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Securities Regulation - Trading by Insiders - S.E.C. v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968)

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CURRENT DECISIONS

Securities Regulation—TRADING BY INSIDERS. In *SEC v. Texas Gulf Sulphur Co.*,¹ drilling activity by the defendant corporation near Timmins, Ontario, on November 12, 1963, indicated the presence of an extraordinarily rich copper and zinc deposit. This led the company's president to instruct members of the exploratory group to keep the information confidential to facilitate the acquisition of additional mining rights. Between November 12, 1963, and March 31, 1964, when drilling was resumed, certain officers and employees of Texas Gulf Sulphur, and persons to whom they had given "tips," allegedly purchased TGS stock and calls, and five TGS officers accepted stock options.² After drilling resumed, and further very favorable results were found, Texas Gulf issued a press release on April 12, 1964, stating that the drilling to date had been inconclusive.³ On April 16, 1964, a detailed official press release announcing the substantial ore find was given wide publication. Between April 12th and April 16th, purchases of TGS stock were made by certain of those persons who possessed the undisclosed information.⁴ During this period of seven months, Texas Gulf stock rose from a close of 17 $\frac{3}{8}$ on November 8, 1963, to 58 $\frac{1}{4}$ on May 15, 1964.⁵

1. 401 F.2d 833 (2d Cir. 1968); Bureau of National Affairs, Daily Report for Executives, Special Supplement No. 11 (Aug. 15, 1968) (hereinafter cited as DRE Supp. No. 11). The principal case and the defendant therein are hereinafter referred to at times as Texas Gulf or TGS.

2. Four of the officers accepting stock options knew the detailed results of the drilling at Timmins; the fifth knew that the results were favorable. The stock option committee had no detailed knowledge of the drilling activity or its results. 401 F.2d 833 (2d Cir. 1968); DRE Supp. No. 11 at 5 (Aug. 15, 1968).

3. The case here dealt *inter alia* with the question of a company's liability for the issuance of misleading press releases with the court holding that TGS violated rule 10b-5 (17 C.F.R. § 240.10b-5 (1968)). *Id.* at 15. This analysis of the case, however, is limited to other questions.

4. One order for 200 shares of TGS stock placed by one defendant with a Canadian broker was executed on the Midwest Stock Exchange on April 15, 1964. Two additional orders, for 300 shares each, were executed at the opening of that exchange on April 16th for another defendant. Yet another defendant left the April 16th press conference and called his broker at 10:20 a.m. to order 2,000 shares of TGS stock for family trusts. The news of the TGS drilling results appeared on the Dow Jones wire at 10:54 a.m. *Id.* at 6.

5. *Id.*

The district court dismissed the complaint against the corporation and all but two of the individual defendants.⁶ The Court of Appeals for the Second Circuit reversed, holding *inter alia* that those Texas Gulf officers and employees who dealt in TGS stock or calls on the basis of undisclosed inside information violated section 10(b) of the Securities Exchange Act of 1934⁷ and rule 10b-5⁸ thereunder.

Of the several questions dealt with in *Texas Gulf Sulphur*, only that involving the interpretation of rule 10b-5, as to what persons may be classified as "insiders" and as to the liability of such "insiders," will be considered here.

It was held in the early case of *Kardon v. National Gypsum Co.*⁹ that the provisions of rule 10b-5 applied to directors and officers of a corporation and required them when dealing with their corporation's securities to disclose any facts known to them by reason of their position which would affect the judgment of persons trading in such se-

6. 258 F. Supp. 262 (S.D.N.Y. 1966).

7. 15 U.S.C. § 78j(b) (1964), which reads in pertinent part:

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

....

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

8. 17 C.F.R. § 240.10b-5 (1968), which reads:

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

(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 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.

9. 73 F. Supp. 798 (E.D. Pa. 1947). In *Kardon* the corporation was owned equally by four men who constituted the board of directors. One of the four made a preliminary agreement with National Gypsum for the sale of the corporation for \$1,500,000. Then, without disclosing even that there had been any negotiations, he purchased all the stock owned by two of the other owners-board members for a total of \$504,000, and consummated the sale with a handsome profit. The court held that the acts constituted a violation of section 10(b) of the 1934 Securities Exchange Act. [15 U.S.C. § 78j(b) (1964) (quoted in note 7 *supra*)].

curities.¹⁰ Subsequently, it was held that a majority stockholder is required to divulge "material" facts when dealing with minority stockholders not having such information.¹¹ Through a series of judicial and SEC rulings, it became clear that the term "insider" could be interpreted to include others in addition to a corporation's officers, directors, and controlling stockholders.¹²

The most exhaustive treatment on the question of what persons may be classified as "insiders" is provided by Professor Loss, who maintains that insiders may be: (1) the officers, directors, or controlling stockholders of the corporation in question; or (2) members of the immediate families of such persons; or (3) "tippees" who receive a tip from an insider and who know or should reasonably infer that the tip was given in breach of trust; or (4) persons who pick up inside information in the course of business dealings with the corporation; or (5) brokers who execute orders for an insider and who know of inside information.¹³

Comprehensive criteria to be applied in determining what persons may be considered insiders under rule 10b-5, relied upon in the *Texas Gulf* decision, are found in the SEC ruling in *In re Cady, Roberts & Co.*,¹⁴ wherein the Commission stated:

10. 73 F. Supp. 798, 800.

11. See, e.g., *James Blackstone Memorial Library Ass'n v. Gulf, Mobile and O. R.R. Co.*, 264 F.2d 445 (7th Cir.), cert. denied, 361 U.S. 815 (1959); *Speed v. Transamerica Corp.*, 99 F. Supp. 808 (D. Del. 1951).

12. In 1965 one writer observed that:

Generally, the class of persons upon whom rule 10b-5 operates to require disclosure of non-public information in securities transactions has been denominated "insiders." This definition clearly includes a corporation's officers, directors and controlling stockholders. It also seems clear that others can in some circumstances be "insiders." However, the outer boundaries of the category are still largely unexplored.

Fleischer, *Securities Trading and Corporate Information Practices: The Implications of the Texas Gulf Sulphur Proceeding* 51 VA. L. REV. 1271, 1280 (1965) (footnotes omitted).

For a general discussion of who may be classified as an "insider" see *id.* at 1280-84.

13. 3. L. LOSS, *SECURITIES REGULATION* 145-53 (2d ed. 1961). Mr. Fleischer places possible insiders into categories somewhat similar to those of Professor Loss. See Fleischer, *supra* note 12, at 1282-84.

14. 40 S.E.C. 907 (1961). In *Cady, Roberts* a man who was a director of Curtiss-Wright Corp. and a registered representative of the brokerage firm of Cady, Roberts & Co., attended a board meeting where it was decided to reduce the dividend rate for the fourth quarter of 1959 from \$.625 per share to \$.375. At a recess of the meeting after the decision had been made but before any announcement of the decision, the director in question telephoned a partner of Cady, Roberts that the dividend had been

[A] special obligation has been traditionally required of corporate insiders, e.g., officers, directors and controlling stockholders. These three groups, however, do not exhaust the classes of persons upon whom there is such an obligation. Analytically, the obligation rests on two principal elements; first, the existence of a relationship giving access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone, and second, the inherent unfairness involved where a party takes advantage of such information knowing it is unavailable to those with whom he is dealing. In considering these elements under the broad language of the anti-fraud provisions we are not to be circumscribed by fine distinctions and rigid classifications. Thus our task . . . is to identify those persons who are in a special relationship with a company and privy to its internal affairs, and thereby suffer correlative duties in trading in its securities.¹⁵

The *Cady, Roberts* decision also reiterated the rule that an insider's failure to disclose material facts known to him by virtue of his position is a violation of the Securities Exchange Act and rule 10b-5.¹⁶ By this rule, if an insider possesses material facts, he must either disclose them to the person with whom he is dealing before trading in the corpo-

cut. This partner entered sell orders for a total of 7,000 shares of Curtiss-Wright stock which were executed at 11:15 a.m. and 11:18 a.m. before the dividend announcement appeared on the Dow Jones wire at 11:48 a.m. The SEC held that the partner had violated section 10(b) (15 U.S.C. § 78j(b) (1964)) and rule 10b-5 (17 C.F.R. § 240.10b-5 (1968)), and suspended him from trading on the New York Stock Exchange for twenty days.

15. 40 S.E.C. 907, 912 (1961) (footnotes omitted).

A recent application of the *Cady, Roberts* rule can be found in *Ross v. Licht*, 263 F. Supp. 395 (S.D.N.Y. 1967), where the court states:

In determining whether a person, not a director or officer, is a corporate insider it seems to me that the test is whether he had such a relationship to the corporation that he had access to information which should be used "only for a corporate purpose and not for the personal benefit of anyone." *Id.* at 409.

16. We [the SEC], and the courts have consistently held that insiders must disclose material facts which are known to them by virtue of their position but which are not known to persons with whom they deal and which, if known, would affect their investment judgment. Failure to make disclosure in these circumstances constitutes a violation of the anti-fraud provisions. If, on the other hand, disclosure prior to effecting a purchase or sale would be improper or unrealistic under the circumstances, we believe the alternative is to forego the transaction.

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

ration's stock, or he must refrain from such trading.¹⁷ Later cases have given interpretations varying only slightly from that of *Cady, Roberts*,¹⁸ but it is that case which is relied on in the *Texas Gulf* holding¹⁹ and treated therein as the accepted statement of law. This was the first time that the *Cady, Roberts* rule had received explicit judicial approval.

The significance of the court of appeals' holding in *Texas Gulf Sulphur* lies in its recognition and expansion of existing concepts, and by applying the SEC policy enunciated in *Cady, Roberts* to the fact situation in *Texas Gulf*, the court gave approval to that policy,²⁰ and extended liability thereunder beyond that of previous cases.²¹ The decision in *Texas Gulf* is a step toward more clearly defining what persons may be classed as "insiders" and what restrictions are placed on such persons' activity in the securities markets.

Since the SEC first filed its complaint there has been a divergence of opinion concerning the significance of the *Texas Gulf Sulphur* proceeding. Some maintain that there had been sufficient "warnings" to cause the financial community to ponder the implication of *Cady, Rob-*

17. For a discussion of the rationale behind and the effect of the *Cady, Roberts* ruling see Cary, *Insider Trading in Stocks*, 21 BUS. LAW, 1009, 1011, 1014-15, 1018 (1966). See also *Ross v. Licht*, 263 F. Supp. 395, 408 (S.D.N.Y. 1967).

18. See, e.g., *Kohler v. Kohler Co.*, 319 F.2d 634, 637-38, 642 (7th Cir. 1963).

19. *SEC v. Texas Gulf Sulphur*, 401 F.2d 833 (2d Cir. 1968); DRE Supp. No. 11 at 7 (Aug. 15, 1968).

20. *Cady, Roberts* was only a proceeding before the SEC whereas *Texas Gulf* brings many of the same issues before the courts. Cary, *supra* note 17, at 1011. Some writers saw judicial sanction of the *Cady, Roberts* rule as the SEC's objective for bringing the complaint against TGS:

It is plain that in the *Texas Gulf* case, the Commission is seeking judicial approval for the rule it announced in *Cady, Roberts & Co.*, namely, that corporate officers, directors, and controlling shareholders, and any one else who has access to information intended to be available only for a corporate purpose may not take advantage of such material information

Kennedy and Wander, *Texas Gulf Sulphur, A Most Unusual Case*, 20 BUS. LAW, 1057, 1061 (1965). Kennedy and Wander recognize, however, that *Texas Gulf* differs from *Cady, Roberts* in that in *Texas Gulf* the SEC seeks to impose liability not on the recipient of undisclosed information but on the insiders who disclosed it. *Id.* at 1064.

21. The court in *Texas Gulf* made no distinction between the company's president and officers and certain of its employees (engineers and geologists) in determining liability under rule 10b-5, and held several of the lower echelon employees liable as insiders. 401 F.2d 833 (2d Cir. 1968); DRE Supp. No. 11 at 4 (Aug. 15, 1969). See also Fleischer, *supra* note 12, at 1280. In prior cases, liability under rule 10b-5 was held to rest only on either corporate officers or majority stockholders. See, e.g., *Speed v. Transamerica Corp.*, 99 F. Supp. 808 (D. Del. 1951); *Kardon v. Nat'l Gypsum Co.*, 73 F. Supp. 798 (E.D. Pa. 1947). In *Ross v. Licht*, 263 F. Supp. 395 (S.D.N.Y. 1967),

erts, and to be prepared for the developments of *Texas Gulf*.²² Similarly, others feel that the issues involved in *Texas Gulf* constitute "no radical departure from the pre-existing rules" and that "[t]he general rules implicit in that case have been operative for a very long time."²³ Still another view is that the SEC's success in prosecuting *Texas Gulf* is a significant change, which will "impose more stringent disclosure and trading requirements on both issuers and those with access to corporate information unavailable to the public."²⁴ Finally, the more moderate (and probably most accurate) opinion is that, while the TGS proceeding is significant, it does not place unreasonable restraints on trading by insiders, for it has long been difficult to justify such trading as is proscribed by the *Texas Gulf* holding.²⁵

In sum, the court of appeals' holding in *SEC v. Texas Gulf Sulphur* has clarified the possible liability of a corporate officer or employee in trading in his corporation's securities on the basis of undisclosed inside information under rule 10b-5 and, in so doing, has extended such liability to certain persons and certain situations not heretofore clearly included. The resulting extension of liability is, however, not unreasonable.

DENNIS C. HENSLEY

Real Property—CONDOMINIUMS—MERGER OF ESTATES. Kauaian Development Co., after acquiring a leaseholding interest in land, executed numerous documents with individual purchasers for the sale of condominium units.¹ Once the corporation submitted the lease to a "horizontal property regime" (the condominium),² the fee to the property

non-officer employees were held liable, but the district court in so holding relied on the district court holding in *Texas Gulf*. See *id.* at 409.

22. Cary, *supra* note 17, at 1011.

23. Fleischer, *Insider Trading in Stocks*, 21 BUS. LAW. 1009, 1020 (1966). It should be noted that Mr. Fleischer's statement was made before the *Texas Gulf* holding under discussion here was rendered and was made only on the basis of the issues raised by the proceeding.

24. Kennedy and Wander, *supra* note 20, at 1058.

25. Fleischer, *supra* note 12, at 1304-05.

1. State Savings & Loan Ass'n v. Kauaian Development Co., 445 P. 2d 109 (Hawaii 1968). An "agreement of sale" normally denotes a transaction whereby the purchaser is entitled to immediate possession; however, in this case the right to possession was not to arise until completion of the construction.

2. The statutory requirements necessary to the creation of a condominium in Hawaii are found in S. L. H. Act. 9, § 8 (1962). This section reads as follows:

A horizontal property regime is created under the Horizontal Property