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Jonathan R. Macey

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FROM FAIRNESS TO CONTRACT: THE NEW DIRECTION OF THE RULES AGAINST INSIDER TRADING*

*Jonathan R. Macey***

INTRODUCTION

The history of the regulation of insider trading¹ is largely the

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** Assistant Professor, Emory University School of Law. A.B., Harvard University 1977; J.D., Yale Law School, 1982. The author is grateful to Peter H. Aranson, William J. Carney, Fred S. McChesney, Henry G. Manne, William T. Mayton and Timothy P. Terrell for helpful comments on earlier drafts of this article. I received valuable research assistance from Cynthia Alexander, Emory Law School class of 1986.

1. As used in this Article, the term "insider trading" refers to trading on the basis of information not yet reflected in the price of a firm's securities. Such information is "inside information" because it is "nonpublic." It is not yet known by the market at large. Modern portfolio theory as well as the efficient market hypothesis, *see infra* note 55, suggest that only insiders can systematically outperform the stock market.

The securities law restrictions on insider trading derive from section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) (1982), and the Securities & Exchange Commission's (SEC) Rule 10b-5, 17 C.F.R. § 240.10b-5 (1984), as well as from section 16(b) of the 1934 Act, 15 U.S.C. § 78p(b) (1982). Rule 10b-5 was promulgated pursuant to the SEC's authority under section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) (1982). Section 10(b) of the 1934 Act gives the SEC authority to prohibit "any manipulative or deceptive device or contrivance." *Id.* Rule 10b-5 states that:

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

- (a) To employ any device, scheme, or artifice to defraud,
- (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
- (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5 (1984).

Section 16(b) restricts certain statutorily defined insiders from making "short swing" securities transactions within a six month period. *See* 15 U.S.C. § 78p(b) (1982). Because of the extremely limited scope of section 16(b), this Article will focus exclusively on Rule 10b-5. The ubiquitous Rule 10b-5 is referred to in over 3,000 cases, and more than 100 decisions expressly concern insider trading. Scott, *Insider Trading: Rule 10b-5, Disclosure and Corporate Pri-*

story of the legal system's quest to find an internally consistent justification for banning such trading.² It is not unusual for a legal rule to prove difficult to apply, but what is remarkable about Rule 10b-5 is that there is such ambiguity as to its basic nature and purpose. Initially, the rule was thought to be grounded on notions of "fairness" and "equity."³ These justifications were vague and ill formed⁴ and did not provide a coherent basis for imposing legal sanctions.

This Article argues that the real concerns about insider trading

vacy, 9 J. LEGAL STUD. 801, 804 (1980).

2. This Article will argue that the Court's justification for Rule 10b-5 was initially grounded on notions of fairness, and has gradually shifted to a "business property" theory predicated on the fiduciary duties of certain parties to the owners of the information. *But see* Scott, *supra* note 1, at 803-04 (positing that the rule continues to expand unfettered). Professor Scott believes there is a "paucity of serious consideration of the purposes of rule 10b-5." *Id.* at 803. This is a surprising observation considering the mammoth amount of literature on the subject, much of which ventures some justification for the rule. *See, e.g.*, Brudney, *Insiders, Outsiders, and Informational Advantages under the Federal Securities Laws*, 93 HARV. L. REV. 322 (1979); Haft, *The Effect of Insider Trading Rules on the Internal Efficiency of the Large Corporation*, 80 MICH. L. REV. 1051 (1982); *Insider Trading in Stocks*, 21 BUS. LAW. 1009 (1966) (panel discussion); Schotland, *Unsafe at Any Price: A Reply to Manne*, *Insider Trading and the Stock Market*, 53 VA. L. REV. 1425 (1967). Professor Scott extracts "three different conceptions of the rule and its objectives" from the available materials. These conceptions are: (1) that the rule is supposed to serve fairness and equity, (2) that the rule is designed to "[facilitate] the flow of information to the market," and (3) that the function of the rule is to "[afford] protection to the property rights of the firm in inside information. Scott, *supra* note 1, at 804. Other justifications for the rule are: (1) that insider trading undermines public confidence in the capital markets; *see* Brudney, *supra*, at 334-35; Carlton & Fischel, *The Regulation of Insider Trading*, 35 STAN. L. REV. 857, 858 (1983); Karjala, *Statutory Regulation of Insider Trading in Impersonal Markets*, 1982 DUKE L.J. 627, 629; (2) that insider trading impedes corporate decisionmaking; *see* Haft *supra* at 1053-64; (3) that insider trading permits managers to profit from bad news as well as good, thereby creating incentives to take abnormal risks and operate the corporation ineffectively; *see* R. Leftwich & R. Verrecchia, *Insider Trading and Managers' Choice Among Risky Projects* 20-22 (Aug. 1981) (University of Chicago Graduate School of Business Working Paper 63) (on file with HOFSTRA L. REV.); and (4) that insider trading raises the firm's cost of capital; *see* Brudney, *supra*, at 356; Mendelson, Book Review, 117 U. PA. L. REV. 470 (1969).

3. *See infra* notes 27-31 and accompanying text.

4. The origin of the intellectual opposition to the fairness conception is Professor Manne's seminal work, *INSIDER TRADING AND THE STOCK MARKET*. Professor Manne suggests that insider trading may not be harmful to the plaintiffs seeking redress, and he argues that insider trading is an important form of entrepreneurial compensation. H. MANNE, *INSIDER TRADING AND THE STOCK MARKET* 93-110, 131-45 (1966); Manne, *Insider Trading and the Law Professors*, 23 VAND. L. REV. 547 (1970) [hereinafter cited as Manne, *Law Professors*]. *See* Carlton & Fischel, *supra* note 2, at 857 n.1. *See also infra* note 52. Perhaps the strongest indictment of the federal regulation of insider trading is that publicly held corporations have themselves done little in the way of formulating their own rules to curb insider trading. In a real world with a highly competitive capital market, one would expect that if outside shareholders believed they were being harmed by insider trading, companies would eliminate such conduct by intra-firm rule. Carlton & Fischel, *supra* note 2, at 859. *But see* Levmore, *Securities and Secrets: Insider Trading and the Law of Contracts*, 68 VA. L. REV. 117 (1982).

are concerns about the optimal allocation of information among parties. Consequently, the fairness considerations of earlier years are better analyzed in contractual terms. This Article further contends that this analysis explains the Supreme Court's rejection of generalized notions of fairness, and its move towards analysis that focuses exclusively on the specific contractual relationships among the parties affected by insider trading.⁵

The Court's present 10b-5 analysis evinces a new understanding of the fact that privileged corporate information is a valuable asset in the nature of a property interest. The real concerns about insider trading are, therefore, concerns about the origin and scope of this property interest.

The long-standing confusion about the nature of Rule 10b-5 stemmed from a failure to conceptualize the problem of insider trading in contractual terms. The small number of commentators who have suggested that insider trading prohibitions might be justified in certain contexts because such trading involves the "theft" or "misappropriation" of someone else's property⁶ have failed to recognize the extent to which the Court is already doing precisely what they suggest.⁷ What is needed now is an articulation of the theoretical underpinnings of this "property rights" analysis, and a means for determining how such rights are to be allocated among parties competing to use the information. This Article provides the framework for such an analysis.

The Article begins by describing the transformation of the Supreme Court's conception of Rule 10b-5. The Court's current formulation, as set forth in *Chiarella v. United States*⁸ and *Dirks v. SEC*,⁹ has evolved dramatically from the days of such early and intellectually unsatisfactory decisions as those in *Speed v. Transamerica*

5. See *infra* notes 90-95 and accompanying text.

6. See Carlton & Fischel, *supra* note 2, at 878; Easterbrook, *Insider Trading, Secret Agents, Evidentiary Privileges, and the Production of Information*, 1981 SUP. CT. REV. 309; Scott, *supra* note 1. Several of the justifications for insider trading described in the articles in note 2 seem to assume *sub silentio* that the rule against insider trading is based on a theory that assigns the property right in privileged information to the firm to which such information pertains. None of these articles suggests that the courts are moving towards the adoption of a business property theory in its interpretation of Rule 10b-5, and none suggests how such property rights ought to be assigned. These are the purposes of this Article.

7. See Carlton & Fischel, *supra* note 2, at 885-86; Easterbrook, *supra*, note 6, at 310, 321; Scott, *supra* note 1, at 814-15.

8. 445 U.S. 222 (1980); see *infra* notes 90-95 and accompanying text.

9. 463 U.S. 646 (1983).

*Corp.*¹⁰ and *SEC v. Texas Gulf Sulphur Co.*¹¹ The direction of the Court's reasoning has been from the general to the specific; generalized notions of fairness have given way to concrete analysis of the relationships among the parties competing to profit from the use of valuable information. But this evolution is by no means complete. The Court has failed to articulate a legal rule that ensures that this property right will be allocated among parties in an optimal manner. The Court's recent opinion in *Dirks* failed completely in this regard.¹² This Article, therefore, suggests an alternative method for determining how to allocate property rights in valuable inside information.

In addition, this Article describes the enormous ramifications of the Court's shift to a "property rights" focus in its application of the rules regarding insider trading. Consistent application of the Court's analysis will yield radically new legal rules regarding damages and standing for insider trading violations. Even the venerable "disclose or abstain doctrine,"¹³ which permits insiders to trade on the basis of material, nonpublic information if they first disclose it, is now subject to considerable doubt. All of these traditional rules are fundamentally inconsistent with the Supreme Court's new rationale for prohibiting insider trading.¹⁴ These rules were developed to conform to an earlier conception of Rule 10b-5, which the Court has now categorically rejected.

The conclusion to be drawn from this analysis is that the Court has moved steadily towards reason in its application of Rule 10b-5. The rule has developed to the point where it may now be applied to promote the efficient use of information, but it has not yet completed its metamorphosis. The Court's current test for allocating property rights in information is badly in need of improvement, and the Court's rules regarding standing and damages lag far behind the rest of the Court's analysis.

10. 99 F. Supp. 808 (D. Del. 1951), *reaff'd on later motions*, 100 F. Supp. 461 (D. Del. 1951), 103 F. Supp. 47 (D. Del. 1952), *opinion on damages*, 135 F. Supp. 176 (D. Del. 1955), *modified*, 235 F.2d 369 (3d Cir. 1956).

11. 258 F. Supp. 262 (S.D.N.Y. 1966), *aff'd in part, rev'd in part*, 401 F.2d 833 (2d Cir. 1968) (en banc), *cert. denied*, 394 U.S. 976 (1969).

12. See *infra* notes 143-153 and accompanying text.

13. See *infra* text accompanying note 43.

14. See *infra* notes 75-102 and accompanying text (describing Court's version of a business property theory).

I. A BRIEF INTELLECTUAL HISTORY OF RULE 10B-5

Since the promulgation of Rule 10b-5 it has been illegal for a corporate insider to engage in securities transactions on the basis of material, nonpublic information.¹⁵ New theoretical justifications for the prohibition have emerged periodically as the old ones have perished under the weight of their own incoherence, and an intellectual history of the rule can be plotted by marking the periodic emergence of new judicial justifications. As the law has moved towards a rational interpretation of Rule 10b-5, the rule's application has finally begun to produce outcomes that enhance allocative efficiency.¹⁶

A. *The Early Days: Fairness*

Not surprisingly, in the early days of Rule 10b-5 jurisprudence the rationale for proscribing insider trading was the most incoherent. At common law, a corporate insider was often under no obligation to disclose material inside information before buying or selling stock.¹⁷ The effect of Rule 10b-5 on the outcome of legal disputes was clear as early as 1951 as a result of Judge Leahy's decision in *Speed v. Transamerica Corp.*¹⁸

In *Speed*, Transamerica, the majority stockholder in the Axton-Fisher Tobacco Company, knew that Axton-Fisher's tobacco inventory had a market value greatly in excess of the value recorded in the firm's financial statements.¹⁹ In order to capture the value of the tobacco inventory for itself, Transamerica bought out the minority

15. See Macey, Book Review, 93 YALE L. J. 1173 (1984) (describing origins of Rule 10b-5).

16. Because information is costly to produce, a market price for information should be determined to achieve its most efficient allocation. See Stigler, *The Economics of Information*, 69 J. POL. ECON. 213 (1961). Allowing the party that produces information to profit from this activity will ensure that the socially optimal quantum of information is produced.

17. See *Freeman v. Decio*, 584 F.2d 186, 191-95 (7th Cir. 1978) (discussing the evolution of the common law rules); Conant, *Duties of Disclosure of Corporate Insiders Who Purchase Shares*, 46 CORNELL L.Q. 53, 54-58 (1960). But see *Strong v. Repide*, 213 U.S. 419 (1909) (director and seventy-five percent owner liable for purchasing shares of the corporation, through an undisclosed agent, on the basis of nonpublic, material, inside information); Langevoort, *Insider Trading and the Fiduciary Principle: A Post-Chiarella Restatement*, 70 CALIF. L. REV. 1, 5-7 (1982). There was often an exception to the common law rule that silence or non-disclosure was not actionable, where the parties stood "in some confidential or fiduciary relation to one another." W. PROSSER & W. KEETON, *THE LAW OF TORTS* § 106 (5th ed. 1984); *RESTATEMENT (SECOND) OF TORTS* § 551 (1977). See *Hotchkiss v. Fischer*, 136 Kan. 530, 16 P.2d 531 (1932); *Stewart v. Harris*, 69 Kan. 498, 77 P. 277 (1904); *Oliver v. Oliver*, 118 Ga. 362, 45 S.E. 232 (1903).

18. 99 F. Supp. 808, 828-32 (D. Del. 1951).

19. *Id.* at 843.

shareholders for a price far below the liquidation value of their shares.²⁰ Transamerica then dissolved the corporation and reaped the benefit of the enhanced value of the tobacco.²¹

Minority stockholders in Axton-Fisher, J. Louis Geller and William S. Speed, brought separate suits against Transamerica. Geller brought an action at common law for deceit.²² Speed, on the other hand, based his case on Rule 10b-5.²³ The court granted Transamerica's motion to dismiss Geller's common law suit because the corporation had not made active misrepresentations to the plaintiff, and thus was not liable for fraud under Kentucky law.²⁴ Speed's 10b-5 suit, however, brought before the same judge and based on the same facts, ultimately resulted in a substantial judgment against the corporation.²⁵

Judge Leahy could not point to any particular language in the rule as the basis for his holding.²⁶ He did, however, provide a theoretical justification for his decision by defending the rule as a means of preventing uninformed stockholders from being treated unfairly:

The duty of disclosure stems from the necessity of preventing a corporate insider from utilizing his position to take *unfair advantage* of the uninformed minority stockholders. It is an attempt to provide some degree of *equalization of bargaining position* in order that the minority may exercise an informed judgment in any such

20. *Id.*

21. *Id.*

22. The action was brought in federal court based on diversity of citizenship. *Geller v. Transamerica Corp.*, 53 F. Supp. 625, 626 (D. Del. 1943), *aff'd per curiam*, 151 F.2d 534 (3d Cir. 1945), *petition for leave to file bill of revision based on discovery of new matter denied*, 63 F. Supp. 248 (D. Del. 1945).

23. *Speed v. Transamerica Corp.*, 71 F. Supp. 457-58 (D. Del. 1947) (holding that plaintiff's complaint alleged a violation of Rule 10b-5).

24. *Geller v. Transamerica Corp.*, 53 F. Supp. 625, 630 (D. Del. 1943), *aff'd per curiam*, 151 F.2d 534 (3d Cir. 1945), *petition for leave to file bill of revision based on discovery of new matter denied*, 63 F. Supp. 248 (D. Del. 1945). Under the Kentucky corporation law, "an officer or director [could] purchase stock from a minority shareholder without being burdened with the obligations of a fiduciary." *Id.*

25. *Speed v. Transamerica Corp.*, 99 F. Supp. 808 (D. Del. 1951), *reaff'd on later motions*, 100 F. Supp. 461 (D. Del. 1951), 103 F. Supp. 47 (D. Del. 1952), *opinion on damages*, 135 F. Supp. 176 (D. Del. 1955), *modified*, 235 F.2d 369 (3d Cir. 1956) (prejudgment interest increased from 2% to 4%).

26. Leahy seems to have relied primarily on clauses (1) and (2) of Rule 10b-5, but he concluded that the rule's three clauses "are mutually supporting and not mutually exclusive." By this he apparently meant that the defendant's breach of its duty to disclose was "a violation of all three subparagraphs." 99 F. Supp. at 829. Professor Loss has noted that "Judge Leahy reacted with some impatience to the defendant's attempt to pin the plaintiff down among the three clauses of the rule." L. LOSS, *FUNDAMENTALS OF SECURITIES REGULATION* 826 (1983).

transaction. . . . One of the primary purposes of the Securities Exchange Act of 1934 . . . was to outlaw the use of inside information by corporate officers and principal stockholders for their own financial advantage to the detriment of uninformed public security holders.²⁷

This passage represents a judicial interpretation of Rule 10b-5 that is clear and unequivocal. The rule's purpose was thought to be maximizing fairness and equity among trading parties. For a person with superior information to buy or sell from an unsuspecting trader was thought to be inherently unfair when that person received his information by virtue of his position as a corporate insider. The SEC²⁸ and some commentators²⁹ still consider fairness to be the basis for the rule.

As many have pointed out, however, not only is insider trading not inherently unfair,³⁰ but "unsuspecting traders" who trade with insiders may in fact benefit from the presence of such insiders in the marketplace.³¹ In addition, the "fairness" justifications for imposing

27. 99 F. Supp. at 829 (emphasis added).

28. The SEC has brought a record number of insider trading cases under the current administration. See Matthews & Becker, *The 'Shad-Fedders Campaign' Focused Sharply on Fraud; Insider Trading Dominated*, N.Y.L.J., Dec. 12, 1983 at 40 col. 1 (more than 20% of the 97 insider trading cases brought by the SEC since 1949 were filed in the last three years). The SEC has "made a point of repeatedly emphasizing that this is a prime area of concern and a principal target of its enforcement activities." Farley, *A Current Look at the Law of Insider Trading*, 39 BUS. LAW 1771 (1984). The SEC has proceeded on the premise that insider trading is unfair. See *infra* note 133 (quoting SEC Chairman John S.R. Shad).

29. Commentators who embrace the fairness conception of 10b-5 include *inter alia* HERMAN, CORPORATE CONTROL, CORPORATE POWER 116 (1981); Ferber, *The Case Against Insider Trading: A Response To Professor Manne*, 23 VAND. L. REV. 621 (1970); Painter, *Rule 10b-5: The Recodification Thicket*, 45 ST. JOHN'S L. REV. 699, 714 (1971); Schotland, *supra* note 2, at 1439 (arguing that even if insider trading increases economic gain it should still be prohibited in order to "satisfy such noneconomic goals as fairness, just rewards and integrity"). Other commentators support restrictions on insider trading but fail to articulate a rational justification for the rule except that it is "not right" to allow insider trading. See Brudney, *supra* note 2, at 353-67; Kaplan, *Wolf v. Weinstein: Another Chapter on Insider Trading*, 1963 SUP. CT. REV. 273; Loss, *The Fiduciary Concept as Applied to Trading by Corporate 'Insiders' in the United States*, 33 MOD. L. REV. 34 (1970). See also Easterbrook, *supra* note 6, at 323-30 (describing and refuting various permutations of the fairness argument).

30. See H. MANNE, INSIDER TRADING AND THE STOCK MARKET 110 (1966) (the chance of investors being hurt by insider trading is slight); Carlton & Fischel, *supra* note 2, at 880-82; Easterbrook, *supra* note 6, at 323-30; Scott, *supra* note 1, at 805-09.

31. If "fairness" concerns do not explain the origins of Rule 10b-5, Interest Group theory may. Interest Group theory predicts that legislative and regulatory outcomes are often the result of pressure from discrete economic groups. See Posner, *Theories of Economic Regulation*, 5 BELL J. ECON. & MGMT. SCI. 335 (1974) (analyzing both public interest and interest group theories of government regulation and concluding that interest group theory is promising but flawed) [hereinafter cited as Posner, *Economic Regulation*]. In fact, "[m]ost recent eco-

liability on insiders finesses the central issue. By declaring insider trading “unfair,” the court is implicitly presuming that the price the plaintiff originally paid for her stock did not reflect the possibility that the insider might engage in insider trading. The basis for such an assumption is by no means obvious. In addition, the “fairness” argument assumes *sub silentio* that the legal system should assign the rights to use insider information to the public at large. This assumption, which has been rejected in recent Court decisions, prevents those who created valuable information from profiting fully from its use.

Even aside from the flaws described above, the “fairness” justification for insider trading rules, as presented in *Speed*, went much too far. Taken to its logical extreme, this vision would ban virtually all trading activity.³² It will almost always be the case that one party has an “advantage” over the other in a given securities trade. One side is likely to have greater knowledge about the relevant supply and demand for a particular stock.³³ One party will inevitably have

conomic analyses of legislation have focused on statutes that appear to promote the narrow self-interest of a particular industry or a group of firms within an industry.” Posner, *Economics, Politics, and the Reading of Statutes and the Constitution*, 49 U. CHI. L. REV. 263, 271 (1982). In a nutshell, this theory views legal rules as economic goods demanded and supplied in the same way as other items of value in society. Legal rules thus flow to the groups that value them most as measured by the ability of such groups to pay for them. *See id.* *See also* Rubin, *Common Law and Statute Law*, 11 J. LEG. STUD. 205 (1982).

Given the lack of a public debate regarding the purpose for Rule 10b-5, it is likely that the SEC, acting as a “political support maximizing regulator,” enacted Rule 10b-5 in order to maximize the support received from some political constituency such as large brokerage firms or organized exchanges. *See* Jarrell, *Change at the Exchange: The Causes and Effects of Deregulation*, 27 J. L. & ECON. 273 (1984); Stigler, *The Theory of Economic Regulation*, 2 BELL J. ECON. & MGMT. SCI. 3 (1971). *See generally* Peltzman, *Toward a More General Theory of Regulation*, 19 J. L. & ECON. 211-40 (1976); Posner, *Economic Regulation*, *supra*, at 335-58.

32. As Professor Scott has observed, the fairness approach to Rule 10b-5 “focuses on the individual parties to a particular trade and asks whether one has an ‘unfair advantage’ over the other in some respect. . . . Judging by the opinions and commentaries, unfairness is one of those qualities that exist in the eye of the beholder and elicit little effort at explanation.” Scott, *supra* note 1, at 805.

33. Exchange Specialists consistently have an advantage over their trading partners by virtue of their access to the so called “limit order book” which enables them to know the relevant supply and demand curves for the stocks they trade. Customers who wish to buy stock at prices beneath the current market and customers who wish to sell at prices above the current market communicate their trading prices to the specialist. The specialist records these prices in the limit order book, and executes the customers’ orders if the market moves accordingly. Suppose, for example, that the market for a particular security is \$20.00 bid and \$20.50 offered. A customer who places a limit order to sell at \$21.00 will be first in line to have his order executed if the market moves up and a \$21.00 bid is entered. Thus the specialist has an inherent informational advantage over other traders since he had access to a range of reserva-

greater sophistication, knowledge, intelligence or expertise.³⁴ The trick, of course, is to determine which of these advantages is "unfair." If, as the court indicated in *Speed*, the goal of the rule is to provide complete equality of bargaining among traders, then there is no logical reason to confine the reach of the rule to informational disparities among trading parties.³⁵

Later cases in the "fairness" era attempted to somehow articulate which informational advantages are unfair and how outsiders are harmed by insider trading. The journey down this precarious intellectual trail has led the courts inexorably to the business property theory that is in its infancy today.³⁶

The Second Circuit, in *SEC v. Texas Gulf Sulphur Co.*,³⁷ fully embraced the fairness concept as the proper theoretical basis for assigning liability under Rule 10b-5. The SEC brought an action to force certain officers of Texas Gulf Sulphur (TGS) to disgorge large profits made from trading in the firm's stock.³⁸ These profits were made by TGS insiders who knew that test holes drilled by the company showed the firm to be on the verge of making a mammoth ore

tion prices for the security in which he specializes. Block traders have a similar inherent advantage over other parties. See generally G. L. LEFFLER, *THE STOCK MARKET* 203-18 (3rd ed. 1963); B. SHULTZ, *THE SECURITIES MARKET AND HOW IT WORKS* 124-52 (A. Squier ed. 1963). See also Brudney, *supra* note 2, at 365.

34. Scott, *supra* note 1, at 805. Professor Brudney has stated that "[t]he principle that forbids trading on informational advantages which others cannot overcome or offset lawfully is not without difficulties in application. . . ." Brudney, *supra* note 2, at 365. Information is leaked systematically to market professionals "because of corporate managers' symbiotic relationship with financial analysts and other professional advisers of large institutional investors." Dooley, *Enforcement of Insider Trading Restrictions*, 66 VA. L. REV. 1, 11 (1980) (footnote omitted). See also Herman, *Equity Funding, Inside Information, and the Regulators*, 21 U.C.L.A. L. REV. 1, 7-8, 12-13 (1973).

35. Professor Scott has observed that "[t]here are other disparities of equal or greater importance and the rule's potential for . . . expansion is clear." Scott, *supra* note 1, at 805. See also Brudney and Clark, *A New Look At Corporate Opportunities*, 94 HARV. L. REV. 997 (1981).

36. Interestingly, the business property theory was alluded to in the very early case of *In re Cady, Roberts & Co.*, 40 S.E.C. 907 (1961), as one of the two "principal elements" upon which Rule 10b-5 is analytically based. *Id.* at 912. *Cady, Roberts* was the first case to hold "tippees" liable for violations of Rule 10b-5. The other element, according to the SEC, was "fairness." Unfortunately, the fairness concept was the only one of these elements analyzed or discussed in the SEC's opinion. Even the fairness rationale was discussed only conclusorily when the opinion posited that Rule 10b-5 is "designed to encompass the infinite variety of devices by which undue advantage may be taken of investors and others." *Id.* at 911. It is impossible to know why this early reference to the business property theory was never discussed, analyzed, or developed.

37. 401 F.2d 833 (2d Cir. 1968) (en banc), *cert. denied*, 394 U.S. 976 (1969).

38. *Id.* at 839.

discovery.³⁹ The company stood to make huge profits if it could acquire the mineral rights to the land upon which the test holes were drilled.⁴⁰

The court found the TGS officials guilty of violating the rules regarding insider trading. The court's opinion has generally been considered part of the "process of extension"⁴¹ of Rule 10b-5, largely because it adopted from *Cady, Roberts*⁴² the now famous "disclose or abstain" doctrine which requires 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, or he chooses not to do so, must abstain from trading in or recommending the securities concerned while such inside information remains undisclosed.⁴³

The court, however, placed a highly significant restriction on this seemingly open ended formulation. Specifically, the court decided that Rule 10b-5 does not require disclosure every time there is asymmetry of information among trading parties.⁴⁴ After *Texas Gulf Sulphur*, the fairness requirement would be satisfied so long as both parties *could* have acquired the relevant information. In the court's words, "the Rule is based in policy on the justifiable expectation of the securities marketplace that all investors trading on impersonal exchanges have relatively *equal access* to material information."⁴⁵

This "equal access" approach to insider trading reduced the possibility, left open in *Speed*, that greater trading skills or superior investigative expertise could provide a basis for recovery in a 10b-5 suit.⁴⁶ The "'equal access to information' view of fairness became the dominant approach, although some other conceptions were still alluded to from time to time in the cases."⁴⁷ The flaw in the equal

39. *Id.* at 844.

40. Texas Gulf Sulphur had discovered "the famous Timmins ore find . . . estimated to contain 55 million tons of copper, zinc and silver." H. MANNE, *INSIDER TRADING AND THE STOCK MARKET* 40 (1966).

41. Scott, *supra* note 1, at 802. See also Dooley, *supra* note 34, at 30 (describing the opinion in *Texas Gulf Sulphur* as containing the sort of "glib generalization" that was "once the hallmark of Rule 10b-5 opinions").

42. *In re Cady, Roberts & Co.*, 40 S.E.C. 907, 911 (1961).

43. 401 F.2d at 848.

44. *Id.* at 848-49.

45. *Id.* at 848 (emphasis added).

46. See *supra* notes 32-35 and accompanying text.

47. Scott, *supra* note 1, at 806. While Professor Scott is correct in saying that the fairness conception of Rule 10b-5 was the dominant basis for liability during the fairness era, he erroneously concludes that the fairness conception continues to be the theoretical underpinning

access approach to insider trading is that it ignores the costs of obtaining information. To prohibit a party with superior access to information from profiting from that access removes all incentives to supply the information to the market.

From a property rights perspective, during the early days of case law development under Rule 10b-5 courts considered privileged corporate information to be held in a sort of constructive trust by corporations for the benefit of the general public. Corporations and their agents, when in possession of material nonpublic information, had to turn this information over to the investment community generally, or refrain from using it themselves. This trust arrangement was considered necessary because of the fairness concerns described above, since it was thought that the public would somehow be harmed if the corporation were to use this information. But it is not at all clear that the public has a right to information created by private firms. Not only has the public not paid for information created by these firms, but the corporations on whom the obligation to disclose or abstain is imposed often incur great expense to develop valuable information.⁴⁸ To deny these firms the ability to fully exploit this information for profit diminishes the wealth of the shareholders who have paid for the information to be created.

B. 1976-1979: A Period of Transition

While the opinion in *Texas Gulf Sulphur* was a marked im-

for liability under Rule 10b-5. It is the thesis of this Article that the theoretical underpinning for the rule has shifted by virtue of the Supreme Court opinions in *Chiarella v. United States*, 445 U.S. 222 (1980) and *Dirks v. SEC*, 463 U.S. 646 (1983). Liability for 10b-5 violations is now founded on a theory of breach of fiduciary duties, a theory that finds its own roots in a "business property theory" of insider trading liability.

48. The most obvious example of the effort and expense involved in developing valuable information occurs in the tender offer context. Prospective tender offerors:

must do substantial research to identify underpriced corporations and to determine how their management can be improved. They may engage investment banking houses and investigate the affairs of many corporations before finding one whose management could be improved. The position of the tender offeror is particularly precarious because, at the time it makes a bid, its investment in information about the target is sunk.

Easterbrook & Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161, 1178 (1981).

Insider trading cases seem to arise most often in the context of corporate control transactions such as tender offers. Consequently, the above quoted observations by Professors Easterbrook and Fischel are particularly relevant. The cost of obtaining information in other contexts has also been well documented. See, e.g., *Texas Gulf Sulphur*, 401 F.2d at 843-44 (describing the expenses incurred by the corporation to acquire information about minerals in the Canadian wilderness).

provement over the bottomless pit of liability suggested by the rationale of *Speed*, the courts had not yet faced the most difficult question to plague proponents of Rule 10b-5 — the question of damages. In this respect, the “fairness” era can be characterized as an era of “glib generalization”⁴⁹ by courts concerning the theoretical underpinnings of Rule 10b-5. The Supreme Court opinions in *Ernst & Ernst v. Hochfelder*⁵⁰ and *Santa Fe Industries v. Green*⁵¹ evince a significant change in judicial approach. These cases represent a significant yet unsuccessful attempt on the part of the Court to answer a difficult theoretical question posed by Professor Manne as early as 1966⁵² and by others more recently.⁵³

49. Dooley, *supra* note 34, at 30. Professor Dooley was referring specifically to the generalization contained in *Texas Gulf Sulphur* that the 1934 Act was intended to prevent “inequitable and unfair practices.” *Id.* (footnote omitted).

50. 425 U.S. 185 (1976).

51. 430 U.S. 462 (1977).

52. The question posed by Professor Manne in the wake of the *Texas Gulf Sulphur* decision was, in essence, “how are the plaintiffs in these cases being harmed?” Professor Manne observed that “there is both a plus and a minus for the outside sellers from insider trading.” H. MANNE, *INSIDER TRADING AND THE STOCK MARKET* 102 (1966). Manne divided selling outsiders into two relevant sub-groups: those who sell at a particular *time* (“time-function” sellers) and those who sell when the stock reaches a particular price (“price-function” sellers). *See id.* at 94-96. “Time-function” sellers may actually benefit by insider trading because they would have sold when they did whether or not the insiders engaged in trading activity. The insiders’ trading activity benefits this group by moving up the price of these shares. *See id.* at 101-02.

Suppose, for example, that an outsider, *X*, was planning to sell 100 shares in Texas Gulf Sulphur stock on April 10, 1963, a date during the period in which insiders were buying TGS shares. The insiders’ purchases drove the price of TGS stock up. During the period in which the insiders were trading, “the market price of TGS stock fluctuated but steadily gained overall.” 401 F.2d at 847. On March 31, the stock price had been only 26. The insiders’ buying drove the stock to 30½ by April 10. *X* was thus unquestionably better off because the insider bought. Insider trading will generally cause stock trading to move in the “current direction.” *See infra* note 110 (discussing efficient market hypothesis).

Manne suggested that “price-function” sellers are likely to be harmed by insider trading. H. Manne, *INSIDER TRADING AND THE STOCK MARKET* 102 (1966). His theory is that outsiders who decide *ex ante* to sell their shares when they reach a certain *price* (known as a reservation price) would have sold at 30½ on April 10. According to Manne, however, these outsiders would have been better off if there had been no insider trading and if the outsiders had held on to their stock until the corporation announced its discovery. If there were zero insider trading, and if the firm’s announcement caused a *sudden jump* in the price of the stock to a level far above the outsiders’ reservation price, then the outsiders were harmed by the insider trading in the sense that they could have sold their stock for more than they did if the insiders hadn’t traded.

There is a fundamental practical flaw in this portion of Professor Manne’s otherwise penetrating analysis. He is assuming that there is perfect enforcement of insider trading rules. However, as he states, “because perfect enforcement of the full-disclosure rule does not and probably cannot exist, any possible harm to outsiders . . . must be considerably discounted.” *Id.* at 103. The question, therefore, becomes whether the “price-function” sellers are better off

Manne pointed to the facts in *Texas Gulf Sulphur* and concluded that the plaintiffs, all of whom were selling shareholders, had actually benefited from the insiders' trading.⁵⁴ The insiders, in buying TGS stock on the basis of inside information, drove the price of the stock up by signalling to the market that new and valuable information about the firm's stock was available. Consequently, unless the selling plaintiffs were somehow *induced* to sell by the purchasing insiders—a highly unlikely possibility in anonymous market transactions such as these—there was no basis for ascribing liability to the insiders. Without insider trading the plaintiffs would have sold at a lower, “incorrect price.”⁵⁵ Thus, Manne argued, to the extent there is any market impact from insider trading, those engaging in trades with insiders are actually better off as a result of such activity be-

trading in a market that allows insiders to trade freely, or in a world of imperfect enforcement of the proscriptions against insider trading. It is likely that in the real world, where the only alternative to permitting insiders to trade is a world of imperfect enforcement, “price-function” sellers as well as “time-function” sellers are better off if insiders are permitted to trade. Essentially, this is so because insider trading, particularly when done by large numbers of insiders, will cause the price of the stock to adjust to its correct level far more quickly than the surreptitious insider trading that will be done if such trading is prohibited.

To the extent that investors have fully diversified portfolios of securities, they will be indifferent about whether the insiders in the firms in which they own stock engage in insider trading. Holders of diversified portfolios will expect to benefit from insider trading as often as they will lose, and will not be harmed by particular instances of insider trading.

53. See, e.g., Scott, *supra* note 1, at 814-15. Indeed, a veritable cottage industry arose among academics attempting to respond to Manne's assertions. See Manne, *Law Professors*, 23 VAND. L. REV. 547 (1970) (noting the intensity of criticism generated by his 1966 book, *INSIDER TRADING AND THE STOCK MARKET*, *supra* note 4).

54. See *supra* note 52 (discussing Manne's arguments).

55. Prices are said to be correct or incorrect to the extent that they arise from supply and demand conditions that accurately reflect all currently available information about the underlying corporation. Various hypotheses predict the quality and amount of information that stock prices are likely to reflect. The “Efficient Market Hypothesis” is the umbrella phrase that is used to describe the general observation that stock prices reflect information with relative speed. There are three essential versions of the hypothesis. The “weak” form of the efficient market hypothesis (known as the random walk theory) predicts that current prices fully reflect the information implied by the historical sequence of prices. The “semi-strong” form predicts that current prices fully reflect public knowledge about the underlying companies. “The strong form asserts that not even those with privileged information can often make use of it to secure superior investment results.” J. LORIE & M. HAMILTON, *THE STOCK MARKET: THEORIES AND EVIDENCE* 70-71 (1973). The quicker the price of a stock comes to reflect all known information about the underlying corporation, the more efficient the market for that stock is considered to be. Put another way, the more efficient the market for a particular stock, the more quickly the stock price will “correct” to a new level when new information about the relevant corporation becomes available. See R. BREALEY, *AN INTRODUCTION TO RISK AND RETURN FROM COMMON STOCKS* 42-54, 115-131 (1969); Fama, *Random Walks in Stock Market Prices*, 21 FIN. ANALYSTS J. 55-59 (1965); Modigliani & Pogue, *An Introduction To Risk and Return: Concepts and Evidence*, 30 FIN. ANALYSTS J. 68-77 (1974).

cause they are receiving a higher price than they would have gotten had the insider stayed out of the market.⁵⁶ To answer Manne's assertions it is not enough simply to invoke vague notions of equity.

1. *The Scienter Requirement.*—The plaintiffs in *Ernst & Ernst v. Hochfelder* were customers of First Securities, a small Chicago brokerage firm.⁵⁷ Leston Nay, the president of the brokerage firm, swindled these customers by convincing them to put their money in "escrow accounts" that he promised "would yield a high rate of return."⁵⁸ As it turned out, however, Nay embezzled the money. Nay committed suicide, First Securities went bankrupt, and the plaintiffs' lawyers turned their attention towards the accounting firm of Ernst & Ernst.⁵⁹ Their theory was that the accounting firm had "aided and abetted" Nay's 10b-5 violations by failing to conduct proper audits of First Securities.⁶⁰ In their response to interrogatories in the district court, the plaintiffs did not claim that Ernst & Ernst had engaged in intentional or deliberate fraud in the conduct of its audits.⁶¹ This left the Supreme Court to decide whether "intent to deceive, manipulate or defraud" must be shown in order to maintain a private suit under Rule 10b-5.⁶²

The Court's opinion, holding that negligence would not sustain a violation of 10b-5, relied primarily on the language and history of Section 10(b).⁶³ Justice Powell conceded the rather obvious but im-

56. See *supra* note 52.

57. 425 U.S. 185, 189 (1976).

58. *Id.*

59. *Id.*

60. *Id.* at 190 n.4.

61. *Id.* at 190 n.5. See also Appellant's brief at 82, *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976).

62. 425 U.S. at 193. The Court did not address whether reckless behavior is sufficient to sustain liability under Rule 10b-5. Instead, the Court left that question for the lower courts to decide. *Id.* at 193-94 n.12. The lower courts have overwhelmingly decided that recklessness will suffice to sustain liability under Rule 10b-5. *Dirks v. SEC*, 681 F.2d 824, 844 (D.C. Cir. 1982), *rev'd on other grounds*, 463 U.S. 646 (1983); *Hackbart v. Holmes*, 675 F.2d 1114, 1117 (10th Cir. 1982); *McLean v. Alexander*, 599 F.2d 1190, 1197 (3rd Cir. 1979); *Rolf v. Blyth, Eastman Dillon & Co.*, 570 F.2d 38, 46 (2d Cir. 1978); *Coleco Industries, Inc. v. Berman*, 567 F.2d 569, 574 (3d Cir. 1977); *Sanders v. John Nuveen & Co.*, 554 F.2d 790, 793 (7th Cir. 1977).

The Court also expressly left open the question of whether the SEC must prove scienter in actions for injunctive relief. 425 U.S. at 193-94 n.12. This question was resolved in *Aaron v. SEC*, 446 U.S. 680, 691 (1980) (holding that "the rationale of *Hochfelder* ineluctably leads to the conclusion that scienter is an element of a violation of § 10(b) and Rule 10b-5, regardless of the identity of the plaintiff or the nature of the relief sought").

63. 425 U.S. at 212-14.

portant point that subsections (b) and (c)⁶⁴ of Rule 10b-5 could be read as proscribing negligent as well as intentional conduct.⁶⁵ Turning again to the statute and its legislative history, the Court nonetheless held that such an interpretation would exceed the power granted to the SEC by Congress under Section 10(b).⁶⁶

After *Hochfelder*, Rule 10b-5 might have been a dead letter. That is, since manipulation and deception were now necessary components of 10b-5 actions, the rule would not have prohibited insider trading unless plaintiffs could show that the insiders induced them to trade. By requiring a showing of manipulation or deception, the Court presented the defendants with the opportunity to present precisely the sorts of arguments that Manne was suggesting. The Supreme Court was implicitly acknowledging the possibility that insider trading might not be harmful to market participants.

2. *Internal Corporate Mismanagement.*—*Santa Fe Industries v. Green*⁶⁷ followed on the heels of the Court's opinion in *Hochfelder*. In *Santa Fe* the Supreme Court held that corporate mismanagement, absent actual fraud, was not within the ambit of Rule 10b-5.⁶⁸ The Court thereby wrestled primary responsibility for promulgating rules concerning corporate governance out of the grips of the SEC and returned it to the state legislatures.

Between 1936 and 1973, Santa Fe Industries acquired 95% of the stock of Kirby Lumber Corp.⁶⁹ In 1974, Santa Fe obtained the remaining 5% of the stock in Kirby by availing itself of the Delaware "short form merger" statute,⁷⁰ which permits a corporation owning 90% or more of another corporation to effect a merger upon approval of the dominant corporation's board of directors. The statute does not require the corporation to give advance notice to, or obtain the consent of, the minority shareholders.⁷¹ The plaintiffs in *Santa Fe* objected to the terms of the merger, complaining that use of the Delaware statute in this case would constitute use of a "device,

64. *Id.* at 212. See *supra* note 1 (quoting relevant text of 10b-5).

65. *Id.* at 212.

66. *Id.* at 214.

67. 430 U.S. 462 (1977).

68. *Id.* at 479.

69. *Id.* at 465.

70. DEL. CODE ANN. tit. 8, § 253(a) (1974).

71. *Id.* "However, notice of the merger must be given within 10 days after its effective date, and any stockholder who is dissatisfied with the terms of the merger may petition the Delaware Court of Chancery for a decree ordering the surviving corporation to pay him the fair value of his shares, as determined by a court-appointed appraiser subject to review by the court." 430 U.S. at 465-66 (construing DEL. CODE ANN. tit. 8, §§ 253, 262 (1974)).

scheme, or artifice to defraud.’ ”⁷² In a logical extension of its decision in *Hochfelder*, the Court dismissed the plaintiff’s arguments, reversing the Second Circuit, and rejected the proposition that a breach of fiduciary duty, absent “deception, misrepresentation or nondisclosure,”⁷³ violates Rule 10b-5.

Taken together, the Court’s opinions in *Hochfelder* and *Santa Fe* represent a significant step forward in the Court’s conception of Rule 10b-5. In *Hochfelder*, the Court made it clear that it would only countenance 10b-5 litigation if plaintiffs could show manipulation and deception. In *Santa Fe* the Court affirmed *Hochfelder*, and went on to hold that otherwise permissible corporate practices are not per se illegal under 10b-5 merely because plaintiffs consider them to be “unfair” *ex post*. During its period of transition, the Supreme Court, while not yet squarely rejecting the fairness approach, began to question its legitimacy. The Court’s demand that plaintiffs show actual manipulation or deception to prevail⁷⁴ led to the ultimate demise of the fairness approach and the Court’s shift towards adoption of the business property theory. It was not until later, however, that the Court provided a persuasive answer to the question “who is harmed by insider trading?”.

C. *The Modern Era: Underpinnings of a Business Property Theory*

The origin of the Court’s current theory of insider trading liability is *Chiarella v. United States*.⁷⁵ Vincent Chiarella worked in 1975 and 1976 as a “markup man” for Pandick Press, a financial printer. Much of Pandick’s business comes from clients making tender offers for other companies. These clients are required to make extensive filings⁷⁶ and disclosures concerning these tender offers.⁷⁷ Pandick

72. 430 U.S. 462, at 466-67 (quoting Plaintiff/Appellees’ complaint).

73. *Id.* at 476.

74. In requiring a showing of scienter, the Court was opening the door for defendants to argue that plaintiffs were not harmed by insider trading because they were not *induced* to trade by the insiders conduct. *Cf. supra* note 52.

75. 445 U.S. 222 (1980).

76. Williams Act § 13(d)(1), 15 U.S.C. § 78n(d)(1) (1982) Sections 13(d)-(e) and 14(d)-(f) of the Securities Exchange Act of 1934, which are collectively known as the Williams Act, regulate tender offers. The Williams Act is codified at 15 U.S.C. §§ 78n(d) to (e) (1982). Section 14(d)(1) requires any person making a tender offer for publicly traded securities to file with the SEC whatever information the SEC may prescribe by rule, if the offer would result in such person becoming the beneficial owner of more than five percent of a given class of securities.

77. *Id.* The SEC has promulgated rules requiring a tender offeror to submit information

Press is retained to print these disclosure documents.

A firm making a tender offer has a strong incentive to keep secret the name of the company for which the offer is being made. Should the tender offer be announced prematurely, the price of the target company's stock will go up, making the target's shares more costly to the offering firm. As a result, firms hiring Pandick Press and other financial printers are in the practice of concealing the identities of the target corporations by using blank spaces or false names in their documents;⁷⁸ the true names are sent to the printer only at the last possible moment.⁷⁹ In addition, financial printers such as Pandick make it clear that their employees are not permitted to trade on the basis of information obtained in the course of their employment. Vincent Chiarella toiled at his printing press in a room decorated with notices imploring employees not to trade on the basis of information gleaned on the job.⁸⁰

In spite of his employer's efforts to preserve secrecy, Chiarella was able to deduce the names of target companies from information contained in the disclosure documents.⁸¹ Using this information, he bought stock in the target companies before the tender offers were publicly known, and realized gains by selling after the takeover attempts were announced.⁸² Such trading enabled Chiarella to supplement his salary by \$30,000 over a fourteen month period.⁸³ Upon discovery of this activity, Chiarella entered into a consent agreement with the SEC⁸⁴ and agreed to return his profits to the sellers of the shares.⁸⁵ He was also immediately discharged by Pandick Press.

In addition to the sanctions imposed by the SEC and by his employer, the government brought a criminal indictment against Chiarella, charging him with seventeen counts of violating Section

regarding the manner and purpose of its purchases, the source of the funds to be used in making the purchases, and its plans regarding the future of the target company as well as adequate financial information about itself whenever the entity making the offer is not a natural person, and such information is material to the target stockholders. *See* SEC Rule 14(d)(1); 17 C.F.R. § 240.14d-1 (1984); Schedule 14D-1, 17 C.F.R. § 240.14d-100 (1984). The adequacy of the financial information that must be supplied depends "on the nature of the bidder." Schedule 14D-1, Item 9, Instruction 1, 17 C.F.R. § 240.14d-1 (1984).

78. 445 U.S. 222, 224 (1980).

79. *Id.*

80. 588 F.2d 1358, 1369 (2d Cir. 1978), *rev'd*, 445 U.S. 222 (1980).

81. 445 U.S. at 224.

82. *Id.*

83. *Id.*

84. SEC v. Chiarella, No. 77 Civ. Action No. 2534 (GLG) (S.D.N.Y. May 24, 1977).

85. 445 U.S. at 224. It is unclear, however, how such sellers were harmed by Chiarella's purchases of their stock. *See supra* note 52.

10(b) of the 1934 Act and SEC Rule 10b-5.⁸⁶ Chiarella was convicted and his conviction was affirmed by the Second Circuit.⁸⁷ On appeal, the Supreme Court noted that an essential element of a cause of action under Rule 10b-5 is an affirmative duty to disclose material facts.⁸⁸ The Court refused to accept the argument that this duty is owed to the trading markets generally. This refusal represented a flat rejection by the Court of the “fairness” rationale for regulating insider trading; a conviction for insider trading would be upheld only if the government could articulate some party to whom the printer owed a specific legal duty.

Justice Powell, writing for the Court, considered two possible alternative sources of such a specific legal duty. First, a duty to disclose or abstain from trading might arise from Chiarella’s relationship with the sellers of the target company’s stock.⁸⁹ Significantly, the Court concluded that Chiarella owed no duty to the people from whom he bought his stock because “he was, in fact, a complete stranger who dealt with the sellers only through impersonal market transactions.”⁹⁰

Second, the Court rejected the conclusion that a trader owes a general duty to all participants in market transactions. The Court, holding that mere possession of material nonpublic information does not give rise to a duty to disclose before trading,⁹¹ explicitly rejected the “parity of information” theory espoused in *Texas Gulf Sulphur*.⁹² Where a fairness rationale would focus on Chiarella’s advantageous position *vis a vis* his uninformed trading partners, the Court’s analysis in *Chiarella* sounded in contractual terms. The Court emphasized the necessity for a “specific relationship between two parties”⁹³ as a precondition to 10b-5 liability. The only possible source for such a specific duty lies in Chiarella’s relationship with his employer, Pandick Press; a duty to disclose or abstain would stem from Chiarella’s contract of employment. Although this issue was not before the Court, the opinion indicates that Chiarella’s employ-

86. *Id.* at 225. Chiarella “was charged with 17 counts of violating the Act because he had received 17 letters confirming purchase of shares.” *Id.* at 225 n.3.

87. 588 F.2d 1358 (2d Cir. 1978), *rev’d*, 445 U.S. 222 (1980).

88. 445 U.S. at 231.

89. *Id.*

90. *Id.* at 232-33.

91. *Id.* at 235.

92. 401 F.2d 833.

93. 445 U.S. at 233.

ment relationship would have given rise to a duty not to trade.⁹⁴

Pandick Press had a strong interest in assuring that its employees did not trade on the basis of information garnered from its clients' tender offer plans. The company would not stay in business for very long if its clients could not rely on confidentiality. The corporations making the tender offers in *Chiarella* invested substantial sums of money in connection with those offers, and Chiarella's trading may have caused Pandick's clients to pay significantly higher prices for the companies they sought to acquire.⁹⁵ Chiarella's trading harmed Pandick Press by damaging the integrity of the firm in the eyes of its clients.

The fact that Chiarella's trading harmed the firm provided the firm with a *motivation* for prohibiting such activity. It did not, however, provide Pandick with a *right* to prohibit Chiarella from trading. The existence of such a right must be grounded on a theory of property rights in information.

In commercial affairs the actions of one individual or firm frequently harm others. If IBM improves the performance of one of its computers, and its sales increase, its competitors may suffer a loss of market share. While these competitors have a motive for prohibiting IBM from implementing its product improvements, they have no right to do so.

The right to prohibit another from trading on the basis of inside information must stem from a notion that information is a form of property interest. The Court's opinion presupposes that the information Chiarella used was a property interest, and that interest gave Pandick the right to prohibit Chiarella from trading. Otherwise, Chiarella's trading would not have violated any preexisting duties.⁹⁶

94. See *infra* notes 143-44 and accompanying text.

95. As Professor Easterbrook observed, "Chiarella's trading posed a threat to the profits of the tender offerors." Easterbrook, *supra* note 6, at 331.

96. Any doubts about the implications of *Chiarella* were dispelled by the Second Circuit's holding in *United States v. Newman*, 664 F.2d 12, 17-19 (2d Cir. 1981), *cert. denied*, 104 S. Ct. 193 (1983). The holding in *Newman* relies squarely on a property theory to find liability under 10b-5. In *Newman*, Adrian Antoniu and E. Jacques Courtois, Jr., employees of the investment banking firms of Kuhn Loeb & Co. and Morgan Stanley & Co., Inc., respectively, conveyed information about proposed takeovers and mergers to James M. Newman, a securities trader with another brokerage firm. The information that Antoniu and Courtois conveyed was confidential and had been entrusted to Morgan Stanley and Kuhn Loeb by their corporate clients. Newman and others purchased stock in the target companies and made substantial profits when the mergers or takeovers were announced. *Id.* at 15. The court upheld Newman's conviction, finding that he "misappropriated—stole to put it bluntly—valuable non-public information entrusted to him in the utmost confidence." *Id.* at 17 (quoting *U.S. v. Chiarella*, 445 U.S. at 245 (Burger, C.J., dissenting)).

The majority opinion in *Chiarella* is thus entirely consistent with a business property theory of insider trading liability.

Corporations making tender offers have every right to prevent others from profiting from news of such offers. Since these firms bear the costs of such offers, they cannot legitimately be forced to share the benefits with the trading markets generally.⁹⁷ The property right in the valuable information that a tender offer is to be made is properly assigned to the corporation that creates this information,⁹⁸ and the corporation has the right to enter into contracts forbidding others from profiting from its use. The agreements between the acquiring corporations and Pandick are illustrations of such contracts. Had Pandick not forbidden *Chiarella* from trading on the basis of the inside information he acquired during the course of his employment, Pandick would have been in breach of its service contract with its clients, the acquiring corporations. Even if there were no legal rules against insider trading, *Chiarella's* legal obligation not to trade would still exist as a result of the string of contracts running from the acquiring corporation to Pandick and down to *Chiarella*.

Viewed in this way, *Chiarella's* legal obligations had nothing to

97. *Cf. Kaiser Aetna v. United States*, 444 U.S. 164 (1979). In *Kaiser Aetna* a land developer, upon consent of the U.S. Army Corps of Engineers, dredged a pond for use as a privately owned marina. The government later sought to open the marina to the public under the doctrine of navigational servitude. The government contended that the developer's dredging, which increased the average depth of the pond from two to six feet, rendered the pond a navigable waterway. The Court rejected the government's argument, and found the marina to be the developer's private property because the developer had a legitimate expectation interest in the benefits of his dredging activity. Opening the marina to public use would cause a substantial devaluation of the property. The Court held that the right to exclude others is a fundamental and universal element of a property interest. *Id.* at 179-80.

98. See J. LOCKE, *THE SECOND TREATISE OF GOVERNMENT* 16-30 (Peardon, ed. 1952):
[E]very man has a property in his own person; this nobody has any right to but himself. The labor of his body and the work of his hands, we may say, are properly his. Whatsoever then he removes out of the state that nature has provided and left it in, he has mixed his labor with, and joined to it something that is his own, and thereby makes it his property. It being by him removed from the common state nature has placed it in, it has by this labor something annexed to it that excludes the common right of other men.

Id. at 17. Locke's analysis is particularly appropriate here because a corporation that makes a tender offer expends great resources to do so. Information that a target company is an appropriate target may be said to exist in a "state of nature," to use Locke's analysis. To encourage these wealth creating activities, we must provide the proper incentive for corporations to "create" the information by conducting research activities. Allowing incumbent management to resist and defeat tender offers decreases the incidence of such offers and therefore ultimately decreases shareholder welfare. See Easterbrook and Fischel, *The Proper Role of a Target's Management in Responding To A Tender Offer*, 94 HARV. L. REV. 1161 (1981). Similarly, rules prohibiting insiders from trading decreases the production of such information.

do with the old "fairness" conception. He was guilty of converting a valuable business opportunity to his own use, since this opportunity belonged to the firm that created it and not to Chiarella. Properly analyzed, Chiarella took information that he knew was intended for the exclusive use of the acquiring corporations; his breach of fiduciary duty was equivalent to theft.⁹⁹

By emphasizing the defendants' fiduciary relationship to the owner of privileged information, the Supreme Court has begun to finally recognize that concerns about insider trading are really concerns about the proper use of valuable privately owned information.¹⁰⁰ The concept of information as a property right as conceived by the Court in *Chiarella* is consistent with the various theories of property formulated by moral philosophers¹⁰¹ as well as the theory espoused by the Court itself.¹⁰²

99. 445 U.S. at 245 (Burger, C.J., dissenting). This conclusion is inescapable in the *Chiarella* case. There is no question that the corporations making the tender offer bids could lawfully purchase stock in the target companies so long as these purchases complied with the provisions of the Williams Act. 15 U.S.C. §§ 78n(d) to (e) (1982). See *supra* note 76. A company making open market purchases of another company's stock can purchase up to five percent of the other company's shares in open market transactions without disclosing its activity. Under Section 13(d), the company has ten days after purchasing the five percent in which to file disclosure with the SEC. If the company's purchases are construed to be a "tender offer," notice is required under section 14(d) when the tender offer is made. See *Wellman v. Dickinson*, 475 F. Supp. 783 (S.D.N.Y. 1979), *aff'd*, 682 F.2d 355 (2d Cir. 1982), *cert. denied*, 460 U.S. 1069 (1983). Thus it was obviously not Chiarella's trading *qua* trading that was illegal, but rather the fact that he was trading on the basis of illegally obtained information. Indeed, the SEC itself implicitly recognized this distinction when it adopted Rule 14e-3, 17 C.F.R. § 240 (1984), approximately four months after *Chiarella* was decided. Rule 14e-3 was designed by the SEC in the wake of *Chiarella* to impose liability upon tender offeror's tippees who buy stock in target companies.

100. See *infra* notes 150-54 and accompanying text.

101. For sources of information regarding various theories of property, see L. BECKER, *PROPERTY RIGHTS: PHILOSOPHIC FOUNDATIONS* (1977); R. SCHLATTER, *PRIVATE PROPERTY: THE HISTORY OF AN IDEA* (1951); Michelman, *Property, Utility, and Fairness: Comments on the Ethical Foundations of "Just Compensation" Law*, 80 HARV. L. REV. 1165, 1202-13 (1967). See also Terrell, "Property," "Due Process," and the Distinction Between Definition and Theory in Legal Analysis, 70 GEO. L.J. 861, 874 (1982) ("The efforts to establish an adequate theory of property are too diverse in style, perspective, conclusion, and implication to be reduced to a single meaningful formula.").

102. See *supra* note 97 (discussing *Kaiser Aetna v. United States*, 444 U.S. 164 (1979)). In *Board of Regents v. Roth*, 408 U.S. 564 (1972), the Court noted that "[i]t is a purpose of the ancient institution of property to protect those claims upon which people rely in their daily lives, reliance that must not be arbitrarily undermined." *Id.* at 577. "To have a property interest in a benefit, a person clearly must have . . . a legitimate claim of entitlement to it." *Id.* See also Terrell, *supra* note 101, at 881-86 (observing that the Supreme Court has employed a "reliance and expectation theory" in analyzing government entitlements); *infra* note 109 (discussing precedent for recognizing property rights in intangibles). In some circumstances, it will be unreasonable for a corporation to have a legitimate expectation of a property

II. THE ECONOMIC FUNCTION OF PROPERTY RIGHTS IN INFORMATION

Information has value. This is perhaps the one point on which all sides of the insider trading controversy agree. It is possible for people to make systematic gains from trading on the basis of material inside information, thereby turning an informational advantage into a pecuniary gain.¹⁰³ Legal rules should be developed that insure the optimal production of information. Analysis of how optimal production might be achieved is best seen by viewing inside information as a form of property interest.

The conception of inside information as a property right is fully consistent with the views of utilitarian theorists such as Jeremy Bentham¹⁰⁴ and David Hume,¹⁰⁵ as well as with modern expositors of law and economics such as Richard Posner,¹⁰⁶ Guido Calabresi¹⁰⁷ and Frank Michelman.¹⁰⁸ The ideas of these theorists differ radically, but they contain one common premise: legal rules, particularly

interest in information it has created. *See infra* notes 116-41 and accompanying text (discussing *Dirks*).

103. The evidence that insiders can make systematic gains from inside information is substantial. This evidence tends to refute the strong form of the efficient market hypothesis which predicts that stock prices reflect information so fast that not even those with privileged information can make use of it to achieve superior trading profits. *See J. LORIE AND M. HAMILTON, supra* note 55, at 71.

The following empirical studies observe that insiders receive greater than market rates of return from trading activity: Baesel & Stein, *The Value of Information: Inferences from the Profitability of Insider Trading*, 14 J. FIN. & QUANTITATIVE ANALYSIS 553 (1979); Finnerty, *Insiders and Market Efficiency*, 31 J. FIN. 1141 (1976); Jaffe, *The Effect of Regulation Changes on Insider Trading*, 5 BELL J. ECON. & MGMT. SCI. 93, 101-05 (1974); Jaffe, *Special Information and Insider Trading*, 47 J. BUS. 410 (1974); Keown & Pinkerton, *Merger Announcements and Insider Trading Activity: An Empirical Investigation*, 36 J. FIN. 855 (1981); Lorie & Niederhoffer, *Predictive and Statistical Properties of Insider Trading*, 11 J. L. & ECON. 35 (1968); Penman, *Insider Trading and the Dissemination of Firms: Forecast Information*, 55 J. BUS. 479 (1982).

104. J. BENTHAM, *THE THEORY OF LEGISLATION* 68-70 (Bombay 1975) (Principles of the Civil Code, pt. 1, chs. 8-10):

Property is nothing but a basis of expectation; the expectation of deriving certain advantages from a thing which we are said to possess, in consequence of the relation in which we stand towards it. . . .

. . . .
. . . [A]ll things considered, the protection of the laws may contribute as much to the happiness of the cottage as to the security of the palace.

Id. at 68, 70.

105. D. HUME, *A TREATISE OF HUMAN NATURE* bk. 3, pt. 2, §§ 2-4 (2d ed. 1978).

106. R. POSNER, *ECONOMIC ANALYSIS OF LAW* ch. 3 (2d ed. 1977).

107. Calabresi & Melamed, *Property Rules, Liability Rules, and Inalienability: One View of the Cathedral*, 85 HARV. L. REV. 1089 (1972).

108. Michelman, *supra* note 101.

property rules, should be structured in such a way as to create incentives for individuals to use resources efficiently.

Our legal culture has a strong tradition of recognizing property rights in intangibles.¹⁰⁹ The fragile and ephemeral nature of inside information suggests a strong need to protect the efficient use of this information. Inside information is not a public good. Consequently, the value of a particular piece of inside information can be used up, and once it has been used up it is impossible for others to profit from it. Suppose, for example, that someone has a piece of information that will drive the price of a share of stock from its current price of \$5.00 to a new, "correct"¹¹⁰ price of \$7.50 when it becomes known to the market. If, by purchasing the stock, an insider drives the price of the stock to its appropriate level, that insider has prevented the information's rightful owner from profiting by its use.¹¹¹ Once the stock price has adjusted to \$7.50, the opportunity for others to profit from the information is gone forever. The insider has appropriated

109. Article I of the United States Constitution delegates to Congress authority "[t]o promote the Progress of Science and useful Arts, by securing for limited Times to Authors and Inventors the exclusive Right to their respective Writings and Discoveries." U.S. CONST. art. I, § 8, cl. 8 (emphasis added). Congress has exercised this authority by enacting statutes regulating patents, 35 U.S.C. §§ 1-376 (1982); copyrights, 17 U.S.C. §§ 1-810 (1982); and trademarks, 15 U.S.C. §§ 1051-1127 (1982).

In addition, the Supreme Court has recognized the existence of property rights in such intangible expectational interests as social security benefits, *Mathews v. Eldridge*, 424 U.S. 319, 332-33 (1976) (citizens have a legitimate expectation in social security benefits and, as property interests, such benefits may not be denied without due process of law), and the right to a public education, *Goss v. Lopez*, 419 U.S. 565, 574 (1975) (right to a public education is a property interest which may not be deprived without due process of law).

Confidential business secrets are specifically protected by criminal statute. See 18 U.S.C. § 1702 (1982). "Confidential and nonpublic commercial information" falls within the definition of property under the mail fraud statute. *United States v. Louderman*, 576 F.2d 1383, 1387 (9th Cir.), *cert. denied*, 439 U.S. 896 (1978).

110. Some commentators have asserted that insider trading should be permitted on the basis that such trading will make the markets for securities more efficient. See Carlton & Fischel, *supra* note 2, at 866. Efficient capital markets are desirable because the more accurately stock prices reflect information, the better these prices are as a guide to capital investment on the economy. *Id.* While Carlton and Fischel are correct about the social desirability of efficient capital markets, it is not clear that legalizing insider trading will result in these markets becoming more efficient. Certainly some information will be reflected in stock prices more quickly. It is also to be expected, however, that corporate officers and directors may delay certain other announcements in order to reap all possible trading gains from such news before going public with it. In cases where the insiders delay public announcement in order to trade, insider trading can be said to make the market less efficient.

111. Even if the insider's use of the information did not diminish the ability of the owner to exploit it — i.e., even if inside information was a public good — the insider trading problem would not disappear because there would still be a problem of underproduction of valuable information. See *infra* notes 112-14 and accompanying text.

for his own use a thing of value: useful information. This information cannot be enjoyed in limitless quantity by everyone. Individuals and firms will not find it sensible to invest in producing information if they cannot profit from its use.

A primary function of property rights generally is to structure incentives to achieve a greater "internalization of externalities."¹¹² But the insider trading rules curtail the extent to which owners of inside information can make use of such information. These limitations inhibit the creation of valuable information. Where Rule 10b-5 bans insider trading or forces the insider to share his property with the market before trading, the legal system is "externalizing" all of the benefits that might be derived from ownership.¹¹³ The owner of the information bears all of the costs of acquiring the knowledge, but must share any benefits with the marketplace in general. Firms will have incentives to produce valuable information and thereby benefit society by creating wealth only if they are able to internalize the benefits as well as the costs of obtaining such information. This sort of internalization is only possible if property owners are permitted to contract as to the use of the information they own. To the extent that the insider trading rules prohibit firms from entering such contracts, the owners are unable to internalize the benefits of their information.¹¹⁴

Property rights need to be enforced in contexts where enforcement will facilitate a system of economic incentives that maximizes societal welfare. The legal system need not assign property rights in information in ways that do not maximize society's welfare.¹¹⁵ Cus-

112. See Demsetz, *Toward A Theory of Property Rights*, 57 AM. ECON. REV. No. 2 347, 348 (1967). An externality is an external pecuniary or nonpecuniary cost or benefit, which is associated with an economic activity or endeavor. "Internalizing" an externality "refers to a process, usually a change in property rights, that enables [the cost and benefits] to bear (in greater degree) on all interacting persons." *Id.* at 348.

113. The positive externalities associated with insider information include the possibility that stock prices will more accurately reflect the true value of the underlying corporation, as well as whatever other benefits (such as exposing fraud) might accrue from encouraging economic actors to ferret out information about corporations. To the extent that these positive externalities cannot be internalized by means of insider trading, they will inevitably be under-produced. The legal system should, therefore, assign property rights so as to internalize these and other externalities.

114. See Demsetz, *supra* note 112, at 357-59.

115. Some economists have argued that the proper function of legislation is to increase economic welfare by correcting market failure such as pollution, crime or deficiencies in charitable giving. These theories also apply to laws designed to effect wealth transfers. See W. BAUMOL, *WELFARE ECONOMICS AND THE THEORY OF THE STATE* (2d ed. 1965); A. PIGOU, *THE ECONOMICS OF WELFARE* (4th ed. 1932). It is not necessary to adopt such a view in order

todians of information that creates no incentives for efficient utilization of resources have no legitimate expectation that such information will be protected.

It is on this point that the Supreme Court's analysis faltered in *Dirks v. SEC*.¹¹⁶ *Dirks* provides an archetypal example of corporate information in which the corporation had no legitimate property right.

Raymond Dirks was an investment analyst and officer of Delafield Childs, Inc., a registered broker-dealer specializing in providing financial analysis of insurance company securities to institutional investors.¹¹⁷ In March of 1973 Ronald Secrist, a former officer of Equity Funding, an insurance holding company, contacted Dirks and informed him that Equity Funding's assets were vastly overstated as a result of massive fraud within the corporation.¹¹⁸ Secrist told Dirks that Equity Funding was selling partnerships in nonexistent real estate and creating fictitious insurance policies and records.¹¹⁹ Secrist also charged that Equity Funding's "top officers had Mafia connections," and that the accounting firm of Haskins & Sells had dropped Equity Funding as a customer because of a disagreement over Equity Funding's business practices.¹²⁰

The information Secrist supplied to Dirks was unquestionably of great value. Once public, this information caused the price of Equity Funding stock to plummet.¹²¹ Advance knowledge of these facts enabled owners of large blocks of Equity Funding stock to sell in advance of the price drop, thus avoiding huge losses. Similarly, traders could consummate "short sales"¹²² or purchase "put" options¹²³ in

to conclude that the legal system should assign the property rights in "inside" information to the party who will use them to maximize society's welfare. Allocative considerations, which provide an alternative justification for assigning property rights, have no role whatsoever in the area of insider trading. That is to say, no one has ever suggested either permitting or banning insider trading on the basis that it serves to transfer wealth from one group to some other, somehow more deserving group. In other areas however, such as public education, welfare rights or social security, other considerations besides economic efficiency may play a dominant role.

116. 463 U.S. 646 (1983).

117. *Id.* at 648.

118. *Id.* at 649.

119. 681 F.2d 824 at 829.

120. *Id.* at 829-30.

121. 463 U.S. at 670 (Blackmun, J., dissenting).

122. Traders who expect the price of a stock that they do not own to go down can "borrow" the stock, and sell the borrowed stock at today's high price. When the price of the stock drops a profit is made by purchasing (also known as covering one's short position in) the security at the new, lower price. The profit is the difference between the purchase price and

order to further profit from knowledge of the debacle at Equity Funding.

Dirks conducted a program of extensive research and investigation in response to Secrist's accusations.¹²⁴ He began by examining all of the publicly available data on Equity Funding's insurance sales.¹²⁵ He then contacted other investment analysts concentrating in insurance company stocks to find out if they were aware of any irregularities at Equity Funding. Dirks also contacted Stanley Goldblum, Equity Funding's Chairman of the Board, and asked him about the charges.¹²⁶

When none of these conventional methods of investigation were successful, Dirks interviewed retired Equity Funding executives, finally coaxing Frank Majerus, and later other former company officials, to admit to doctoring the company's insurance records or having been aware of such improprieties.¹²⁷ Dirks' motivation for such exhaustive research was plain. As an analyst he received a commission for securities transactions that clients directed through his firm. While the record does not reveal the precise amount of the commissions Dirks received, one institutional investor promised him \$25,000 in commissions for the advice he provided.¹²⁸ Dirks "openly discussed the information . . . with a number of clients and investors."¹²⁹ Many of these people sold their Equity Funding stock, and five investment advisers liquidated holdings of more than \$16 million.¹³⁰ The value of the information Dirks provided to his clients equals the difference between the price at which these firms sold their stock in the market and the price to which the stock dropped after the news of the fraud became public.¹³¹

the previous selling price less the interest cost incurred by borrowing the security. *See generally* L. LOSS, FUNDAMENTALS OF SECURITIES REGULATION 251-58 (1983).

123. An option is the right to buy or sell a particular security at a particular price within a specified period of time. A "put" option is a particular type of option that gives the owner the right to sell a particular security to the party on the other side of the option contract for a specified price within a given period of time. As the price of the stock goes down the value of the right to sell becomes concomitantly greater. *See generally id.*

124. 681 F.2d at 830.

125. *Id.*

126. *Id.*

127. *Id.* at 830-31.

128. 463 U.S. 649 n.2.

129. *Id.* at 649.

130. *Id.*

131. Neither Dirks nor his employer made any direct gains from trading on the basis of the information regarding Equity Funding. Because of the extreme uncertainty as to the status of the law on insider trading liability for someone like Dirks, it is likely that Dirks believed he

The SEC censured Dirks for trading on the basis of the inside information he had obtained about Equity Funding.¹³² Harkening back to the bygone fairness era,¹³³ the SEC contended that whenever “‘tippees’ — regardless of their motivation or occupation — come into possession of material ‘information they know is confidential and know or should know came from a corporate insider’ they must either publicly disclose that information or abstain from trading.”¹³⁴ The SEC’s theory of liability was “rooted in the idea that the antifraud provisions [of the Securities laws] require equal information among all traders.”¹³⁵ The Supreme Court had expressly rejected such a theory in *Chiarella*.¹³⁶ The Court echoed this conclusion in

would be in violation of the law by trading himself. Such uncertainty may have meant that Dirks was unable to capture the complete value of the information he uncovered.

132. 681 F.2d at 829.

133. The SEC has taken every opportunity to expand the scope of Rule 10b-5. See *supra* note 99 (discussing SEC Rule 14e-3). The Chairman of the SEC, John S.R. Shad, has said, “We’ve got to maintain a broad public perception that the public is being treated fairly. If the public at large felt it was playing a rigged game or that someone had a marked deck, it would impugn the integrity of the markets.” *N.Y. Times*, May 27, 1984, § 3 (Business) at 21, col. 6. Chairman Shad’s remarks evince not only a complete lack of understanding of the arguments of Professor Manne, see *supra* note 52, but misunderstanding of other, more basic, economic arguments as well. Portfolio theory strongly suggests that from the outsider’s perspective, insider trading, if permitted, would be irrelevant to the investor with a diversified portfolio of securities. The theory, an integral part of modern finance theory, categorizes all risk as either systematic or nonsystematic risk. Nonsystematic risk refers to risk factors that are associated with a particular firm or stock. These factors include such things as the quality of the firm’s management, and the possibility that firm discoveries (such as that made by Texas Gulf Sulphur) will affect the value of the firm’s stock. Systematic risk relates to general market risks. The general level of interest rates, and the overall state of the economy, are examples of systematic risk. Portfolio theory suggests that investors, by purchasing a diverse portfolio of securities, can eliminate all of the firm specific or nonsystematic risk associated with owning a particular stock. This suggests that investors who trade in efficient markets, where the price of a stock reflects all known information about the relevant firm, see *supra* note 55, are “‘protected’ by the price established by the market mechanism.” Scott, *supra* note 1, at 808.

Professor Scott also observed that, contrary to Chairman Shad’s prediction, investors would not flee the securities markets if insider trading were permitted. In anticipation of Shad’s gambling analogy, Scott predicted that investors would simply adjust the purchase price for stocks where insider trading is a possibility. *Id.* Professor Scott stated, “[I]f I know you are using percentage dice, I won’t play without an appropriate adjustment of the odds. . . .” *Id.* Casual empirical observation also shows that Shad is mistaken. The insider trading laws do not serve as much of a deterrent to insider trading. Significant insider trading still takes place, yet there has been no evidence that investors who do not have access to such information are fleeing the marketplace. It is also true that institutional investors are playing an increasingly larger role in the ownership of stock. Such institutions are easily able to diversify their portfolios, thereby eliminating all nonsystematic risk from their investments.

134. 463 U.S. at 651.

135. *Id.* at 657.

136. 445 U.S. at 233-34.

Dirks.¹³⁷

The Court's rationale for rejecting the SEC's approach was based on a theory that recognizes the value to society of protecting property rights in inside information. In this case, the property rights were properly allocated to Raymond Dirks:

Imposing a duty to disclose or abstain solely because a person knowingly receives material nonpublic information from an insider and trades on it could have an inhibiting influence on the role of market analysts, which the SEC itself recognizes is necessary to the preservation of a healthy market. . . . The analyst's judgment . . . is made available [in various ways] to clients of [the analyst's] firm. It is the nature of this type of information, and indeed of the markets themselves, that such information cannot be made simultaneously available to all of the corporation's stockholders or the public generally.¹³⁸

The Supreme Court opinion in *Dirks*, like the earlier decision in *Chiarella*, protected the property interests of those who made socially desirable investments in acquiring certain information. In *Dirks*, the Court reached the rather unsurprising conclusion that holding Dirks culpable for his behavior would discourage other analysts from conducting similar investigations in the future. One way to *encourage* such investigations is to afford Dirks and others like him a property right in their discoveries, thereby permitting them to reap the profits of their labor.

This is not to suggest that all information becomes the property of its discoverer. Suppose, for example, that Dirks had received a tip from Secrist that Equity Funding was about to launch a tender offer for some other firm. Dirks should not profit from receipt of that information, because the information properly belonged to Equity Funding.¹³⁹ Secrist, in providing the information to Dirks, would have breached a duty to Equity Funding to keep this information confidential. The Court in *Dirks* described the "initial inquiry" as

137. 463 U.S. at 656.

138. *Id.* at 658-59 (footnote omitted). After *Dirks*, the SEC finally began to base its own enforcement cases on what it describes as a "misappropriation" theory. The SEC uses the term misappropriation "to cover any stock activity in which an employee 'appropriates' confidential information from his employer and uses it to achieve personal gains in the market." N.Y. Times, *supra* note 133, § 3, at 21, col. 2.

139. After *Chiarella*, the SEC interpreted this conclusion in its own rules. See SEC Rule 14e-3, 17 C.F.R. § 240.14e-3 (1984). See also SEC v. Materia, 745 F.2d 197 (2d Cir. 1983), *cert. denied*, 105 S. Ct. 2112 (1985) (SEC enforcement action under misappropriation theory).

being "whether there has been a breach of duty by the insider."¹⁴⁰ The Court's inquiry is nothing less than a judicial allocation of property rights in the information in question.¹⁴¹ Had Equity Funding properly owned the information, Secrist would have violated a fiduciary duty to the corporation by disclosing it. Equity Funding, however, could not be said to have a legitimate property interest in news about massive internal fraud. Recognizing a property right in this kind of information would enable Equity Funding to prolong its illegal activity. As the Court recognized, society benefits by providing people like Dirks with economic incentives to ferret out fraud, because it lowers the cost of preventing such activity.

III. ASSIGNING PROPERTY RIGHTS IN INFORMATION

Unfortunately, the Court in *Dirks* failed to provide a satisfactory means for determining when a party can legitimately expect to have a legally cognizable property right in information. In order to determine whether there is a property interest, courts were directed to focus on irrelevant criteria such as "whether the insider receives a direct or indirect personal benefit from the disclosure, such as a pecuniary gain or reputational benefit that will translate into future earnings."¹⁴²

A. *The Court's Method of Assigning Property Rights in Information*

The *Dirks* holding regarding the allocation of property rights in information sharply limits the utility of the opinion. In fact, had the SEC known about this test in advance, the case might have turned out entirely differently. It is very likely that Secrist envisioned receiving just the kinds of reputational benefits the Court describes,¹⁴³

140. 463 U.S. at 663.

141. The Court ignores that aspect of *In re Cady, Roberts & Co.*, 40 S.E.C. 907 (1961) that is based on "fairness" concerns, and emphasizes for the first time language in the opinion that is consistent with the business property theory. The Court thus describes with approval the two elements set out in *Cady, Roberts* for establishing a Rule 10b-5 violation: "(i) the existence of a relationship affording access to inside information intended to be available only for a corporate purpose, and (ii) the unfairness of allowing a corporate insider to take advantage of that information by trading without disclosure." 463 U.S. at 653-54. See also *supra* note 36.

142. 463 U.S. at 663.

143. If Mr. Secrist envisioned gaining another job in the insurance business it would have been extremely important for him to distance himself to the fullest extent possible from the fraud at Equity Funding. From the perspective of a future employer, exposing the fraud would be the surest way for Secrist to separate himself from the wrongdoing. Alternatively,

it is not clear why the Court did not think he received any benefit. The opinion implies that the information about the fraud at Equity Funding belonged to Equity Funding, and that only Secrist's supposedly noble, public spirited motivation for giving the information to Dirks enabled the Court to find that neither Secrist nor Dirks violated a duty to Equity Funding's shareholders.¹⁴⁴

Justice Blackmun argued in dissent that "Secrist violated his duty to Equity Funding shareholders by transmitting material non-public information to Dirks with the intention that Dirks would cause his clients to trade on that information."¹⁴⁵ This reasoning inexplicably assigns the property rights in information to the corporation to which it pertains. The majority opinion is even less satisfactory on this point. It would assign the property rights in the privileged information to the corporation unless the party in possession of the information magnanimously gives it away for a socially beneficial purpose such as exposing fraud.¹⁴⁶

The majority's method of assigning such property rights will inevitably lead to an underproduction of information of the kind that Dirks produced. Without the tip from Ronald Secrist, Dirks would never have begun his efforts to uncover the fraud at Equity Funding.¹⁴⁷ Having gone so far in the right direction, the Court errone-

Secrist may have fully retired when he left his post at Equity Funding. As a disgruntled former employee forced out of the insurance business, it would not be surprising if Secrist was trying to obtain a form of revenge on his former bosses at Equity Funding. Even so, Secrist's tip to Dirks, if done for purposes of revenge, would result in an "indirect personal benefit" to Secrist of the kind that the Court directs other courts to "focus on" for the purpose of obtaining liability. *Id.* at 662-63.

144. *Id.* at 665-66. It is impossible to imagine that the Supreme Court was suggesting that revenge may be a proper justification for permitting individuals who owe a fiduciary duty to their employers to disclose inside information. Yet, curiously, the Court in *Dirks* makes no inquiry into Secrist's actual motives for disclosing the information about Equity Funding to Dirks. The Court blithely assumes that Secrist's motives were purely benign. This alternative is, of course, a possibility. It is by no means the only possibility. Yet the Court does not engage in the very line of concededly complex inquiry that it directs other courts to pursue.

145. 463 U.S. at 678-79 (1983) (Blackmun, J., dissenting).

146. *Id.* at 660-61. The majority opinion will frequently require plaintiffs in 10b-5 cases to embark upon bizarre and unnecessary investigations in order to prove that the tipper received some sort of personal gain from the tipping. *SEC v. Thayer*, No. 84 Civ. 0066 (S.D.N.Y. Jan. 5, 1984), and *SEC v. Brant*, No. 84 Civ. 3470 (S.D.N.Y. July 12, 1984), are examples of such cases. In *Thayer*, the prosecution's theory was that former Secretary of Defense Paul Thayer tipped because he received personal benefits from a woman with whom he had a close personal relationship. *N.Y. Times*, *supra* note 133, § 3, at 21, col. 4. In *Brant*, one of the allegations was that a defendant, R. Foster Winans, passed information along to his roommate, David J. Carpenter. *Id.*

147. 681 F.2d at 829-30.

ously attempted to “eliminate use of inside information for personal advantage” by designing a liability rule that focuses on “whether the insider will benefit, directly or indirectly from his disclosure.”¹⁴⁸

The Court in *Chiarella* correctly identified inside information as a property interest, but in *Dirks* the Court formulated a legal rule that tends to assign the property interest to the least deserving party. Suppose, for example, that Secrist had demanded that Dirks pay him for his information. Under the Court’s reasoning, liability would attach to Dirk’s conduct because the tipper, Secrist, received a “direct personal benefit from the disclosure.”¹⁴⁹ Yet society would have no less of an interest in knowing about the corporation’s fraudulent activities, and the corporation should still have no right to keep this information confidential.

B. *An Alternative Approach: The Proper Subject of Contract Test*

In *Dirks* the Court erred in its quest to find a line of demarcation for tippee liability. The SEC had argued that Dirks should not escape liability simply because the party who gave him information had a “proper purpose” for doing so, contending that if a proper purpose test was adopted, parties would always be able to avoid liability by fabricating such a purpose.¹⁵⁰ The Court’s focus on the tipper’s pecuniary or reputational benefit was a response to this contention. The pecuniary gain test is thus a means for determining whether the information was transmitted for a “proper purpose.”¹⁵¹

Implicit in the Court’s proper purpose inquiry is a coherent notion of property rights. If Equity Funding had properly owned the information that Secrist disclosed to Dirks, then under no circumstances would disclosure have been appropriate. Such disclosure would have been a form of theft unless the corporation had granted permission to have the disclosure made.¹⁵²

The Court’s inquiry should have focused on whether the information disclosed by Dirks could properly have been the subject of a contract between Secrist, the tipper, and Equity Funding, his employer. Such an inquiry would allow the property rights in insider information to be assigned so as to maximize the production of use-

148. 463 U.S. at 663.

149. *Id.*

150. *Id.*

151. *Id.* at 663-64.

152. *Cf. supra* notes 99-102 and accompanying text.

ful information. In the *Dirks* case, for example, it would have been illegal for Equity Funding to have entered into a contract with Secrist that prevented him from exposing the illegal activities of that firm. Such a contract plainly would have been void *ab initio*.¹⁵³ The strong public interest in ferreting out the fraud at Equity Funding would outweigh whatever contractual obligation Secrist might have with his employer to keep this information confidential. For the court to promote confidentiality in this context would encourage corporate fraud by barring honest employees from exposing such activity. In economic terms, enforcing a contract that requires an employee to keep information about a fraud secret is allocatively inefficient. Those potentially harmed by fraud must spend resources to protect themselves. A finding that *Dirks* breached a fiduciary duty by exposing fraud would increase the expenditure necessary for innocent people to protect themselves. Such a result would waste real resources and result in a transfer of wealth from society as a whole to the officers of Equity Funding who engaged in fraud.

In *Chiarella*, on the other hand, it was perfectly proper for the clients of Pandick Press to demand that information about pending tender offers be kept confidential. No illegal purpose was served by the confidentiality, and the information properly belonged to the firms who created it. The "proper subject of a contract" test just described would lead private parties to spend the optimal amount of society's resources in the quest for information. In *Chiarella*, for example, if defendant's illegal stock purchases prevented corporations making tender offers from fully profiting from the information they created, there would be a suboptimal number of tender offers. In *Dirks*, on the other hand, it was appropriate to allow the investment analyst to use the information he obtained. Preventing him from doing so would facilitate continued fraud, and thus the result reached by the Court in *Dirks* was entirely correct. Unfortunately, the "personal benefit" test that the Court used to determine liability often will assign the property right in privileged information to the wrong party, leading to an underproduction of information that would be useful to the market.

The proper subject of contract test should, therefore, replace the

153. Contracts to perform illegal acts are void and unenforceable. See J. CALAMARI & J. PERILLO, *THE LAW OF CONTRACTS* 781 (2d ed. 1977); *RESTATEMENT (SECOND) OF CONTRACTS* §§ 178-79, 182 (1979). Where a contract is illegal by reason of the wrongful purpose of one of the parties, that party has no rights against the other party. J. CALAMARI & J. PERILLO at 783.

pecuniary gain test that the Court enunciated in *Dirks*. The pecuniary gain test inevitably discourages parties such as Secrist from tipping to investment analysts and others. The proper subject of contract test utilizes the profit motive and the ability of firms to contract to ensure that socially useful information will reach the market while information that should be confidential will remain so.

Ronald Coase's seminal work, *The Nature of the Firm*,¹⁵⁴ provides an important theoretical underpinning for the proper subject of contract test advanced in this Article. His work, upon which the modern theory of the firm is predicated, defines a firm as a nexus of contracts among the suppliers of the organization's various inputs.¹⁵⁵ A firm's decision about whether to hire a unit of production directly, or to contract externally for it, is largely a function of transaction, coordination and contracting costs.¹⁵⁶ There is no basis for making a distinction between the fiduciary duties that result from a full time employment contract and the fiduciary duties that arise from a contractual relationship with another corporation. The Court's present fiduciary duty analysis attempts to make this kind of distinction by suggesting that contractual insiders, such as employees, owe a fiduciary duty to stockholders, while contractual outsiders, such as printers or investment analysts, do not.¹⁵⁷

This attempt to distinguish between insiders and outsiders gives rise to many of the problems associated with the Court's current analysis.¹⁵⁸ The proper subject of contract test eliminates this distinction entirely. The presence or absence of a fiduciary duty should be viewed as a consequence of a contractual relationship between the firm and another party. It makes no difference analytically whether or not the other party is a full-time employee of the firm or an independent contractor. It should make no difference legally, either.

154. Coase, *The Nature of the Firm*, 4 *ECONOMICA* 386, 391-92 (1937).

155. *Id.*

156. *Id.*

157. *But see Dirks v. SEC*, 463 U.S. 646, 655 n.14 (1983) (outsiders such as underwriters, accountants, lawyers and consultants may be fiduciaries with liability for insider trading); *SEC v. Lund*, 570 F. Supp. 1397, 1403 (tippee liable under § 10(b) as a "temporary insider").

158. *See Fama, Agency Problems and the Theory of the Firm*, 88 *J. POL. ECON.* 288 (1980); Jensen & Meckling, *infra* note 189. *See also Chiarella v. United States*, 445 U.S. at 231-35 (1980); Carlton & Fischel, *supra* note 2, at 888-89; Coase, *supra* note 154; Klein, Crawford, & Alchian, *Vertical Integration, Appropriate Rents, and the Competitive Contracting Process*, 21 *J. L. & ECON.* 297 (1978).

C. *The Proper Subject of Contract Test Applied*

It might appear from the preceding discussion that the proper subject of contract test proposed in this Article will invariably be easy to apply. Indeed, application of the test to the facts of either *Dirks* or *Chiarella* is simple and straightforward. This will not always be the case.¹⁵⁹ This section provides examples of how the proper subject of contract test would apply to two rather notorious cases of insider training.

1. “*Heard On The Street.*”—In March, 1984, the *Wall Street Journal* revealed that R. Foster Winans, a writer of the newspaper’s widely read “Heard on the Street” column, had informed certain outsiders about stories he planned to write.¹⁶⁰ The stories concerned stock tips that Winans had culled from various sources within the financial community. The information that Winans collected during the course of his employment was valuable. The *Wall Street Journal* paid Winans to collect it and distribute it to readers of the *Journal*. If the information was “stale” when distributed in the paper, its value was diminished.

Confidentiality was thus an integral and proper subject of Mr. Winans’ employment contract with the *Wall Street Journal*. Not only was the newspaper within its rights when it fired Winans, but under principles of agency law the newspaper also was entitled to Winans’ profits. Agents are compelled to account to their principals for any profits gained through the use of confidential information.¹⁶¹ Such an accounting must be made even if the principal cannot show that it was damaged by the actions of its agent.¹⁶² It is entirely proper that the *Wall Street Journal* be compensated for the damages Winans imposed on the business reputation of the newspaper. Despite language to the contrary in *Dirks*, liability in this case

159. Of course, as Justice Powell indicated, the “personal benefit” test articulated in *Dirks* will not always be easy to apply either. 463 U.S. at 663.

160. ‘*Heard on the Street: A \$900,000 Windfall*, Newsweek, May 28, 1984 at 63; Winans, along with two co-defendants, was subsequently convicted of multiple criminal infractions. *United States v. Winans*, 612 F. Supp. 827 (S.D.N.Y. 1985).

161. 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 [a corporate officer] has ‘inside’ information that the corporation is about to purchase or sell securities . . . profits made by him in stock transactions undertaken because of his knowledge are held in constructive trust for the principal.

RESTATEMENT (SECOND) OF AGENCY § 388, Comment c (1958).

162. *Id.* See also *Diamond v. Oreamuno*, 24 N.Y.2d 494, 248 N.E.2d 910, 301 N.Y.S.2d 78 (1969); *Brophy v. Cities Serv. Co.*, 31 Del. Ch. 241, 70 A.2d 5 (1949).

should not be contingent upon whether Winans obtained a pecuniary or reputational gain by making these tips. Even if Winans had not received any personal benefit, the damage to the *Wall Street Journal* would still be the same.

Not only did the *Wall Street Journal* fire Winans immediately upon learning of his activity,¹⁶³ the newspaper also conducted a thorough internal investigation, and published the complete results of the investigation over several days.¹⁶⁴ Later, the SEC reported that Winans had made \$31,000 by supplying the information. The four people to whom he supplied it, David J. Carpenter, Peter N. Brant, Kenneth P. Felis and David W.C. Clark, made a total of \$909,000 from trading on the advance information.¹⁶⁵

The *Wall Street Journal's* own actions in firing Winans and conducting such a thorough housecleaning indicate that the newspaper was damaged by its employee's trading. A newspaper has a strong interest in developing a reputation for reliability. If readers thought that the *Journal's* financial news was tainted by its reporters' quest for personal profit, the paper's influence, and therefore its readership and advertising revenues, would decline.¹⁶⁶ The only relevant question is whether the information properly belonged to the *Journal*. Adoption of the proper subject of contract test proposed in this Article would enable courts to provide an unambiguous answer to this question.¹⁶⁷

2. *Texas Gulf Sulphur Revisited.* — Application of the proper subject of contract test to the famous case of *SEC v. Texas Gulf*

163. See Newsweek, *supra* note 160.

164. The *Wall Street Journal*, Apr. 2, 1984, at 1, col. 6; *Id.* Apr. 5, 1984, at 1, col. 2; *Id.* Apr. 9, 1984 at 1, col. 2.

165. *Id.*

166. For this point I am indebted to Professor Peter Aranson of the Emory University Department of Economics.

To the extent that the information in Winans' column was of value to the readers of the *Wall Street Journal*, he was depriving those readers of that value by exploiting the information in advance of its general circulation in the newspaper. See Manne, *A Case of SEC Again Overstepping Its Limits*, *Atlanta Journal-Constitution*, September 23, 1984 at C1, col. 1 (stating that the *Wall Street Journal* was harmed by Winans' disclosures).

167. The Court's pecuniary gain test is particularly unsatisfying in those cases where the tipper's liability is only cast into doubt because of the plaintiff's difficulty in establishing pecuniary gain. When insiders trade or tip they are either breaching a fiduciary duty or they are not. The liability issue should hinge on the nature of the information disclosed, and whether it properly belongs to the firm to which it pertains. For this reason, "the proper subject of contract" test is the more appropriate means for determining liability. It relieves courts of the need to indulge in the irrelevant inquiry into personal motives that the *Dirks* pecuniary gain test envisions.

*Sulphur Co.*¹⁶⁸ does not produce such unambiguous results. As described earlier,¹⁶⁹ Texas Gulf Sulphur insiders made an important mineral discovery on land that they were testing in Timmins, Ontario. In order to profit from this important find, TGS had to acquire the mineral rights to the land.¹⁷⁰ If news about the discovery had become public, the company would have been forced to pay a much higher price to acquire rights to the minerals. Thus, complete secrecy about the nature of the discovery was essential to protect the interests of the TGS shareholders.¹⁷¹

In fact, the company's officers and directors went to some lengths to assure that news of the discovery did not become public.¹⁷² After obtaining a visual estimate of the copper and zinc content of the property, the company decided to acquire rights to the land.¹⁷³ Claude O. Stephens, the President of TGS, told the group that had made the discovery to keep the results of its findings "confidential and undisclosed even as to other officers, directors and employees of Texas Gulf Sulphur."¹⁷⁴ In addition, the successful test hole was actually concealed, and a barren hole intentionally drilled, in order to mask the group's findings.¹⁷⁵ Land samples were shipped outside the country for chemical tests.¹⁷⁶ The company did not conduct any further drilling on the site until its land acquisition program was nearly completed.¹⁷⁷ But despite the compelling need for secrecy, several corporate officers and directors took advantage of the privileged information by buying stock and call options¹⁷⁸ in TGS stock.¹⁷⁹

The information about the mineral strike plainly belonged to Texas Gulf Sulphur. The corporation, which had recently experienced financial difficulties, had a great deal at stake.¹⁸⁰ The infor-

168. 258 F. Supp. 262 (S.D.N.Y. 1966), *aff'd in part, rev'd in part en banc*, 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969).

169. See *supra* notes 37-47 and accompanying text.

170. 258 F. Supp. at 271.

171. 401 F.2d at 844.

172. *Id.* at 844-45.

173. *Id.* at 844.

174. *Id.* at 843.

175. *Id.*

176. *Id.*

177. *Id.* at 843-44.

178. A "call" is a particular type of option contract by which the bearer receives the right to purchase a certain number of shares of a stock at a fixed price within a fixed time period. See *id.* at 841 n.3. See generally L. Loss, *supra* note 122, at 251-58.

179. 401 F.2d at 844.

180. See H. MANNE, *INSIDER TRADING AND THE STOCK MARKET*, *supra* note 4, at 40 (describing poor financial condition of company prior to its mineral discovery).

mation may in fact have been the company's most valuable asset. If the corporate officers had attempted to profit by buying up the mineral rights themselves, they would have been guilty of usurping a corporate opportunity.¹⁸¹ Keeping news of the mineral discovery secret was therefore an implicit part of the employment contracts between TGS and its employees.

Under the theory suggested in this Article, however, the analysis does not end here. Two questions remain to be answered. First, a court would have to determine whether the trading activity of the TGS employees endangered the company's land acquisition program, or harmed it in some other way. Next, even if the corporation was not injured, it would still remain to be determined whether the insiders who traded actually had the corporation's permission to use its information.

a. Danger to the TGS Acquisition Program. — Insider trading causes stock prices to change by signalling the market that there is new information about the stock being bought or sold.¹⁸² In the case of TGS, it is entirely possible that the trading activity of the insiders could have informed the market by enabling market participants to estimate the nature of TGS's important discoveries. If such information forced TGS to pay increased prices to acquire the mineral rights, the corporation was directly injured by the trading activity of the insiders.¹⁸³ Since there was no evidence that this was the case, it is likely that the positive signal sent to the market by the insider trading was a vague one that did not result in harm to the corpora-

181. See, e.g., *Miller v. Miller*, 301 Minn. 207, 222 N.W.2d 71 (1974); *Equity Corp. v. Milton*, 43 Del. Ch. 160, 221 A.2d 494, 497 (1966); *Guth v. Loft, Inc.*, 23 Del. Ch. 255, 5 A.2d 503 (1939).

182. Easterbrook, *supra* note 6, at 336.

Purchases [of stock] often convey information to the market about the prospects of the firms [whose stock is being purchased]. If the information indicates that the firm's prospects are better than those previously perceived, the price of the shares rises. Large purchases give the market a good deal of information. Traders find out or infer why one person is buying so much, and the new knowledge causes prices to adjust. For this reason, large transactions for technical portfolio-adjustment reasons should have no effect on price, while smaller purchases based on new information should have an effect, even a dramatic one. This seems to be the pattern in the market.

Id.

183. Suppose that Texas Gulf Sulphur's only assets were the exploration rights to the tract of land in Ontario. A flurry of trading activity by insiders would likely inform the market that something of significance was taking place on the tract. Market participants might then decide to bid for the mineral rights to the land themselves, thus driving the price up, to the obvious detriment of the TGS shareholders.

tion of the kind just described. Had such harm occurred, however, the damage to the corporation would have been precisely the same as if the insiders had usurped the corporate opportunity by buying the land themselves.

b. Breach of Contract. — Even assuming that the insider trading in TGS securities did not reveal the corporation's land acquisition program and drive up the price of the mineral rights, it is not clear that the insiders had the right to trade on this information. Professor Manne argues that it is socially desirable to allow insiders to trade because it is the only satisfactory way to compensate the entrepreneurs who are vital to the survival of large publicly held corporations.¹⁸⁴ Under a business property theory of privileged corporate information, it would be entirely proper for a corporation to permit insiders to trade in the way Manne envisioned. It would also be entirely proper for the corporation to forbid insiders to engage in some or all such activity.¹⁸⁵ Such a rule was in place at Pandick Press, where Vincent Chiarella worked, as well as at the *Wall Street Journal*, where R. Foster Winans was employed.¹⁸⁶ Both men were immediately fired when their trading was discovered by their employers.¹⁸⁷ The question in *Texas Gulf Sulphur*, therefore, becomes whether the TGS insiders were forbidden (explicitly or implicitly) by the terms of their employment contracts to engage in insider trading. It would not have been unreasonable under the circumstances for the corporation to have imposed such a stipulation on its employees.

Since secrecy was essential to the success of TGS's discovery,

184. See H. MANNE, INSIDER TRADING AND THE STOCK MARKET, *supra* note 4, at 138-41.

185. We can expect that firms will permit insider trading if the value of the right to engage in such trading is more valuable to the insiders than to the firm. Similarly, firms will be expected to forbid such activity when the right is more valuable if retained by the firm. Given the low costs associated with contracts between firms and insiders, if firms are allowed to contract with their employees about whether they can engage in insider trading, the party who will gain the most from having the right will receive it because he or she will be willing to pay the most for it. See Carlton & Fischel, *supra* note 2, at 863; see also Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1 (1960). It may be, however, that the cost to the firm of insuring that managers do not abuse their right to trade may raise the cost of transacting, thereby making it more efficient for the firm to ban such trading. See *supra* notes 99-102 and accompanying text.

186. It is interesting to note that the disclosures by the Wall Street Journal about Winans' activity have "caused newspapers across the country to review policies regarding employees' stock ownership and the pre-publication release of newspaper stories." N.Y. Times, *supra* note 133, § 3, at 21, col. 3.

187. See *Chiarella v. United States*, 445 U.S. 222, 224 (1980); Newsweek, *supra* note 160, at 63.

the corporation may have wanted to insure *ex ante* that its prospects were not endangered by greedy insiders.¹⁸⁸ Clearly the President of the firm and the corporation's lawyers, both of whom engaged in insider trading, were not in a position to evaluate dispassionately the potential cost of their activity to the corporation. The corporation may have wanted a blanket provision against insider trading as a way of avoiding such palpable conflicts of interest.¹⁸⁹ Because *Texas Gulf Sulphur* was decided under a much different theory of insider trading liability,¹⁹⁰ the court did not delve into the question of whether the TGS employees were contractually constrained from engaging in insider trading. Under a business property theory, however, such an inquiry would have been dispositive.¹⁹¹

IV. ENFORCEMENT OF THE PROPERTY RIGHT IN INFORMATION

It is appropriate at this point to consider the enormous implications of the Court's current insider trading doctrine. As things now stand, a business property theory informs the Court's analysis of the existence of liability for insider trading, but the old "fairness" theory still controls other aspects of insider trading analysis. It is this lack of a "grand unifying theory" that accounts for the current confusion and incoherence in the law.

In *Dirks* and *Chiarella* the Supreme Court adopted a theory of insider trading liability premised on the insider's breach of a fiduciary duty. The duty is owed to the owner of the inside information, and it is this party that is harmed by insider trading.¹⁹² Consistent with the Supreme Court's analysis, the party to whom the fiduciary duty is owed should have standing to sue. Presently, however, only purchasers and sellers have standing to sue under Rule 10b-5.¹⁹³ Yet it is the owner of the property right who should be able to collect damages, and it is the owner's injury that should provide the measure of these damages.

The rules regarding standing¹⁹⁴ and damages¹⁹⁵ for violations of

188. See *supra* notes 169-81 and accompanying text.

189. This kind of provision would be a means of avoiding what Jensen and Meckling have termed "agency costs." Jensen & Meckling, *Managerial Behavior Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976).

190. See *supra* notes 37-46 and accompanying text.

191. See *supra* notes 96-102 and accompanying text (discussing business property theory of insider trading liability).

192. See *supra* notes 142-58 and accompanying text.

193. *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 754-55 (1975).

194. See *infra* notes 197-225 and accompanying text.

Rule 10b-5 have lagged behind the rest of the Court's analysis in *Dirks* and *Chiarella*. These rules are still informed by the old "fairness" conception of insider trading liability, and therefore must be changed to conform to the Court's new analysis. In addition, just as insider trading is proscribed because it violates insiders' fiduciary duties, an insider's disclosure of privileged information is similarly wrongful. Thus the disclose or abstain doctrine of *Texas Gulf Sulphur*¹⁹⁶ is incompatible with the Court's current reasoning about insider trading. In order to respect a fiduciary duty, an insider must neither disclose nor trade.

A. Standing

In light of the Court's fiduciary duty analysis, it seems ironic that the only persons who may bring a private suit for violations of Rule 10b-5 are purchasers and sellers who have bought or sold during the time the insiders were trading. Yet that is the law. In 1975 Justice Rehnquist, in *Blue Chip Stamps v. Manor Drug Stores*,¹⁹⁷ adopted the so-called "Birnbaum rule" of the Second Circuit,¹⁹⁸ requiring that plaintiffs in 10b-5 cases be actual purchasers or sellers. The irony is that the party to whom the fiduciary duty is owed lacks standing, while outsiders to whom no duty is owed retain standing but lack a basis for recovery.

1. *Standing in the Fairness Era.* — The holding in *Blue Chip Stamps* is a striking example of the Court providing the best possible answer when asked the worst possible question.¹⁹⁹ Under the fairness theory, the people injured by insider trading are those who would have acted differently had they had the benefit of the insider's infor-

195. See *infra* notes 226-37 and accompanying text.

196. See *supra* notes 41-47 and accompanying text.

197. 421 U.S. 723 (1975).

198. The name of the rule is derived from *Birnbaum v. Newport Steel Corp.*, 193 F.2d 461 (2d Cir.), *cert. denied*, 343 U.S. 956 (1952).

199. 421 U.S. 723. The case was decided in 1975, or during what this Article describes as the "Transition Period" of the Court's thinking about Rule 10b-5. The case represents an effort on the part of the Court to limit the open-ended reach of the "fairness" conception of Rule 10b-5. The case also provides an example of the Court's effort to provide a response to the "who is harmed question." It seems clear that the opinion evinces some dissatisfaction with the intellectual underpinnings of the "fairness" rationale for 10b-5 liability. If the Court thought insider trading was inherently unfair, it is unlikely it would have denied standing to such a large group of injured plaintiffs. See *id.* at 737-38. The Court's preferred justification, eliminating the dangers of vexatious litigation, is highly dubious. Other methods for limiting the dangers of abuse by plaintiffs could have been devised. Indeed, the majority opinion recognizes in the end that the facts in *Blue Chip Stamps* themselves seem to pose none of the problems to which the Court adverts in its opinion. *Id.* at 754-55.

mation. The Court was faced with the option of limiting the class of plaintiffs to actual buyers and sellers, or expanding the class to include three other groups.²⁰⁰ These groups were: (1) potential purchasers who did not purchase because of gloomy representations made about the corporation;²⁰¹ (2) actual shareholders who did not sell because of unduly rosy representations;²⁰² and (3) shareholders, creditors, and others related to the issuer who suffered a loss in the value of their investment because of corporate or insider activities in connection with the illegal purchase or sale of securities by insiders.²⁰³

In *Blue Chip Stamps* the fairness rationale informed the Court's liability theory. The damages that accrue to plaintiffs under this theory result from what they *would have done* had they had the same information as the insiders.²⁰⁴ In effect, damages are based on the opportunity cost imposed upon the plaintiffs by the defendants' illegal trading.²⁰⁵ As such, there is no rational basis for restricting recovery to buyers and sellers. Even the *Blue Chip Stamps* opinion acknowledged that "the *Birnbaum* limitation on the plaintiff class in a Rule 10b-5 action for damages is an arbitrary restriction which unreasonably prevents some deserving plaintiffs from recovering damages."²⁰⁶ A simple example illustrates the point. Suppose plaintiff *X* sells a share of stock of ABC Corp. for \$10.00, then watches the price of the stock rise to \$100.00 on the basis of some exciting news concerning the corporation. If an insider has bought after learning the news but before it is publicly announced, *X* may sue the

200. *Id.* at 737-38.

201. *Id.* at 737.

202. *Id.* at 737-38.

203. *Id.* at 738.

204. See Thompson, *The Measure of Recovery Under Rule 10b-5: A Restitution Alternative to Tort Damages*, 37 VAND. L. REV. 349 (1984).

205. As used here, the term "opportunity costs" refers to the value of the profits foregone by the plaintiffs as a result of buying or selling stock during a time in which insiders are trading. This is consistent with the economic definition, in which "cost" is defined as the most valuable forsaken alternative to an act. Opportunity cost is defined as the most valuable alternative that must be forsaken to undertake a given act. A. ALCHIAN & W. ALLEN, *EXCHANGE & PRODUCTION* 464 (3d ed. 1983).

206. 421 U.S. at 738. The Court was citing Lowenfels, *The Demise of the Birnbaum Doctrine: A New Era For Rule 10b-5*, 54 VA. L. REV. 268 (1968). There were a host of other articles critical of the *Birnbaum* purchaser-seller requirement. See, e.g., Boone & McGowan, *Standing to Sue under SEC Rule 10b-5*, 49 TEXAS L. REV. 617 (1971); Bromberg, *Are There Limits to Rule 10b-5?*, 29:3 THE BUS. LAW. 167 (1974); Jacobs, *Birnbaum in Flux: Significant 10b-5 Developments*, 2 SEC. REG. L.J. 305 (1975). In *Blue Chip Stamps v. Manor Drug Stores*, the SEC filed an amicus brief arguing against the *Birnbaum* rule. 421 U.S. at 738.

insider for damages. Consistent with the fairness theory, *X*'s recovery will equal the \$90.00 that was "lost" or foregone as a result of the sale to the insider. But suppose *X* did not buy or sell, but can prove that she *would have* bought the stock but was dissuaded from doing so by gloomy pronouncements by the insider. *X*'s loss would be just as tangible as if she had actually sold to a purchasing insider. Yet under the *Birnbaum* rule, *X* is prohibited from suing.

In this example *X* should have no right to recover at all, since she suffered no harm by the insider's trading.²⁰⁷ Given a choice between applying a misguided theory of liability narrowly or expansively, Justice Rehnquist, in *Chiarella*, chose the expedient, albeit intellectually barren course.²⁰⁸

2. *Moss v. Morgan Stanley Inc.* — The recent case of *Moss v. Morgan Stanley Inc.*²⁰⁹ is a striking illustration of the confusion surrounding the rule of standing in 10b-5 cases in the wake of *Chiarella*. As in *Chiarella*, the cause of action in *Moss* arose in the context of a corporate tender offer. E. Jacques Courtois, Jr. was employed in the mergers and acquisitions department of Morgan Stanley & Co., a New York investment bank.²¹⁰ Courtois tipped several of his colleagues in the investment banking world about a tender offer planned by Warner-Lambert Company, a Morgan Stanley client, for Deseret Pharmaceutical Company. On November 30, 1976, James M. Newman, a stockbroker, bought 11,700 shares of Deseret stock on the basis of information supplied by Courtois. Among the sellers of Deseret stock that day was the plaintiff, Michael Moss, who sold 5,000 shares on the market for \$28.00 per share.²¹¹

A week after Moss sold his stock, Warner-Lambert publicly announced its tender offer for Deseret at \$38.00 per share, and Moss brought a cause of action under Rule 10b-5 against Newman and Morgan Stanley. The Second Circuit, applying the fiduciary duty standard espoused in *Chiarella*,²¹² concluded that Newman owed no duty of disclosure to Moss and upheld the dismissal of Moss' suit.²¹³ Consistent with the analysis in this Article, the court held that the

207. See *supra* notes 91-93 and accompanying text.

208. 421 U.S. at 727 ("the only portion of the litigation . . . before us is whether" plaintiffs may sue without being purchasers or sellers). See also *supra* notes 200-03 and accompanying text.

209. 719 F.2d 5 (2d. Cir. 1983), *cert. denied*, 104 S. Ct. 1280 (1984).

210. 719 F.2d at 8.

211. *Id.*

212. *Id.* at 12-17.

213. *Id.* at 23.

only fiduciary duties Newman breached were to Morgan Stanley and Warner. In the words of the court, the plaintiff could not attain standing by riding “‘piggyback upon the duty owed by defendants to Morgan Stanley and Warner.’”²¹⁴

The opinion in *Moss* illustrates that the holding in *Chiarella*, which requires the presence of a preexisting fiduciary duty to sustain a 10b-5 suit, cannot be reconciled with the holding in *Blue Chip Stamps v. Manor Drug Stores*, which requires that private plaintiffs in 10b-5 cases be actual purchasers or sellers. Under the *Blue Chip Stamps* doctrine Morgan Stanley does not have standing to sue because it was not a purchaser or a seller, yet under the reasoning in *Chiarella*, Morgan Stanley is the injured party. Purchasers and sellers such as Moss, who do have standing to sue under *Blue Chip Stamps*, have no basis for recovery because the defendants owe them no fiduciary duty. The logical implication of this analysis is that *Chiarella* overrules *Blue Chip Stamps*. If there is a private right of action under Rule 10b-5 it must be to the party to whom a fiduciary duty is breached, not to purchasers and sellers.²¹⁵

3. *Standing and the Business Property Theory.* — Under a business property theory the proper plaintiffs are the owners of the privileged information, and ought to be the sole private parties eligible to bring suit to enforce their property interest. It is important to note, however, that it may not always be possible to protect a property interest in information by seeking redress in the courts. In *Texas Gulf Sulphur* for example, the corporation could not have prevented outside parties who lawfully found out about the presence of the rich mineral deposits from taking advantage of this knowledge. Had other parties lawfully learned of the discovery, they could have purchased the mineral rights in the land for themselves. Barring that, they could have profited by purchasing TGS stock.²¹⁶ Similarly, if other investment analysts had discovered the fraud at Equity Fund-

214. *Id.* at 13 (quoting *Moss v. Morgan Stanley Inc.*, 553 F. Supp. 1347, 1353 (S.D.N.Y. 1983)).

215. The only alternative is to deny a private right of action under 10b-5 in most cases. After *Chiarella* a private right of action still exists in cases where the defendant has purchased stock in his own firm on the basis of inside information. Such an insider will owe a fiduciary duty to the shareholders in the firm for which he works, and hence both the purchaser-seller requirement of *Blue Chip Stamps* and the fiduciary duty requirement of *Chiarella* are satisfied. But, where the insider sells stock on the basis of negative inside information, purchasing plaintiffs would be barred from recovery because of the lack of fiduciary duty owed to the purchasers.

216. *Chiarella*, 445 U.S. at 232-33.

ing simultaneously or shortly after Dirks' investigation, Dirks would have had no basis for protecting his ability to profit from the information.

In the two examples above, Dirks and TGS, as owners of the information, would have no legal basis for preventing third parties from profiting from their discoveries: they would not have an exclusive property right in the information, and the third parties would not have any fiduciary duty to respect a prior property right in the interest by keeping the information confidential.²¹⁷ In the *Texas Gulf Sulphur* example, the third party discoverers would owe no duty to the corporation absent some specific relationship giving rise to such a duty.²¹⁸ The same reasoning would apply in the *Dirks* hypothetical to prevent Mr. Dirks from stopping others from investigating the fraud at Equity Funding.

It would be possible for Congress to protect discoverers of socially valuable inside information by allowing something akin to copyright protection for such material. It is not at all obvious, however, that it would be desirable to afford such protection.²¹⁹ The stock market will be more efficient if the parties who produce valuable inside information have incentives to trade soon after discovery. In this way the information becomes reflected in the stock price more quickly, and the market will serve as a more efficient guide for the allocation of capital generally.

This reasoning is consistent with the proper subject of contract analysis.²²⁰ In the above examples the parties making the initial discovery had no contractual relationship with the third parties threatening to usurp their discoveries. While there is some justification for constraining the actions of such third parties, in most instances it is competition from third parties such as these that provides greater impetus for the initial discoverers to act quickly, thus making the marketplace more efficient.²²¹

217. *Id.*

218. *Id.* at 232.

219. While society has incentives to promote the production of information, the particular kind of information that is subject to the protection of the copyright laws is information that has continuing value in the public domain for long periods of time. Valuable information pertaining to stock prices, by contrast, is of value to society only when actually used. *See supra* notes 110-11 and accompanying text. As the text following this footnote indicates, the more quickly insiders use this information, the better. Laws that would make it easier for insiders to delay trading on valuable information should therefore be discouraged.

220. *See supra* notes 151-58 and accompanying text.

221. *See supra* notes 112-15 and accompanying text.

Put another way, TGS could protect its property interest from parties with whom it had no privity of contract only by working to keep its interest secret. Dirks could enable his clients to profit from his knowledge of the fraud at Equity Funding by making sure that they were among the first to know about it.

While the only parties who should be permitted to bring lawsuits for violations of Rule 10b-5 are the proper owners of the information being stolen, defendants in these cases should not be strictly limited to those who are in privity of contract with the owners of the information. Owners of privileged information should also be permitted to seek redress against "tippees" who receive such information from parties in privity with the owner. The *Wall Street Journal* had a contractual relationship with R. Foster Winans, whom it employed as a writer. His four accomplices, who reaped profits of \$900,000, are akin to recipients of stolen goods. Someone who receives stolen property is culpable if he knows or should have known that the merchandise was stolen.²²² The same reasoning applies to insider trading under the Court's current business property approach. As the Court pointed out in *Dirks*:

a tippee assumes a fiduciary duty to the shareholders of a corporation not to trade on material nonpublic information only when the insider has breached his fiduciary duty to the shareholders by disclosing the information to the tippee and the tippee knows or should know that there has been a breach.²²³

The relationship between the tipper and the owner of the privileged information should determine the tippee's legal obligation to the owner of the property interest.²²⁴ As the Court observed in *Dirks*, "the tippee's duty to disclose or abstain is derivative from that of the insider's duty."²²⁵ Under a business property analysis the owners of the stolen information should be the sole private parties with standing to sue for violation of Rule 10b-5, and they should be able to proceed not only against those with whom they are in privity, but against derivative tippees as well.

222. See W. LAFAVE & A. SCOTT, CRIMINAL LAW § 88 (1972).

223. *Dirks*, 463 U.S. at 660.

224. This liability theory is consistent with the Court's fiduciary duty theory, although not with the Court's pecuniary gain theory. Also, in determining liability it should make no difference whether the tipper was an actual employee of the firm or whether the tipper was an independent contractor, such as a printer, accountant, lawyer or a consultant. *Id.* at 655 n.14.

225. 463 U.S. at 659. See also *Chiarella*, 445 U.S. at 230 n.12.

B. *Damages in Private Lawsuits*

As described above, the party damaged by insider trading is the owner of the information misappropriated.²²⁶ The amount of damages sustained by the owner will depend on both the nature of the owner's business and the subject matter of the information pilfered. The proper measure of damages can best be explained by reference to specific examples.

1. *The Measure of Damages in Chiarella.* — Suppose XYZ corporation is making a tender offer for ABC corporation. The XYZ company has hired Pandick Press to do the necessary financial printing, and Vincent Chiarella has been assigned to do the typesetting work. Chiarella deduces that XYZ is making a bid for ABC and buys ABC stock.

These purchases may or may not signal the market that XYZ is making a bid for ABC.²²⁷ If they do, Chiarella's action will drive the price of ABC stock up to the level at which the market expects it to trade if a successful offer is made, discounted by the probability of the offer ultimately being successful. The purchases are damaging to XYZ, the offering company, because the tender offer will appear less attractive to target shareholders. The purchases may even cause the tender offer to fail.²²⁸ Alternatively, it is possible that Chiarella's purchases will drive up the price of ABC stock by signalling the market in a more general way that there is good news on the horizon. If so, the damages to XYZ may not be as great.²²⁹ It is even possible that Chiarella's purchases will not affect the market at all. If the purchases do not cause the price of ABC stock to rise,²³⁰ then ABC, the owner of the information, is not injured by Chiarella's trading. Its damages, therefore, are zero. As discussed below,²³¹ while it might be desirable to impose fines or penalties on Chiarella in order to deter him and others from such activity in the future, there is no particular reason to permit XYZ to receive a windfall from Chiarella's illegal activity. Thieves are generally subject to both civil damages and criminal fines. Such a dual enforcement

226. See *supra* notes 150-59 and accompanying text.

227. See *supra* note 182 and accompanying text.

228. 13A B. FOX & E. FOX, BUSINESS ORGANIZATIONS, CORPORATE ACQUISITIONS AND MERGERS § 27.05[4] (1984).

229. Damages will be lower because the price of ABC stock may not rise as much due to the greater uncertainty in the market about the nature of the information being transmitted.

230. It is unlikely that the purchases will not affect the price of the stock at all. See Easterbrook, *supra* note 6, at 336.

231. See *infra* notes 250-55 and accompanying text.

scheme is likely to provide an optimal level of protection for legitimate property interests.²³² Such an enforcement mechanism is available for violations of insider trading rules, but it is not being properly applied by the SEC.

2. *Damages in the Wall Street Journal Case.* — While the assessment of damages in *Chiarella* could be made with some precision, determining the harm caused to the *Wall Street Journal* by Mr. Winan's behavior is not so simple. The damage he caused was primarily to the newspaper's reputation. As noted above, the *Journal* made a concerted effort to mitigate its damages by conducting an investigation of the incident and firing Winans.²³³ Nonetheless, some damage was probably done, and certainly some costs were associated with the paper's efforts to mitigate. Yet the Court's standing decision in *Blue Chip Stamps* prevents the *Wall Street Journal* from seeking reimbursement from Winans under Rule 10b-5.

The amount of injury sustained by the *Journal* may bear no relation to the \$900,000 made in actual trading by the tippees. The proper measure of damages may be arrived at by looking at such objective criteria as the paper's lost advertising revenues and circulation. Once again, however, it should be noted that to achieve optimal enforcement, penalties in excess of actual damages may be desirable due to the difficulty of detecting insider trading abuses.

3. *Damages in Texas Gulf Sulphur.* — Texas Gulf Sulphur was damaged by the insider trading in its stock to the extent that such trading informed the market about the firm's discovery and drove the acquisition price of the mineral rights above their pre-trading level.²³⁴ Since the insider trading was conducted by top officials in the company, including the firm's president and general counsel,²³⁵ a shareholder derivative suit would be the most appropriate means to redress the harm done to the corporation.²³⁶ Even if the insider trading did not cause the corporation to pay more for the mineral rights, TGS might still have suffered damages as a result of the insiders' trading. Unless the insiders had been assigned the firm's property rights in the privileged information as part of their compensation package, they were usurping a valuable corporate opportunity by

232. See *infra* notes 256-57 and accompanying text.

233. See *supra* text accompanying notes 163-64.

234. See *supra* notes 37-43 and accompanying text.

235. See 401 F.2d at 840 n.2 for a list of the trading done by the parties.

236. Under current law, however, these shareholders do not have standing to sue. See *supra* notes 197-225 and accompanying text.

profiting from the trading activity themselves rather than assigning the profits to the shareholders.²³⁷ If the corporation had not assigned the property interest to the insiders, the corporation's damages would be increased by the amount of the insider's gains.

Consequently, in *Texas Gulf Sulphur*, the damages from the insider's trading would equal the sum of (1) any increase in the cost of the mineral rights resulting from the insider trading and (2) any profits made by insiders who were not contractually entitled to engage in trading on the basis of the corporation's information. Damages would be zero if the insiders were contractually entitled to trade and such trading did not signal the market as to the firm's plans.

Even if the firm had assigned the insiders the right to profit from its information, shareholders could reasonably expect that such trading be conducted so as to avoid harm to the corporation. For this reason, even if the insiders were contractually entitled to trade on the basis of the inside information, a derivative action would be appropriate if the trading were done in such a way as to harm the corporation's shareholders by prematurely alerting the market to the mineral discovery.

C. *The Disclose or Abstain Rule*

In *Chiarella*, the Court did not decide whether the defendant had breached a fiduciary duty to his employer by trading on the tender offer information he uncovered.²³⁸ In *United States v. Newman*,²³⁹ the Second Circuit held that a duty to keep such information confidential was breached when insiders misappropriated information belonging to the clients of an investment banking concern.²⁴⁰ These cases make it clear that the obligation to refrain from trading stems from a preexisting contractual obligation to not engage in such activity. By parity of reasoning, it is clear that where there is such a duty, it is breached as much by wrongful disclosure as by wrongful

237. On the other hand, if the right to trade were part of the executives' compensation package, a shareholder in a derivative suit would have no more right to bring a suit for insider trading "than to challenge directly a salary or bonus decision." See Carlton & Fischel, *supra* note 4, at 890. Carlton and Fischel do not consider the possibility that the insiders may be subject to a derivative suit if they *abuse* their privilege to trade on inside information by damaging the corporation. Salary and bonus decisions do not present fiduciaries with the same possibility for abuse. See Jensen & Meckling, *supra* note 189 (discussing managerial shirking).

238. *Chiarella*, 445 U.S. at 236.

239. 664 F.2d 12 (2d Cir. 1981), *cert. denied*, 104 S. Ct. 193 (1983).

240. *See id.* at 17.

trading.

During the fairness era insiders could avoid liability by refraining from trading until making disclosure of the confidential information they possessed.²⁴¹ Such disclosure absolved the insider of liability because the courts' liability theory was based on the supposed unfairness caused by the asymmetry of information between the trading parties.²⁴² Disclosure, by definition, eliminated the asymmetry of information and thus the unfairness involved in the transaction. The following example, drawn from *Texas Gulf Sulphur*, illustrates the point.

On April 16, 1964, the insiders at Texas Gulf Sulphur released an official statement that detailed the precise nature of the firm's Canadian ore discovery.²⁴³ The court absolved from liability those insiders who traded after the official statement had been disseminated to the market.²⁴⁴ If the insiders in *Texas Gulf Sulphur* had held this press conference before the company had finished acquiring the land containing the mineral deposits, the firm would have been severely damaged. The price for the mineral rights TGS was trying to acquire would have risen sharply once the discovery became known to the land's owners. Holding the press conference before acquiring the mineral rights, in order to trade legally, would clearly have been a breach of the insiders' fiduciary duty to TGS.

Trading insiders can thus breach the very fiduciary duty that *Chiarella* describes, while making the sort of disclosure that the Second Circuit held was essential to avoiding liability under the fairness theory. As with other aspects of the Court's fiduciary duty theory,²⁴⁵ the foregoing analysis is consistent with the business property theory set forth in this Article. Permitting defendants to avoid liability by disclosure is "antithetical to the basic notion of a property right, which by definition entails the legal protection of private appropriation for private benefit."²⁴⁶ Insider liability results from the misappropriation of someone else's property, and damages may result from the owner's loss of the use of such information. Disclosure prevents the owner from profiting by use of the information in precisely the

241. See *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 848 (2d Cir. 1968) (en banc), cert. denied, 394 U.S. 976 (1969).

242. *Id.*

243. *Id.* at 846-47.

244. *Id.* at 848.

245. See *supra* notes 100-02 and accompanying text.

246. Fischel, *Efficient Capital Market Theory, the Market for Corporate Control, and the Regulation of Cash Tender Offers*, 57 TEXAS L. REV. 1, 13 (1978).

same way as does trading.²⁴⁷

A fundamental characteristic of ownership is the right to exclude others from using the thing that constitutes the property interest. The owner's right to exclude others from using a piece of inside information is compromised by an agent's disclosure of that information to others. If an owner has the right to prevent his agent from trading on some item of information, the owner must also have the right to prevent the agent from disclosing it to others.

By now it should be clear that the disclose or abstain doctrine, like the current rules on standing and damages, cannot be reconciled with the fiduciary duty theory of insider trading liability. The proper subject of contract analysis described in this Article clarifies and reinforces this conclusion. The contract between the insider and the owner of information is the source of the fiduciary duty not to trade. This contract also creates a fiduciary duty not to disclose, since the information's owner may be harmed even more by disclosure than by trading.

D. *The Desirability of Public Enforcement: Agency Costs*

If the basis for insider trading liability stems from a business property theory that is properly evaluated by the proper subject of contract analysis, it is not at all obvious that rules beyond traditional agency and contract principles are necessary to constrain improper insider trading.²⁴⁸ The groups that benefit from proper application of the insider trading rules are the firms to whom the information belongs. Shouldn't these firms bear the enforcement costs of these rules?

Insider trading activity that damages a firm is simply another form of agency cost with which the firm must contend. There is often a substantial divergence of interests between a firm's shareholders and its managers. Managers frequently do things that are not in the best interests of the shareholders. Classic examples of such behavior range from outright embezzlement, to usurpation of corporate opportunities, to corporate contributions to a manager's favorite charities. From the firm's perspective, insider trading involves precisely the same sorts of agency problems as do the examples above.

247. Consistent with the efficient market hypothesis, stock prices adjust to insider trading because such trading provides the market with new information concerning the corporation whose stock is being traded. Of course, direct disclosure of such information accomplishes the same thing.

248. See *supra* note 161 and accompanying text.

The SEC does not provide an expensive enforcement mechanism by which firms can police the usurpation of corporate opportunities, so why should it provide such a mechanism for policing insider trading? An argument can be crafted that public enforcement of a ban on insider trading is needed for the same reasons that public enforcement is needed to curb wrongful conduct generally. Relying exclusively on corporations to police the insider trading abuses of its agents may result in a suboptimal level of enforcement. The difficulty of detecting insider trading, the large gains for those who escape detection, and the large economies of scale in monitoring,²⁴⁹ all suggest that the contract law remedies available to firms damaged by insider trading are insufficient to achieve an optimal level of enforcement.

Corporate insiders, like all potential wrongdoers, are deterred from wrongful conduct because they expect to be punished if caught; deterrence is therefore a function of the penalty for wrongful conduct multiplied by the probability that such punishment will be imposed.²⁵⁰ The more difficult insider trading is to detect, the more severe the punishment must be in order to prevent such activity. There is a great deal of evidence to support the conclusion that insider trading is remarkably hard to detect.²⁵¹ Insider trading can be conducted in virtually complete secrecy. Monitoring insider trading requires that market transactions be watched closely.²⁵² It is likely that significant economies of scale are realized by having institutions such

249. See *infra* notes 252-54 and accompanying text.

250. Stigler, *The Optimum Enforcement of Laws*, 78 J. POL. ECON. 526, 527 (1970). Enforcement problems seem particularly acute in the area of insider trading, where the "frequent and open violations demonstrate that the present enforcement system has not deterred insider trading appreciably." Dooley, *supra* note 34, at 2. See Stigler at 527. See also Schwartz & Tullock, *The Costs of a Legal System*, 4 J. LEGAL STUD. 75, 78 (1975).

251. See Dooley, *supra* note 34, at 2, 5-17. The SEC has attempted to obtain a high level of deterrence by concentrating its enforcement on highly publicized cases.

252. At first blush, it may seem that the firm for which one works is the lowest cost monitor of insider trading activity. The primary monitors of insider trading, however, are the organized exchanges, the SEC, and the NASD (National Association of Securities Dealers). These institutions monitor all trading activity within their respective jurisdictions via a complex and sophisticated computer tracking system. Of course, once the monitoring has been completed and the inside trader apprehended, it does not follow that the firm whose information was appropriated should be barred from determining whether to proceed with litigation. It is typical in the realm of criminal law to permit the victim to determine whether to press charges against the wrongdoer. Similarly, in insider trading cases the firm whose information is appropriated should be able to determine how to proceed. It may be the case, however, that a derivative suit by a shareholder will be necessary in order for the firm's interests to be adequately protected.

as the SEC, the New York Stock Exchange (NYSE), and the National Association of Securities Dealers (NASD) conduct these activities.²⁵³ But the SEC's monitoring activities overlap with the activities of private organization such as the NASD and the NYSE which conduct monitoring activities at no charge to the taxpayer. There is no evidence that such double surveillance is necessary, and it is not obvious why the SEC is needed as a supplement to the private sector. The SEC spends millions of dollars on enforcement, yet brings relatively few cases,²⁵⁴ providing further support for the position that its efforts are superfluous at best.

The ease with which insiders can escape detection implies that punishment for those who are caught must be harsh. Thus the optimal fine may greatly exceed the amount of the damages that the injured party could collect in a contract suit. Yet society may be reluctant to permit the owners of insider information to collect sufficient penalties to effectively deter future violations by others. Penalty clauses are voidable in contract suits,²⁵⁵ but recovery of actual damages might prove an insufficient deterrent.

The Insider Trading Sanctions Act of 1984 (ITSA)²⁵⁶ extends the enforcement remedies available to the SEC by permitting it to recover penalties of three times the profit gained or loss avoided from insider trading. The ITSA also increases the maximum criminal penalty for knowing and willful violations of the Act from \$10,000 to \$100,000.²⁵⁷ The damages won in lawsuits brought by the SEC are to be paid into the U.S. Treasury, and do not affect the rights of plaintiffs to bring private suits. If applied in a manner consistent with the analysis presented in this Article, the provisions of the

253. See *The SEC's Spy System: Monitoring Computers — And Fielding Tips*, Business Week, April 23, 1984 at 29 (describing SEC's computerized surveillance system); Dooley, *supra* note 34.

254. Dooley, *supra* note 34, at 73 (very few cases are brought, and the existing system of SEC enforcement is so costly that it is "indefensible").

255. U.C.C. § 2-718(1). "A term fixing unreasonably large liquidated damages is void as a penalty." *Id.* J. CALAMARI & J. PERILLO, CONTRACTS 564-65 (1977). Under the U.C.C. the question of whether damages are "unreasonable" may be determined not only at the time the contract is signed, but also *ex post* in light of the actual harm suffered by the parties. See W. HAWKLAND, A TRANSACTIONAL GUIDE TO THE UNIFORM COMMERCIAL CODE 171 (1966). The basis for the rule that penalty clauses are not enforceable is that parties may only agree as to terms that affect their primary rights. They are not free to establish remedies, since that is the role of public law rather than private contractual law. J. CALAMARI & J. PERILLO, *supra* at 565.

256. Insider Trading Sanctions Act of 1984, Pub. L. No. 98-376, 98 Stat. 1264 (codified in scattered subsections of 15 U.S.C.A. § 78 (Supp. 1984)).

257. *Id.*

ITSA will help compensate for the disparity between the expected benefit and the expected penalty for engaging in insider trading. To the extent that the penalties collected by the SEC compensate it for the cost of maintaining a monitoring and enforcement mechanism, the public is relieved of the burden of this expense.

As a practical matter, it is highly doubtful that the SEC will be able to cover the costs of its enforcement scheme with the proceeds it takes in from insider trading suits. The deficit must be made up by the public. In addition, the SEC is likely to pursue an enforcement policy that conforms to the SEC's agenda rather than to the public interest or the directives of the Supreme Court.²⁵⁸ Concerns about the optimal use of information have never dominated the Commission's agenda in the past. The SEC seems to be reluctant to follow the direction of the Supreme Court in moving towards enforcement of Rule 10b-5 in such a way as to promote the efficient use of information. For this and other reasons, it is by no means certain that public enforcement is necessary in order to achieve the optimal level of enforcement. It may be that private remedies provide the optimal level of deterrence, especially when the costs of public enforcement are taken into account.²⁵⁹

Arguments in favor of a purely private enforcement scheme are considerably strengthened by closer consideration of the total costs visited upon those caught engaging in stock trading in violation of a

258. The Chairman of the SEC, John S.R. Shad, has repeatedly asserted that insider trading must be curtailed to eliminate the broad perception that the public is treated unfairly when insider trading occurs. See *supra* note 133 (quoting Chairman Shad). The SEC Chairman's remarks are in sharp contrast to the language of the Supreme Court in *Chiarella*, where Justice Powell specifically rejected the contention that insiders owe a general duty to the market:

We cannot affirm [Chiarella's] conviction without recognizing a general duty between all participants in market transactions to forgo actions based on material, nonpublic information. Formulation of such a broad duty, which departs radically from the established doctrine that duty arises from a specific relationship between two parties, . . . should not be undertaken absent some explicit evidence of congressional intent.

445 U.S. at 233 (citation omitted).

Professor Dooley suggests that the SEC's private agenda called for enlarging the scope of Rule 10b-5 because, in so doing, the SEC "solidified its position in the vanguard of the movement to federalize corporate law and thus assured itself a central role in any future regulatory scheme." See Dooley, *supra* note 34, at 62.

259. The monitoring described above is, of course, enormously expensive. In the case of SEC enforcement, the costs are borne not only by people active in the securities markets, but by taxpayers generally. This is not the case with the monitoring mechanisms established by the organized exchanges, where member firms pay the costs associated with monitoring insider trading.

preexisting duty. These costs, which include such things as damage to the defendant's reputation and personal stature, as well as loss of future employment opportunities, greatly enhance the deterrent effects of contractual remedies. As a result of R. Foster Winans' illegal activities while employed at the *Wall Street Journal*, for example, it is highly unlikely that Winans will be able to obtain employment as a financial columnist in the near future. His expected punishment under a purely private enforcement scheme, therefore, includes not only the return of the illegal trading profits, but also the future income he forfeits as a consequence of his *ultra vires* trading activity. Similarly, the prospects of Chiarella locating employment as a financial printer are remote.

From the previous discussion it should be clear that determining the optimal level of enforcement will not be easy. The realization that inside information is a legally cognizable private property interest, however, does not inevitably lead to the conclusion that the regulatory power of the state should not be used to police the interest. The police power of the state is used to protect virtually all private property interests. In other contexts it has been recognized that special protection must be provided by the state in order to protect the value of certain information.²⁶⁰ The ephemeral, intangible nature of information augers in favor of special protection.

In a recent and important article, Professors Carlton and Fischel correctly observe that the most efficient level of enforcement of insider trading rules would be reached by permitting state rather than federal law to determine the applicable legal rules.²⁶¹ They are mistaken, however, when they claim that "public enforcement with high penalties might deter a significant amount of beneficial, consensual insider trading."²⁶² If the proper subject of contract test suggested in this Article were adopted, beneficial insider trading would

260. See *supra* note 109.

261. See Carlton & Fischel *supra* note 2, at 890-91. See also R. WINTER, GOVERNMENT AND THE CORPORATION (1978) (arguing that in order to obtain the revenue associated with attracting corporations to their states, the states have incentives to pass corporation laws that benefit shareholders). Thus, as Professors Carlton and Fischel conclude, "[t]he preferable course would be to allow competition among states, rather than federal fiat, to resolve the issue of the desirability of public enforcement of nonconsensual insider trading." Carlton & Fischel, *supra* at 891.

262. *Id.* If institutions such as the SEC began enforcing insider trading laws to protect property rights in information, rather than to uphold an elusive value such as fairness and equality among traders, then strict public enforcement with high penalties would only serve to enhance the value of the property right. Public enforcement of other property rights does not prevent the parties who own such rights from taking advantage of them.

not be proscribed. The danger to which Carlton and Fischel advert results from the current confusion in the courts as to the proper allocation of the property right in the information. Under the test proposed in this Article, the information belongs to the corporation if the information might properly be the subject of a contract between the corporation and its agents.

As Carlton and Fischel observe, the SEC's prosecution of Raymond Dirks, if successful, would have had an "adverse effect . . . on incentives to acquire valuable information" because it would deprive investment analysts of the "incentive to invest resources to gather information in the first place."²⁶³ Adoption of the proper subject of contract test would result in only harmful insider trading being proscribed. Beneficial conduct, like that of Mr. Dirks, would not be affected.²⁶⁴

In all likelihood, the best way to police insider trading would feature a central monitoring system as a means to supplement the contractual obligations that this Article argues are at the heart of the Court's 10b-5 analysis. Under this enforcement scheme, the SEC — or better yet, a private firm or firms — would continue to serve as a monitor of illegal trading activity, and supply the information about such trading to the rightful owner of the information. The party legally entitled to use the information could then determine how best to proceed. If a corporate employee is found trading on information that rightfully belongs to his employer, the corporation's determination about whether to press charges should be subject to the usual cautions about intra-firm conflicts of interest, particularly where the employee is also a member of the firm's board of directors.

Conclusion

The purpose of this Article has been to point out that the legitimate policy concerns about insider trading are really concerns about the proper allocation of property rights in valuable information. The Supreme Court's recent opinions in *Dirks* and *Chiarella*, by focusing on the fiduciary duty owed by traders to the owners of insider information, employ a method of analysis consistent with this hypothesis. Justice Powell, speaking for the Court in *Dirks*, erred in his attempt to devise a useful method of assigning property rights to such information. His method, the "pecuniary gain" test, will not result in the

263. *Id.* at 885.

264. *See supra* notes 143-54 and accompanying text.

optimal allocation of valuable information. This Article has suggested a proper subject of contract test as the means for assigning property rights in information. Application of this alternative test will allow privileged corporate information to be used in the way that maximizes societal welfare.

Finally, this Article has pointed out several inconsistencies in the law that have arisen since the Court formulated its fiduciary duty theory of insider trading liability. These inconsistencies are not likely to survive the test of time. The intellectual history of insider trading liability posited in this Article suggests strongly that over time, the Court's analysis tends to eliminate incoherence and inconsistency. This Article has described the direction the law should take to eliminate existing anomalies in such areas as standing and damages. Specifically, the owners of the information that is being traded upon should be granted standing to sue for its misappropriation, and the harm to such owners should provide the sole measure of damages in 10b-5 cases.