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Corporation Law—Officers—Profits Resulting from the use of Inside Information Inure to the Corporation Although No Harm to the Corporation Was Alleged

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RECENT CASES

CORPORATION LAW—OFFICERS—PROFITS RESULTING FROM THE USE OF INSIDE INFORMATION INURE TO THE CORPORATION ALTHOUGH NO HARM TO THE CORPORATION WAS ALLEGED

Management Assistance, Inc. (MAI), a New York corporation, purchases used IBM machines and leases the equipment to other companies. MAI assumes under its leases an obligation to maintain and service the equipment. In order to meet this obligation, MAI enters into servicing agreements with the International Business Machine Corporation (IBM). Sometime prior to August 1966 IBM Corp. notified MAI that an increase in service charges would become effective on August 1. This increase had a severe effect on MAI's earnings—the first month in which the increase went into effect MAI's earnings were off 400%.[1] The increase in IBM's service charge and its impact upon MAI's August earnings was not made public until October 18, 1966 when it was printed in the Wall Street Journal. However, before such publication it became apparent to the defendants, solely by virtue of their position as MAI's directors, that earnings would be sharply reduced.[2] In September the defendants sold 56,500 shares of MAI common stock which was at that time trading at a high of $28. After the public announcement of the decline in earnings the stock traded at a low of $11 per share. Thus, by selling prior to the drop in price the defendants realized profits of approximately $960,500. The plaintiff brought a stockholder's derivative action[3] asking defendants to account to MAI for the profits. Defendants moved for dismissal on the ground that plaintiff's motion failed to state a cause of action. The Supreme Court, New York County, in granting the motion, held no cause of action was stated because the alleged "breach of duty was not in relation to the conduct of the business of the corporation."[4] On appeal, the Appellate Division *reversed*, one judge dissenting without opinion. *Held*, the profits realized from the traded stock should inure to the corporation since such profits resulted from the use of "inside information" which belonged not to the defendants but to the corporate entity. *Diamond* v. *Oreamund*, 29 A.D.2d 285, 287 N.Y.S.2d 300 (1st Dep't 1968).

Under the common law of deceit, in an arm's length transaction where no fiduciary relation exists, a person is liable only for misrepresentation of a material fact.[5] Mere nondisclosure does not constitute a breach of duty.[6] In order to

1. MAI earned $66,233 in August, 1966 as compared with $262,263 in July, 1966. (Wall Street Journal, Oct. 19, 1966, at 17, col. 4).
2. Diamond v. Oreamuno, 29 A.D.2d 285, 286, 287 N.Y.S.2d 300, 302 (1st Dep't 1968) [hereinafter cited as instant case].
3. It should be noted that plaintiff was not the purchaser of the stock nor was it alleged that the corporation purchased any stock.
4. Plaintiff-Appellant's brief R 10. Judge Gold's opinion was not reported.
5. A material fact, relative to a stock transaction, is defined as a fact which would, if generally known, ultimately cause a significant change in market price. In addition, " . . . the

mitigate the harshness of this rule, the courts have developed a number of exceptions. If a person makes any disclosure, he has a duty to say enough so that his words will not be misleading.[7] Also, there is a duty to disclose material facts if a fiduciary relationship can be found. However, the majority of courts have held that though an officer or director occupies a fiduciary relation to the corporation they owe no fiduciary duty to an individual stockholder. The courts adhering to this so-called "majority" rule[8] reason that officers and directors are not strict trustees since as officers and directors they do not take legal title to the corporate property. They are considered fiduciaries (quasi-trustees) to the corporation, however, because they are placed in a position of trust to manage the corporation's business affairs.[9] But the majority of courts hold there is no logical reason to extend the directors' corporate fiduciary duty to the individual stockholders.[10] The "majority" rule would appear to be adopted from the law of trusts. The law states that fiduciary duty only attaches when the trustee deals with the corpus of his trust, corporate property and business opportunities. But the officer or director is not dealing with the corpus of his trust when he sells his own shares or purchases shares in the corporation.[11] Moreover, the mere relation of officer or director to stockholder is not sufficient to raise an implied trust analogous to that of financial advisor and client.[12] Nor is a business relation between two parties itself sufficient to create a confidential relation between the parties and thereby become a basis for imposing a constructive trust.[13] The mere fact of superior knowledge on the part of the director or officer is held not to create a fiduciary duty[14] since the shareholder is free to ask for a summary of

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news must be capable of physical exploitation in the market by some individual before the matter becomes public knowledge." H. Manne, *Insider Trading and the Stock Market* 55 (1966).

6. W. Prosser, Torts § 101 and cases cited therein. (3d ed. 1964).

7. *Id.* at n.28.

8. The "majority" rule has been adopted by twenty states. Cases are cited in Chenery Corp. v. S.E.C., 128 F.2d 303, 307 (D.C. Cir. 1942), *remanded on other grounds*, 318 U.S. 80 (1943).

9. 3 Fletcher, Cyclopedia Corporations § 838 and cases cited therein (1965 rev ed.).

10. This theory was stated as early as 1847 by the court in Smith v. Hurd, 53 Mass. (12 Met.) 371, 384 (1847):

> There is no legal privity, relation, or immediate connection, between holders of shares . . . in their individual capacity, on the one side, and the directors . . . on the other. The directors are not the . . . trustees of individual stockholders.

11. Chatz v. Midco Oil Corp., 152 F.2d 153, 155 (7th Cir. 1945); Adams v. Mid-West Chevrolet Corp., 198 Okla. 461, 179 P.2d 147, 156 (1947).

12. Goodwin v. Agassiz, 283 Mass. 358, 186 N.E. 659, 660 (1933).

13. In Fisher v. Guaranty Trust Co., 259 App. Div. 176, 182 18 N.Y.S.2d 328, 334 (2d Dep't 1940), *aff'd per curiam*, 285 N.Y. 679, 34 N.E.2d 379 (1941) the court stated that, "No matter what the relationship is or may be termed, it has never been held that the director is accountable for the proceeds of his purchase where the stockholder did not rely on the director in making the sale." *See* 3 Bogert, Trusts and Trustees § 482 (2d ed 1962) at p. 150.

14. The court in Goodwin v. Agassiz stated:

> Fiduciary obligations of directors ought not to be made so onerous that men of experience and ability will be deterred from accepting such office. Law 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

facts on which the insider is basing his sale or purchase. In such a case, the law of fraud requires a complete disclosure by the insider. A half truth under the circumstances would be equivalent to misrepresentation. Thus, under the "majority" rule the individual shareholder deals at arm's length with the corporate director and should not expect him to volunteer information regarding the future value of the corporate stock.

The "special facts" doctrine, first enunciated in *Strong v. Repide*,[15] represents an exception to the "majority" rule. The courts following the "special facts" doctrine[16] impose a limited fiduciary duty on the director in stock transactions with an individual shareholder. In situations where the director gains special knowledge of circumstances which might affect the value of the stock,[17] a fiduciary relationship is created. The director in that instance has a legal obligation to disclose any and all facts affecting the value of the stock. The third rule imposing duties of disclosure on an officer or director has been labeled by the courts as the "minority" rule.[18] This rule carries the degree of the fiduciary

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> cannot undertake to relieve against hard bargains made between competent parties without fraud. (Emphasis added.)

283 Mass. 358, 362-63, 186 N.E. 659, 661 (1933).

The court's statement seems quite surprising in view of the fact that one year later § 16 (b) of the Securities Exchange Act was passed by Congress. The congressional hearings indicate that § 16 (b) was specifically designed to protect "outside" stockholders from "insiders" with advance information. *See* Smolowe v. Delendo Corp., 136 F.2d 231, 236 n.8 (2d Cir. 1943), *cert. denied*, 320 U.S. 751, citing Hearings before Committee on Interstate and Foreign Commerce on H.R. 7852 and H.R. 8720, 73d Cong., 2d Sess. 85 (1934); Rubin and Feldman, *Statutory Inhibitions Upon Unfair Use of Corporate Information by Insiders*, 95 U. Pa. L. Rev. 468 (1947).

But see Leech, *Transactions in Corporate Control*, 104 U. Pa. L. Rev. 725, 746 (1956).

15. 213 U.S. 419 (1909) (In Strong v. Repide a director had purchased 800 shares in the company while he was negotiating a contract which would make the shares worth approximately eight times their sale price. The Supreme Court held that, entirely apart from the question of whether the defendant was bound to act like any other fiduciary, he should "in consideration of all the existing circumstances . . . [have made full disclosure of all] the facts before making the purchase.") *Id.* at 431.

16. New York has adopted the "special facts" rule. *See, e.g.*, Lesnik v. Public Industrials Corporation, 144 F.2d 968 (2d Cir., 1944).

17. In the instant case the knowledge of a decline in corporate earnings would be clasified as "special facts," thereby making the defendant a fiduciary to the purchaser and necessitating an affirmative disclosure of the plight of the corporation. The argument that a person not already a stockholder in the corporation who *buys from a director or officer* of the corporation is not owed a fiduciary obligation was answered by Judge Learned Hand:

> When they [corporate officers] sold shares, it could indeed be argued that they were not dealing with a beneficiary, but with one whom his purchase made a beneficiary. That should not, however, have obscured the fact that *the director or officer assumed a fiduciary relation to the buyer* by the very sale; for it would be a sorry distinction to allow him to use the advantage of his position to induce the buyer into the position of a beneficiary, although he was forbidden to do so, once the buyer had become one.

Gratz v. Claughton, 187 F.2d 46, 49 (1951). (Emphasis added). *See* 3 Loss, *Securities Regulation* 1455 (2d ed. 1961): "It is safe to assume that an outsider *selling* to a person who is not already a stockholder has the same fiduciary obligation as an insider who *buys* from a stockholder."

18. The leading cases cited as authority for the "minority" rule are Oliver v. Oliver, 118 Ga. 632, 45 S.E. 232 (1903) (the president of the company purchased shares at $110 failing to disclose an assured sale of the company plant which made the shares worth $185), and Stewart v. Harris, 69 Kan. 498, 77 P. 277 (1904) (The defendant insider stated to the

relationship between director and shareholder one step further in establishing a fiduciary obligation. The director or officer cannot enter a stock transaction without first fully disclosing any material fact he knows about the corporation's activities. Under the "minority" rule the courts have held the officers and directors to be fiduciaries of each individual stockholder.[19] The courts adhering to the "minority" rule reason that when officers or directors use corporate inside information to trade in the stock of the corporation, they are using a corporate asset which is the property of the corporation.[20] Therefore, an officer or director should not be permitted to use inside information for his personal profit. From this basic premise, the court in *Diamond* held that the fiduciary duty of the defendant directors[21] bars their personal gain made by the advance use of corporate inside information.[22]

Though prior to *Diamond*, New York courts had carved out an exception to the "majority" rule by adopting the "special facts" doctrine the courts had restricted payment of the insider's profits to the individual shareholder.[23] However, the question that arises, as in the principal case, is should the insider account to the corporation? Basic trust law would put the rights of recovery in the corporation the theory being that since the insider used a corporate asset, corporate inside information, for his personal gain he thereby violated his fiduciary duty to the corporation. Yet the courts have held otherwise. Directors and officers may deal in the stock of their corporation since the corporate stock is held to be personal property[24] and is not within the scope of the director's fiduciary duties to the corporation.[25] This rule is based on the theory that a corporation has no interest in its outstanding shares. The shares are not assets of the corporation and are, therefore, not part of the corpus of the director's trust. However, the courts have announced certain exceptions.

New York courts have found a sufficient cause of action in a stockholder's derivative action when, as a result of the insider's stock transaction, there was: a

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plaintiff that the firm was in bad condition and pointed out that a large amount of property had been charged off when he knew the property had since become valuable).

19. Mansfield Hardwood Lumber Co. v. Johnson, 263 F.2d 748 (5th Cir. 1959), *cert. denied*, 361 U.S. 885.

20. Ballantine, Corporations 213 (Rev. ed. 1946); Taylor v. Wright, 69 Cal. App. 2d 371, 381, 159 P.2d 980, 984-85 (1945).

21. The court stated, "The information Oreamuno and Gonzalez [defendants] acquired pertained to, and they obtained it in the course of managing, the affairs of MAI, their principal." Instant case at 286, 287 N.Y.S.2d at 302.

22. The lower court's decision, which dismissed plaintiff's allegations for failure to state a cause of action, was reversed by the Appellate Division on the sole theory that the defendants used a corporate asset for their personal gain. The court stated, "We need not in this case concern ourselves with added elements. These fiduciaries . . . are being charged because they converted into money to their own use something belonging not to them but to their corporation—inside information." *Id.* at 288, 287 N.Y.S.2d at 303-304.

23. Lesnik v. Public Industrials Corporation, 144 F.2d 968 (2d Cir., 1944).

24. 11 Fletcher, Cyclopedia Corporations § 5096 (1965 rev. ed.).

25. Kaufman v. Wolfson, 153 F. Supp. 253 (S.D.N.Y. 1957); Hauben v. Morris, 255 A.D. 35, 5 N.Y.S.2d 721 (1st Dep't 1938), *aff'd*, 281 N.Y. 652, 22 N.E.2d 482.

transfer of corporate control;[26] "looting" of the corporation;[27] loss and waste of corporate assets;[28] and diversion of a corporate opportunity.[29] But the common denominator in the above cases is an alleged harm to the corporation. No court in New York has held directors accountable to their corporation for profits made *unless* the corporation sustained some loss or harm by the director's action.[30] Interestingly enough, in a Delaware case *Brophy v. Cities Service Co.*,[31] the court was presented with a similar issue to that posed by *Diamond*. The *Brophy* court specifically ruled that harm to the corporation need not be shown:

> In equity, when the breach of a confidential relation by an employee is relied on and an accounting for any resulting profits is sought, loss to the corporation need not be charged in the complaint.[32]

The court concluded that since the defendant had used confidential information belonging to the corporation the profits made in the stock transaction also belonged to the corporation. The *Brophy* court's reasoning was obviously predicated on the same fiduciary principles which were held acceptable by the court in *Diamond*.

New York common law does not impose upon directors a fiduciary duty which precludes them from selling their stock in the corporation they represent.[33] Accordingly the court in *Diamond* is careful to note:

> These fiduciaries are not being charged because they *sold stock*, or because *transactions in securities* might subvert their proper functioning as executives of MAI or blemish its reputation.[34]

Rather, the court held the directors were being charged because they used a corporate asset *i.e.* corporate inside information, for their personal gain. Furthermore, the fact that the directors' method of conversion, in realizing profits, was

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26. *See, e.g.*, Benson v. Braun, 286 A.D. 1098, 145 N.Y.S.2d 711 (2d Dep't 1955). *See generally*, Jennings, *Trading in Corporate Control*, 44 Calif. L. Rev. 1, 9 (1956).

27. *See, e.g.*, Leibert v. Clapp, 13 N.Y.2d 313, 196 N.E.2d 540 (1963).

28. *See, e.g.*, Gerdes v. Reynolds, 28 N.Y.S.2d 622 (Sup. Ct. 1941).

29. *See, e.g.*, Irving Trust Co. v. Deutsch, 73 F.2d 121 (2d Cir. 1934).

30. *See*, Fontheim v. Walker, 282 App. Div. 373, 122 N.Y.S.2d 642 (1st Dep't 1953), *aff'd* 306 N.Y. 923, 119 N.E.2d 605. *But see* Bailey v. Jacobs, 325 Pa. 187, 194, 189 A. 320, 324 (1937): "If they [directors] make a personal profit through the use of corporate assets, they must account for it to the corporation. It is immaterial that their dealings may not have caused a loss or been harmful to the corporation; *the test of liability is whether they have unjustly gained enrichment*" (Emphasis added). *See generally* Marcus v. Otis, 168 F.2d 649, 654 (2d Cir. 1948), *modified* 169 F.2d 148 (2d Cir. 1948) (The use by a director of corporate funds to buy stock in another corporation was both a conversion and violation of a fiduciary duty allowing corporate recovery of the director's profits; 3 Fletcher, Private Corporations § 898 (1947); Ballantine, Corporations 206 (Rev. ed. 1946).

31. 31 Del. Ch. 241, 70 A.2d 5 (1949) (The board of directors secretly adopted a policy to start buying outstanding shares in the market. The defendant, a confidential secretary to a director, anticipating that such policy would bid up the market price of the shares purchased some of the corporation's outstanding shares for himself).

32. *Id.* at 243, 70 A.2d 5 at 8.

33. Hauben v. Morris, 255 App. Div. 35, 5 N.Y.S.2d 721, (1st Dep't 1938) *aff'd*, 281 N.Y. 652, 22 N.E.2d 482.

34. Instant case at 288, 287 N.Y.S.2d at 303. (Emphasis added).

"transactions in securities is not the legally significant factor."[35] Implicit in the decision of the court is the rationale adopted by a minority of the states.[36] However, the *Diamond* court surprisingly does not find it necessary to support its holding by citing as authority the other jurisdictions that have adopted the "minority" rule. Instead, the court in the instant case rests its rather cursory decision on the principles of agency and trust law, in particular, Section 388 Restatement of Agency 2d:

> Unless otherwise agreed, an agent who makes a profit in connection with transactions conducted by him or upon behalf of his principal, is under a duty to give such profit to the principal.

and Comment (c) therein:

> An agent who acquires confidential information in the course of his employment . . . has a duty to account for any profits made by the use of such information, *although this does not harm the principal.*[37]

The rule adopted by the *Diamond* court would allow, in a stock transaction between a director and an outsider, a third party stockholder to bring an action on behalf of the corporation for an accounting of profits, whether or not a loss was sustained by the corporation. The decision represents a bold departure from the present New York common law in the area of stock transactions by "insiders." The Appellate Division overrules what has apparently been accepted law in the lower courts of New York for some time. For example, in *Leffert v. Marcus*[38] a stockholder's derivative action was brought against the defendant-directors who had sold their stock in the corporation at an advantageous price after using their corporate position to issue misleading statements concerning the corporation's business affairs. The complaint in *Leffert* alleged a breach of fiduciary duty in that the defendants used their corporate position for personal profit rather than for the benefit of the corporation. The *Leffert* court dismissed the complaint ruling that the plaintiff failed to state a cause of action and noted significantly "the absence of an allegation establishing any injury . . . to the corporation."[39] It may be argued, however, that *Leffert* is distinguishable from *Diamond* since the defendants in *Leffert* are being charged with affirmative misrepresentations rather than the use of corporate inside information. But, it would seem that there is little significant difference between a director misusing his position to misrepresent the truth and a director misusing his position by

35. *Id.*
36. *See* Cases cited and text accompanying *supra* note 18.
37. Instant case at 288-89, 287 N.Y.S.2d at 304. (Emphasis added).
38. 12 Misc. 2d 1097, 174 N.Y.S.2d 546 (Sup. Ct. 1958), *reversed on other grounds*, 7 A.D.2d 989, 183 N.Y.S.2d 886 (1st Dep't 1958). *Accord*, Newman v. Baldwin, 13 Misc. 898, 179 N.Y.S.2d 19 (Sup. Ct. 1958) Defendant directors spread false reports concerning corporation in order to create a rise in the market price of stock and then sold at a profit. The court found "[t]he corporation lost nothing by the acts of the defendants . . . and is entitled to no recovery therefor at common law" *Id.* at 902, 179 N.Y.S.2d at 23.
39. *Id.* at 1099, 174 N.Y.S.2d at 548. The appellant, in the instant case alleges a similar point of law in his brief, pp. 8-9.

failing to disclose the truth in connection with a sale of his personal holdings. In both instances, the director misuses his corporate office; in both instances he had to use inside information and then either misrepresent or fail to disclose the truth. Presumably then, given the facts of the *Leffert* case, the *Diamond* court would have reached an opposite result. There is one other New York case in this area that should be noted. In *Perlman v. Feldman*[40] a stockholder's derivative action, based upon a violation of the common law, was upheld by the Second Circuit Court of Appeals. The *Perlman* court sustained the plaintiff's claims on the theory that when Feldman and the other directors sold their controlling stock, they received an unusual profit since control of the corporation carried with it a valuable asset of the corporation, namely, the right to control the corporation's production of steel, then in great demand. *Perlman* held that the directors could not appropriate the value of this corporate asset to themselves. Based on this holding, support may be found for the instant decision on the theory that both cases involved the use of a corporate asset and the lack of an alleged harm to the corporation.

In permitting a shareholder to bring a derivative action against the corporate directors, the *Diamond* court imposes a common law liability closely parelleling that imposed by § 16 (b) of the Securities Exchange Act of 1934.[41] The section requires an insider to forfeit *to the corporation* "short-swing"[42] profits made in corporate stock transactions, regardless of loss to the corporate entity. The wisdom of the court's application of federal statutory principles to the factual context of *Diamond* is brought forth from a discussion of the history and purpose of the Act.

The congressional hearings that led to the statute's enactment are replete with examples showing how insiders exploited for their personal gain "inside information" which came to them as fiduciaries. The Senate Report stated:

> Among the most vicious practices unearthed at the hearings before the subcommittee was the flagrant betrayal of their fiduciary duties by directors and officers of corporations who used the confidential information which came to them in such positions, to aid them in their market activities . . . and enable them to profit by information not available to others.[43]

In particular, § 16 (b) was designed to "fill the gap" in fiduciary law which allowed the insider to make personal profits from using corporate inside information.[44] Indeed, the very practice which § 16 (b) was designated to deter is

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40. 219 F.2d 173 (2d Cir. 1955).
41. 48 Stat. 881, 15 U.S.C. § 78p(b) (1934). One significant purpose of the Act was to eliminate the idea that the use of inside information for personal advantage was a normal emolument of corporate office. *See* H.R. Rep. No. 1383, 73d Cong., 2d Sess. 13-14 (1934); S. Rep. No. 792, 73d Cong., 2d Sess. 9 (1934); 10 SEC Ann. Rep. 50 (1944).
42. Section 16 (b) does not apply to all buying or selling of corporate securities by insiders. It is applicable only when both purchase and sale occur within a six month period.
43. Sen. Rep. No. 1455, 73d Cong., 2d Sess., 55 (1934).
44. Sen. Rep. No. 792, 73d Cong., 2d Sess., 9 (1934).

presented by the facts in *Diamond*. In the present case, the defendants, solely by virtue of their position as directors, learned that corporate earnings would sharply decline. Before this information was known by the other shareholders or the public the defendants sold their stock in the corporation. Thus, a substantial profit was realized by the defendants on the basis of their insiders' knowledge. One New York case has held that § 16 (b) is not penal, but is remedial in that its purpose is to deter "what was reasonably thought to be a widespread abuse of a fiduciary relationship."[45] Moreover, the continuing tendency of the decisions unders federal statutory law have been toward ever wider application of its proscriptions.[46]

Within this context of the Act's purpose the present decision is strikingly significant when looked at as *extending* federal statutory law by reaching violations not covered by § 16 (b). This is demonstrated by the instant case where the defendant's purchase *and* sale not being within § 16 (b)'s mechanistic six month limitation,[47] the plaintiff was precluded from bringing an action under the section.[48] And though the six month limitation would not be a bar to an action under § 10 (b) of the Act, relief in accordance with the section's provisions could only be granted to the purchaser of the defendant's stock.[49] Therefore, the only remedy available to the plaintiff in the present case was under common law fiduciary principles. However New York courts, antecedent to the *Diamond* court's decision, had limited recovery in such instances to the defrauded purchaser of the director's stock. Also, a derivative action for an accounting of the director's profits could not be maintained unless the corporation has sustained some actual harm or loss.[50]

It is submitted that by so limiting the imposition of liability upon directors, the New York courts have provided mere illusory remedies for dealing with fiduciary violations. Generally, when confidential information is used by a director as a basis for his sale or purchase of the corporate stock, the corporation will not suffer any loss. Moreover, why should injury to the corporation be *sine qua non* to the maintenance of a derivative action when a director violates

45. Adler v. Klawans, 267 F.2d 840, 844 (2d Cir. 1959).
46. *See, e.g.*, S. E. C. v. Texas Gulf Sulphur Co., CCH Fed. Sec. L. Rep. ¶ 92, 251 (1968).
47. *See supra* note 42.
48. Another limitation of § 16 (b), though not applicable in the instant case, is that it covers only listed securities. For a summary of proposals to expand the classes of securities covered by § 16 (b), *see* Senate Committee on Banking and Currency, Report on Unlisted Securities, Sen. Rep. No. 700, 85th Cong., 1st Sess. (1957).
49. 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 or any national securities exchange—(a) . . .

> (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.

48 Stat. 891, 15 U.S.C. § 78j (1964).
50. *See* cases cited and text accompanying *supra* notes 26-30.

his fiduciary duty by using a corporate asset for personal gain? The courts have, and correctly so, prevented further attempts by directors from utilizing corporate inside information by divesting the offenders of their profits. However, the courts mistakenly have placed the legal redress of recovering profits in the hands of the defrauded purchaser. This procedural remedy would apparently be ineffective given the nature of todays security industry. The parties to a stock transaction are generally anonymous as a result of the highly mechanized stock exchanges and the purchaser may never realize that the stock transaction was made on the basis of inside information. Accordingly, the director's unjust enrichment never becomes his "just" demise. It would seem the only *effective* and *practical* means to curtail fraudulent insider trading would be to allow the stockholders, who are generally aware of a director's activity, to bring an action and thereby have the director's profits inure to the corporation.[51] Since the two principal aims in protecting the public investor are to prevent possible abuses by corporate insiders from arising, in addition to, making it facile as possible for offenders to be stripped of their profits,[52] the court's decision would apparently, for the immediate future, insure this desirable policy.[53]

NICHOLAS J. SARGENT

NEGLIGENCE—COMPLAINT ALLEGING MOTHER'S MENTAL DISTRESS WITH PHYSICAL MANIFESTATIONS CAUSED BY WITNESSING DEATH OF HER DAUGHTER OCCASIONED BY THE ALLEGED NEGLIGENCE OF DEFENDANT HELD TO STATE A CAUSE OF ACTION EVEN THOUGH MOTHER NOT IN ZONE OF PERIL

While crossing a street, the plaintiff's infant daughter was struck and injured by the defendant, who was allegedly operating his automobile in a negligent manner. Such injuries proximately caused the decedent's death. The plaintiff, the mother of the decedent, who was sitting on the porch of her home, and the sister of the decedent who was standing on the curb near the point of

51. It could be argued that since the profits would be turned over to the corporate treasury the directors who were guilty of making the profits and then deprived of them nevertheless share in the recovery. However, the pro rata share of the benefit apportionable to the defendant's interest would rarely be sufficient to justify a desire to have the total profit annuled. In the instant case defendants owned, after the sale, 14% of the stock outstanding.

52. *See* Comment, *The Prospects for Rule X-10B-5: An Emerging Remedy for Defrauded Investors*, 59 Yale L. J. 1120, 1156 (1950).

53. This policy, which the *Diamond* court adopts, is not beyond criticism since the defendants in the instant case would be exposed to double liability. Presumably, the purchasers of the stock would be successful in a suit alleging the directors had failed to disclose material information. However, such a dilemma could be resolved by giving precedence to the claim of the purchaser; though there are some legal writers who advocate a double recovery on the theory that a wrong was perpetrated against *both* the corporation and purchaser. *See* Comment, *The Prospects for Rule X-10B-5: An Emerging Remedy for Defrauded Investors*, 59 Yale L. J. 1120, 1140-42 (1950). Compare Stevens, Corporations 701-02 (2d ed. 1949).