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Common Law Fiduciary Concepts Extend Liability for Disclosure of Inside Information to Third Parties.

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CASE NOTES

CORPORATIONS—Insider Trading—Common Law Fiduciary Concepts Extend Liability For Disclosure Of Inside Information To Third Parties

Schein v. Chasen, 478 F.2d 817 (2d Cir.), *cert. granted*, — U.S. — (1973).

Melvin Chasen, president of Lum's, Inc., publicly announced that Lum's earnings for fiscal 1970 would be approximately $1.00 to $1.10 per share. A few months later he learned that the earnings would be closer to $0.75 per share. Before making this new information public, Chasen telephoned Benjamin Simon, a stockbroker employed by Lehman Brothers, Inc. in Chicago, and told Simon of the expected drop in earnings. Simon telephoned the information to Eugene Sit, who relayed the information to James Jundt. Sit and Jundt were employees of Investors Diversified Services, Inc. (IDS), and together they managed the portfolios of two mutual funds, IDS New Dimensions Fund, Inc. (Dimensions) and Investors Variable Payment Fund, Inc. (Investors). Relying on this information, Investors and Dimensions sold a total of 83,000 Lum's shares at $17.50 per share. Shortly thereafter, the New York Stock Exchange halted trading in Lum's, and later that day the expected drop in earnings was announced to the public. When trading resumed, Lum's closed at $14.00 per share, $3.50 lower than that realized by Dimensions and Investors on their earlier sale. Jacob Schein and other shareholders of Lum's brought a derivative suit to recover any profits realized on the sale in question from the president of Lum's and from all those to whom he had passed the "inside information." The district court dismissed the suit, holding that the plaintiffs had failed to state a claim upon which relief could be granted.[1] Held—*Reversed and remanded.* Liability for misuse of corporate inside information extends to those third persons, who, though not officers or directors of the injured corporation, are involved with officers or directors in a common enterprise to misuse confidential information for their own enrichment.[2]

1. Gildenhorn v. Lum's, Inc., 335 F. Supp. 329 (S.D.N.Y. 1971).
2. Schein v. Chasen, 478 F.2d 817, 822 (2d Cir.), *cert. granted*, — U.S. — (1973). The United States Supreme Court has granted certiorari solely on a procedural point involving a Florida statute which provides:

> The supreme court of this state may, by rule of court, provide that, when it shall appear to the Supreme Court of the United States, to any circuit court of appeals

Until recently, the task of policing the securities field has been almost exclusively federal. Section 16(b) of the Securities Exchange Act of 1934 proscribes the unfair use of information obtained by a director, officer, or beneficial owner by reason of his relationship to the issuer.[3] Further, the statute allows the shareholders of the injured corporation to bring a derivative suit to recover any profit realized because of a violation of the Act.[4] The manifest Congressional intent of section 16(b) is to "protect the stockholders . . . against a breach of fiduciary duty by corporate insiders,"[5] such as the use of their positions to gain and utilize confidential corporate information to their own advantage in the sale or exchange of that corporation's securities. In addition to 16(b), section 10(b) of the Act renders unlawful the use of manipulative or deceptive practices in connection with the purchase or sale of securities.[6] Rule 10b-5, promulgated pursuant to section 10(b), prohibits the making of any untrue statements of material facts or the failure to make necessary public statements of material facts that would relate to the sale of corporate securities.[7] The rule is obviously a rather broad and open ended prohibition relating to the sales of securities with liability extending to a yet to be determined group of possible defendants.[8] In applying this new cause of action, the Court of Appeals for the

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> of the United States, or to the Court of Appeals of the District of Columbia, that there are involved in any proceeding before it questions or propositions of the laws of this state, which are determinative of the said cause, and there are no clear controlling precedents in the decisions of the supreme court of this state, such federal appellate court may certify such questions or propositions of the laws of this state to the supreme court of this state for instructions concerning such questions or propositions of state law, which certificate the supreme court of this state, by written opinion, may answer.

FLA. STAT. ANN. § 25.031 (1961). Defendants Simon (Simon v. Schein, *cert. granted*, 42 U.S.L.W. 3333 (U.S. Dec. 4, 1973) (No. 440)) and Lehman Brothers (Lehman Bros. v. Schein, *cert. granted*, 42 U.S.L.W. 3333 (U.S. Dec. 4, 1973) (No. 439)) contend that the Court of Appeals for the Second Circuit should have utilized the certification statute.

3. 15 U.S.C. § 78p(b) (1970).

4. *Id.* Authority for a shareholder derivative suit is found in that portion of the statute which reads, "Suit to recover such profit may be instituted at law or in equity . . . by the issuer, or by the owner of any security of the issuer in the name and in behalf of the issuer . . . ."

5. Birnbaum v. Newport Steel, 193 F.2d 461, 464 (2d Cir.), *cert. denied*, 343 U.S. 956 (1952). For an analysis of *Birnbaum*, see Whitaker, *The Birnbaum Doctrine: An Assessment*, 23 ALA. L. REV. 543 (1971).

6. 15 U.S.C. § 78j (1970). The statute reads in its relevant part:

> It shall be unlawful for any person . . .
> (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 . . . .

7. 17 C.F.R. 240.10b-5 (1972). The statute provides:

> It shall be unlawful for any person . . .
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading . . . .

8. One apparent limitation is that one who *loses* money on an inside tip has no remedy under the Securities Exchange Act. In Kuehnert v. Texstar Corp., 286 F. Supp.

Second Circuit in *SEC v. Texas Gulf Sulphur*[9] held, *inter alia*, that an insider may not make use of material inside information knowing it is unavailable to the investing public, and must refrain from trading in the corporation's stock until the information has been made public.[10]

In addition to those persons deemed insiders by statute (directors, officers, and beneficial shareholders),[11] hereinafter referred to as "pure" insiders, the federal courts have not hesitated to extend the reach of the securities statutes to those persons who receive information from pure insiders, or "tippees."[12] In the *Matter of Cady, Roberts & Co.*[13] the Securities and Exchange Commission ruled that the insider obligation is founded upon two elements: (1) the existence of a relationship providing access, even indirectly, to confidential inside information; and (2) the inherent unfairness of the position such an insider has over one who has no such knowledge.[14]

In *Texas Gulf Sulphur*, after the Court of Appeals for the Second Circuit reversed and remanded, the corporate insider was found to be accountable for the profits of his tippee.[15] Upon the second appeal, the court acknowledged the additional hardship on the insider, however, it felt the judgment was a proper exercise of the court's equity powers, and would serve as a deterrent to others who might try to escape liability by the use of a relative, friend, or business associate in transacting their purchases or sales.[16]

Tippees themselves are not immune from liability for profits gained when such profits can be attributed to their having received an unlawful disclosure of inside information. In *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*[17] the court stated:

[T]his Court finds that the selling defendants, or "tippees", who, the

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340, 345 (S.D. Tex. 1968) the court found Kuehnert to be a tippee, and stated, "This court further holds, as a matter of law, that section 78j(b) of the Act and Rule 10b-5 were not intended to be and cannot be used by such a person to sustain a cause of action for fraud."

9. 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969).

10. *Id.* at 848.

11. 15 U.S.C. § 78p(b) (1970). The statute reads: "For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer . . . ." A beneficial owner is one who holds, either directly or indirectly, more than 10% of any class of any equity security (other than an exempted security). 15 U.S.C. § 78p(a) (1970).

12. "Tipping" is the "selective disclosure of material inside (nonpublic) information for trading or other personal purposes." 1 A. BROMBERG, SECURITIES LAW: FRAUD § 7.5(2), at 190.7 (1973).

13. 40 S.E.C. 907 (1961).

14. *Id.* at 912.

15. SEC v. Texas Gulf Sulfur, 312 F. Supp. 77, 95 (S.D.N.Y. 1970), *aff'd in part, rev'd in part*, 446 F.2d 1301 (2d Cir.), *cert. denied*, 404 U.S. 1005 (1971).

16. SEC v. Texas Gulf Sulfur, 446 F.2d 1301, 1308 (2d Cir.), *cert. denied*, 404 U.S. 1005 (1971).

17. 353 F. Supp. 264 (S.D.N.Y. 1972).

complaint alleges, knew or should have known of the confidential nature of the information, are liable to the same extent as insiders.[18]

In *Ross v. Licht*[19] the court arrived at a similar finding, holding that even if the defendants did not meet the traditional tests of who is an insider, they were tippees, and therefore subject to the same obligations and liabilities as insiders.[20]

Although there is an abundance of federal securities law, as embodied in the Securities Exchange Act and cases arising under that Act, the individual states have not been eager to exercise dominion over securities transactions. Under the common law, insider trading was not considered such a breach of fiduciary duty as would sustain a derivative suit.[21] The "special facts rule"[22] appeared, which granted recovery when "special facts" or circumstances warranted such a remedy, but even the special facts rule contained elements of what actually constituted common law fraud.[23]

Gradually, however, the states have begun to exercise more control over transactions involving corporate securities. The first major break from the reluctance to find liability on the part of corporate insiders who trade in their company's stock came in *Brophy v. Cities Service Co.*[24] In that case an employee armed with inside information realized a profit from dealing in his employer's stock. In the ensuing derivative suit, the Delaware Court of Chancery held for the plaintiff stockholders, maintaining that "[p]ublic policy will not permit an employee occupying a position of trust and confidence toward his employer to abuse that relation to his own profit, regardless of whether his employer suffers a loss."[25]

Undoubtedly, the leading case in the area of common law derivative suits brought for the purpose of recovering profits made by insiders is *Diamond v. Oreamuno.*[26] In that case suit was brought by shareholders of Manage-

18. *Id.* at 279.

19. 263 F. Supp. 395 (S.D.N.Y. 1967).

20. *Id.* at 410. The position of the tippee in a chain of tippees is arguably not relevant: "In theory, it should not matter whether the tippee is first degree—getting his information directly from the company—or tenth degree—receiving it through sequence of nine tippers." 2 A. BROMBERG, SECURITIES LAW: FRAUD § 7.5(6)(g), at 190.19.

21. *See* H. HENN, CORPORATIONS 471-72 & n.4 (2d ed. 1970).

22. The special facts rule was introduced in Strong v. Repide, 213 U.S. 419, 434 (1909), where a director of a corporation employed an agent to purchase stock in the corporation on the director's behalf. The director's identity was concealed, and he knew of negotiations that would substantially increase the value of the stock. The Supreme Court found that under those facts and circumstances the director was liable for fraud, answerable to those from whom he had purchased the corporation's stock.

23. *See* Conant, *Duties of Disclosure of Corporate Insiders Who Purchase Shares,* 46 CORNELL L.Q. 53, 59 (1960).

24. 70 A.2d 5 (Del. Ch. 1949).

25. *Id.* at 8.

26. 287 N.Y.S.2d 300 (Sup. Ct. 1968), *aff'd,* 301 N.Y.S.2d 78 (1969).

ment Assistance, Inc. (MAI) against two men, one a director of the corporation and the other serving in a dual capacity as a director and as president. The suit was brought to recover profits the two men had made by using confidential information. The New York Court of Appeals found for the plaintiff shareholders, holding that a common law cause of action does exist against a director or officer of a corporation who exploits for his own benefit knowledge acquired by virtue of his position.[27] In dismissing the argument that there was no actual showing of harm to the corporation itself, the court held that the possible loss of integrity and image of probity, plus the need to insure the continued public acceptance and marketability of the stock were reasons enough to sustain the suit.[28] Additionally, in seeking to justify the court's action in an area arguably controlled by federal securities law, the opinion noted that an insider might be able to escape liability under section 16(b) of the Securities Exchange Act[29] by holding his stock for 6 months, thus avoiding the "short-swing" proscriptions of the Act.[30] By allowing the derivative suit here, the court supplied a state remedy in a case where the federal remedy was undesirable or unavailable.[31] Appropriately, the court cited section 28(a) of the Act, which recites that "[t]he rights and remedies provided by this chapter shall be *in addition to any and all other rights and remedies that may exist at law or in equity*."[32] The *Diamond* case thus represents a substantial alteration of the common law principles applicable to transactions involving officers, directors, and their use of inside information.

As pointed out by the dissenting justice in *Schein v. Chasen*, however, the court in *Diamond* was dealing with *officers* and *directors*.[33] In the instant case the court was faced with defendants who were not officers or directors, and who were thus apparently not subject to the reach of the *Diamond* case.[34] Through the application of equitable fiduciary concepts, the plain-

27. 301 N.Y.S.2d 78, 80 (1969).

28. *Id.* at 82.

29. 15 U.S.C. § 78p(b) (1970).

30. *Id.* The statute proscribes the

> [P]urchase and sale, or any sale and purchase, of any equity security of such issuer (other than an exempted security) within any period of less than six months, unless such security was acquired in good faith in connection with a debt previously contracted . . . .

31. Diamond v. Oreamuno, 301 N.Y.S.2d 78, 84-85 (1969). The plaintiffs in *Diamond* were unsure of the proper procedure to be followed in a 10b-5 class action suit, especially in the selection and notification of the "class." The expense and effort required in such a suit makes it undesirable where the potential reward is less than the potential expenditure.

32. 15 U.S.C. § 78bb (1970).

33. Schein v. Chasen, 478 F.2d 817, 826 (2d Cir.), *cert. granted*, — U.S. — (1973).

34. The dissent in the instant case was unwilling to expand the *Diamond* holding: "Liability in *Diamond* was predicated entirely on such a relationship, and in its absence, the *Diamond* rationale for liability ceases to exist." Schein v. Chasen, 478 F.2d 817, 827 (2d Cir.), *cert. granted*, — U.S. — (1973).

tiffs in *Schein* sought to expand the reach of *Diamond* to include those persons who had received information from an officer, but were not connected with the injured corporation in any other way.

While they cannot be held to be trustees in the technical sense of the term, directors and officers do share a fiduciary relationship with the corporation and its stockholders.[35] A fiduciary of a corporation must exercise his official duties with the utmost good faith. One should never be permitted to use his position for gain or benefit to the detriment of the corporation, and must account to the corporation for any personal gain or advantage obtained by reason of his relationship to the corporation.[36] Confidential information is a species of property belonging exclusively to the corporation.[37] Therefore, a corporate fiduciary who has been entrusted with such information should not exploit it for his own benefit, regardless of whether or not injury to the corporation ensues.[38] Of necessity, equity dictates that one who acts with the fiduciary, knowing the fiduciary is in breach of the trust imposed upon him, is liable along with the fiduciary to the principal.[39]

35. *See, e.g.*, Application of Vogel, 268 N.Y.S.2d 237, 240 (Sup. Ct. App. Div. 1966); Globe Woolen Co. v. Utica Gas & Elec. Co., 121 N.E. 378, 379 (N.Y. 1918).

In Bosworth v. Allen, 168 N.Y. 158, 164 (1901) the court held that directors are treated as trustees in equity.

36. *See, e.g.*, Zahn v. Transamerica, 162 F.2d 36, 42-43 (3d Cir. 1947); Loft, Inc. v. Guth, 2 A.2d 225 (Del. Ch. 1938).

37. *See, e.g.*, 3 W. FLETCHER, PRIVATE CORPORATIONS § 884 (Perm. ed. 1972).

38. Diamond v. Oreamuno, 301 N.Y.S.2d 78, 81-82 (1969); Wilshire Oil Co. v. Riffe, 381 F.2d 646, 651 (10th Cir.), *cert. denied*, 389 U.S. 822 (1967). *See also* 3 W. FLETCHER, PRIVATE CORPORATIONS § 884 (Perm. ed. 1972).

39. Oil & Gas Ventures—First 1958 Fund, Ltd. v. Kung, 250 F. Supp. 744, 749 (S.D.N.Y. 1966); United Homes, Inc. v. Moss, 154 So. 2d 351, 354 (Fla. Dist. Ct. App. 1963).

In Pumphrey v. Quillen, 141 N.E.2d 675, 680 (Ohio Ct. App. 1955), *aff'd*, 135 N.E. 2d 328 (Ohio 1956), the court held:

> All of those who actively participate, by cooperation or request, in a tortious act to defraud which results in damage, or who lend aid to the wrongdoers, or ratify or adopt the acts done for their benefit, are equally liable with him. *Express agreement is not necessary, and all that is required is that there should be a common design or understanding, even though it be a tacit one.* (Emphasis added).

The court in the instant case also cited the American Law Institute's RESTATEMENT (SECOND) OF AGENCY § 312 (1958), which reads, "A person who, without being privileged to do so, intentionally causes or assists an agent to violate a duty to his principal is subject to liability to the principal" and comment *c* to section 312 which reads in part, "A person who, with notice that an agent is thereby violating his duty to his principal, receives confidential information from the agent, may be enjoined from disclosing it and required to hold profits received by its use as a constructive trustee." Schein v. Chasen, 478 F.2d 817, 823-24 (2d Cir.), *cert. granted*, — U.S. — (1973).

The court in *Schein* could have also relied on other sections of the Restatement for support: section 314 deals with persons who receive the principal's property from an agent knowing the agent is committing a breach of duty, and holds that person liable for its value; section 388 makes the agent account for profits made in connection with transactions conducted by him on behalf of his principal, and comment *c* to section 388 reads in part, "He is also liable for profits made by selling confidential information to third persons, even though the principal is not adversely affected." Section 395 sub-

The courts have used these equitable principles to extend liability in situations analogous to the one where benefits are derived from insider trading. In *Knox Glass Bottle Co. v. Underwood*[40] an officer of the corporation and his friends took advantage of the officer's position to secure profitable contracts for themselves. The court in that instance held that where a stranger to a corporation participates with an officer of the corporation in the commission of a breach of duty owed to it, the stranger, equally with the officer, commits a wrong and ought not to be allowed to profit from it.[41] Again, in *United Zinc Cos. v. Harwood,*[42] an officer of the corporation and his friends sold property to the corporation at a price in excess of its value, receiving stock in the corporation in exchange. The court held that where strangers confederate with an officer in a transaction which results in unlawful profit to themselves, all are jointly liable for the funds or property unlawfully diverted.[43]

It thus remained for the court in *Schein* to assemble the various elements of officer fiduciary duty, the exclusiveness of confidential corporate information, the breach of duty by the corporate insider in relating the information unlawfully, and the unlawful use by the outside third parties, to establish the liability of all parties involved. Following the *Diamond* holding that "[t]he primary source of the law in this area ever remains that of the State which created the corporation,"[44] the court in *Schein* examined the Florida case of *Quinn v. Phipps.*[45] There, the Florida Supreme Court held that the origin of fiduciary relationships is immaterial,[46] and that such relationships need not be based strictly on legal grounds, but may be based on moral,

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jects the agent to a duty not to use or communicate confidential information, and comment *e* of that section requires him to account for profits made through the use of confidential information.

40. 89 So. 2d 799 (Miss. 1956), *aff'd on rehearing*, 91 So. 2d 843 (Miss. 1957).

41. *Id.* at 820.

42. 103 N.E. 1037 (Mass. 1914).

43. *Id.* at 1038.

44. Diamond v. Oreamuno, 287 N.Y.S.2d 300, *aff'd*, 301 N.Y.S.2d 78, 85 (1969). Florida, the state where Lum's originated, has adopted the Uniform Securities Act (FLA. STAT. ANN. § 517.301 (1961)). Section 101 of the Act, with minor variations, is identical to Rule 10b-5 of the federal Securities Exchange Act. The Florida act was apparently not available to the plaintiffs in *Schein* due to a narrow interpretation of what constitutes an "act." However, FLA. STAT. ANN. § 517.23 (1961) recites that "The same civil remedies provided by laws of the United States now or hereafter in force, for the purchasers of securities under any such laws, in interstate commerce, shall extend also to purchasers of securities under this chapter," indicating that Florida did not expect her securities statutes to contain exclusive remedies. For a comparison of the Florida Uniform Securities Act with the corresponding federal act, see Comment, *Opening a Pandora's Box—Disclosure Under the Florida Securities Act,* 23 U. MIAMI L. REV. 593 (1969).

45. 113 So. 419 (Fla. 1927), *cited in* Annot., 54 A.L.R. 1173 (1928). The dissenting justice's opinion in *Schein* was curiously silent on the *Quinn* doctrine.

46. *Id.* at 421.