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Corporations--Common Law Liability of Outsiders to Corporation for Profits Gained by Trading on Inside Information

Linda M. Castleman-Zia

"vouching in" if both courses are available. However, the possibility of "vouching in" should still be examined in cases where the court lacks personal jurisdiction or exercises its discretion to deny the third-party petition.

THOMAS M. SCHNEIDER

CORPORATIONS – COMMON LAW LIABILITY OF OUTSIDERS TO CORPORATION FOR PROFITS GAINED BY TRADING ON INSIDE INFORMATION

Schein v. Chasen[1]

In November of 1969 Lum's Inc., a Florida corporation, invited members of the securities industry to Caesar's Palace to explain the effect of recent acquisitions on the corporation's profits. At this meeting Chasen, president of Lum's, announced that the corporation's earning prospects for the fiscal year ending July 31, 1970, would be approximately $1.00 per share. Two months later, upon learning that the estimate was too optimistic, Chasen phoned Simon, an employee of the Lehman Brothers stock brokerage firm. Simon had been helpful in raising funds from his clients for the purchase of Caesar's Palace and in advising Lum's on its investment attractiveness. Based on his relationship with Lum's, Simon had requested he be informed in advance of changes confronting the corporation. Simon reconveyed the information to investment advisors of two mutual funds that together owned 83,000 shares of Lum's. On January 9, 1970, prior to any public announcement of the lower projected earnings, the mutual funds sold their shares for approximately $17.50 per share. On January 12, Lum's released the new estimates and the stock closed at $14.00 per share that day.

Plaintiff, a shareholder of Lum's, brought a derivative suit against Lehman Brothers, Simon, and the mutual funds[2] which was filed in the southern district of New York invoking diversity jurisdiction. The common law theory of recovery was based on a two step analysis of fiduciary obligations owed to a corporation. First, *Diamond v. Oreamuno*[3] established that corporate officers, dealing in the corporation's stock, owe the corporation a fiduciary obligation not to exploit information acquired by virtue of their positions. Traditionally, corporate officers were free to deal personally in the corporation's stock unless such dealing involved a conflict of interest, the sale of control, the oppression of

1. 313 So. 2d 739 (Fla. 1975).
2. Originally, suit was brought against all parties involved in the transaction. However, Chasen and the two investment advisors were dismissed for lack of personal jurisdiction. The dismissals were not appealed.
3. 24 N.Y.2d 494, 301 N.Y.S.2d 78, 248 N.E.2d 910 (1969).

Missouri Law Review, Vol. 41, Iss. 4 [1976], Art. 7

minority stockholders, competition with the corporation, or usurpation of corporate opportunities.[4] Because Florida law was controlling[5] and there were no Florida decisions on point, the plaintiff claimed that Florida would look at other judisdictions' decisions and take note of *Diamond.*

Secondly, the plaintiff contended that the fiduciary obligation of corporate officers established in *Diamond* could be expanded to cover outsiders who received and misused inside information from the officers. The defendants could be held liable either indirectly by a common enterprise theory or directly as "non-technical" fiduciaries (*i.e.,* one who becomes a fiduciary through the acquisition of confidential corporate information).[6]

The district court granted summary judgment for the defendants, concluding that the narrow holding of *Diamond* could not be extended to cover the defendants.[7] The Second Circuit reversed.[8] The Supreme Court vacated the appellate decision and recommended that the question of defendants' liability be certified to the Florida Supreme Court.[9] The Florida court agreed with the district court, holding that no fiduciary obligation could be found by which the defendants would be liable to the corporation. The court went further and declared its unwillingness to adopt the theory of *Diamond.*[10]

Schein presented a unique complaint which could not be remedied

4. H. HENN, LAW OF CORPORATIONS §§ 235, 239 (2d ed. 1970).

5. New York follows the general choice of law principle that the state of incorporation governs the existence and extent of corporate fiduciary obligations. Since Lum's was incorporated in Florida, Florida common law controlled.

6. The second circuit decision extensively discusses the liability of the defendants as "co-venturers of the *director who breaches his duty.*" Schein v. Chasen, 478 F.2d 817, 822 (2d Cir. 1973) (emphasis added). But the court also intimates that the defendants could be liable as fiduciaries themselves. This theory is introduced in the court's discussion of Quinn v. Phipps, 93 Fla. 805, 113 So. 419 (1927). It is not discernable as to whether the court meant to employ these two separate theories of accountability or if the *Quinn* case injected terms inconsistent with the circuit decision. Because both theories are discussed by the Florida court, a separate analysis of both is included.

7. 335 F. Supp. 329 (S.D.N.Y. 1971).

8. 478 F.2d 817 (2d Cir. 1973).

9. 416 U.S. 386 (1974). Certification to the Florida Supreme Court is explicitly provided for in Florida Appellate Rule 4.61.

A second issue was whether actual damage to the corporation must be alleged in order to state a cause of action. The circuit court found that a general allegation of damages was sufficient to state a cause of action under Florida law. The Florida court stated that "actual damage to the corporation must be alleged. . . ." 313 So. 2d at 746.

Missouri has case language to the effect that it is not necessary that the company suffer a loss before a director can be held liable for a breach of his fiduciary duties. It is only necessary that the fiduciary gain a profit through his violations. *See* Bromschwig v. Carthage Marble & White Lime Co., 334 Mo. 319, 66 S.W.2d 889 (1933).

10. 313 So. 2d at 746. It can be argued that since the common law recovery is in part based on *Diamond,* and the court rejected it, the discussion of outsider liability is dictum.

under Section 10(b) of the Securities Exchange Act and rule 10b-5.[11] The plaintiff in *Schein* was neither a defrauded buyer nor seller of corporate shares as required by rule 10b-5.[12] This derivative suit was brought by shareholders for the benefit of the corporation alleging violations of fiduciary obligations owed to it. The recovery sought would benefit the whole community of corporate interests—shareholders, cerditors,[13] and the entity itself,[14] but not the individuals defrauded by the inside information trading. The purpose of a derivative suit is to police the corporate management, to protect ownership, educate officers in principles of fiduciary responsibilities and loyalty, encourage full disclosure to stockholders, and discourage participation in management by persons not truly interested in the corporation.[15] Unlike rule 10b-5, the purpose is not to protect the investing public and insure equality of information and bargaining positions.[16]

The Florida court likened the plaintiff shareholders to private attorneys general who are to "enforce proper behavior on the part of corporate officials."[17] The proper domain of the derivative suit is then implicitly limited to the corporation. Florida's interpretation of the purpose and domain of the derivative suit was more narrow than that of the Second Circuit. The Second Circuit extended the purpose of the derivative suit to the protection of the prestige and goodwill of a corporation from insider leaks.[18] To fully effect this protection, that court would have extended the domain of derivative suits to third-party co-venturers.[19]

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11. Section 10(b) of the Securities and Exchange Act, 15 U.S.C. § 78(j) (1970), and its implementing rule 10b-5, 17 C.F.R. § 240.10b-5 (1975), condemn certain fraudulent acts in connection with the purchase or sale of any security.

12. Courts have interpreted § 10(b) as requiring that suit be brought by either a buyer or seller who was defrauded by the transaction. This has become known as the *Birnbaum* doctrine. *See* Birnbaum v. Newport Steel Corp., 193 F.2d 461 (2d Cir. 1952). In Superintendent of Insurance v. Bankers Life & Casualty Co., 404 U.S. 6 (1971), a corporation brought suit against individuals who had fraudulently bought its stock. By expanding the concept of "sale," an action was allowed under rule 10b-5 even though the corporation had not been directly involved with the sale of its stock. The individuals had financed the buying of the stock through a sale of the corporation's treasury bonds. After this case it was believed that derivative actions might lie against fraudulent buyers or sellers dealing in the corporation's stock. However, the *Birnbaum* doctrine was recently revitalized by Blue Chips Stamps v. Manor Drug Stores, _____ U.S. _____, 95 S. Ct. 1917 (1975). *See* Evans, *Securities Regulation—Standing to Sue Under Rule 10b-5—Supreme Court Adopts Birnbaum Doctrine,* 41 Mo. L. Rev. 296 (1976).

13. H. Henn, Law of Corporations § 358, at 751 (2d ed. 1970).

14. The corporation alleged that it had suffered damage in that such breaches of fiduciary obligations tarnished its prestige and good will. 478 F.2d at 822.

15. Dykstra, *The Revival of the Derivative Suit,* 116 U. Pa. L. Rev. 74, 77 (1967).

16. 1 A. Bromberg, Securities Law Fraud § 3.2 (1975); Shapiro v. Merrill Lynch, Peirce, Fenner & Smith, Inc., 495 F.2d 228, 235 (2d Cir. 1974).

17. 313 So. 2d at 742 (quoting *Diamond*).

18. 478 F.2d at 822.

19. A 1930 Missouri case stated that good will is a corporate asset protected by the law, and allowed a corporate suit to be maintained for its protection.

The willingness of a court to allow shareholders to sue outsiders is thus, in part, dependent on its concept of the purpose of derivative suits. The more expansive the view of that purpose, the greater the willingness to hold outsiders accountable to the corporation as fiduciaries.

A second unique feature of *Schein* is that the defendants, unlike those in *Diamond,* were outsiders who held no position of trust in the corporation. The willingness (or unwillingness) of the courts to hold the outsiders liable to the corporation is based, in part, on a finding that the defendants participated in a common enterprise in which Chasen breached his fiduciary duty. The defendants could then be held accountable indirectly to the corporation if a common enterprise is found to have existed.[20]

The Second Circuit cited the *Restatement (Second) of Agency*[21] for the proposition that individuals may be held liable to the corporation for participating in an enterprise whereby a fiduciary breaches his obligation. The requirements set out therein are: knowing participation, intentionally causing or assisting in the violation, and receiving and using confidential information.[22] The court did not attempt to establish the facts needed to meet the requirements. It simply stated that "it is obvious that the sequence of events detailed in the pleadings, if proved, will substantiate the existence of a common enterprise. . . ."[23]

The Florida Supreme Court found no common enterprise. Instead of finding an intentional participation by the defendants, the court discovered "unsolicited and haphazard revelation of certain information. . . ."[24]

A close examination of the facts tends to support the common enter-

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This may indicate an expansive view of the purpose of the derivative suit in Missouri and thus encourage holding outsiders liable to achieve such purpose. *See* Southwest Pump & Machinery Co. v. Forslund, 225 Mo. App. 262, 29 S.W.2d 165 (K.C. Ct. App. 1930).

20. This presumes that the court would follow *Diamond* and find a fiduciary duty to exist under these circumstances.

21. 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.

RESTATEMENT (SECOND) OF AGENCY § 312 (1958). Comment c to § 312 states further:

> [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.

22. It appears that the circuit court loosely employed the term "common enterprise." It did not discuss the commonly accepted prerequisites for the existence of a common enterprise. For discussions on the accepted meaning of the term and the resulting confusion from the court's use of the term see H. HENN, LAW OF CORPORATIONS § 49 (2d ed. 1958); Note, *Common Law Corporate Recovery for Trading on Non-Public Information,* 74 COL. L. REV. 269 (1974); Note, *Securities Fraud under State Common Law,* 45 U. OF COL. L. REV. 519 (1974).

23. 478 F.2d at 822.

24. 313 So. 2d at 745 (quoting from the Second Circuit's dissent).

prise theory. Simon was fully aware of the non-public nature of the information relayed to him, yet intentionally notified the mutual funds to save himself embarrassment from having advised them to purchase Lum's stock. The mutual funds' investment advisors were also aware that the information was confidential and they intentionally misused it when they sold their entire holdings of Lum's before the news release.[25]

In addition to their respective findings as to a common enterprise, the courts' willingness or unwillingness to hold outsiders liable to the corporation was based on their respective interpretations of *Diamond*. The Second Circuit, through its discussion of *Quinn v. Phipps*,[26] suggested that the defendants could be directly liable to the corporation as non-technical fiduciaries. The court discussed the requirements of *Diamond* which give rise to a fiduciary obligation and decided that they were met in *Schein*. The court believed that the officers in *Diamond* owed a fiduciary obligation to the corporation because of their acquisition of confidential information. The acquisition of such knowledge "owned" by the corporation clothed them with a fiduciary duty not to misuse it for their own advantage.[27] The Florida court interpreted *Diamond* as requiring a "position such as officer, director, employee or agent which would create fiduciary obligations to Lum's,"[28] and the making of a profit from the violation of such duties. None of the defendants held positions of trust with the corporation, and Simon and Lehman Brothers did not even profit from the transaction.[29]

It is not specifically stated in *Diamond* what factors give rise to the fiduciary obligation of the officers. Several statements indicate that it was the officers' *inside positions* in addition to their acquisition of the information that created the obligation. For example, the court stated that "an *agent who acquires* confidential information in the course of his employment"[30] or "a corporate *fiduciary, who is entrusted* with potentially valuable information, may not appropriate that asset. . . ."[31] *Diamond* does not tend to support the theory that the defendants in *Schein* could become fiduciaries through acquisition of confidential information alone.[32]

25. For a full discussion of the relationship between Chasen and Simon and the ensuing events see CCH FED. SEC. L. REP. [1973 Transfer Binder] ¶ 94,134 at 94,558.

26. 93 Fla. 805, 113 So. 419 (1927). *See* note 6 *supra*.

27. 478 F.2d at 823.

28. 313 So. 2d at 744 (quoting from the Second Circuit's dissent).

29. *Id.* at 742. The court refers to profit as immediate pecuniary profit. It does not discuss the possible non-pecuniary benefits involved such as enhancing the funds' image of the brokerage firm and reciprocal exchanges of confidential information.

30. 301 N.Y.S.2d at 83; 248 N.E.2d at 914 (quoting from the *Restatement*) (emphasis added).

31. 301 N.Y.S.2d at 81; 248 N.E.2d at 912 (emphasis added).

32. Other cases might lend more credence to the liability of outsiders to the corporation. *See* Brophy v. Cities Service Co., 31 Del. Ch. 241, 70 A.2d 5 (1949); Ohio Oil Co. v. Sharp, 135 F.2d 303 (10th Cir. 1943).

No Missouri cases discuss the liability of outsiders to the corporation for gains made from the use of inside information by a common enterprise.

By rejecting the Second Circuit's decision, Florida bypassed the necessity of dealing with several problems presented by outsider liability. The derivative suit allows the corporation to recover for violations of duties owed it. The resulting damage to its reputation and goodwill is not necessarily the same as the profits gained by the co-venturers. By automatically allowing the corporation to claim this amount in damages, the theory of recovery is blurred with that of rule 10b-5[33] and with principles of equity (*i.e.,* as between the parties, who has a greater right to the money). While the recovery of profits as damages may be necessary because of the difficulty of determining the amount of actual damages in such a case, a clear distinction should be drawn as to the theory of recovery employed.

A second problem which must be resolved by a court contemplating outsider liability is the apparent potential for double liability. The defendants in *Schein* argued that if held liable to the corporation for their profitable trading, they would have been placed in double jeopardy because the defrauded buyers could also have sued them. By clearly enunciating the purposes of and interests protected by the derivative suit, this problem can be solved. Here a separate injury has resulted apart from that incurred by the defrauded buyers. Liability is incurred because of multiple injuries resulting from a single act. It is not based on a single injury.[34]

The Second Circuit failed to adequately establish the limits of outsiders' liability to a corporation. The court discussed the requirements that the co-venturers' assistance be intentional and knowing. However, left unexplored was the relevancy of the remoteness of tippee to insiders, the motive of tippee, the generality of the tip, the circumstances under which the tip was received and the nature of the gain realized. The effect of such factors on an outsider's liability must be set out in future decisions.[35]

The justification for holding outsiders liable to the corporation rests on the distinction between the interests protected by the derivative suit and those of the federal securities law. The Florida court's analysis did

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a discussion of the liability of outsiders who acted "in concert" with a fiduciary who breached his duty see Johnson v. Duensing, 340 S.W.2d 758 (K.C. Mo. App. 1960). The cases do represent a strong desire to hold directors and officers to a strict degree of loyalty. *See* Johnson v. Duensing, 340 S.W.2d 758, 768 (K.C. Mo. App. 1960). A good argument, then, in Missouri for holding outsiders liable would be that such would deter insider trading. This argument was presented by the Second Circuit in *Schein,* 478 F.2d at 823.

33. *See* Note, *Common Law Corporate Recovery for Trading on Non-Public Information,* 74 COL. L. REV. 269 (1974).

34. *See* Note, *Securities Fraud under State Common Law,* 45 U. OF COL. L. REV. 519 (1974). Because many courts fail to recognize this distinction, counsel should argue in the alternative that while there is a technical possibility of double liability, it is practically impossible in indirect, impersonal transactions. In these types of transactions it is next to impossible for the defrauded buyer or seller to prove causation.

35. For discussions of the factors which should be considered see 6 L. LOSS, SECURITIES REGULATION 3563 (2d ed. 1961); Note, *"Tippee" Liability Extended to Remote Third Parties,* 53 NEB. L. REV. 279, 285 (1974).