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Stocks--Texas Gulf Sulphur: Rule 10b-5 Insider Liability Expanded?

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action against the manufacturer if he is liable for breach of warranty to his buyer. Since the warranties are intended to cover only defective goods, recovery for breach of implied warranty should be limited to the extent that the goods are defective and to any resulting harm. Recovery should not be predicated on an implied warranty theory where the seller’s negligent rendering of the services results in injury; this would properly be an action based on negligence.

John Campbell Palmer IV

Stocks—Texas Gulf Sulphur:
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On November 8, 1963, the defendant corporation commenced core drilling on a tract of Canadian land. When a chemical assay revealed a remarkably high mineral content, the president of the corporation ordered the results of their initial drilling kept confidential, even as to other officers, directors and employees of the corporation. During the following four months, certain officers and individuals said to have received tips from these officers purchased corporation stocks or calls thereon. On the morning of April 11, 1964, the president of the corporation read unauthorized newspaper reports of the drilling which seemed to infer a rich strike. At 3:00 p.m. on Sunday, April 12, the corporation issued a press release which purported to give the drilling results as of the release date. Designed to quell rumors of a major ore strike, the release was published in newspapers the following day. Yet, while the drilling continued, the corporation prepared for the ultimate disclosure of the discovery. A corporation statement relative to

carefully performed services leaves an inexplicable chasm between these two concepts. 


So remarkably high was the copper, zinc, and silver content, that none of five Texas Gulf Sulphur experts had ever seen or heard of a comparable initial exploratory drill hole in a base metal deposit. SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 843 (2d Cir. 1968).

“‘A ‘call’ is a negotiable option contract by which the bearer has the right to buy from the writer of the contract a certain number of shares of a particular stock at a fixed price on or before a certain agreed-upon date.”

Id. at 841 n.3.
the extent of the discovery was given to the Canadian news media to be released over the airways at 11:00 p.m. on April 15; however, the news media failed to release it until 9:40 a.m. on April 16. At a press conference called by the corporation on April 16, an official detailed statement was read to representatives of American financial media from 10:00 a.m. to 10:15 a.m. Between the time the first press release was issued on April 12 and the dissemination of the corporation's official announcement on the morning of April 16, three defendants, A, B and C, engaged in market activity. A purchased stock on April 15. B ordered shares on April 15 and at 8:30 a.m. on April 16; both orders were executed on April 16 when the exchange opened. C left the corporation press conference, called his broker son-in-law shortly before 10:20 a.m. on April 16 and ordered shares for family trust accounts of which C was a trustee but not a beneficiary. The son-in-law executed this order, and he and his customers purchased additional shares. In April 1965, the Securities and Exchange Commission (SEC) commenced its action against the corporation, corporate individuals and tippees involved in stock purchases between November 8, 1963, and April 16, 1964. The SEC alleged that the defendants made illegal use of inside information by dealing in the corporation securities before the information had been disclosed to the investing public. Specifically charged were violations of the provisions of section 10(b) of the Securities Exchange Act of 1934, and its rule 10b-5. The

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3 Tippees are outsiders who trade in securities on the basis of non-public information which has been leaked to them by inside tippers.

4 "There are two broad categories of information about the securities market. The first is, in essence, financial sophistication about the market generally or about an industry or firm gleaned from information available to all. This by definition is not inside information. The second category is knowledge of specific events or the probability of future events gained as a result of an individual's access to corporate information not available to the general public. This is inside information." Jennings, Insider Trading In Corporate Securities: A Survey of Hazards and Disclosure Obligations Under Rule 10b-5, 62 Nw. U.L. Rev. 809, 810 (1968).

5 The statute reads as follows:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange— ... (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. Securities Exchange Act of 1934, 48 Stat. 891 (1934), 15 U.S.C. § 78j(b) (1964). The rule provides:

It shall be unlawful for any person, directly or indirectly, by the
district court found that two of the defendants, A and B, were guilty of illegal insider activity, but otherwise the Commission's complaint was ordered dismissed. Appeals were taken by the SEC and A and B. Held, affirmed with respect to A and B, but reversed and remanded with respect to the corporation and remaining individual defendants. The information acquired by the corporation from the first chemical assay made in November constituted "material" inside information and until such material information was properly disclosed to the public, all insiders were prohibited from dealing in the corporation's securities. SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968)."7

Before the enactment of federal regulations in the field of securities trading, only a minority of American jurisdictions imposed an affirmative fiduciary duty on corporate management to disclose material information when dealing with a stockholder.8 The majority of jurisdictions took the view that the corporate official's only fiduciary duty was to the corporation and not to the individual.9 A

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 statement made, in light of the circumstances in 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 (1968).

"The basic test of materiality is whether a reasonable man would attach importance . . . in determining his choice of action in the transaction in question." List v. Fashion Park, Inc., 340 F.2d 457, 462 (2d Cir. 1965), cert. denied, 382 U.S. 811 (1965), rehearing denied, 382 U.S. 933 (1965). In the majority opinion of Texas Gulf Sulphur, Judge Waterman concludes that material facts include "not only information disclosing the earnings and distributions of a company, but also those facts which affect the probable future of the company and those which may affect the desire of investors to buy, sell, or hold the company's securities." SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 849 (2d Cir. 1968). For a listing of cases by circuit supporting the proposition that a corporate insider's nondisclosure is prohibited by section 10(b) and rule 10b-5 only if material information is withheld, see Annot., 22 A.L.R.3d 798 (1968).

7 Although the Texas Gulf Sulphur decision contains many issues worthy of extensive treatment, this comment is limited to a discussion of the "insider" issue, being specifically concerned with the inclusive aspects of the insider doctrine. Because the courts are currently expanding insider liability under rule 10b-5, emphasis is placed upon both the recent judicial extension of insider activity and the practical problems posed for business.

8 E.g., Blazer v. Black, 196 F.2d 139 (10th Cir. 1952); Oliver v. Oliver, 118 Ga. 162, 45 S.E. 232 (1903); Hotchkiss v. Fisher, 126 Kan. 530, 16 P.2d 531 (1932); Stewart v. Harris, 69 Kan. 498, 77 P. 277 (1904).

variation of the majority view existed which required a duty to disclose information only when "special facts" existed. Therefore, in many situations, an injured stockholder had to resort to the common law action of deceit in order to recover damages, or he had to seek recission of the sale in equity.

The stock market crash in 1929 emphasized the need for stronger legislation, "to curb the abuses in securities trading." This expansive federal legislation was passed in 1933 and 1934. In implementing this legislation the federal government relied primarily on section 17(a) of the 1933 act and section 15(c)(1) of the 1934 act. Loopholes existed, however, since 17(a) was applicable only to prevent fraud arising out of the "offer or sale of securities," and rule 15(c)(1)—2 promulgated under section 15(c)(1), dealt with the control of the purchase and sale of securities, but was limited to over-the-counter transactions by brokers and dealers. No statute encompassed fraud in the purchase of securities by individuals, other than brokers and dealers in over-the-counter transactions. As a result, in 1942 the SEC enacted rule 10b-5, a broad provision designed to strengthen the weaknesses of the earlier Commission acts.

At common law, insiders generally included corporate officers, directors, and controlling shareholders, but rule 10b-5 when read

N.E. 659 (1933); Shaw v. Cole Mfg. Co., 132 Tenn. 210, 177 S.W. 479 (1915); Annot., 84 A.L.R. 615 (1933).
11 The difficulties in maintaining these actions are discussed in Note, The Prospects For Rule X-10B-5: An Emerging Remedy For Defrauded Investors, 59 YALE L.J. 1120, 1123 (1950).
17 17 C.F.R. § 240.10b-5 (1968).
18 Rule 10b-5 was intended to close the "loophole in the protections against fraud administered by the Commission by prohibiting individuals or companies from buying securities if they engage in fraud in their purchase." SEC Securities Act Release No. 3230, May 21, 1942. Birnbaum v. Newport Steel Corp., 193 F.2d 461 (2d Cir. 1952). For a discussion of the broad language of Rule 10b-5, see Note, The Prospects For Rule X-10B-5: An Emerging Remedy For Defrauded Investors, 59 YALE L.J. 1120, 1123 (1950).
19 See, James Blackstone Memorial Library Ass'n. v. Gulf, M. and O,
literally covers "any person." In a continuing effort to protect the investing public, the SEC has sought, and the courts have granted, an expansive application of rule 10b-5. A case of importance in this expansion is In re Cady, Roberts and Co., where it was made evident that the duty of disclosure is imposed upon persons other than traditional insiders. 

Cady, Roberts was a broker-dealer case holding that rule 10b-5 standards of conduct imposed on a registered broker-dealer do not permit him to "jump the gun" for the benefit of himself, his partner or discretionary accounts. Cady, Roberts sounded the warning in clear terms to the business world: any person in a special relationship with a company and privy to its internal affairs is under a firm correlative duty not to exploit the uninformed investor.

The action against Texas Gulf Sulphur presented the SEC with an opportunity to test its Cady, Roberts doctrine in the courts. It was apparent that the SEC was also attempting to extend the scope of insiders to include lower echelon corporate employees and family members. The district court, however, based the Texas Gulf Sulphur decision on the materiality of the information and did not consider whether or not all of the defendants were insiders within the contemplation of rule 10b-5. The court of appeals, in reversing the lower court's decision on materiality, held that lower echelon employees were insiders and had violated section 10(b)


As to whether an individual is considered an insider for disclosure purposes, the Cady, Roberts court stated:

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." Id. at 912 (citations omitted).

Whitney, Section 10b-5: [sic] From Cady, Roberts To Texas Gulf: Matters Of Disclosure, 21 Bus. Law. 193, 199 (1965). In Cady, Roberts a brokerage firm had a representative who was also on the board of directors of a corporation. Upon learning that the corporation's dividend was to be reduced, the director informed the brokerage firm of this fact before a public announcement was made. On the basis of this information, the firm sold the corporation stock of its customers.


In response to the concerns and anxieties of businessmen caused by the SEC charges against Texas Gulf Sulphur, the New York Stock Exchange
and rule 10b-5. While the language of the appellate court in *Texas Gulf Sulphur* is broad enough to include family members as insiders, the court instead treated them as agents of their defendant husbands. This language could include "tippees" as well. The SEC, however, was content to impose liability on the tipper alone. It has been suggested that this approach was taken for the purpose of discouraging tipping. Another theory is that the SEC, in its refusal to prosecute the tippees, read "any person" in a restrictive manner which excludes tippees. Even SEC lawyers have expressed doubt that liability can be imposed on tippees. However, one recent case, *Ross v. Licht*, treated tippees as being subject to the same

published in December of 1966 a pamphlet proposing guidelines as to when corporate officials could buy and sell securities without incurring rule 10b-5 liability. Note, *Insider Liabilities Examined*, 18 S. L. Rev. 808, 818 (1967), citing N.Y. Stock Exch., *The Corporate Director and The Investing Public*, (1963), 2 CCH Fed. Sec. L. Rep. § 26,100 (1966). The same concern and anxiety exist today, as is evidenced by the fact that one thousand businessmen recently paid $100 apiece to attend an informative discussion of the *Texas Gulf Sulphur* case and its ramifications. Robards, *To Disclose or Not: The Law Seeks An Answer*, N.Y. Times, Oct. 13, 1968, § 6 (Business and Finance), p. 1. Furthermore, directors' liability insurance rates have increased by as much as 400% since July, 1968. *Time*, Oct. 18, 1968, at 100. These employees included the corporation's chief geologist, a field geologist, and a geophysicist. Concerning acquisition of the information, "it would seem that the information need only be obtained 'in the course' of the insider's employment. Accordingly, the employment rationale would include a secretary who learns of material information while taking dictation or a janitor who finds it in a wastepaper basket." Jennings, *Insider Trading In Corporate Securities: A Survey of Hazards and Disclosure Obligations Under Rule 10b-5*, 62 Nw. U.L. Rev. 809, 827 n.82 (1968).

Alas, 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." SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 848 (2d Cir. 1968). Although there has been no judicial extension of the "any person" blanket to members of the insider's family, it has been urged that failure to impose restrictions upon families would deprive rule 10b-5 of its strength. Note, *SEC v. Texas Gulf Sulphur Co.: The Inside and Outside of Rule 10b-5*, 46 B.U.L. Rev. 205, 213 (1966), citing III L. Loss, *Securities Regulation*, 1450, (2d. ed. 1961). In the *Texas Gulf Sulphur* case, the issue of whether to extend rule 10b-5 to families or not is clearly presented; however, the court avoids the issue, treating the wives' purchases as made in the names of their husbands.


263 F. Supp. 395 (S.D.N.Y. 1967). In the Ross case, three dentists,
duty of disclosure as are corporate insiders. The holding in Ross, taken in conjunction with the Cady, Roberts doctrine, the broad holding in Texas Gulf Sulphur, and its accompanying dicta, indicate that the outside boundaries of rule 10b-5 might also encompass tippees. Such a future result would be consistent with the court's current expansion of the definition of insiders.

Corporate executives are concerned not only with intracorporate problems as presented by Texas Gulf Sulphur, but also with the intercorporate problems raised by subsequent SEC actions. In August 1968, Glen Alden Corp. agreed to forgo the widespread practice of inviting single, large investors to briefing sessions on prospects and profits. On August 26, 1968, the SEC instituted an administrative proceeding against Merrill, Lynch, Pierce, Fenner and Smith, Inc. The nation's largest brokerage firm was charged with giving inside information to investment companies while withholding such information from other clients. Also charged were the tippees, some fourteen investment companies. These latest SEC actions seem to be an expansion of rule 10b-5 to include a corporation's or individual's business associates as insiders.

who had no corporate connections but rather were friends of directors, were held liable for nondisclosure in securities transactions. The court stated that the three probably could be termed insiders; if not, they definitely were tippees and in any event would be liable for aiding and abetting a rule 10b-5 violation. For liability to exist on the part of tippees, it must be proven that the tippee was aware that his tip had been wrongfully revealed by an insider. The tippee must be a knowing confederate. Accord, In re Calton Crescent, 173 F.2d 944 (2d Cir. 1949), aff'd sub nom., Manufacturers Trust Co. v. Becker, 338 U.S. 304 (1949).

As Darke's tippees are not defendants in this action, we need not decide whether, if they acted with actual or constructive knowledge that the material information was undisclosed, their conduct is as equally violative of the Rule as the conduct of their insider source, though we note that it certainly could be equally reprehensible. SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 852 (2d Cir. 1968).

The SEC alleged that Glen Alden Corporation had given important information to several mutual funds while withholding it from the public. Although Glen Alden admitted nothing, a permanent injunction was accepted. Newsweek, Sept. 9, 1968, at 75.

In June 1966, Merrill, Lynch, as manager of an underwriting syndicate, allegedly discovered that Douglas Aircraft was entering into a period of financial difficulty. This information was passed on to fourteen large, favored investing institutions, but was withheld from the public and the rest of Merrill, Lynch's customers. As a result, the large institutions were able to sell most of their Douglas stock. Id. at 75.

In order to insure the existence of a fair securities market, the SEC now appears to be seeking authority to apply rule 10b-5 insider liability to prohibit the use of inside information by investors of any status. As a result, the determination of which individuals fall within the class of insiders should create very few problems. Instead, problems arise because the instances when disclosure is required have been multiplied, thus subjecting a larger group to the array of other problems left in the wake of the Texas Gulf Sulphur decision.  

Within the economy's complex interdependent network, it is not uncommon to find individual businessmen serving both as corporate officers and as investment representatives. Under recent SEC proceedings, conflicts of interest and other problems arise. Executives or persons with access to inside information may have to forgo trading—whether it leads to loss or gain. Increased liability upon executives may lead to less efficient corporate management. Should corporations disclose everything or institute a complete blackout on information? How long should insiders allow the public to absorb disclosed information before dealing in the corporation's securities? Will limitations be placed on private suits against insiders?

At the present time there are no absolute solutions to these problems, and it is quite likely that the final word will come from the United States Supreme Court. As an alternative, the SEC or Congress may decide that the "cure is worse than the disease" and promulgate definite guidelines. For the present, however, the busi-

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39 Questions about the effects of the Texas Gulf Sulphur case abound. Executives and lawyers bemoan the "loose" language of the decision. What is "material" information? What is the proper method of disclosure of inside information? Just when must full public disclosure be made? How long after disclosure must an insider wait before trading in the corporation's securities? These problems affect all insiders, whether they be of the traditional corporate breed or of the recently spawned "any person" class.

40 The appellate court was unimpressed with this argument. SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 851 (2d Cir. 1968).

41 The SEC is considering barring all corporate insiders from trading in the corporation's securities within twenty-four hours of any official announcement. U.S. NEWS AND WORLD REPORT, Sept. 9, 1968, at 104.

42 In 1966 there were forty-nine private actions stemming from the Texas Gulf Sulphur decision. These plaintiffs sought $2,800,000 in compensatory damages and over $77,000,000 in punitive damages. SEC v. Texas Gulf Sulphur Co., 258 F. Supp. 262, 267 n.1 (S.D.N.Y. 1966).

43 For a study of recommended legislation in Canada and Great Britain, see Whitney, Section 10b-5: (sic) From Cady, Roberts To Texas Gulf: Matters of Disclosure, 21 BUS. LAW. 193, 205 (1965).
ness world must adapt to the *Texas Gulf Sulphur* restrictions and re-

requirements.

*Stephen Lewis Atkinson*

*Robert Mason Steptoe, Jr.*

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**Torts—Landowner’s Standard of Care Based on Ordinary Principles of Negligence**

Plaintiff, a social guest of defendant, suffered injury when a cracked porcelain handle of a bathroom water faucet broke in his hand. Defendant had been aware of the defective condition of the handle for several weeks but failed to warn the plaintiff. There was no showing that the faucet handle crack was obvious. Defendant’s motion for a summary judgment was sustained, and plaintiff appealed. *Held*, reversed. The proper test of liability to be applied to the possessor of land is whether, in the management of his property, he has acted as a reasonable man in view of the probability of injuries to others. The plaintiff’s status as a trespasser, licensee, or invitee is not determinative of the occupier’s liability. The two dissenting justices contended that liability based on the historical visitor distinctions provided stability and predictability to this area of the law, and supplied a workable approach to the problems involved. *Rowland v. Christian*, 70 Cal. Rptr. 97, 443 P.2d 561 (1968).

This case is significant since it abolishes in California the old tests for standard of care owed to a trespasser, a licensee, and an invitee, and establishes a single new test based on ordinary principles of negligence. Analysis of the decision requires consideration of three aspects of the problem raised by it: the history of the visitor distinctions, the value of the visitor distinctions today and the validity of the new California test.

**I. HISTORY OF THE VISITOR DISTINCTIONS**

The privileged position of the landowner\(^1\) was taken for granted when the distinctions in the liability of the occupier were developed in the middle of the nineteenth century. Several factors account for this treatment. At that time the principle that a man should be

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\(^1\) The term “landowner” is used interchangeably in this comment with “occupier,” “occupant,” and “possessor.” These terms all refer to that person who is in possession and control of the premises.