Early Development of Insider Trading Law in the United States

The origins of insider trading law in the United States are found in a series of nineteenth-century state court decisions. These cases were typically brought as private contract disputes over face-to-face stock transactions between senior corporate officers and outsiders, and the courts were not consistent in their approaches. By the time the modern federal statutory regime was adopted in the early 1930s, the state courts were split between two common law rules, neither one of which bears much resemblance to the current regime’s approach.

1.1 THE NINETEENTH CENTURY AND THE MAJORITY RULE

Perhaps the earliest insider trading case came before the Alabama Supreme Court in 1836. In Spence v. Whitaker, William Whitaker, the treasurer and most active trustee of a joint-stock company, informed a shareholder, John Spence, that his recently acquired shares in the company were encumbered by a debt that would force their forfeiture if not paid immediately.¹ Spence asked whether dividends due on the shares would cover the debt and was informed by Whitaker that no dividends had been declared by the company.² Whitaker then volunteered a solution. He offered to buy six shares of Spence’s stock at $92 a share to free up enough cash to cover the debt and remove the lien. Whitaker assured Spence that the offer reflected fair market value.³ Spence had no independent means of verifying any of Whitaker’s claims because Whitaker had not maintained the company’s register of accounts as he was required to do by the firm’s articles. Thus, believing he had no other choice, Spence agreed to proceed with the trade on Whitaker’s terms. Spence later sought to

¹ Spence v. Whitaker, 3 Port. 297 (1836).
² Ibid. at 299.
³ Ibid.
rescind the trade when he learned that there had never been a lien on his shares and
his stock was in fact worth $415 a share at the time of the trade.4

The Alabama Supreme Court applied the elements of common law fraud to the
facts of Spence. The general rule, persisting to this day, is that an agreement may be
rescinded as fraudulent where it was intentionally induced by a statement the maker
knew to be false, or where it was intentionally induced by active concealment of the
truth.5 Silence, or failure to disclose the truth, may also support an action for fraud
where there is an independent duty to disclose some fact or facts.6 The presence of
a fiduciary or similar relation of trust and confidence between the parties is one
consistently recognized basis for such a duty to disclose.7 The court appeared to find
evidence to support all three bases for fraud in Spence. Whitaker’s false representa-
tions that Spence’s shares were encumbered and that they had a book value of only
$92 a share induced Spence to sell at one-quarter of their true value.8 Moreover,
Whitaker’s failure to maintain the company’s books was arguably an attempt at
active concealment, preventing Spence and others from learning the truth.9 More
still, the court seemed to suggest that Whitaker’s status as trustee, “in whom faith and
confidence had been reposed, and whose agency imparted to him more intimate
knowledge of the condition and value of the subjects of the trust, than the [benefi-
ciary], or others, could possess,” created a duty to disclose the truth about the
encumbrance and value of the shares under these circumstances.10 The court
concluded that regardless of “whether the evidence of artifice, misrepresentation
and fraudulent design” in this case would offer sufficient grounds to avoid the
contract on their own, when considered together with the fact that Whitaker was
trustee to Spence, these circumstances were “amply sufficient” to warrant rescission
of the share sale as fraudulent.11

Though Spence clearly held that Whitaker had a duty to disclose the true value of
the company shares to Spence prior to the sale, the court’s reasoning left the precise
nature and source of this duty ambiguous. Did the duty derive from Whitaker’s
insider position as treasurer and trustee alone, or did it stem from his insider status
in combination with other factors such as his failure to maintain records and his
misleading representations? Of course, a great deal turns on which rule a court
follows. If a duty to disclose attaches by virtue of one’s position as senior officeholder
alone, then virtually every trade by senior management in possession of material
nonpublic information would be fraudulent and therefore voidable.

4 Ibid. at 324–25.
6 Ibid. at § 161. (Such silence is treated as “equivalent to an assertion that the fact does not exist.”)
7 Ibid. at § 161(d).
8 See Spence, 3 Port. at 324–25.
9 Ibid. at 325.
10 Ibid. at 325–26.
11 Ibid.
The New York courts took up the problem three decades later in Carpenter v. Danforth.\footnote{Carpenter v. Danforth, 52 Barb. 581 (1868).} Francis Carpenter sold 136 shares of the National Bank Note Company to George Danforth, then a director of the company, for $60 a share ($10 more than par value). During negotiations, Danforth told Carpenter that he was prepared to offer more than any of the other officers would for the shares, and that he wanted the shares to increase his voting power at the upcoming shareholder meeting.\footnote{Ibid. at 587.} Within thirteen months of the sale, the company declared two dividends, one of 310 percent and one of 200 percent. Carpenter later sued to rescind the sale as fraudulent when he learned of these dividends.

Carpenter’s principal argument was that Danforth’s position as director placed him in a position of “trust and confidence” to all shareholders such that the stock sale must be declared void as fraudulent unless “Danforth paid a full and fair price for the stock” and also disclosed to Carpenter “every fact or circumstance known to him . . . and not known to [Carpenter], material on the question of the value of the stock.”\footnote{Ibid. at 583.} The court recognized this issue as being of “great” and, in this case, “controlling importance.” It began with the observation that a corporation is not a living thing and can therefore only act by agents. A corporation’s directors are the principal agents for managing the general affairs of that corporation, and such management will determine its profits. Since the value of the shareholder’s stock is determined by the present value of its right to future dividends of profits, there is “a certain trust relation between shareholders and the directors of a corporation.”\footnote{Ibid. at 584.} But, the court went on, “the trust put in the directors usually extends . . . only to the management of the general affairs of the corporation, with a view to dividends of profits.”\footnote{Ibid.} Directors “are not trustees for the sale of the stock of the corporation.”\footnote{Ibid. at 587–91.} Consequently, the court held that the trust relation between Danforth as director and Carpenter as stockholder was real, but that it did not touch upon transactions in the stock itself “except so far as the good or bad management of the general affairs of a corporation by its directors, indirectly affects the value of the stock.”\footnote{Ibid. at 587.} Thus, Danforth as director had no duty to Carpenter as shareholder to disclose any information advantage he may have had concerning the value of the corporation’s shares prior to executing the sale. To rescind the sale for fraud, Carpenter would have to show that Danforth made some affirmative misrepresentation or that he took active measures to conceal the true state of the company’s affairs from Carpenter. The court thus concluded that these facts could not support rescission for fraud.\footnote{Ibid. at 587–91.}
After Carpenter, the trend continued in the direction of limiting the scope of the trust relationship between directors and shareholders to decisions pertaining to the management of the firm’s business affairs, and not to transactions in the firm’s shares. The Indiana Supreme Court took up the issue in The Board of Commissioners of Tippecanoe County v. Reynolds.20 In this case, the president of the Indianapolis Railroad Company purchased (through an agent) 570 shares of the firm’s stock from Tippecanoe County for $0.90 on the dollar of its face value. At the time of this purchase, the president was negotiating the sale of the company for more than ten times the price he paid the county. The county later claimed the sale was induced by fraud and sued the president for the difference between the price paid for the county’s shares and the subsequent sale price. Despite the fact that the president had failed to declare dividends and had represented that the stock was not worth its face value, the court concluded there had been no affirmative misrepresentation or active concealment on the part of the president.21 Consequently, the court held that the only live issue was whether the defendant, as president and director of the company, was “a trustee of the [county] as a stockholder, whereby it became his duty, as a purchaser of the stock, to pay a fair and adequate price for it ... and to disclose ... all the material facts within his knowledge, not known to the plaintiff, affecting the value of the stock.”22 Citing Carpenter, the court reasoned that the scope of directors’ duties to shareholders is limited to the prudent management of the company’s property. The stock held by the county was, however, its own property, over which neither the firm nor its officers had any “control, power, or dominion.”23 The court thus concluded it is “very clear” that “in the purchase of stock by a director from the holder, the relation of [trust] does not exist between them.”24 The decisions in Carpenter and Tippecanoe County were soon followed by decisions in a number of other jurisdictions,25 and by the close of the nineteenth century the understanding that directors do not owe any special duties of trust and confidence to shareholders in connection with the purchase or sale of stock had become the majority rule.26

A few nineteenth-century courts did, however, recognize more expansive duties of trust and confidence for corporate officers. In Fisher v. Budlong,27 for example, the shareholder of an insurance company sought advice from the firm’s president as to the value of his shares. The president told the shareholder that the shares were worth

20 The Bd. of Comm’rs of Tippecanoe Cnty. v. Reynolds, 44 Ind. 509 (1873).
21 Ibid. at 512.
22 Ibid. at 513.
23 Ibid. at 515.
24 Ibid. at 516.
25 See, e.g., Deadrick v. Wilson, 67 Tenn. 108 (1874); Crowell v. Jackson, 23 A. 426 (N.J. 1891); Krumbhaar v. Griffths, 25 A. 64 (Penn. 1892); Haarstick v. Fox, 53 P. 251 (Utah 1895).
27 Fisher v. Budlong, 10 R.I. 525 (1873).
significantly less than their par value and recommended that they be sold as soon as possible. The president then offered to find a buyer for the shares. A few days later, the president informed the shareholder that he had found a “good offer” at $2 less than par value. The shareholder agreed to sell, and the president demanded and was paid a commission for arranging the transaction. It later came to light that the president had purchased the shares for himself (through an intermediary) and that they were worth twice the price paid. The Rhode Island Supreme Court recognized that a “vendor is not obliged to disclose all the circumstances within his knowledge which might affect the value of the thing sold.” Indeed, the court even affirmed that “a buyer should not be liable to a suit for deceit for misrepresenting a seller’s chance of selling for a good price.” Nevertheless, the court held that any “peculiar relation implying confidence or leading to confidence” would “take the case out of the ordinary rule,” and such a “peculiar relation” was present here. According to the court, the “material point” in this case was the fact that the president “professed to be aiding the plaintiff in selling his stock, and getting a good price.” Indeed, proof that the president purported to act as agent on the seller’s behalf was found in the fact that he demanded and received a commission for the sale. As a result, “the seller was led to repose a trust and confidence in the president.”

Had the court stopped there, it would be fair to say that Fisher was consistent with the majority rule because the “special relationship” between the president and shareholder seemed to turn on the president’s position as agent for the sale of the shares rather than as officer of the firm. But the court went on to point out that, even apart from this agency relationship, the shareholder had a right to suppose that the defendant, as president of the corporation, knew the shareholder’s situation and could be relied upon for his statements as to the value of the shares. Accordingly, the court noted that “although any single officer cannot perhaps be considered as standing in the relation of trustee to each stockholder,” such a relationship is nevertheless “a reason for confidence, and more especially when this officer is the sole manager of the corporation, and the stockholder has a right to call on him for this very information.” But while Fisher suggested a more expansive scope for the relation of trust and confidence between corporate officers and shareholders, this rule was slow to gain adherents. Other nineteenth-century cases finding a special relationship between officers and shareholders that triggered a duty to disclose typically relied on some additional facts such as those found in Spence.

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28 Ibid. at 526.
29 Ibid. at 527.
30 Ibid. at 528.
31 Ibid.
32 Ibid.
33 Ibid. at 529.
34 Ibid.
1.2 THE EARLY TWENTIETH CENTURY AND THE RISE OF
THE MINORITY RULE: 1900 TO 1934

The close of the nineteenth century coincided with the rise of progressivism in
American politics and realism in American jurisprudence. The pro-management,
laissez-faire political attitudes so prevalent during the early years of the Industrial
Revolution were challenged by a greater awareness of the associated problems of
urbanization and income disparity. Unions were gaining power, and workers’ rights
began to take precedence over the ethic of economic expansion at any price. At the
same time, the formalism of classical nineteenth-century contract law was being
questioned by the new legal realism. Realists challenged the mechanical application
of “outdated” legal principles such as caveat emptor as generating harsh results that
favored the wealthy and powerful over the poor and oppressed. There was a strong
push by legal scholars to measure historically received legal principles by the new
social sciences, and to soften their application by appeal to considerations of fairness
and social justice. Increased pressure was placed on the pro-management majority
rule in insider trading cases as these progressive and realist ideas gained traction
among politicians and judges in the early twentieth century.

In *Oliver v. Oliver*, the president and director of Gate City Oil Company
purchased 658 shares of the firm’s stock at $110 a share from a shareholder without
first disclosing that he had previously arranged for the profitable sale of one of the
company’s facilities, making the shares worth $185 a share. There was no evidence
that the president had lied or actively taken measures to prevent the shareholder
from learning of the shares’ true worth. The facts did not therefore support rescis-

ion on grounds of fraudulent misrepresentation or active concealment. Rather, to
avoid the sale, the shareholder was compelled to demonstrate that the president had
an independent duty to disclose all facts material to the sale prior to entering into
the agreement.

In taking up this issue, the Supreme Court of Georgia cautioned that courts
“cannot put parties upon an equality which does not in fact exist. They cannot
deprive one of the advantage which superior judgment, greater skill, or wider
information may give.” For, quoting Chief Justice John Marshall’s language in
*Laidlaw v. Organ* (a case that is discussed in great detail in Chapter 6 of this book).

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35 See, e.g., Mulvance v. O’Brien, 58 Kan. 463 (1897) (the president of a corporation had a duty
to disclose where he acted as agent for the sale of the shareholders’ stock and made various
misrepresentations and engaged in active concealment in effecting the sale).
36 Oliver v. Oliver, 118 Ga. 362 (1903).
37 Ibid. at 233.
“it would be difficult to circumscribe the contrary doctrine within proper limits.”

In short, “[c]ourts are created for the enforcement of civil contracts and are powerless to relieve against hard bargains, unless authorized so to do by some rule of civil law.”

One such rule, however, is that a failure to disclose an information advantage may be fraudulent where the parties stand in a special relation of trust. The court then addressed the question of whether the relation that a director bears to an individual stockholder alone is enough to generate the duty to disclose. The court recognized the well-settled understanding that the director is trustee for the company and therefore serves the interests of the “entire body of stockholders.” But it went further and observed that “the fact that he is trustee for all is not to be perverted into holding that he is under no obligation to each.”

Consistent with the legal realism of the day, the Oliver court refused to privilege legal form over substance. It concluded that the corporation is an artificial entity, and it is the individual shareholders who are the “real parties at interest.” Consequently, no “process of reasoning and no amount of argument can destroy the fact that the director is, in a most important and legitimate sense, trustee for the stockholder.” The director is not trustee in the strict sense of holding title to the shares or of being precluded from transacting with shareholders. Rather the director stands in the relation of “quasi trustee as to the shareholder’s interest in the shares.”

In reaching this conclusion, the court expressly refused to follow the majority rule’s limitation of the scope of a director’s duty of trust to the prudent management of the firm’s actual property, which would exclude stock owned by shareholders. The court found that when a director purchases shares from a stockholder, “he is not buying paper, but in effect is buying an undivided and substantial interest in property which has been committed to the director’s care, custody, and control.” The court therefore concluded that directors do indeed stand in the relation of fiduciary to individual shareholders and their shares. The court then held that the duties of a director as fiduciary of the shareholder’s interests are as follows:

Where the director obtains the information giving added value to the stock by virtue of his official position, he holds the information in trust for the benefit of those who placed him where this knowledge was obtained, in the well-founded expectation that the same should be used first for the company, and ultimately for those who were the real owners of the company. The director cannot deal on this information to the prejudice of the artificial being which is called the corporation, nor, on any

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39 Oliver, 118 Ga. at 233.
40 Ibid.
41 Ibid.
42 Ibid.
43 Ibid.
44 Ibid. at 234.
45 Ibid.
sound principle, can be permitted to act differently towards those who are not artificially but actually interested.\textsuperscript{46}

In short, the \textit{Oliver} court treated material nonpublic information concerning the value of the firm’s shares as a firm asset held in trust first for the benefit of the firm and then secondarily (or by extension) for the benefit of the shareholders.\textsuperscript{47} Hence, assuming such information can be disclosed without harm to the firm (the director’s principal obligation as fiduciary), the court ruled the director’s secondary quasi-fiduciary obligations to the shareholder create a duty to disclose prior to trading. If the information cannot be disclosed without harm to the firm, the director’s status as fiduciary requires that he or she abstain from trading altogether. If, as in this case, the director trades without making the requisite disclosures to the shareholder, the sale must be set aside as fraudulent.\textsuperscript{48}

While \textit{Oliver} was the first case to recognize the director’s relationship to individual shareholders in stock transactions as essentially fiduciary in nature, the Supreme Court of Kansas followed it just one year later in \textit{Stewart v. Harris}.\textsuperscript{49} In \textit{Stewart}, the president of a bank availed himself of an information advantage to purchase twelve shares of the bank’s stock from a shareholder for much less than their actual value. At trial, the jury was instructed that “the president or other managing officer of a corporation . . . stands in the relation of a trustee to all the stockholders who are not themselves engaged in” its active management.\textsuperscript{50} For a trustee, any purchase from a shareholder without “first having informed such stockholder of the true condition of the bank, and of the amount and value of its assets, is a fraud.”\textsuperscript{51} The jury found for the plaintiff, and the director appealed, complaining that these jury instructions were erroneous because they were inconsistent with majority rule. Quoting extensively from \textit{Oliver} as a “well-considered case,” the \textit{Stewart} court adopted that court’s reasoning and rule in affirming the trial court’s instruction that a relation of trust exists between directors and ordinary shareholders, and that this relation gives rise to a duty to disclose or abstain from trading. In following \textit{Oliver}, the court expressly rebuked the majority rule as articulated in \textit{Tippecanoe County}\textsuperscript{52} as leaving stockholders the “legitimate prey” of their corporation’s directors. The \textit{Stewart} court explained that it could not “give its approval to a course of dealing that will permit

\textsuperscript{46} Ibid.
\textsuperscript{47} Interestingly, the court’s property rights–based rationale hints at conversion, in addition to breach of trust, as a possible ground for rescission when a director trades based on the firm’s material nonpublic information.
\textsuperscript{48} Ibid. at 234–35.
\textsuperscript{49} \textit{Stewart v. Harris}, 66 L.R.A. 261 (1904).
\textsuperscript{50} Ibid. at 279.
\textsuperscript{51} Ibid.
\textsuperscript{52} The \textit{Stewart} court recognizes \textit{Tippecanoe County} as the “pioneer case to announce the doctrine” that directors sustain no trust relation to stockholders, despite the fact that \textit{Carpenter} precedes it.
those occupying a trust relation to be unmindful of the trust, betray the confidence reposed, and profit by such betrayal.”

The Oliver and Stewart courts’ contempt for the majority rule as antiquated and socially naïve reflected the legal realism that was making its way into the jurisprudential mainstream by this time. And though it remained the minority rule, the fiduciary model articulated by these courts continued to gain adherents in the early decades of the twentieth century.

As the majority and minority rules vied for jurisdictions, the US Supreme Court addressed the question of insider trading for the first time in Strong v. Repide. In Strong the Court reviewed the judgment of the Supreme Court of the Philippine Islands concerning the purchase of shares of the Philippine Sugar Estates Development Company by its president, director, and owner of three-quarters of the firm’s shares. It appears the company’s only assets were its real estate holdings in the Philippines, and that the political realities of the time were such that these holdings could not be developed and were worthless unless they could be sold to the government. The president, the government, and other interested parties had been engaged in prolonged negotiations that appeared to the general public to be going nowhere. In reality, the government had made a strong offer for the land and the president was holding out for a stronger offer. With the offer already on the table, the president engaged an intermediary to approach Erica and Richard Strong’s agent (whose office was adjacent to the president’s) and offer to purchase their 800 shares of the company at the current market price, which was much less than their value in light of the government’s pending offer. At this time, the public perception remained that a deal was unlikely. The Strongs’ agent agreed to sell their shares. The deal was announced two and a half months later, sending the share price up almost 1,000 percent. When the Strongs later learned that the president had been the true counterparty to their trade, they sought to rescind the sale as fraudulent.

Since the president made no affirmative misrepresentations to the Strongs’ agent, the Court found the issue to be whether “it was the duty of the defendant, acting in good faith, to disclose to the agent of the [Strongs] the facts bearing upon or which might affect the value of the stock.” The Court was careful to weigh the precedent, citing the minority rule in Oliver and Stewart, as well as the majority rule in Tippecanoe County. The Court then proceeded to stake out a middle ground.

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53 Ibid. at 281.
54 For example, in Jacquith v. Mason, 99 Neb. 509, 514–16 (1916), the Supreme Court of Nebraska quoted extensively from Oliver and Stewart in finding the president and director of an insurance company owed a fiduciary duty to shareholders to disclose information of a pending tender offer before purchasing their shares well below the offer price.
55 Strong v. Repide, 29 S. Ct. 521 (1909). Though the Court addressed the problem of trading based on information asymmetries in Laidlaw v. Organ, 15 U.S. 178 (1817), it did not take up the problem of true insider trading until this case.
56 Ibid. at 430–31.
between the two approaches in what has come to be known as the “special facts” doctrine. According to the Court, even if it is conceded that the ordinary relations between directors and shareholders in a business corporation are not of such a fiduciary nature as to make it the duty of a director to disclose to a shareholder the general knowledge which he may possess regarding the value of the shares of the company, yet there are cases where, by reason of the special facts, such duty exists.57

The Court identified a number of special facts that, together, warranted taking this case out of the general rule. To begin, the defendant was not only president and director of the company, but he also owned three-quarters of the firm’s shares, was administrator general of the company, and, by the other shareholders’ acquiescence, was the chief negotiator with the government for the sale of the property. Moreover, this was not just the negotiation of a significant deal; it was for the sale of all of the company’s assets, and he was the only person aware of the status of these negotiations. When combined, these facts placed the president more in the role of agent for the sale of the lands on behalf of the shareholders than as simply managing the assets of the company. Once the land was sold, there would be no assets left to manage. And, finally, concealing his identity when procuring the purchase of the stock by his agent indicated that he knew that making the offer himself would have put the Strongs on notice of a possible deal. He therefore took active measures to conceal this from them. As the Court put it, his “concealment of identity was not a mere inadvertent omission . . . but was a studied and intentional omission, to be characterized as part of the deceitful machinations to obtain the purchase” at a reduced price.58 The Court held that these special facts were enough to create a duty to disclose, even if the bare director-shareholder relationship would not generate such a duty on its own.

Though the special facts doctrine articulated in Strong is usually recognized as an alternative to the majority and minority rules, it is probably best thought of as offering an equitable exception to the majority rule. It takes care not to recognize a general fiduciary duty of directors to all shareholders as such. In this sense it is inconsistent with Oliver, Stewart, and other minority rule cases. Instead, like Fisher (and perhaps Spence) before it, it simply recognizes that sometimes, under the right circumstances, deceitful conduct on the part of a director may be so extreme that a duty to disclose arises where it would otherwise not exist. Again, this is entirely consistent with the majority rule. Regardless of whether it is thought of as a third

57 Ibid. at 431. There is language in Strong suggesting that the Court read Oliver and Stewart as special facts cases (see, e.g., ibid.), but, as demonstrated previously, a close reading of those cases makes it clear that the courts were convinced that the “ordinary relations between directors and shareholders” was enough to create the fiduciary duty.

58 Ibid. at 433.
rule, or as an equitable exception to the majority rule, the special facts doctrine was adopted by a number of jurisdictions in the early twentieth century.

The minority and majority rules reached their final pre-Securities Exchange Act expressions in the cases *Hotchkiss v. Fischer*[^59] and *Goodwin v. Agassiz*.[^60] In *Hotchkiss*, the Supreme Court of Kansas embraced perhaps the most extreme version of the minority rule. The widowed owner of 2,300 shares of the Elmhurst Investment Company was in need of cash and approached the president and director of the company to inquire as to the firm’s financial fitness and the likelihood a dividend would be announced at the upcoming shareholders meeting. The director honestly stated that he could not be certain a dividend would be announced, but he supplied and explained all material facts regarding the financial condition of the company to the shareholder. He answered all of her questions truthfully, but he refused to respond to her inquiry as to the true “worth” of her shares. The director explained to her, “I have told you the conditions of the affairs of the company, and I will be glad to furnish you any further information,” but as to the worth of the stock, that “is a matter you have to determine yourself.”[^61] The shareholder was concerned that, if no dividend was announced at the upcoming meeting, her shares would be worth less, so she decided to offer her shares for sale in advance. There was evidence that the market price for the shares at the time was between $1.00 and $1.15 a share. The director offered to buy her shares at $1.25 a share, and she accepted. The shares later proved to be worth three times this amount, and the shareholder sought to rescind the trade as induced by fraud.

The director’s conduct appears to have been above reproach in many respects. He supplied all material information requested and explained it truthfully and accurately. He only refused to offer any prediction as to whether a dividend would be announced and his opinion as to the true value of the shares. The widow, by contrast, appeared to be fishing for material nonpublic information so as to determine whether she should sell her shares before or after the upcoming meeting, and at what price. Despite this, the court held that the director violated his fiduciary duty to the shareholder. It was not enough that the director provided the appropriate statements and explained them on their face because “[w]ithout being analyzed and interpreted, the statement[s] would contain little information respecting financial condition to a shareholder who did not acknowledge competency to interpret [them].”[^62] The court went on, “[w]hen interpreted, the statement would reflect book value of shares. Book value might have little relation to market value, and might have still less relation to actual value.”[^63] The director’s failure to engage his

[^61]: *Hotchkiss*, 136 Kan. at 532.
[^62]: Ibid. at 534.
[^63]: Ibid.
institutional knowledge and expertise to interpret these facts for the shareholder prior to purchasing her shares violated the relation of “scrupulous trust and confidence” between director and shareholder.

Though the fiduciary model reflected in the minority rule was clearly gaining momentum in the first decades of the twentieth century, the majority of jurisdictions still rejected it. Moreover, looking ahead to Chapter 2 of this book, it would be a stretch to infer that even these early minority rule cases provided strong common law precedent for the expansive insider trading enforcement regime to come. Note some important asymmetries: first, the insiders in every one of these early cases held positions at the highest levels of corporate governance (presidents and directors); there is not the slightest hint that lower-level insiders would be recognized as standing in the relation of fiduciary to shareholders as they are today. Second, all of these early cases were brought as civil contract disputes, seeking nothing more than rescission of the trade or restitution of the benefits of the trade. None of these cases hint at the possibility of civil fines or criminal liability. Third, all of the early cases addressed thus far dealt with face-to-face transactions; none of them found a fiduciary duty for insiders to disclose material nonpublic information when trading over impersonal stock exchanges.

The problem of insider trading over impersonal exchanges was finally addressed just one year prior to the promulgation of the Securities Exchange Act of 1934 in Goodwin. Upon reading a newspaper article stating that the Cliff Mining Company had closed exploratory operations on a particular property, Goodwin sold 700 shares of the company’s stock through brokers on the Boston Stock Exchange. It turns out that those 700 shares were purchased by two Cliff Mining Company directors who had been recently convinced by a geologist’s theory that the property might be profitably mined after all. The geologist’s new theory was not made public in order to allow for the purchase of mining rights on adjacent properties. The directors were not responsible for the newspaper article read by Goodwin, but he nevertheless sought to rescind the trade, claiming that he never would have sold his shares if he had known of the new theory and that the directors had a fiduciary duty to disclose their material nonpublic information prior to purchasing his shares.

The Supreme Judicial Court of Massachusetts forcefully rejected the claim that the directors stand in some fiduciary relation to shareholders when trading the company’s shares. In doing so, the court reaffirmed prior Massachusetts precedent and noted that it was “supported by an imposing weight of authority in other jurisdictions.”64 The court recognized that a “rule holding that directors are trustees for individual stockholders with respect to their stock” exists, but “in comparatively few states.”65 Though the court embraced the rule that the director-shareholder

64 Goodwin, 283 Mass. at 362.
65 Ibid.
relationship alone creates no fiduciary duties in stock transactions, it followed Strong in appreciating that special facts or circumstances may nevertheless impose an equitable duty to disclose on the part of directors in face-to-face transactions. The court held that such special facts cannot, however, arise over impersonal exchanges. The court explained that

> [a]n honest director would be in a difficult situation if he could neither buy nor sell on the stock exchange shares of stock in his corporation without first seeking out the other actual ultimate party to the transaction and disclosing to him everything which a court or jury might later find that he then knew affecting the real or speculative value of such shares.66

The court pointed out that such a rule would be highly impractical, and that the “[f]iduciary obligations of directors ought not to be made so onerous that men of experience and ability will be deterred from accepting such office.”67 And, finally, echoing the still-lingering influence of legal formalism and the principle of caveat emptor, the Goodwin court emphasized that

> [l]aw in its sanctions is not coextensive with morality. It cannot undertake to put all parties to every contract on an equality as to knowledge, experience, skill and shrewdness. It cannot undertake to relieve against hard bargains made between competent parties without fraud.68

As one commentator later put it, the Supreme Judicial Court of Massachusetts seemed comfortable concluding that the directors had merely “exercised a perk of being an insider”69 in buying Cliff Mining stock over the exchange.

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In sum, leading up to the promulgation of the Securities Exchange Act of 1934, which to this day provides the principal statutory support for the federal insider trading enforcement regime in the United States, the state common law of insider trading was split, with the majority of jurisdictions finding no fiduciary relation between senior management and individual shareholders in stock trading. Special facts might give rise to an equitable duty to disclose for senior management in face-to-face transactions, but not over anonymous exchanges. A minority of courts were prepared to recognize a fiduciary duty for senior management to disclose material nonpublic information to individual shareholders prior to any face-to-face transaction in the firm’s shares, but it remained unclear whether even these jurisdictions

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66 Ibid.
67 Ibid., 362–63.
68 Ibid., 363.
would extend this duty to trading over anonymous exchanges. No jurisdiction had recognized a duty to disclose for low-level insiders trading on the company’s material nonpublic information. Finally, the early recorded cases addressed the problem of insider trading as a matter of contract law or restitution; no jurisdiction imposed civil fines or criminal liability for insider trading prior to the implementation of the federal statutory regime.