St. John's Law Review

Volume 48, December 1973, Number 2 Article 27

Inside Information--Common Law Liability (Schein v. Chasen)

St. John's Law Review

they did so only after finding that 10b-5 did not impose a duty to disclose on this outside director. This implies that the court was following the admonition of Judge Hays. Additionally, a statement by Judge Moore suggests further that the scienter requirement announced in *Lanza* is not the sole test for 10b-5 liability.[60]

The precise holding of *Lanza* is that a director who is a nonparticipant in a transaction and who personally makes no misrepresentations will not be held liable for mere negligence contributing to the fraud perpetrated upon the other party to the transaction.

The scienter requirement for liability where the defendant is not directly involved in the transaction is probably a beneficial rule. The cases in other circuits which have recognized a standard of negligence have all concerned persons involved in the unlawful transaction in one way or another. This is certainly far different from imposing liability on a director who had nothing whatsoever to do with the wrongful conduct. Whether the Second Circuit will apply a negligence standard in circumstances other than those presented here remains to be decided.

INSIDE INFORMATION — COMMON LAW LIABILITY

Schein v. Chasen

Insider trading in public securities markets has long been subject to condemnation.[1] In order to combat this undesirable practice, Congress has vested the courts and the SEC with a complete arsenal of weapons. Of primary significance[2] among these is section 10b of the Securities Exchange Act of 1934,[3] and rule 10b-5 enacted pursuant

---

60 *See* note 24 *supra*.

---

1 *See* 2 L. Loss, Securities Regulation 1037 (2d ed. 1961) [hereinafter cited as Loss]. Such condemnation has not been universal, however. See H. Manne, Insider Trading and the Stock Market (1966). *See also* Manne, *Insider Trading and the Law Professors*, 23 Vand. L. Rev. 547 (1970), and the authorities cited therein at nn.2 & 4. *Compare* Ferber, *The Case Against Insider Trading: A Response to Professor Manne*, 23 Vand. L. Rev. 621 (1970), *with* Manne, *A Rejoinder to Mr. Ferber*, 23 Vand. L. Rev. 627 (1970).

2 Another formidable weapon for dealing with insider trading is section 16(b) of the 1934 Act, 15 U.S.C. § 78(p)(b) (1970). Liability under section 16(b) is limited to true insiders: directors, officers and controlling (10% or more) shareholders. Any profit made by such an insider as a result of a purchase and sale or sale and purchase of corporation securities within a six month period may be recovered by the corporation or by any security holder on behalf of the company in a quasi-derivative suit. As a streamlined statute imputing absolute liability, section 16(b) implements the policy that an insider should not be "playing the market" in his own corporation's securities. *See* Smolowe v. DeLendo Corp., 136 F.2d 231, 235-36 (2d Cir.), *cert. denied*, 320 U.S. 751 (1973); Loss, *supra* note 1, at 1041 *et seq.* However, section 16(b) lacks the broad scope of rule 10b-5 and thus is less effective as a general deterrent to the many varying types of insider trading.

3 Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) (1970), provides:

thereto.[4] The broad language of rule 10b-5,[5] aided by the mutually reinforcing enthusiasm of federal judges and the plaintiffs' bar[6] in their efforts to eradicate insider trading, has resulted in an extension of the rule far beyond the ken of the SEC of the 1930's.[7] However, as the range of conduct proscribed by rule 10b-5 has been extended, enforcement procedures have generated some confusion.[8]

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.

4 Rule 10b-5, 17 C.F.R. § 240.10b-5 (1970):

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,

(1) to employ any device, scheme, or artifice to defraud,

(2) 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, or

(3) 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.

5 *Cf.* note 3 *supra.* One commentator has stated that "the broad remedies of Rule 10b-5 are more desireable for plaintiffs than the express remedies provided by the 1933-34 Acts." Ruder, *Pitfalls in the Development of a Federal Law of Corporations by Implication through Rule 10b-5,* 59 Nw. U.L. Rev. 185, 193 (1964).

6 Recognizing the tremendous growth of these provisions, Mr. Justice Marshall noted, "10b and Rule 10b-5 may well be the most litigated provision in the Federal Securities laws." SEC v. National Sec., Inc., 393 U.S. 453, 465 (1969). Most of this growth has occured within the past ten years. Between 1942 when 10b-5 was promulgated and 1962, only fifty-four 10b-5 cases were reported. *See* Ruder, *Civil Liability Under 10b-5: Judicial Revision of Legislative Intent,* 57 Nw. U.L. Rev. 627, 687-90 (1963) [hereinafter cited as *Civil Liability*]. Since 1962 the volume has increased to over one hundred cases annually. Ruder, *Multiple Defendants in Securities Law Fraud Cases: Aiding and Abetting, Conspiracy, In Pari Delecto, Indemnification and Contribution,* 120 U. Pa. L. Rev. 597, 598 n.2 (1972) [hereinafter cited as *Multiple Defendants*].

7 *See* Painter, *Inside Information: Growing Pains for the Development of Federal Corporation Law under Rule 10b-5,* 65 Colum. L. Rev. 1361, 1393 (1965); Painter, *Rule 10b-5: The Recodification Thicket,* 45 St. John's L. Rev. 699, 700 (1970) [hereinafter cited as *Recodification*], where the author comments on the "fascinating morass of federal common law which has grown up under that benevolent umbrella with the innocuous title of Rule 10b-5." *Id.* at 699.

8 A private right of action under rule 10b-5 was first recognized in Kardon v. National Gypsum Corp., 69 F. Supp. 512 (E.D. Pa. 1946) (motion to dismiss); 73 F. Supp 798 (E.D. Pa. 1947) (decision on the merits); 83 F. Supp. 613 (E.D. Pa. 1948) (additional findings of fact and law). The existence of this private cause of action has been attacked as violative of the congressional intent. *See Civil Liability, supra* note 6, at 642-60. Professor Ruder's article provides a comprehensive analysis of the nature of the private action as of 1963. *See* Diamond v. Oreamuno, 24 N.Y.2d 494, 502-03, 248 N.E.2d 910, 914-15, 301 N.Y.S.2d 78, 84-85 (1969), for commentary on the limited nature of the remedies available under 10b-5. *See also* Note, *A Suggested Locus of Recovery in National Exchange Violations of Rule 10b-5,* 54 Cornell L. Rev. 306 (1969).

Since *Birnbaum v. Newport Steel*,[9] the requirement that actions brought under rule 10b-5 relate to a purchase or sale of securities has limited individual plaintiffs to those trading in a security prior to disclosure of relevant inside information.[10] Such a limitation[11] can often effectively reduce the number of eligible plaintiffs to zero.[12] Those individuals who are qualified are considered private attorneys-general for without them the desired deterrent effect of the statute would be left to the vagaries of SEC action,[13] and the somewhat cumbersome

---

9 193 F.2d 461 (2d Cir.), *cert. denied*, 343 U.S. 956 (1952). In *Birnbaum* the plaintiff brought suit against a controlling shareholder who sold his stock at greater than market value thereby breaching his duty to minority shareholders by relinquishing control of the corporation. Plaintiffs also alleged acts of specific fraud in various misrepresentations made by the defendant to the minority shareholders. The defendants' conduct, in the plaintiffs' view, constituted a violation of section 10b and rule 10b-5.

The Second Circuit affirmed a district court holding that 10b-5 was only to prevent "fraud perpetrated upon the purchaser or seller" of the security in question. *Id.* at 463. Unlike section 16(b), which grants shareholders a cause of action against insiders, *see* note 2 *supra*, 10b-5 provides a remedy only for those within a narrow class, *i.e.*, the defrauded purchasers or sellers.

10 Applying the *Birnbaum* doctrine, *see* note 9 *supra*, in the context of trading on a public stock exchange, a plaintiff must establish that at the time of the fraud he purchased the particular security. When use of inside information by a defendent is alleged, the plaintiff must prove his purchase or sale during the period of trading on the inside information, *i.e.*, the time between defendant's 10b-5 violation and the time of public disclosure of the inside information. Shapiro v. Merrill, Lynch, Pierce, Fenner & Smith, Inc., 353 F. Supp. 264, 270-72 (S.D.N.Y. 1972); Hirsh v. Merrill, Lynch, Pierce, Fenner & Smith, Inc., 311 F. Supp. 1283, 1286-90 (S.D.N.Y. 1970).

11 In Schein v. Chasen, 478 F.2d 817, 821 (2d Cir. 1973), *cert. granted*, 42 U.S.L.W. 3325 (U.S. Dec. 3, 1973) (Nos. 73-439, 73-440, 73-495), the period of inside information trading was only four hours. Only those individuals who purchased or sold shares during that narrow time span could recover losses under 10b-5. *See* note 10 *supra*. However, defendants sold 83,000 shares of stock in this brief period. *See* note 23 *infra*.

12 The *Birnbaum* doctine has been the subject of severe criticism. *See, e.g.*, Lowenfels, *The Demise of the Birnbaum: A New Era for Rule 10b-5*, 54 VA. L. REV. 268 (1968). For commentary tracing the history of rule 10b-5 and *Birnbaum* see Note, *SEC Rule 10b-5: A Recent Profile*, 13 W. & M.L. REV. 860, 900-26 (1972).

Despite criticism, the *Birnbaum* doctrine recently has been reaffirmed by the Second Circuit. Drachman v. Harvey, 453 F.2d 722, *rev'd and remanded en banc*, 453 F.2d 736, 738 (2d Cir. 1972); GAF Corp. v. Milstein, 453 F.2d 709, 721-22 (2d Cir. 1971), *cert. denied*, 406 U.S. 910 (1972); *See also* Levine v. Seilon, Inc., 439 F.2d 328, 329 (2d Cir. 1971), where the court noted that the SEC urged the overruling of *Birnbaum* and the court declined the invitation.

13 SEC litigation in this area traditionally sought only injunctive relief. *See, e.g.*, SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969); *In re* Cady Roberts & Co., 40 S.E.C. 907 (1961). However, the SEC can, as an ancillary remedy, bring an action to require the insider to disgorge profits due to insider trading. These profits are then paid to the corporation which holds as trustee "subject to disposition in such manner as the court might direct upon application from the SEC or other interested person, or on the court's own motion." SEC v. Texas Gulf Sulfur Co., 446 F.2d 1301, 1307 (2d Cir.), *cert. denied*, 404 U.S. 1005 (1971). Double liability would be prevented by using the fund as a primary source to pay any private judgments against the insiders. After a prescribed period of time had elapsed the proceeds would then be turned over to the corporation.

class action device.[14] The inadequacy of these remedial devices has given rise to a body of common law under which liability for insider trading may be more readily established.

In 1969, the New York State Court of Appeals in *Diamond v. Oreamuno*[15] held that corporate directors who traded on inside information breached their common law fiduciary duty[16] to their corporation. Further, the court held that the resulting profits could be recovered via a derivative suit without a showing of damage to the corporation.[17]

In *Schein v. Chasen*,[18] the Second Circuit, per Judge Waterman,

---

The overriding policy is not to reimburse the corporation but to prevent the insider from realizing any profit from his wrongdoings. Conceivably the corporation would realize no benefit, only the burden of administering the trust fund. *See* note 51 and accompanying text *infra*.

[14] *Cf.* Eisen v. Carlisle & Jacquelin, 479 F.2d 1005 (2d Cir. 1973), *cert. granted*, 42 U.S.L.W. 3212 (U.S. Oct. 15, 1973) (No. 73-203).

[15] 24 N.Y.2d 494, 248 N.E.2d 910, 301 N.Y.S.2d 78 (1969).

[16] In finding this duty the court relied heavily on the congressional intent of 16(b) to prevent abuse of the fiduciary relationship that obligates a director. Although no section 16(b) violation was present in *Diamond*, the court saw in section 16(b) an underlying fiduciary duty which could be enforced via a derivative suit. 24 N.Y.2d at 500, 248 N.E.2d at 913-15, 301 N.Y.S.2d at 82-83. *See* Loss, *supra* note 1, at 1123 *et seq.* for a discussion of the relation of section 16(b) and general agency concepts. *See also* Gower, *Investor Protection in the USA*, 15 MOD. L. REV. 446, 453 (1950), *commenting on* Brophy v. Cities Serv. Co., 31 Del. Ch. 241, 70 A.2d 5 (1948).

[17] 24 N.Y.2d at 498, 499, 248 N.E.2d at 912, 301 N.Y.S.2d at 81. *Diamond* generated a considerable amount of commentary, generally favorable, in view of the decision's deterrent effect on insider trading. *See, e.g.*, 83 HARV. L. REV. 1421 (1969); 31 U. PITT. L. REV. 296 (1969); 22 VAND. L. REV. 1412 (1969). However, there was criticism of the "trustee" analogy used to obviate a showing of damage to the corporation. *See* 18 BUFF. L. REV. 193 (1968); 37 FORD. L. REV. 477 (1968); 23 S.W.L.J. 921 (1969).

The New York Supreme Court, Appellate Division, in *Diamond*, noted that there was a possible harm to the corporation which created "an added element of liability." Diamond v. Oreamuno, 29 App. Div. 2d 285, 287, 287 N.Y.S.2d 300, 303 (1st Dep't 1968): "The prestige and good will of a corporation . . . may be undermined by the revelation that its chief officers had been making personal profits out of corporate events which they had not disclosed to the community of stockholders." However, neither the appellate division nor the Court of Appeals relied on this, but instead based the result on the theory that defendants had unjustly realized profits that they should not in equity be permitted to retain. "Just as a trustee has no right to retain for himself the profits placed in his possession but must account to his beneficiaries, a corporate fiduciary, who is entrusted with potentially valuable information, may not appropriate that asset for his own use even though, in so doing, he causes no injury to the corporation." 24 N.Y.2d at 498, 248 N.E.2d at 912, 301 N.Y.S.2d at 81. The *Diamond* court's analogy is subject to criticism. A trust asset which is exploited by a trustee, could have been used to profit the trust. Thus the trustee's personal gain is a deprivation of the trust. A corporation, however, could not realistically deal in the asset of corporate inside information or use it to trade in its own securities. Therefore no corporate opportunity is appropriated. *See* Brodsky, *Derivative Suits Based on Inside Information Trading*, N.Y.L.J., July 5, 1973, at 4, col. 3 [hereinafter cited as *Derivative Suits*].

[18] 478 F.2d 817 (2d Cir. 1973), *cert. granted*, 42 U.S.L.W. 3325 (U.S. Dec. 3, 1973) (Nos. 73-439, 73-440, 73-495).

extended this reasoning to hold 10b-5 tippees,[19] in a common enterprise with their tipper, to be in breach of a similar fiduciary duty to the corporation in whose securities they traded. The *Schein* plaintiffs were shareholders in Lums, Inc., a Florida corporation, and based federal jurisdiction for their derivative suit on diversity of citizenship. The complaint alleged that upon realizing that corporate earnings would be substantially lower than anticipated,[20] Chasen, the president of Lums, Inc., notified Simon, a Chicago broker employed by Lehman Brothers, of this development.[21] It further alleged that Simon, in turn, notified the manager of two mutual funds,[22] who sold over 80,000 shares of Lums approximately four hours before the official announcement and suspension of trading.[23] Naming all parties to the transaction as defendants,[24] plaintiffs claimed that they were jointly and severally liable for the profits amassed as a result of their misuse of corporate information.[25] Without alleging any prior agreement by the defendants, plaintiffs claimed breach of a duty owed to them.

In the district court, Judge Tyler dismissed the complaint for failure to state a cause of action.[26] On appeal, the Second Circuit reversed and remanded.[27] Guided by the doctrine of *Erie Railroad v.*

19 *See Recodification, supra* note 7 at 708-09.

20 478 F.2d at 820. In November, 1969, Chasen addressed a seminar of some sixty investors and predicted earnings of $1.00 to $1.10 per share for the fiscal year ending July 1, 1970. On January 5, 1970, he learned that the earnings would be only about $.76 per share. *Id.*

21 *Id.*

22 Simon notified defendant Sit, who in turn notified defendant Jundt. Both Sit and Jundt were employees of Investors Diversified Services, Inc. (IDS). IDS was a distributor and investment advisor for a number of mutual funds. IDS employed Sit and Jundt to manage the portfolios of Investor Variable Payment Fund, Inc. and IDS New Dimensions Fund, Inc. Both funds as well as IDS were named as defendants. 478 F.2d at 820.

23 Investors Variable Payment Fund, Inc. sold 43,000 shares of Lums while IDS New Dimensions Fund, Inc. sold 40,000 shares. Both sales occured at approximately 10:30 a.m., Friday, Jan. 9, 1970, and realized a price of about $17.50 a share. At 1:30 p.m. trading was suspended pending the official announcement which was made at 2:45 p.m. on Monday, Jan. 12, 1970. When trading resumed, Lums closed at $14.00, a drop of approximately $3.50. 478 F.2d at 820-21.

24 Plaintiffs named as defendants Chasen, IDS, Lehman Brothers, Investors Variable Payment Fund, Inc., Simon, IDS New Dimensions Fund, Inc., Sit, Jundt, and Lums, Inc. Judge Tyler of the Southern District of New York dismissed plaintiff's suit as to Sit, Jundt and Chasen, under rule 12(b)(2) of the Federal Rules of Civil Procedure since the court lacked personal jurisdiction over them. N.Y. CIV. PRAC. § 313, 302(a) (McKinney 1972). Gildenhorn v. Lums, Inc., 335 F. Supp. 329, 331 n.1, 334, 335 (S.D.N.Y. 1971), *rev'd on other grounds sub nom.* Schein v. Chasen, 478 F.2d 817 (2d Cir, 1973). Plaintiff did not appeal this dismissal. Simon had also moved below for dismissal on jurisdictional grounds but his motion was not decided, 478 F.2d at 819. The Second Circuit declined to consider Simon's motion on appeal and left it to the trial court on remand.

25 478 F.2d at 821.

26 Gildenhorn v. Lums, Inc., 335 F. Supp. 329 (S.D.N.Y. 1971).

27 478 F.2d 817 (2d Cir. 1973).

Tompkins,[28] the Second Circuit affirmed the district court's determination that Florida law governed.[29] On reviewing defendants' motion to dismiss, the court assumed the veracity of the allegations in the complaint. Here, the panel was faced with the bi-partite question of whether the "stretch of *Diamond*"[30] extended to the facts before the court and whether so extended *Diamond* represented the law of Florida.[31] In finding that plaintiffs stated a cause of action,[32] the court answered both questions in the affirmative.

Interpreting plaintiffs' contention that corporate information was

---

28 304 U.S. 64 (1938).

29 The district court in deciding the conflicts question applied the choice of law rules of New York. Klaxon Co. v. Stentor Elec. Mfg. Co., 313 U.S. 487 (1941).

Derivative actions are generally governed by the law of the state of incorporation. *See* Hausman v. Buckley, 299 F.2d 696, 702-03 (2d Cir.), *cert. denied*, 369 U.S. 885 (1962) (Venezuelan law applied in derivative suit on behalf of Venezuelan corporation), and cases cited therein. Under the "grouping of contacts" test used in tort actions, New York courts will apply the law of the state having greatest contact with the cause of action. *See* Babcock v. Johnson, 12 N.Y.2d 473, 191 N.E.2d 279, 240 N.Y.S.2d 743 (1963).

In *Schein* the district court reasoned that Lums, a Florida corporation, was at least theoretically damaged in Florida. 335 F. Supp. at 332. Chasen was a Florida citizen and the other defendants were residents of various states throughout the Midwest. The only New York contact was that the transactions occurred on the New York Stock Exchange. As a result, the court reasoned, both under the grouping of contacts test and the "government interest" test of Tooker v. Lopez, 24 N.Y.2d 569, 249 N.E.2d 394, 301 N.Y.S.2d 519 (1969), Florida law would apply and New York would yield to Florida's interest in establishing and regulating the fiduciary duties of officers of Florida corporations. *Compare* Kell v. Henderson, 26 App. Div. 2d 595, 270 N.Y.S.2d 552 (3d Dep't 1968), *with* Arbuthnot v. Allbright, 35 App. Div. 2d 315, 316 N.Y.S.2d 391 (3d Dep't 1970).

The district court concluded "that under any conceivable test, a New York court would apply Florida law." 335 F. Supp. at 329. This holding was not appealed to the Second Circuit. 478 F.2d at 820-21 & n.3.

30 478 F.2d at 822.

31 *Id.* at 823. Although *Diamond* expressly held that no allegation of damages to the corporation was required, plaintiffs here alleged such damages, albeit in a general way. The court denied defendant's motion to dismiss for plaintiff's failure to allege damages with "sufficient particularity." *Id.* at 824. The court reasoned that Florida law is unclear on the question but apparently does not require more than a general ad damnum allegation. The court found Palma v. Zerbey, 189 So. 2d 510 (Fla. App. 1966) (per curiam), *cert. denied*, 200 So. 2d 814 (Fla. 1967), unpersuasive on the question of particularity of damages. *Palma* held that the plaintiffs therein had failed to sufficiently allege damages and wrongful acts on the part of the defendant. Except for *Palma*, the specific question of particularity has not been raised. The following decisions, however, make the court's conclusion with respect to specificity of damages questionable at best.

In James Talcott, Inc. v. McDowell, 148 So. 2d 36 (Fla. Dist. Ct. 1962), the court reasoned that a derivative suit required two distinct allegations: (a) an "act whereby the corporation was caused to suffer damage," 148 So. 2d at 38, and (b) wrongful refusal of the corporation to seek redress for such act. The suit was dismissed for lack of the latter. In Marovek v. Atlantic Hotel, Inc., 148 So. 2d 721 (Fla. Dist. Ct. 1963), the court, citing *McDowell*, commented on the necessity of alleging damage to the corporation and held for defendants on plaintiff's failure to prove such damage. *See also* Gadd v. Peason, 351 F. Supp. 895 (M.D. Fla. 1972), where the court distinguished private actions for personal injuries and derivative actions for corporate injuries.

The issue over specificity of damages in *Schein* may well have been avoided had the Second Circuit taken advantage of Florida's certification statute. *See* note 39 and accompanying text *infra*.

32 478 F.2d at 822.

misused as an allegation of a common enterprise and relying heavily thereon,[33] the court reasoned: "Co-venturers of the director who breaches his duty should be . . . subject to the same liabilities as those of the director himself for the misuse of corporate information."[34] It held that the very receipt of the inside information cloaked the defendants with a fiduciary duty not to utilize or reveal the information.[35] In the court's view, the policies which forbade the director from trading directly could not permit him to evade the reach of *Diamond* by passing his information to outsiders.[36]

Conceding the undesirability of insider trading,[37] one must still question the extent to which the Second Circuit has gone to combat it. As Judge Kaufman indicated in his dissenting opinion,[38] the court neglected in its interpretation of Florida law to avail itself of the Florida certification statute.[39] This statute provides an enlightened

---

[33] The court noted that the defendant did not deny the existence of a common enterprise, but merely argued that *Diamond* was inapplicable. 478 F.2d at 822. *See* notes 20-26 and accompanying text *supra*. *But see* Judge Kaufman's dissenting opinion. *Id.* at 827; note 34 *infra*. Of course, since the defendants merely moved to dismiss for plaintiffs' failure to state a cause of action (FED. R. CIV. P. 12(b)(6)) and a denial of common enterprise would raise a question of fact, no such refutation was called for.

[34] 478 F.2d at 822. The majority had no difficulty finding the existence of the common enterprise necessary to its opinion. Judge Kaufman argued in his dissent, however, that such an enterprise is not shown by the plaintiffs' pleadings. The facts "simply do not comport with the concept of a joint enterprise" but show only a "seemingly unsolicited and haphazard revelation of certain information." *Id.* at 829.

See SEC v. Lums, Inc., CCH FED. SEC. L. REP. ¶ 94,134 (S.D.N.Y. 1973) (SEC action for injunctive relief based on same events). Judge Tyler's opinion, in *Lums*, indicated a close relationship between Simon and Chasen and the existence of an "accommodation between [them] where Simon would be informed in advance of changes confronting Lums, for the stated purpose of avoiding the embarrassment of appearing to [his] clients to have failed to do his homework when such changes were made public." *Id.* at ¶ 94,558. This relationship sprang from Simon's assistance in the sale of a large debenture and the sale of Lums' stock. Chasen sought and obtained the opinion of counsel that informing Simon would be permissible. Furthermore, Chasen extracted a promise of confidentiality from Simon. Since the SEC sought only injunctive relief, a showing of negligence is sufficient. It is arguable that the more stringent requirement of scienter could not have been met as to Chasen. *See* Brodsky, *Insider Liability for Leaking Information*, N.Y.L.J., Nov. 21, 1973, at 4, cols. 7-8.

Since the Second Circuit, in *Schein*, was dealing with a motion to dismiss, the above factors were not before the court. However, when the facts are developed on remand, it is submitted that Judge Kaufman's analysis of the pleadings will be vindicated and no common enterprise will be found. *But see* notes 35, 54 *infra*.

[35] 478 F.2d at 822-23.

[36] *Id.*

[37] *See* note 1 *supra*.

[38] 478 F.2d at 828.

[39] FLA. STAT. ANN. § 25.031 (1961) 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 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

procedure which permits a federal appellate court, when faced with a question where Florida law is dispositive, to certify the question to the Florida Supreme Court.[40] By failing to resort to this procedure, the Second Circuit in *Schein* has enunciated a rule on insider trading which is of doubtful applicability in the Florida courts.[41]

Moreover, the court's decision is subject to criticism on general principles of agency and unjust enrichment. *Diamond* represented a significant extension in the law of fiduciary duties by eliminating the requirement of damage to the corporation.[42] The *Schein* panel, in

> federal appellate court may certify such questions or propositions of the laws of this state to the supreme court of this state for instruction concerning such questions or propositions of state law, which certificate the supreme court of this state by written opinion may answer.

This section has been implemented by rule 4.61 of the Florida Appellate Rules.

The authority to answer certified questions was initially granted the Florida Supreme Court in 1945 ([1945] Fla. Laws, ch. 23098, § 1 at 1291) but the statute was ignored until 1960. *See* Kaplan, *Certification of Questions from Federal Appellate Courts to the Florida Supreme Court and Its Impact on the Abstention Doctrine*, 16 U. MIAMI L. REV. 413, 425-30 (1962). In Clay v. Sun Ins. Office Ltd., 363 U.S. 207 (1960), the United States Supreme Court expressed its approval of the Florida certification procedure. The Fifth Circuit was reversed for passing on the constitutionality of a Florida state law without first determining how the highest Florida court would resolve the state law question.

The Supreme Court did not consider significant the fact that at the time, rule 4.61 had not been promulgated. *Id.* at 212. The Court reasoned that even absent the statute the doctrine of abstention required avoiding a premature constitutional question, and commented on the "rare foresight" of the Florida legislature. *Id.* For further commentary on this unique procedure see Boyd v. Bowman, 455 F.2d 927 (5th Cir. 1973), and cases cited therein. *See generally* Kaplan, *Certification of Questions from Federal Appellate Courts to the Florida Supreme Court and Its Impact on the Abstention Doctrine*, 16 U. MIAMI L. REV. 413 (1962); Note, *Florida's Interjurisdictional Certification: A Reexamination to Promote Expanded National Use*, 22 U. FLA. L. REV. 21 (1969).

The Supreme Court of the United States has granted *Schein* certiorari, 42 U.S.L.W. 3325 (U.S. Dec. 3, 1973) (Nos. 73-439, 73-440, 73-495), to review the question of the Second Circuit's neglect of the Florida certification procedure.

40 *See* note 39 *supra*.

41 Although any interpretation or extension of state law by a federal court is subject to this characterization, the criticism is particularly appropriate in this instance. By resorting to an "Erie guess," Martinez v. Rodriquez, 410 F.2d 729, 730 (5th Cir. 1969), rather than availing itself of the Florida certification statute, the court has created a major and arguably unnecessary extension of Florida law. There is no evidence that Florida courts would ever accept the basic rationale of *Diamond*, let alone extend it to the facts of the instant case. Even under the law of New York, where the stock transactions occurred, the decision is a significant extension of the duties of "fiduciaries." *Diamond* is the furthest a New York court has gone in the area of insider common law liability and the court there relied on the policies underlying rule 10b-5 and section 16(b). *See* notes 2 & 17 *supra*. In a case where the policy considerations of 16(b) are not applicable there is no guarantee that a New York court would so extend *Diamond*. *See* Loss, *supra* note 1, at 1403 who finds "no guarantee against evasion of 16(b) via trading through friends, relatives, or via mutual back-scratching."

42 The New York Court of Appeals in *Diamond* relied on RESTATEMENT (SECOND) OF AGENCY § 388, Comment c (1958), in support of its reasoning that a director has a duty to account for his profits. This reliance has been criticized on the ground that the *Restatement* represents an overly broad proposition not adopted by the courts. Note, *A Comparison of Insider Liability Under* Diamond v. Oreamuno *and Federal Securities Laws*, 11 B.C. IND. & COM. L. REV. 499, 504-05 (1970). But even if the *Restatement* is an over-generalization, it

addition to declaring this doctrine to be Florida law has, through the fiction of a common enterprise,[43] eliminated the requirement that the defendant be enriched.[44]

Perhaps, the most troublesome problem caused by the court's decision is the possibility of multiple liability, a question which the court dismissed in a footnote.[45] The standard for damages promulgated in

still requires the existence of profits in the unfaithful fiduciaries. *See* note 45 and accompanying text *infra.*

43 Interestingly, the appellate division in *Diamond* dismissed the action against those directors who did not participate in the sales. 29 App. Div. 2d 285, 287, 287 N.Y.S.2d 300, 305 (1st Dep't 1968), *aff'd,* 24 N.Y.2d 494, 248 N.E.2d 910, 301 N.Y.S.2d 78 (1969). The *Schein* majority distinguished such a situation from the instant case in that the defendants herein were "actively engaged in furthering the transaction that resulted in the 'dumping' of Lums stock rather than just 'acquiescing' in it." 478 F.2d at 822 n.6. Judge Kaufman attacked this reasoning on the ground that since the acquiescing directors in *Diamond* were fiduciaries of the corporation it is incongruous to dismiss as to them and yet "hold liable a non-fiduciary who did not cause or assist in the breach." *Id.* at 827 n.3. It is interesting to note that the Second Circuit has recently held that a non-participating director is not liable under rule 10b-5 absent a showing of scienter. Lanza v. Drexel & Co., 479 F.2d 1277 (2d Cir. 1973). *See* p. 405 for detailed treatment of *Lanza.*

44 RESTATEMENT OF RESTITUTION § 201 (1936), provides:

> Where a fiduciary in violation of his duty to the beneficiary communicates confidential information to a third person, the third person, if he had notice of the violation of duty, holds upon constructive trust for the beneficiary *any profit which he makes through the use of such information.*

(Emphasis added). See RESTATEMENT (SECOND) OF AGENCY § 312 (1958), cited by the Second Circuit in *Schein,* 478 F.2d at 823-24. Both authorities require a profit by the defendant. *See, e.g.,* Federal Sugar Ref. Co. v. U.S. Sugar Equalization Bd., 268 F. 575 (S.D.N.Y. 1920); Chandler v. Washington Toll Bridge Auth., 17 Wash. 2d 591, 137 P.2d 97 (1943); Barnes v. Eastern & W. Lumber Co., 205 Ore. 553, 287 P.2d 929 (1955) (en banc). In *Schein,* arguably, the only profit from the breach was distributed to the shareholders. *But see* RESTATEMENT OF RESTITUTION § 1(c) (1936) (broad concept of benefit). However, by using the fiction of a joint venture, the court has imposed joint and several liability on all parties — even those who, by any standard, received no benefit. This is too broad a finding of joint and several liability.

In Higgins v. Shenango Pottery, 256 F.2d 504 (3d Cir. 1958), 279 F.2d 46 (3d Cir. 1960), *cert. denied,* 364 U.S. 899 (1961), an unfaithful director formed a limited partnership which used corporate assets and information in competition with the corporation. The court held all the partners, even limited partners, jointly and severally liable, reasoning that the plaintiff had established his case by showing that the partnership had received the benefits. This result, though it does lend support to the court's approach, can readily be distinguished because of the statutory characteristics of a partnership. In *Higgins,* there was no doubt of the existence of the partnership since it was registered in accordance with Pennsylvania law. Moreover, limited partners share in profits realized by the partnership even though their risk is limited to their investment.

In *Schein,* however, the plaintiffs' entire case hinged upon the establishment of a common enterprise and its joint and several liability. It is submitted that this finding was unwarranted. *See* Minor v. Baldridge, 123 Cal. 187, 55 P. 783 (1898), where the court concluded that a joint tort-feasor must receive some benefit before a plaintiff can recover in unjust enrichment. *See also* Patterson v. Prior, 18 Ind. 440, 81 Am. Dec. 367 (1862).

45 478 F.2d at 825 n.10.

An additional difficulty posed by the result is the range of liability imposed. Although the actual standard of 10b-5 liability is itself somewhat elusive, *see, e.g.,* Manne, *Rule 10b-5: Evolution of a Continuum of Conduct to Replace the Catch Phrases of Negligence and Scienter,* 45 N.Y.U.L. REV. 1206-07 (1970), it seems clear that the requirement of proving a common enterprise imposes a greater burden on the *Schein* plaintiff than he would have

Schein, viewed alone, is a definite improvement over the potentially open-ended liability under a 10b-5 class action.[46] However, the *Schein* standard is not the sole measure; an insider is now subject to potential treble liability, *viz.*, to individuals under *Birnbaum*, in an SEC proceeding for disgorgement of profits,[47] and now under *Schein*. These liabilities may not be mutually exclusive.[48]

The court attempted to minimize the danger of multiple liability, noting that the defendants, knowing of the various actions against them, were capable of protecting themselves. The court, without elaborating further referred to "the method employed in Securities and Exchange Commission v. Texas Gulf Sulphur Co., 312 F. Supp. 77, 93 (S.D.N.Y. 1970) [*TGS*]. . . ."[49] Just what affirmative action the court had in mind is somewhat of a mystery. In *TGS*,[50] an action for disgorgement of profits,[51] the court required profits garnered through the use of inside information to be paid over to the corporation and held in

---

under 10b-5. Whether mere negligence or scienter is required for 10b-5 liability, *see* Lanza v. Drexel & Co., 479 F.2d 1277, 1299-1309 (2d Cir. 1973), either element will often be easier to prove than the joint or common enterprise required by *Schein*.

Once the latter requirement is met, however, it seems evident that *Schein* spreads a larger net than 10b-5. In SEC v. Lums Inc., CCH SEC. L. REP. ¶ 94,134 (S.D.N.Y. 1973), the district court dismissed a 10b-5 action against Lehman Brothers, one of the *Schein* defendants, on the ground that since they were not aware of the actions of Simon, they were not "a controlling person" within the context of section 20(a) of the 1934 Act. In reaching this conclusion, the court reasoned that section 20(a) was the exclusive standard and rejected any argument that liability could be alternatively predicated on the theory of *respondeat superior*. *But see Multiple Defendants*, *supra* note 6, at 601-08. The court concluded that the section 20(a) "good faith" defense was available to Lehman Brothers, and that its failure to supervise Simon raised a close question but did not vitiate the defense. The court refused to impose "hindsight liability" for Lehman Brothers' failure to prevent the potential conflicts by overseeing Simon's relationship with Chasen. *Id.* at ¶¶ 94,565-568. There is, however, a possibility that Lehman Brothers will be held liable in *Schein* for conduct not within the purview of 10b-5. Thus, once a common enterprise can be shown, a common law action like *Schein* offers the advantage of a potentially greater number of defendants to pay damages.

46 *See* Brodsky, *Inside Information-Triple Headed Liability*, N.Y.L.J., July 18, 1973, at 4, col. 2 [hereinafter cited as *Inside Information*].

47 *See* note 13 *supra*.

48 *Inside Information*, *supra* note 46, at 1, col. 1. Of course, it is always possible to incur a potential fourth liability under section 16(b), *see* note 2 *supra*. *But see* Note, *The Prospects for Rule X-10b-5: An Emerging Remedy for Defrauded Investors*, 59 YALE L.J. 1120, 1140-42 (1950), where the author argues that in comparing 10b-5 and 16(b) liability there is no double liability but two distinct liabilities incurred by a single violation. "There is little reason for allowing [the insider] to escape one liability merely because he has managed to incur another." *Id.* at 1141. Otherwise 16(b) liability would be limited to innocent transactions. The author rejects any argument that "profits" under 16(b) are limited to net profits after deduction of losses in a law suit. *Contra*, Note, *A Comparison of Insider Liability under* Diamond v. Oreamuno *and Federal Securities Laws*, 11 B.C. IND. & COM. L. REV. 499, 508-13 (1970).

49 478 F.2d at 825 n.10.

50 446 F.2d 1301 (2d Cir. 1971).

51 *Inside Information*, *supra* note 46, at 4, col. 2.

escrow pending court ordered distribution. Private judgments were to be satisfied out of this fund with the residue to inure to the corporation.

While application of the *TGS* procedure to *Schein* might possibly resolve the problems inherent in a *Schein* recovery, it would be inconsistent with the purpose of a derivative action. A corporate trust approach imposes a burden on the corporation which logically can be justified in a disgorgement proceeding. There the SEC sues to prevent illicit gains and the overriding purpose is to benefit innocent traders. Moreover, in *TGS* the corporation itself was a defendant. This logic breaks down in a derivative suit, however, where the corporation, supposedly the plaintiff, receives no benefit from the recovery and is only burdened with the administration of the fund.[52] Perhaps the Second Circuit recognized that the corporation was not the proper plaintiff in *Schein*, and was therefore paving the way for shifting the recovery from the nominal plaintiff to the party actually injured.[53] If so, this approach would be equitable and fair to both plaintiff and defendant since it guarantees recovery to the injured party while attempting to avoid multiple liability. Moreover, the damage, if any, was predicated on the loss of "prestige and good will of the corporation by the public revelation that the director has been involved in unethical conduct."[54] Since payment from a fund, administered by the corporation, to the actually damaged parties would help to restore its damaged corporate image, it follows that this procedure might make the corporation whole.

The ultimate effect of *Schein* on the law of insider trading is somewhat unclear. The requirement of an express common enterprise would reduce any deterrent effect to a very limited class of cases. Since this is likely to be the situation involving the greatest culpability, the decision provides a useful, albeit narrow, deterrent. However, a broader reading of the decision is possible. Both the language used by the Second Circuit,[55] and the ease with which the court found a common

---

52 *See* note 13 *supra*.

53 This could very well be a disincentive to the bringing of a *Schein* suit. The basic theory behind a derivative suit is that the shareholder is sufficiently interested in the corporation to litigate for its benefit. Therefore, when the corporation recovers, the shareholder will gain indirectly. This is questionable when the corporation, as in *Schein*, will not recover, but will only be burdened by administering the funds of others.

54 478 F.2d at 822-23.

55 The court noted that the mere receipt of the inside information "automatically clothes [the outsiders] with a duty to Lum's not to use the information for their own selfish advantage." 478 F.2d at 823. Moreover, the court reasoned that in

> light of the corporate interest which the *Diamond* rule is designed to protect, it is immaterial to the preservation of that interest whether the director trades on his own account in the corporation's stock or whether he passes on the information to the outsiders who then trade in the corporation's stock. In either event so long

enterprise[56] may actually suggest the extension of *Diamond-Schein* liability to all 10b-5 tippees under a presumption of common enterprise, or perhaps, without any need to prove common enterprise at all. Although this would provide a much broader deterrent, it is submitted that such an interpretation would be improper. Even with the requirement of a common enterprise, *Schein* represents a far reaching extension of the law. Any further extensions would be unwarranted. By limiting liability to the exceptional cases of true common enterprise, the ramifications of *Schein* will be contained. Any broader prophylactic efforts against insider trading seem best left to the evolution of federal securities laws specifically enacted for that purpose.

> as the director is involved the prestige and good will of the corporation may be tarnished by the public revelation that the director has been involved in unethical conduct.

Id. at 822-23.

[56] *See* notes 34-35 *supra*.