The court noted that an employee of a corporate fiduciary owes no duty of disclosure to the general public. *Id.* at 15.

174. *Id.* at 17-18. In *Chiarella* the Commission argued that the defendant breached a fiduciary duty to his employer by trading on confidential corporate information. *See* Chiarella v. United States, 445 U.S. 222, 243 (1980) (Burger, C.J., dissenting). *Newman*, however, does not suggest approval of such a theory, for *Chiarella* held that a duty to disclose arises from a special relationship with the *issuer's* shareholders. *See infra* notes 176-79 and accompanying text. In *Chiarella* the printer was a fiduciary of the aggressors in impending takeover bids.

175. *See supra* notes 58-70 and accompanying text.

176. Footnote fourteen independently justifies the result reached in *Newman*. Newman's informants, investment bankers, were insiders of the issuer. Under this approach, Newman would be criminally liable as a tippee. *See generally* Phillips, *Insider Trading Liability After* Dirks, 16 REV. SEC. REG. (S & P) 841, 846 (1983) (footnote fourteen's impact on *Newman* remains unclear); N.Y.L.J., Aug. 18, 1983, at 2, cols. 3-4 (same).

177. *Dirks* offers some support for the *Newman* misappropriation theory. *See* N.Y.L.J., Aug. 18, 1983, at 2, cols. 3-4 (*Dirks* does not undermine *Newman*). The Court pointed out that Dirks did not "misappropriate or illegally obtain the information about Equity Funding." Dirks v. SEC, 103 S. Ct. 3255, 3267 (1983). Moreover, Chief Justice Burger, the proponent of the misappropriation theory in *Chiarella*, joined the Court's opinion in *Dirks*. A number of commentators, however, contend that the *Newman* misappropriation theory is inconsistent with *Dirks*. *See, e.g.*, Phillips, *Insider Trading Liability After Dirks*, 16 REV. SEC. REG. (S & P) 841, 845-46 (1983) (*Dirks'* rationale "squarely contradicts" misappropriation theory); 15 SEC. REG. & L. REP. (BNA) No. 37, 1773 (Sept. 23, 1983) (*Dirks* "lend[s] no support" for misappropriation theory); N.Y.L.J., Sept. 6, 1983, at 2, col. 1 ("very little in *Dirks* to support" *Newman* theory); Legal Times, July 11,

ceives corporate information in the course of employment and exploits that information, he should inherit the firm's ethical obligations to the issuer. The *Newman* theory provides the means for imposing the firm's fiduciary duties on those employees who knowingly exploit inside information.[178] The employee, by violating his fiduciary duty to the employer, should acquire a duty to abstain from trading in the client's securities.[179]

Without the functional application of *Newman*, *Chiarella* and *Dirks* dictate an absurd result. For example, if an attorney with a special relationship to an issuer[180] "tips" his secretary for an improper purpose[181] and the secretary trades, the latter is clearly liable under *Chiarella* as a "participant after the fact."[182] If, however, the attorney discloses the information for a legitimate purpose, such as through routine dictation, the secretary would avoid liability for trading unless the *Newman* theory applied.[183] The secretary's conduct is the same in both situations. If he acquires a derivative duty in the first situation,[184] he should also inherit a duty in the second.[185]

1983, at 15, col. 1 ("*Dirks* decision tends to vitiate . . . misappropriation theory"). These criticisms correctly assert that *Newman* is no longer viable to the extent that it rests on a duty to persons other than the issuer. Nevertheless, *Dirks* does not forclose a union of the *Newman* and "constructive insider" theories to impose a fiduciary responsibility on a misappropriating employee toward the issuer's shareholders.

178. Many commentators criticize the misappropriation theory as an improper intrusion into a state law matter. *See, e.g.*, Wang, *Post-*Chiarella *Developments in Rule 10b-5*, 15 REV. SEC. REG. (S & P) 956, 961 (1982) (misuse of information covered by state law); Comment, *The Dutiful Relationships of Section 10(b): The* Chiarella *Decisions*, 42 U. PITT. L. REV. 637, 649-50 (1981) (theft of information adequately covered by state law). These criticisms, however, do not apply to the author's functional use of *Newman*. The critics premise their argument on the adequacy of state law. If the misappropriating employee acquires a duty to his employer's client, however, he becomes a "constructive insider" under footnote fourteen. *See supra* notes 164-74 and accompanying text. If he trades, he violates 10b-5. The presence of state blue sky laws does not supplant the federal sanction.

179. The SEC does not follow this approach. The Commission views the "misappropriation" and "constructive insider" concepts as completely separate. Telephone interview with Phillip Parker, Associate Director, SEC Enforcement Division (Feb. 8, 1984).

180. *See supra* note 70 and accompanying text.

181. *See supra* notes 67-68 and accompanying text.

182. *See* United States v. Chiarella, 445 U.S. 222, 230 n.12 (1980).

183. *Dirks* states that a tippee is liable only if the tipper breached a fiduciary duty in making the disclosure. Dirks v. SEC, 103 S. Ct. 3255, 3264 (1983). *See supra* notes 76-79 and accompanying text.

184. *See supra* note 163 and accompanying text.

185. *Cf.* Dirks v. SEC, 103 S. Ct. 3255, 3271 (1983) (Blackmun, J., dissenting) (*Dirks'* "improper purpose" requirement anomalous because it does not affect shareholders' injury).

IV. CONCLUSION

The *Chiarella-Dirks* emphasis on fiduciary duty undoubtedly leaves unregulated some unfair trading practices.[186] Footnote fourteen provides a workable device to impose a fiduciary obligation on those outsiders who occupy a special position within the securities markets. A balanced reading of the footnote, however, suggests its limitations. It covers only those persons with preexisting duties to the issuer's shareholders and, derivatively, those persons who misappropriate inside information from corporate fiduciaries.

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186. For example, aggressors in takeover fights typically obtain corporate information that is inaccessible to members of the general public. *E.g.,* 13A B. FOX & E. FOX, BUSINESS ORGANIZATIONS, CORPORATE ACQUISITIONS AND MERGERS § 27.05 [4] (1981). *See supra* note 57 and accompanying text. Similarly, journalists investigating corporate wrongdoing regularly obtain confidential information. Neither the aggressor nor the journalist is a fiduciary of the issuer. *See supra* notes 96-100 and accompanying text (discussing the elements of a fiduciary relationship). As a result, they are not constructive insiders and can trade on secret information. *See generally* Wall St. J., Feb. 27, 1984, at 23, col. 3 (SEC investigation of insider trading violations by CBS employees).

APPENDIX

LAW FIRM POLICY STATEMENTS CONCERNING INSIDER TRADING

1. Anonymous

Staff members are to observe strict rules of confidentiality with regard to any and all information received in the capacity of employment. This requires that information concerning clients of the firm must not be discussed with anyone within or outside of the office. Written materials should not be taken outside the office except when authorized.

A breach of confidentiality could result in termination.

2. Bryan, Cave, McPheeters & McRoberts (St. Louis, Mo.)

As previously noted, the policy of this Firm is that *all* client matters are confidential. Many matters which we handle for our clients are of such a nature that any disclosure of, or reference to, such problems outside the Firm could have a major adverse impact not only upon our clients but also upon the Firm and its relationship with our clients.

In this regard, you are reminded that many of our clients have publicly traded securities and that the Firm routinely receives information which has not been released to the public and which could be of great significance in the securities trading market. The antifraud provisions of the Federal securities laws, as well as our ethical standards, mandate that the confidentiality of nonpublic information be preserved and, in particular, that such information not be used as the basis for trading in securities. This obligation extends not only to the lawyers of the Firm, but also to all legal assistants, secretaries and administrative personnel. The Securities and Exchange Commission vigorously enforces this policy, as evidenced by the attached article which appeared in the *Federal Securities & Corporate Developments* section of the *Securities Regulation & Law Report* in October 1983.

You are reminded that such information should not only be held in confidence by you, but, in addition, that you are not permitted to use any information either for personal gain or to assist others to achieve a personal gain.

Any violation of the foregoing policy against trading securities on the basis of confidential information could result in civil or criminal proceedings brought against you by the Securities and Exchange

Commission and other agencies and *will* result in your dismissal from the Firm.