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Vi. Common Law Derivative Recovery Of Insider Profits

Chris-Craft and the more restrictive posture that the Supreme Court generally has adopted toward private actions under the federal securities laws.

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VI. COMMON LAW DERIVATIVE RECOVERY OF INSIDER PROFITS

Whether a corporate insider may be held accountable to the corporation for profits realized through trading in the corporate stock on the basis of undisclosed material information is a question that neither common law doctrine nor the existing federal statutory scheme has answered adequately. Under common law, insider trading[1] traditionally imposed no fiduciary duties on a corporate insider with respect to the corporation[2] since the fiduciary obligations extended only to corporate affairs.[3] A transaction in corporate stock was deemed to be a private transaction rather than a corporate function. Thus, an insider could purchase or sell stock of his or her corporation as a private individual, free of any extrinsic obligations to the corporation.

Supplementing the unrestrictive common law doctrine with respect to insider trading obligations is section 10b of the Securities Exchange Act of 1934 ('34 Act).[4] Section 10b makes unlawful the use or employment of any manipulative or deceptive device in violation of Securities Exchange Commission (SEC)[5] regulations in connection with the sale or purchase of

[1] Insider trading is a term of art connoting the purchase or sale of corporate stock by persons who, because of their relationship to the corporation, are privy to nonpublic material information. Anyone in possession of material inside information may be considered an insider under the Securities Exchange Act of 1934 ('34 Act). 15 U.S.C. §§ 78a-78kk (1976). *See, e.g.*, SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 848 (2d Cir. 1968), *cert. denied sub nom.* Coates v. SEC, 394 U.S. 976 (1969).

[2] Although insider traders owed no common law fiduciary duty to the corporation, there is a conflict of opinion with regard to the common law duties owed by an insider to shareholders from whom securities are purchased or to whom securities are sold without disclosure of information which affects the value of the shares. *See* 3A W. FLETCHER, CYCLOPEDIA OF CORPORATIONS §§ 1167-74 (1974) [hereinafter cited as FLETCHER]; H. Henn, Law of Corporations § 239 (2d ed. 1970) [hereinafter cited as HENN]; 3 L. LOSS, SECURITIES REGULATION 1446-48 (2d ed. 1961) [hereinafter cited as Loss]. Under the majority rule, no fiduciary or affirmative duties of disclosure arise in a stock transaction between an insider and an outside shareholder. *See, e.g.*, Janigan v. Taylor, 344 F.2d 781, 784 (1st Cir. 1965). Under the minority rule, a fiduciary duty is owed to outside stockholders and full disclosure of all material facts is required prior to purchase or sale of corporate stock by an insider. *See, e.g.*, Mansfield Hardwood Lumber Co. v. Johnson, 268 F.2d 317, 321-27 (5th Cir. 1959). A third, less widely recognized rule only imposes a fiduciary duty of disclosure under special facts or exceptional circumstances. *See, e.g.*, Strong v. Repide, 213 U.S. 419, 434 (1909).

[3] Directors and officers of a corporation are under pervasive duties of loyalty and allegiance to their corporation. These fiduciary duties require good faith and fair dealing in all corporate endeavors. *See generally* HENN, *supra* note 2, at §§ 235-38.

[4] 15 U.S.C. § 78j (1976). *See generally* Loss, *supra* note 2, at 1448-73.

[5] The Securities and Exchange Commission (SEC) is a quasijudicial federal agency

any security. The SEC regulation which effectuates section 10b is Rule 10b-5.[6] Rule 10b-5 explicitly proscribes any act or practice which operates or would operate as a fraud or deceit in connection with a securities transaction. Section 10b and Rule 10b-5 thus act as comprehensive antifraud provisions,[7] and have been extended judicially to encompass nondisclosure of material information,[8] as well as affirmative misrepresentations[9] when an insider trades in the stock of his or her corporation. Rule 10b-5 has expanded the duty which an insider owes to shareholders from whom securities are purchased.[10] The cause of action for breach of Rule 10b-5 duties is limited, however, in that standing to sue in a private action brought under Rule 10b-5 is restricted by a purchaser-seller requirement.[11] The purchaser-seller requirement mandates that only actual purchasers or sellers of the involved securities may maintain a private damage action under Rule 10b-5. Insofar as a corporation generally will not meet the purchaser-seller requirement,[12] a Rule 10b-5 action normally will not be a viable means to effect corporate recovery of insider profits, either directly or through a shareholder derivative action.[13]

Corporate recovery of profits realized through insider trading may be

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which was established by the '34 Act for the purpose of administering federal securities laws. 15 U.S.C. §§ 78d to d-2 (1976). The SEC is composed of five bipartisan commissioners appointed by the President with the advice and consent of the Senate to serve five year terms. *Id.* § 78d.

[6] 17 C.F.R. § 240.10b-5 (1978). See generally FLETCHER, *supra* note 2, at § 900.3.

[7] Rule 10b-5 has been judicially construed to provide for a private cause of action to recover damages. *See, e.g.,* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 196 (1976); Kardon v. National Gypsum Co., 73 F. Supp. 789, 800 (E.D. Pa. 1947). In addition, in a 10b-5 action, the common law requirements of scienter, deception, reliance and privity are generally relaxed. *See* HENN, *supra* note 2, at 298; 6 LOSS, *supra* note 2, at 3869-96; Comment, *Damages to Uninformed Traders For Insider Trading on Impersonal Exchanges,* 74 COLUM. L. REV. 299, 302-305 (1974) [hereinafter cited as *Uninformed Traders].*

[8] *See, e.g.,* SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 848 & 854 (2d Cir. 1968).

[9] *See* Arber v. Essex Wire Corp., 490 F.2d 414, 418 (6th Cir.), *cert. denied,* 419 U.S. 830 (1974).

[10] *See, e.g.,* SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968).

[11] *See* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975). *Blue Chip* reaffirmed the rule set forth in Birnbaum v. Newport Steel Co., 193 F.2d 461, 464 (2d Cir.), *cert. denied,* 343 U.S. 956 (1952), which held that standing to sue in a private 10b-5 action is dependent upon fraud perpetrated in connection with the actual purchase or sale of a security. *See generally 1976-1977 Securities Law Developments: Rule 10b-5,* 34 WASH. & LEE L. REV. 882, 882-87 (1977).

[12] *See, e.g.,* Norsul Oil and Mining, Ltd. v. Texaco, Inc., 309 F. Supp. 1242, 1245 (S.D.N.Y. 1970). Generally, corporations will not meet the purchaser-seller requirement when an insider trades in the corporate stock since the sale or purchase of stock will involve an anonymous extra-corporate third party rather than the corporation. *But see* Brophy v. Cities Serv. Co., 31 Del Ch. 241, 70 A.2d 5 (1949) (insider trading based on knowledge of corporation's plan to purchase own stock; corporation could have met purchaser-seller requirement by virtue of purchase).

[13] A shareholder derivative action, as developed in equity, allows a corporate stockholder to enforce a right of the corporation where the corporation has refused to sue on its own behalf. *See generally* FED. R. CIV. P. 23.1; HENN, *supra* note 2, at §§ 358-76.

allowed, however, under section 16(b) of the '34 Act.[14] Section 16(b) gives the issuer of a security a cause of action to recover any profits realized by a corporate officer, director, or beneficial owner in connection with the sale and purchase or purchase and sale of the securities of the issuer within a six month period.[15] If the issuer of a security fails or refuses to bring suit under section 16(b) within sixty days after a request to initiate suit is made by an owner of the issuer's securities, a shareholder derivative action may be brought.[16] The purpose of section 16(b) is to protect outside shareholders from the manipulative practices which result from insider trading on undisclosed inside information,[17] and to provide all persons trading in the stock market with equal access to material information.[18] By allowing corporate recapture of profits gained through shortswing transactions which occur within a six month period, section 16(b) acts as a deterrent to certain insider trading.[19]

The deterrent effect of section 16(b) is limited, however, insofar as only officers, directors, or beneficial owners are subject to the regulatory provisions.[20] In addition, section 16(b) only regulates trading that occurs within a six month period. Thus, an insider who holds stock for at least six months prior to resale is not subject to 16(b) liability regardless of whether the transaction involved the use of undisclosed material information.[21] As a result of these pervasive limitations on its scope, section 16(b) cannot fully provide for corporate recovery of all insider trading profits. These shortcomings in the existing federal statutory scheme illustrate the inadequacy of presently available federal remedies[22] and suggest the need for develop-

[14] 15 U.S.C. § 78p (1976); *see* HENN, *supra* note 2, at § 298; 2 Loss, *supra* note 2, at 1040-89. Section 16(a) of the '34 Act requires that any director, officer, or 10% beneficial owner of a corporation must file initial reports with the SEC disclosing the amount of all equity securities of the corporation which the insider owns. 15 U.S.C. § 78p(a) (1976). Subsequent reports must be filed promptly upon any change in the ownership of such securities. *Id.*

[15] 15 U.S.C. § 78p(b) (1976); *see* text accompanying notes 16-19 *infra.*

[16] *See* note 13 *supra.* Derivative actions brought under § 16(b) are subject to a two-year statute of limitations, 15 U.S.C. § 78p(b) (1976), and must be brought in federal court. 15 U.S.C. § 78aa (1976).

[17] Smolowe v. Delendo Corp., 136 F.2d 231, 235-38 (2d Cir.), *cert. denied,* 320 U.S. 751 (1943). Section 16(b) recovery is based on the notion that confidential nonpublic information is essentially corporate property. *See* Cook & Feldman, *Insider Trading Under The Securities Exchange Act,* 66 HARV. L. REV. 385, 408 (1953). *Contra,* H. MANNE, INSIDER TRADING AND THE STOCK MARKET (1966) (defense of insider trading as a positive market force).

[18] *See* Cady, Roberts & Co., 40 S.E.C. 907, 912 (1961).

[19] While failing to cover transactions which do not occur within a six month period, § 16(b) presumes the use of inside information in any shortswing transactions and imposes liability per se regardless of whether the transactions involved were predicated on inside information and regardless of the insider's good faith.

[20] Section 16(b) will not deter trading by people such as "tipees," who are not officers, directors, or beneficial owners of the corporation. "Tipees" are extra-corporate persons to whom confidential inside information is disclosed.

[21] *See, e.g.,* Roberts v. Eaton, 212 F.2d 82, 85-86 (2d Cir.), *cert. denied,* 348 U.S. 827 (1954).

[22] Sections 10b and 16(b) of the '34 Act are presently the primary federal remedies for

ment of an alternative cause of action.

In *Diamond v. Oreamuno,*[23] the New York Court of Appeals attempted to create such an alternative remedy. The plaintiff-shareholder in *Diamond* brought suit in state court asserting a derivative action against officers and directors of Management Assistance, Inc. (MAI).[24] Due to a sharp increase in the cost of services in August 1966, MAI's monthly net earnings declined approximately seventy-five percent.[25] Prior to public disclosure of MAI's decreased earnings, the chairman and president of MAI sold substantial personal holdings of MAI stock with knowledge of the corporation's markedly decreased earnings.[26] Through their timely sales of stock, the defendants allegedly were able to realize substantially more for their securities than they would have had they not been privy to the inside information regarding MAI's earnings outlook.[27] Plaintiff-shareholder sought to have the defendants account to the corporation for the "profit" realized on the sales of their stock prior to public disclosure of the inside information, which when disclosed effected a substantial drop in the market value of MAI stock.[28]

In upholding the sufficiency of the *Diamond* complaint, the New York Court of Appeals recognized the inapplicability of federal remedies.[29] Alternatively, the court relied on common law principles of agency and trusteeship to define a fiduciary duty between a corporate insider and his or

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recovery of insider trading profits. 15 U.S.C. §§ 78j & p (1976). Class action suits, however, may provide a third possible federal remedy. *See* FED. R. CIV. P. 23. *See generally* Bernfeld, *Class Actions and Federal Securities Law,* 55 CORNELL L.Q. 78, 78-94 (1969); Note, *Class Action Treatment of Securities Fraud Suits Under the Revised Rule 23,* 36 GEO. WASH. L. REV. 1150, 1150-68 (1968). In Diamond v. Oreamuno, 24 N.Y.2d 494, 248 N.E.2d 910, 301 N.Y.S.2d 78 (1969), the court explicitly acknowledged that federal class actions might become an effective alternative to existing remedies. *Id.* at 502, 248 N.E.2d at 915, 301 N.Y.S.2d at 84. The mechanics of such an action, however, remain unresolved. Thus class actions presently are an uncertain vehicle to effect derivative recovery of insider trading profits. Difficulties involved in litigating a class action suit to recover insider profits would include procurring certification under FED. R. CIV. P. 23, properly defining the plaintiff class, providing requisite notification to members of the class, determining the measure of damages, and administering the distribution of the recovered profits. *See* Note, *Class Action Treatment of Securities Fraud Suits Under The Revised Rule 23,* 36 GEO. WASH. L. REV. 1150, 1153-66 (1968).

[23] 24 N.Y.2d 494, 248 N.E.2d 910, 301 N.Y.S.2d 78 (1969). *Diamond* was the first state case to allow stockholder derivative recovery of insider profits derived by corporate officers or directors from trading in the corporate stock. *See generally* 9 GA. L. REV. 189 (1974); 83 HARV. L. REV. 1421 (1970); 1970 WIS. L. REV. 576; 55 VA. L. REV. 1520 (1969).

[24] 24 N.Y.2d at 496-97, 248 N.E.2d at 911, 301 N.Y.S.2d at 79-80.

[25] *Id.*

[26] *Id.*

[27] *Id.* The defendants sold their stock for $28 per share. Following public disclosure of MAI's drop in earnings, the value of MAI stock fell to $11 per share. *Id.*

[28] *Id.; see* note 27 *supra.* The plaintiff-shareholder alleged that the defendants had breached a fiduciary duty to the corporation by trading on the basis of undisclosed material information, thus giving rise to a common law cause of action. 24 N.Y.2d at 496, 248 N.E.2d at 911, 301 N.Y.S.2d at 79.

[29] 24 N.Y.2d at 500-03, 248 N.E.2d at 913-15, 301 N.Y.S.2d at 82-85 (federal remedies inapplicable because statutory requirements not met).

her corporation with respect to the exploitation of inside information for personal benefit.[30] Two primary elements served to establish this duty. First, the court impliedly held that inside information was the functional equivalent of a corporate asset to which fiduciary duties could attach.[31] Traditionally, inside information has not been considered a corporate asset unless the information was of such a nature as to provide the corporation with a "corporate opportunity."[32] The *Diamond* court, however, did not address the issue of fiduciary duty in terms of lost corporate opportunity. Rather, *Diamond* relied on the Restatement (Second) of Agency, which emphasizes the means by which confidential information is acquired and strictly imposes liability for misuse if the information was acquired in the course of an agent's employment.[33] Thus, *Diamond* impliedly held that corporate information acquired by virtue of a confidential employment relationship is tantamount to a corporate asset to which fiduciary responsibility is owed.[34]

Second, the *Diamond* court held that actual damage to the corporation is not an essential element for a cause of action founded on a breach of duty

[30] The *Diamond* court relied upon Brophy v. Cities Serv. Co., 31 Del Ch. 241, 70 A.2d 5 (1949). In *Brophy,* an employee who was not an officer or director of Cities Services Co., had knowledge of a Cities Services plan to purchase significant quantities of its own stock on the open market. With this knowledge, the employee bought stock for his personal account prior to the Cities Services' purchase. Subsequently, the employee sold the stock after the company's purchase resulted in an increase in the market price of the securities. A stockholder derivative suit was brought to effect common law recovery of all profits realized from the employee's purchase and sale of this stock. *Id.* at 7. The *Brophy* case may possibly be distinguished from *Diamond* in that actual pecuniary harm could have occurred to the corporation in *Brophy.* The employee's purchase of stock conceivably caused Cities Services to purchase its stock at a higher price. The *Brophy* court, however, did not require actual loss to the corporation to be pleaded or proved in the derivative action. *Id.* at 8. *See generally* 63 HARV. L. REV. 1446, 1446-48 (1950).

[31] 24 N.Y.2d at 497-98, 248 N.E.2d at 912, 301 N.Y.S.2d at 80. If inside information is considered a corporate asset, the use of that information in insider trading by an officer or director would be tantamount to misappropriation or conversion. Virtually no controversy exists over the liability imposed on corporate officers or directors for such unauthorized use of corporate assets. *See* FLETCHER, *supra* note 2, § 1102.

[32] Under the corporate opportunity doctrine, an officer or director is under a fiduciary duty not to appropriate, for their own benefit, opportunities in which the corporation has a right, interest, or expectancy. *See, e.g.,* Irving Trust Co. v. Deutsch, 73 F.2d 121 (2d Cir. 1934). *See generally* HENN, *supra* note 2, § 237.

[33] 24 N.Y.2d at 501, 248 N.E.2d at 914, 301 N.Y.S.2d at 83. The RESTATEMENT (SECOND) OF AGENCY § 388, Comment c (1958) states in relevant part:

> An agent who acquires confidential information in the course of his employment or in violation of his duties has a duty . . . to account for any profits made by the use of such information, although this does not harm the principal. . . . So, if he [a corporate officer] has "inside" information that the corporation is about to purchase or sell securities, or to declare or to pass a dividend, profits made by him in stock transactions undertaken because of his knowledge are held in constructive trust for the principal.

[34] The actual pecuniary value of inside information to the corporation in a *Diamond*-type situation is uncertain.

by a corporate fiduciary.[35] Absent a requirement of actual damage, the court reasoned that corporate officers or directors, as fiduciaries with respect to corporate assets, should not be allowed to retain profits derived solely from exploitation or violation of their fiduciary obligations.[36] The *Diamond* court realized that existing federal legislation would not apply to all cases of trading on inside information,[37] and thus sought to remedy the unregulated abuse of inside information by creating a common law cause of action premised on notions of fiduciary responsibility.[38]

Other states, however, have not followed New York's innovative concept and have refused to create a state remedy allowing derivative recovery of insider profits regardless of whether actual harm occurred to the corporation. In *Schein v. Chasen,*[39] the Florida Supreme Court explicitly refused to adopt the *Diamond* rationale to allow derivative recovery of profits realized by non-insiders who trade in the corporation's stock on the basis

[35] 24 N.Y.2d at 498, 248 N.E.2d at 912, 301 N.Y.S.2d at 81. Harm to the corporation was not deemed essential because the function of an action founded on breach of a fiduciary duty is not merely compensation but deterrence. *Id.* The New York Court of Appeals viewed a remedy based on breach of fiduciary responsibility as an essentially preventative measure. By removing the inducement to use inside information to trade in the corporate stock, the *Diamond* court sought not merely to compensate for, but to prevent such abuse. *Id.*

[36] In actions based on conversions or misappropriations of corporate assets, actual harm to the corporation generally is irrelevant. *See, e.g.,* Higgins v. Shenango Pottery Co., 256 F.2d 504 (3d Cir. 1958); Irving Trust Co. v. Deutsch, 73 F.2d 121 (2d Cir. 1934). *See also* FLETCHER, *supra* note 2, § 1102. The *Diamond* court intimated, however, that insider realization of profits based on undisclosed information could, in effect, cause harm to the corporation by adversely affecting the marketability of the corporate stock by undermining public regard for the corporation once the public becomes aware of the insider dealings. 24 N.Y.2d at 499-500, 248 N.E.2d at 912-13, 301 N.Y.S.2d at 81-82. The prestige and good will of a corporation may inevitably suffer as a result of the appearance of corporate dishonesty conveyed through insider trading.

[37] *See* text accompanying notes 4-22 *supra.*

[38] 24 N.Y.2d at 497-504, 248 N.E.2d at 912-15, 301 N.Y.S.2d at 80-86.

[39] 313 So. 2d 739 (Fla. 1975). In *Schein,* corporate shareholders of Lum's, Inc., a Florida corporation, initially brought a derivative suit in a New York federal district court to recover profits realized by numerous defendants through trading on the basis of inside information. The district court held Florida law to be applicable and granted summary judgment to the defendants from which the plaintiffs appealed. Gildenhorn v. Lum's, Inc., 335 F. Supp. 329 (S.D.N.Y. 1971). On appeal, the Second Circuit agreed that the substantive law of Florida should govern the case. Schein v. Chasen, 478 F.2d 817, 821 (2d Cir. 1973). Since there was no clearly enunciated state law, the Second Circuit looked primarily to New York law as set forth in *Diamond* and sought to discern how the Florida court would interpret the *Diamond* decision. *Id.* The court, in reversing the district court's decision, held that the *Diamond* holding should be extended to reach third parties who knowingly join or participate in an enterprise whereby a violation of a fiduciary duty to the corporation occurs. 478 F.2d at 822. On appeal to the United States Supreme Court, the Second Circuit's opinion was vacated and remanded. Lehman Bros. v. Schein, 416 U.S. 368 (1974). The Supreme Court directed that the question be certified to the Florida Supreme Court as is provided for under Florida law. FLA. STAT. ANN. § 25.031 (West 1973). The Court emphasized that certification was particularly appropriate in light of the novelty of the issue presented, the lack of Florida precedents, and the questionable ability of a New York court to predict accurately uncertain Florida law. 416 U.S. at 391.

of inside information received from an insider prior to public disclosure. In *Schein,* a corporate president privately informed certain outsiders that his corporation's earnings would be significantly lower than had been publicly predicted.[40] On the basis of this information, and prior to public disclosure, the outsiders sold their holdings of the corporation's stock, anticipating the significant decrease in the market value of the stock which occurred upon public disclosure of the company's actual earnings.[41] The Florida Supreme Court rejected *Diamond* and refused to hold third party extra-corporate defendants to the same risk of liability as insiders who trade on the basis of undisclosed inside information.[42] In so holding, the Florida court declined to extend the fiduciary duty imposed on corporate officers and directors to those who become functional fiduciaries through the acquisition of confidential information belonging to the corporation.[43] The Florida Supreme Court adopted the reasoning that the central element of third party fiduciary liability must be the third party's active and intentional encouragement and participation in an agent's violation of a fiduciary duty owed to the corporate principal.[44] Absent such active involvement by a extra-corporate third party in the breach of a fiduciary duty, the *Schein* court determined that the *Diamond* rationale for liability ceases to exist,[45] and thus refused either to adopt or expand the innovative *Diamond* ruling.[46]

Recently, in *Freeman v. Decio,*[47] the Seventh Circuit similarly rejected *Diamond* by holding that Indiana law would not recognize a *Diamond*-type cause of action. In *Freeman,* the plaintiff-shareholder initiated a derivative suit in federal court alleging that the defendant corporate directors sold

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[40] 313 So. 2d at 741.

[41] *Id.*

[42] *Id.* at 746-47.

[43] The Second Circuit had previously adopted the position that fiduciary responsibility should extend beyond corporate employees. Schein v. Chasen, 478 F.2d 817, 823 (2d Cir. 1973). The Second Circuit relied upon the RESTATEMENT (SECOND) OF AGENCY § 312 which defines third party liability as arising when one causes or assists an agent to violate his fiduciary duty, and Comment c to § 312 which indicates that one who receives confidential information with notice that an agent is violating a duty by disclosing such information, in effect, becomes a fiduciary with respect to that information. RESTATEMENT (SECOND) OF AGENCY § 312, Comment c (1958).

[44] 313 So. 2d at 745.

[45] *Id.* The Florida Supreme Court adopted the reasoning set forth in Judge Irving Kaufman's dissent from the Second Circuit's opinion in Schein v. Chasen. *Id.* at 743-46. Kaufman distinguished *Diamond* as pertaining only to officers and directors, who by virtue of their position are in a fiduciary relationship to the corproation. 478 F.2d at 826-27. Absent a fiduciary relationship, Kaufman found the *Diamond* rationale for imposition of liability to be inapposite. *Id.* Judge Kaufman disagreed with the majority reasoning of the Second Circuit that a joint or common enterprise with a corporate officer existed, and thus, found no basis for extension of the *Diamond* rationale. *Id.* at 825-28.

[46] 313 So. 2d at 746. The Florida court also stipulated that actual damage to the corporation must be alleged and proved to substantiate a stockholder derivative action. *Id.* at 746-47.

[47] 584 F.2d 186 (7th Cir. 1978).

and transferred personal holdings of the corporation's stock on the basis of material nonpublic information.[48] Given the lack of Indiana precedent, the Seventh Circuit was required to determine whether the Indiana courts would be more likely to follow the New York Court of Appeal's holding in *Diamond* or the Florida Supreme Court's holding in *Schein.*[49] Reviewing the *Diamond* decision, the Seventh Circuit recognized the public policy considerations on which *Diamond* is based, and acknowledged that the discouragement of insider trading is widely accepted from a policy point of view.[50] Nevertheless, the Seventh Circuit questioned the propriety of the *Diamond* court's ruling and refused to accept the *Diamond* rationale.[51]

The *Freeman* decision rests primarily on the Seventh Circuit's rejection of the premise, set forth in *Diamond,* that inside information is the equivalent of a corporate asset to which fiduciary responsibility will attach. Acceptance of this premise removes the need to prove actual injury to the corporation.[52] The *Freeman* court, however, rejected the premise and determined that there is no injury to the corporation in a *Diamond*-type suit which can serve as a basis for recognizing a right of recovery in favor of the corporation.[53] The Seventh Circuit suggested that considering inside information as a corproate asset presupposes an answer to the inquiry, and that "[i]t might be better to ask whether there is any potential loss to the corporation from the use of such information in insider trading before

[48] *Id.* at 187. Freeman sought to recover derivatively under Indiana law the profits realized through the defendant's trading in the corporate stock. The complaint alleged that the defendant-directors sold and transferred personal stock prior to public announcement of significantly reduced corporate earnings. The complaint sought recovery on the grounds that Indiana law should provide for a derivative cause of action to recover insider profits, and that alternatively, two of the defendant directors had violated § 16(b) of the '34 Act. The district court, in an unreported opinion, held that Indiana law did not provide for such a derivative cause of action and that the plaintiff had not succeeded in creating a genuine dispute as to whether material inside information was the basis of the defendant's transactions. The district court also dismissed the § 16(b) claim against one of the defendant directors, holding that the securities in question were not purchased within a six-month period of their sale as defined by § 16(b). The court did not rule on the § 16(b) claim against a second director and the Seventh Circuit subsequently determined that it lacked jurisdiction over the claim. 584 F.2d at 188, 188 n.2.

[49] *Id.* at 189.

[50] *Id.* The *Freeman* court discussed the economically based argument that prohibiting insider trading impedes the efficiency of the securities market with respect to capital allocation. *Id.* at 190. *See generally* H. MANNE, INSIDER TRADING AND THE STOCK MARKET (1966). The Seventh Circuit, however, admitted that most authorities favor the discouragement of insider trading when confronted with the necessity of balancing economic efficiency with fairness in the marketplace. 584 F.2d at 190. Even Judge Kaufman, in his dissent from the Second Circuit's *Schein* opinion, *see* note 45 *supra,* conceded that trading on inside information merits universal condemnation. 478 F.2d at 825.

[51] 584 F.2d at 191-96. The Seventh Circuit determined that the Indiana courts most likely would refuse to adopt *Diamond* and alternatively would elect to follow the logic of *Schein. Id.* at 196.

[52] *See* text accompanying notes 29-36 *supra.*

[53] 584 F.2d at 192.

deciding to characterize the inside information as an asset with respect to which the insider owes the corporation a duty of loyalty. . . ."[54] While *Diamond* had suggested that insider trading might in fact cause actual harm to a corporation's public reputation,[55] the Seventh Circuit minimized the significance of such a possibility and emphasized that the existence of any injury to a corporation's reputation for integrity must be considered speculative absent evidence that such injury occurs.[56] The *Freeman* court also questioned whether it was proper to conclude that an insider who trades on the basis of inside information is unjustly enriched at the corporation's expense given that the corporation could not have used the information for its own economic benefit.[57] While a corporate officer or director will be required to account to the corporation for usurping a corporate opportunity,[58] the Seventh Circuit concluded that such an element of loss was absent from a *Diamond*-type situation,[59] and thus there was no harm to the corporation which would justify a *Diamond* cause of action.

The Seventh Circuit also addressed the analytical possibility that a defendant held liable to the corporation under a common law theory of fiduciary responsibility ultimately may be subjected to double liability if subsequently found to be liable under federal law.[60] The *Diamond* court, while acknowledging that defendants who trade on the basis of inside information often violate federal law,[61] concluded that the existent federal remedies were limited so as effectively to preclude the possibility of double recovery.[62] The New York Court of Appeals reasoned that an SEC initiated 10b-5 action only would be brought to provide injunctive relief in exceptional circumstances.[63] While a private 10b-5 action is conceivable, the anonymous nature of stock exchange transactions arguably presents insurmountable obstacles to any purchaser-instituted actions.[64] The *Diamond*

[54] *Id.* at 193. In conformity with the corporate opportunity doctrine, *see* note 32 *supra*, the *Freeman* court suggested that inside information should be considered as a corporate asset only where "the corporation was in a position to potentially avail itself of the opportunity" to exploit the inside information for a corporate benefit. *Id.*

[55] 24 N.Y.2d at 497-99, 248 N.E.2d at 912-13, 301 N.Y.S.2d at 81-82; *see* note 36 *supra*.

[56] 584 F.2d at 194. The *Freeman* court questioned whether an injury to a corporation's public reputation, if existent, would form an adequate basis for an action founded on a breach of a fiduciary duty. *Id.* The court indicated that an action for damages based on a breach of the general duty of care might be a more appropriate remedy if harm to the corporate goodwill actually occurs. *Id.*

[57] *Id.* at 193. The Seventh Circuit correctly discerned that a corporation which attempted to exploit nonpublic inside information by dealing in its own securities would become potentially liable under federal and state securities laws. *Id.* at 194.

[58] *See* note 31 *supra*.

[59] 584 F.2d at 194.

[60] *Id.* at 195. The fear of dual liability was raised by the defendants in *Diamond* and *Schein*, and was addressed by the Seventh Circuit in *Freeman*. *See* text accompanying notes 58-65 *infra*.

[61] 24 N.Y.2d at 502, 248 N.E.2d at 914, 301 N.Y.S.2d at 84.

[62] *Id.* at 501-503, 248 N.E.2d at 914-15, 301 N.Y.S.2d at 84-85.

[63] *Id.*; *see, e.g.*, SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968).

[64] Trading in shares on national stock exchanges involves highly impersonal, generally

court thus concluded that the recognition of a common law cause of action in favor of a corporation, providing for corporate recovery of insider trading profits, in all likelihood would not expose defendants to potential double liability.[65]

The *Freeman* court questioned the reasoning of the New York Court of Appeals and expressed concern over the potential imposition of double liability.[66] The concern over double liability is unfounded, however, if the *Diamond* cause of action is accepted since the use of inside information will result in the occurrence of two distinct legal wrongs. An insider who uses non-public material information by dealing in the corporate stock will breach fiduciary duties owed to the corporation as well as violate federal securities laws.[67] Two causes of action will arise based on separate and distinct sources of liability. The resulting dual recovery, under both state and federal law, arguably will further the control of insider trading by providing an increased deterrent.[68]

While acknowledging that the imposition of double liability may be analytically justifiable since two causes of action may be involved, the Seventh Circuit questioned whether the derivative cause of action created by *Diamond* could remain viable if the investors who are the direct victims of insider trading were able to bring a private 10b-5 class action suit.[69] A primary justification for the creation of the *Diamond* cause of action was

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anonymous transactions, and often may involve the transfer of uncertificated shares. The anonymous nature of the exchange makes tracing of the actual purchaser or seller who deals with a corporate insider virtually impossible. Such tracing difficulties greatly limit, if not preclude, the chances of bringing a successful private 10b-5 action to recover insider trading profits. 24 N.Y.2d at 503, 248 N.E.2d at 915, 301 N.Y.S.2d at 85. Similarly, the mechanical difficulties of bringing federal class action suits arguably would preclude any threat of double recovery under class actions. *See* note 22 *supra*.

[65] 24 N.Y.2d at 504, 248 N.E.2d at 915, 301 N.Y.S.2d at 86.

[66] The *Diamond* court had argued that even if double liability were a reasonable possibility, the mere possibility should not deter the formulation of a common law remedy insofar as a defendant faced with the unhappy prospect of potential double liability could interplead all possible claimants thus binding them to the judgment. *Id.* at 503, 248 N.E.2d at 915, 301 N.Y.S.2d at 85. *See* FED. R. CIV. P. 22. The *Freeman* court questioned the efficiacy of resort to an interpleader action since state courts arguably would lack jurisdiction over the interpleaded 10b-5 claimants. 584 F.2d at 195. *See* 55 VA. L. REV. 1520, 1531 n.51 (1969). The jurisdictional criticism of the *Diamond* court's suggested use of an interpleader is valid. Resort to an interpleader action becomes unnecessary, however, if separate and distinct cause of action are found to exist. *See* text accompanying notes 66-71 *infra*.

[67] *See* Note, *From* Brophy *To* Diamond *To* Schein: *Muddled Thinking, Excellent Result,* 1 J. CORP. L. 83, 95-98 (1975) [hereinafter cited as *Muddled Thinking*]. Note, *Common Law Corporate Recovery For Trading on Non-Public Information,* 74 COLUM. L. REV. 269, 289-94 (1974). Arguably, the fact that the measure of damages under both corporate recovery and purchaser-shareholder recovery would be equal creates the misplaced concern that double recovery is possible. *Muddled Thinking, supra* at 97-98. Given that two distinct causes of action exist, the similarity in damage computation does not create duplicate liability. *Id.* at 98.

[68] *Muddled Thinking, supra* note 67, at 97-98.

[69] 584 F.2d at 195.

the perceived inadequacy of the existing federal laws.[70] The *Freeman* court thus viewed the corporation in a *Diamond*-type derivative suit as a "surrogate plaintiff", the need for which would disappear if federal provisions were enforceable through private 10b-5 actions.[71]

The Seventh Circuit argued that the private 10b-5 class action has made substantial advances toward becoming the kind of effective remedy for insider trading that the New York Court of Appeals had hoped that it would become, and thereby has removed the justification for a common law cause of action.[72] There is, however, very little support for the Seventh Circuit's view of the present efficacy of private 10b-5 actions. The Seventh Circuit based its claim that private federal remedies may now be a more effective deterent to insider trading on *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*[73]

In *Shapiro,* the Second Circuit upheld private 10b-5 recovery of damages by market investors who dealt only through the national stock exchanges and who did not claim to have purchased or sold directly from the defendant insiders.[74] *Shapiro* was decided, however, prior to the Supreme Court's explicit reaffirmation in *Blue Chip Stamps v. Manor Drug Stores,*[75] of the purchaser-seller requirement, and other jurisdictions have not readily followed the *Shapiro* decision in allowing recovery under an expanded view of the purchaser-seller requirement.[76] Additionally, the *Shapiro* rationale was rejected in *Fridrich v. Bradford*[77] wherein the Sixth Circuit

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[70] *See* text accompanying notes 4-22 *supra.*

[71] 584 F.2d at 195.

[72] *Id.*

[73] 353 F. Supp. 264 (S.D.N.Y. 1972), *aff'd,* 495 F.2d 228 (2d Cir. 1974). The *Freeman* court cited three cases in support of the contention that private damage recovery has been allowed on behalf of investors who transacted through impersonal stock exchanges. Two of the cases, SEC v. Texas Gulf Sulphur Co., 446 F.2d 1301 (2d Cir.), *cert. denied,* 404 U.S. 1005 (1971), and SEC v. Shapiro, 494 F.2d 1301 (2d Cir. 1974) did not involve private actions. Only *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.* involved a private action. 353 F. Supp. at 268.

[74] The plaintiffs in *Shapiro* purchased shares of Douglas Aircraft Company common stock during a four day period in which the defendants either sold from existing positions or effected short sales of more than 165,000 shares. 353 F. Supp. at 269. The defendants' transactions were made with knowledge of, and prior to public disclosure of, significantly reduced corporate earnings. *Id.*

[75] 421 U.S. 723 (1975); *see* note 11 *supra.*

[76] The *Shapiro* rationale has been accepted by the United States District Court for the central district of California. *See In re* Equity Funding Corp. of America Sec. Litigation, 416 F. Supp. 161, 185 (C.D. Cal. 1976). The *Equity Funding* court rejected the notion that the purchaser-seller requirement mandates the actual purchase or sale of stock from the defendants. Rather, in conformity with *Shapiro,* the district court held that a 10b-5 action need not involve direct privity where massive trading without disclosure of material inside information is alleged. 416 F. Supp. at 185.

[77] 542 F.2d 307, 319 (6th Cir. 1976), *cert. denied,* 429 U.S. 1053 (1977). The Sixth Circuit refused to extend private 10b-5 actions "to impersonal market cases where plaintiffs have neither dealt with defendants nor been influenced in their trading decisions by any act of the defendants." 542 F.2d at 321.

criticized *Shapiro* as assuming the very injury which is then declared compensable.[78] Further doubt may be cast upon *Shapiro*'s continued validity by the stringent, if not perclusive, requirements for bringing federal class action suits.[79] Thus, despite the Seventh Circuit's contentions, the federal securities laws have not been expanded sufficiently to allow market investors to remedy abuses of inside information. The purchaser-seller requirement continues to pose practical difficulties with regard to establishing standing to sue in private 10b-5 actions,[80] and the analytical justification for the *Diamond* decision remains valid.

The *Diamond* cause of action serves to regulate insider trading by providing a remedy for the unregulated exploitation of inside information. The validity of the *Diamond* remedy is dependent on the validity of the premise that inside information is the equivalent of a corporate asset to which fiduciary responsibility is owed. Such categorization of inside information creates a valuable legal fiction. As with any legal fiction, however, application of the corporate asset theory to inside information cannot be justified by readily perceived or manifest legal principles, but rather must be justified through empirical analysis.

The Seventh Circuit suggests that inside information only should be considered as a corporate asset if there is potential loss to the corporation through the use of such information in insider trading.[81] The Seventh Circuit's position is nothing more than a restatement of the common law corporate opportunity doctrine,[82] and fails to acknowledge the value of the public policy justifications of the *Diamond* decision.[83] By providing for a common law derivative right to recover insider trading profits, the New York Court of Appeals sought not merely to fill an accurately perceived inadequacy in the federal securities laws, but also sought to insure equality of access to information in the securities marketplace. The policy objective of providing investors with fair and equal access to market information[84] justifies deterrence of insider trading, whether implemented through federal or state law.[85] Federal law, although a powerful regulating force, should not be considered preemptive of state law in the field of securities regulation.[86] As the *Diamond* court discerned, there is nothing in the federal law which indicates that states may not fashion additional remedies

[78] *Id.* at 318. The Sixth Circuit emphasized that a causal connection must be established between the defendant's misconduct and the plaintiff's loss. *Id.*

[79] *See* note 21 *supra*. *See also* Eisen v. Carlisle & Jacqueline, 391 F.2d 555 (2d Cir. 1968); Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976).

[80] *See, e.g.*, Fridrich v. Bradford, 542 F.2d 307 (6th Cir. 1976).

[81] 584 F.2d at 193.

[82] *See* note 32 *supra*.

[83] *See* text accompanying notes 84-85 *infra*.

[84] *See* note 50 *supra*.

[85] Section 28(a) of the '34 Act states that "[t]he rights and remedies provided by this chapter shall be in addition to any and all other rights and remedies that may exist at law or in equity." 15 U.S.C. § 78bb (1976).

[86] *See id.*

to effectuate purposes similar to those which justify the federal scheme.[87] Implementation of the *Diamond* cause of action deters insider trading and thereby effectuates purposes similar to those which justify Rule 10b and section 16(b) of the '34 Act.[88]

The *Diamond* cause of action, however, has the potential to be a far greater impediment to the misuse of nonpublic material information. The scope of the *Diamond* decision may be extended in two ways. First, *Diamond* may be extended to cover third party defendants who actively cause or assist an insider to violate a fiduciary duty.[89] Second, *Diamond* may be extended to impose liability on any third party who receives nonpublic material information with the knowledge that the disclosure of such information violates a fiduciary duty.[90] If the objective of deterring the improper use of inside information and providing equality of access to market information is to be given full effect, the second alternative should be adopted.[91] To allow third party extra-corporate defendants to retain profits gained by virtue of an insider's breach of a fiduciary duty essentially would permit an insider to avoid liability merely by providing an outsider with the material information upon which to trade.[92] The *Diamond* decision represents a positive step toward filling the continuing void in remedial alternatives for recovery of insider trading profits. Recognition and extension of the *Diamond* cause of action will help eliminate the abuse of inside information and will further the legitimate policy objective of deterring insider trading.

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[87] 24 N.Y.2d at 503, 248 N.E.2d at 915, 301 N.Y.S.2d at 85.

[88] *See* text accompanying notes 4-22 *supra.*

[89] *See* RESTATEMENT (SECOND) OF AGENCY § 312 (1958).

[90] *See id.* § 312, Comment c (1958).

[91] *See* SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968) (tipees found to be insiders within purview of 10b-5).

[92] The Second Circuit correctly discerned that it would be self-defeating to limit the reach of *Diamond* to directors and officers while allowing third party co-venturers to escape liability. 478 F.2d at 822-23.