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## “Tippee” Liability Extended to Remote Third Parties: *Schein v. Chasen*, 478 F.2d 817 (2d Cir. 1973)

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## 'Tippee' Liability Extended To Remote Third Parties

*Schein v. Chasen*, 478 F.2d 817 (2d Cir. 1973).

*Schein v. Chasen*,<sup>1</sup> utilizing common law principles, held that one who is given a "tip" by a corporate insider also acquires the insider's fiduciary duties to the corporation. As a result, the "tippee" must refrain from trading in the corporation's securities until the information is publicly disclosed. The purpose of the rule is to prevent the unfair use of information which is not available to the general public.<sup>2</sup> The legal issues raised by *Schein* with respect to the obligations of persons other than corporate insiders<sup>3</sup> who acquire non-public corporate information have important implications for the securities industry and the investing public.

Stockholders in Lum's, Inc., a Florida corporation engaged in restaurant franchising, brought a derivative common law action<sup>4</sup> against the corporate president, Melvin Chasen, and his alleged "tippees."<sup>5</sup> The suit sought damages<sup>6</sup> alleged to have been caused

1. 478 F.2d 817 (2d Cir. 1973).

2. "Tipping" is considered violative of the basic policy that requires uniform disclosure of corporate information to the investing public. See Wiesen, *Disclosure of Inside Information—Materiality and Texas Gulf Sulphur*, 28 Md. L. Rev. 189 (1968). It has been pointed out, however, that "tipping" and insider trading may be necessary evils of the securities industry. See H. MANNE, *INSIDER TRADING AND THE STOCK MARKET* ch. 5 (1966).

3. The term "insider" denotes one who has a direct fiduciary duty to a corporation by virtue of his position as an officer, director or majority stockholder. See *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 848 (2d Cir. 1968).

4. The action was limited to common law because there were no short-swing profits to bring the action under the purview of the Securities Exchange Act of 1934, § 16b, 15 U.S.C. § 78p(b) (1964), nor could the corporation commence an action under Rule 10b-5 of the Act, 17 C.F.R. 240.10b-5 (1973), because Lum's had not traded the securities on its own account. See Comment, *Distinguishing Between Direct and Derivative Shareholder Suits*, 110 U. PA. L. REV. 1147 (1962).

5. The individual defendants were Chasen, Benjamin Simon, Lehman Brothers, Eugene Sit, James Jundt, Investors Variable Payment Fund and IDS New Dimensions Fund. Chasen, Sit and Jundt were granted motions to dismiss in the trial court because they had not been prop-

by the defendants' use of inside information in selling their Lum's holdings and demanded that any profits realized from such exploitation be disgorged and paid back to Lum's.

Chasen learned that Lum's earnings prospects for fiscal year 1970 were not as optimistic as the public had been led to believe.<sup>7</sup> Prior to public disclosure of the updated information, Chasen allegedly "tipped" the revised figures to a stockbroker employed by Lehman Brothers. He, in turn, relayed the information to a portfolio manager of a mutual fund who immediately telephoned another portfolio manager. At their direction, the funds sold all of their Lum's holdings at a price in excess of what they would have realized had they sold after the information was made public.<sup>8</sup>

The trial court dismissed the proceeding for failure to state a cause of action under Florida law.<sup>9</sup> On appeal, the stockholders

erly served under the New York Long Arm Statute. N.Y. CIV. PRAC. §§ 302(a), 313 (McKinney 1972). Simon filed a motion to dismiss on the same grounds but it was not acted upon. 478 F.2d at 819.

6. Although it is not clear what the precise nature of damages claimed to have been caused Lum's was, it would appear that under the rule of *Diamond v. Oreamuno*, 24 N.Y.2d 494, 248 N.E.2d 910, 301 N.Y.S.2d 78 (1969), no actual damage would have to be proved; the mere involvement of a corporate officer creates a presumption that the good will of the corporation is tarnished. 478 F.2d at 822-23. The question of damages presented in "tippee" situations like the fact pattern in *Schein* is extremely complex owing to the anonymity of stock market transactions. See Comment, *Insider's Liability Under Rule 10b-5 for the Illegal Purchase of Actively Traded Securities*, 78 YALE L.J. 864 (1969). Note that while *Schein* was intent upon establishing a disincentive to insider trading, a requirement which demands disgorging of profits over and above the sale price of the stock after confidential information is made public, augers against a disincentive. The "tippee" has nothing to lose by trading on his "tip"; the least he will be able to realize is the fair market value of the stock. See note 8 and accompanying text *infra*.
7. Chasen had originally quoted earnings prospects of approximately \$1 to \$1.10 per share when he addressed a seminar of securities industry members in November of 1969. The adjusted figures that he "tipped" to Simon were approximately 76¢ per share. 478 F.2d at 820.
8. After the adjusted figures were made public, the price per share dipped from \$17.50 to \$14. The funds altogether sold a total of 83,000 shares realizing \$274,500 more than they would have had they waited until after public disclosure of the figures. 478 F.2d at 820-21.
9. The trial court arrived at the conclusion that the plaintiffs had failed to state a cause of action under Florida law and, since it was the applicable law, dismissed the action. *Gildenhorn v. Lum's Inc.*, 335 F. Supp. 329 (S.D.N.Y. 1971). The court of appeals found that since the question of liability was one of first impression in Florida, it was proper to consider the law of other jurisdictions in order to decide the question. As pointed out in the dissent, it is puzzling that the court did not use Florida's certified question statute, FLA. STAT. ANN.

argued that relief should be granted on the basis of *Diamond v. Oreamuno*,<sup>10</sup> a New York decision, which held that corporate directors and officers who acquire inside information by virtue of their positions, may not use that information to their own advantage by trading without full disclosure. *Diamond* sought to discourage insider trading by fashioning a remedy from existing agency principles.<sup>11</sup> The court reasoned that when a corporate official, who is entrusted with certain information, uses it to his own advantage, he holds any realized profits in constructive trust for the corporation.<sup>12</sup>

Although the *Diamond* rule has been challenged as being a questionable expansion of common law agency principles,<sup>13</sup> the United States Court of Appeals for the Second Circuit had little trouble extending its reach to remote third parties. *Schein* held that the duty owed by a corporate officer extends to those who acquire confidential information through him. The court reasoned that the "tippees" were clothed with fiduciary duties to Lum's the same as if they were Lum's officials,<sup>14</sup> even though the information was received through intermediaries.

As primary authority for its position, the court made use of the American Law Institute's Restatement (Second) of Agency Section 312<sup>15</sup> which provides that one who causes or assists an agent to violate his fiduciary duties also becomes a fiduciary. Special note was made of the section's comment c<sup>16</sup> which, in effect,

§ 25.031 (1961). This would have enabled the court to avoid speculation as to what the Florida Supreme Court would have done. 478 F.2d at 828.

10. 24 N.Y.2d 494, 248 N.E.2d 910, 301 N.Y.S.2d 78 (1969).

11. *Diamond* made use of the RESTATEMENT (SECOND) OF AGENCY § 388 (1958). This section, in effect, prohibits the abuse of employer-employee relationships and the commentary expressly mentions corporate officers. 24 N.Y.2d at 499, 248 N.E.2d at 912, 301 N.Y.S.2d at 81.

12. Additionally, *Diamond* saw the misuse of inside information as a conversion of corporate assets. See Note, *Securities—Inside Information as a Corporate Asset*, 1970 WIS. L. REV. 576.

13. See Comment, *A Comparison of Insider Liability Under Diamond v. Oreamuno and Federal Securities Law*, 11 B.C. IND. & COM. L. REV. 499 (1970).

14. 478 F.2d at 823.

15. RESTATEMENT (SECOND) OF AGENCY § 312 (1958) provides: "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."

16. Comment c to § 312 states 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 re-

states that one who receives information and knows that it is given to him in violation of the informant's fiduciary duties may be required to hold any profits gained from the use of such information in a constructive trust. A cursory reading of the section and its comment indicates that it may be compatible with the principle espoused in *Schein*, but the section's characterization of the sanctioned conduct should be closely scrutinized. The section places liability only upon one who "causes or assists an agent to violate a duty to his principal. . . ." <sup>17</sup> Comment c, however, envisions liability in a situation where the only requirement is that the individual have "notice that an agent is . . . violating his duty to his principal. . . ." <sup>18</sup> The Restatement's requirement that liability is imposed only on those who "cause or assist" an agent to violate a duty to his principal may have prompted the court's following statement:

Although there is no allegation in the complaints that a prior explicit agreement existed between Chasen and the defendants, it is obvious that the sequence of events detailed in the pleadings, if proved, will substantiate the existence of a common enterprise . . . . <sup>19</sup>

Judge Kaufman, in a dissenting opinion, pointed out that there was no basis for determining that the facts, as alleged, demonstrated a common enterprise on the part of the defendants. <sup>20</sup> Although he agreed that a disincentive to insider trading was needed, he argued that the method used by the majority was based upon a misapplication of the *Diamond* rule and a misunderstanding of section 312. His interpretation of the *Diamond* rule would limit its application to corporate officers and directors who actually trade in their own securities. <sup>21</sup>

Viewed solely as a common law decision, *Schein* unquestionably expands the *Diamond* rule by establishing remote "tippee" li-

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quired to hold profits received by its use as a constructive trustee.

17. See note 15 *supra*.

18. See note 16 *supra*.

19. 478 F.2d at 822.

20. "[T]he facts simply do not comport with the concept of a joint enterprise, a term which implies the existence of a prior plan to carry out a mutually beneficial project." *Id.* at 827.

21. Judge Kaufman found significance in the fact that the complaint in *Diamond* was dismissed against certain directors who merely "acquiesced" in the insider trading. According to Kaufman, not only is the *Diamond* rule limited to corporate directors and officers, it applies only to those officials who have actually traded and recognized a personal benefit. *Id.* at 827.

ability, something heretofore not recognized by common law decisions.<sup>22</sup>

At common law, courts have been constrained to attach liability to a "tippee" and have done so only where the "tippee" could also have been classified as an insider.<sup>23</sup> Apparently, there is a requirement that the "tippee" occupy a position of trust or share in a confidential relationship created apart from the mere giving and receiving of information. He is then considered to have breached a position of trust when he receives confidential information. Such a separate position of trust is illustrated by the situation where the "tippee" is also an employee in the insider's corporation or has vested interests to be served by the misuse of inside information.<sup>24</sup> Merely receiving and using confidential information as a "tippee" did not create liability.

Although some form of "tippee" liability might be implicit in certain common law principles, particularly the Restatement of Restitution,<sup>25</sup> it is apparent that some nexus must exist between the insider and his "tippee" before the latter can be assumed to have taken on any fiduciary responsibility. This nexus is generally considered in terms of a "sufficient link" between the insider and his "tippee" which can be established by showing that a "knowing confederation" existed between the two individuals.<sup>26</sup> Establishing

22. Outside of *Schein*, no common law decision has found remote "tippees" to be liable. See Rapp & Loeb, *Tippee Liability and Rule 10b-5*, 1971 U. ILL. L.F. 55.

23. See, e.g., cases cited by *Schein* as authority for the principle that one can acquire another's fiduciary duties, *Ohio Oil Co. v. Sharp*, 135 F.2d 303 (10th Cir. 1943); *Brophy v. Cities Service Co.*, 31 Del. Ch. 241, 70 A.2d 5 (1949); *Quinn v. Phipps*, 93 Fla. 805, 113 So. 419 (1927). In *Quinn* the court distinguished between "technical" and "normal" fiduciaries. In *Sharp* "tippees" were also employees of the injured corporation as was the defendant in *Brophy*. In each decision it is clear that the position of trust and not the mere use of information was determinative of the fiduciary responsibility.

24. See *Ross v. Licht*, 263 F. Supp. 395 (S.D.N.Y. 1967); *Brophy v. Cities Service Co.*, 31 Del. Ch. 241, 70 A.2d 5 (1949). See also note 23 *supra* and decisions cited therein.

25. RESTATEMENT OF RESTITUTION § 201(2) (1937) 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 a constructive trust for the beneficiary any profit which he makes through the use of such information.

The section was cited in *In re Cady, Roberts & Co.*, 40 S.E.C. 907, 912 n.17 (1961), a decision where the fiduciary duties of insiders were carefully studied. See note 30 and accompanying text *infra*; Rapp & Loeb, *Tippee Liability and Rule 10b-5*, 1971 U. ILL. L.F. 55.

26. See 6 L. LOSS, SECURITIES REGULATION 3556-68 (2d ed. 1961, Supp.

the nexus of "knowing confederation" between an insider and one who is the *indirect* recipient of his information is difficult. One must necessarily ask: What is the relationship between the insider and the remote "tippee"?

The Restatement language relied upon in *Schein* conceivably subsumes a "knowing confederation" requirement by its use of the terminology "cause or assist." Arguably, the court interpreted this language to require a joint and common enterprise before liability can be established. The term "joint and common enterprise" has an established legal meaning and has been defined as

something like a partnership, for a more limited period of time, and a more limited purpose. It is an undertaking to carry out a small number of acts or objectives, which is entered into by associates under such circumstances that all have an equal voice in directing the conduct of the enterprise. The law then considers that each is the agent or servant of the others, and that the act of any one within the scope of the enterprise is to be charged vicariously against the rest.<sup>27</sup>

Yet, the court's use of comment c seems to indicate that notice of the breach of trust may be the only requirement in establishing "tippee" liability. One is left in the uncomfortable position of determining what the exact prerequisites are to remote "tippee" liability. There are several alternative interpretations of the court's decision, each with its own separate result.

First, it can be assumed that the decision requires the existence of a joint and common enterprise as a condition precedent to "tippee" liability. Viewed in that light, *Schein* is of little consequence because it is apparent that older decisions would have attached liability where there was active solicitation on the part of the "tippee." The defendant in this type of situation is actually a primary participant in the wrongdoing, rather than an aider or abettor of the misconduct.<sup>28</sup>

On the other hand, the court's decision might be interpreted as requiring only notice as a condition precedent to liability. Such an interpretation would place heavy emphasis on the court's use of comment c and that comment's use of the phrase: "with notice that an agent is thereby violating his duty to his principal." A notice requirement would clearly require less than would a

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1969), [hereinafter cited as Loss]; *Jackson v. Smith*, 254 U.S. 586 (1921); *Irving Trust Co. v. Deutsch*, 73 F.2d 121 (2d Cir. 1934).

27. W. PROSSER, *HANDBOOK OF THE LAW OF TORTS* § 72 (4th ed. 1971).

28. See Ruder, *Multiple Defendants in Securities Law Fraud Cases: Aiding and Abetting, Conspiracy, In Pari Delicto, Indemnification and Contribution*, 120 U. PA. L. REV. 597 (1972).

showing of joint or common enterprise, but it is unclear what kind of notice is contemplated. Should the notice be actual or constructive?

Although *Schein* did not deal with the question of whether actual notice is required, the omission of such an inquiry may be discounted to some extent by the fact that all of the defendants were accomplished technicians in the securities industry. Consequently, it may be implicit in the court's holding that constructive knowledge will suffice. Perhaps, the court felt that the expert "tippee" has a duty of inquiry—a higher standard to measure up to in his daily business activity.<sup>29</sup>

Assuming, *arguendo*, that constructive notice is sufficient to establish liability, one is left to ask whether it makes a difference if the "tippee" comes by his information directly from the insider or indirectly, *i.e.*, is the "tippee" a remote or direct recipient? Perhaps the remoteness of the individual "tippee" should be considered. As information is passed from hand to hand, the materiality of it becomes diluted and it is less likely to spark inquiry as to its origin.<sup>30</sup> It is arguable that one who receives information third or even fourth-hand has no duty to inquire as to the origin or confidentiality of the information. He is certainly less likely to suspect that the information is given to him in breach of a fiduciary duty.

Construed as requiring a joint and common enterprise on the part of an insider and his "tippees" as a prerequisite to "tippee" liability, *Schein* is fairly unremarkable. On the other hand, should the decision be interpreted as merely requiring notice of the breach of fiduciary duty, *Schein* may be the beginning of nearly

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29. At least one writer has voiced the opinion that an expert "tippee" has a duty to investigate information that is given to him. See Gluckman, "*Tippee*" Liability Under Section 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934, 20 KAN. L. REV. 47 (1971). The fact that Chasen's "tippees" were experts in their field may be indicative of this type of philosophy.

30. Such a view is not unique to the writers in the area. See 6 LOSS at 3563; 2 A. BROMBERG, SECURITIES LAW: FRAUD—SEC RULE 10b-5 § 7.5 (1967), as supplemented, [hereinafter cited as BROMBERG]. "Since the information tends to be generalized and distorted as it passes from hand to hand, remoter tippees probably will have less responsibility under this criterion [specificity of information] than the original tippees." *Id.* at § 7.5. Professor Bromberg deals with the dilution of information as part of his test to determine degrees of "tippee" culpability. His test looks to the specificity of the information, its probable accuracy, the "tippee's" knowledge of the information's source and whether the information's materiality has been affected by subsequent stages of "tipping."

unlimited "tippee" liability. Should constructive notice suffice as the propagating factor in establishing liability, there seems to be little that would mitigate in favor of even the most remote "tippee." Of course, it is possible that *Schein* may be limited to its facts. It is of no small consequence that the individual "tippees" were experts in their field, but it is impossible to determine the relevance of this fact since the court failed to discuss its implications.

The impact of *Schein* is not limited to common law actions. At least for future second circuit decisions, *Schein* gives some indication of the court's view of existing securities law. There is little doubt that had the action come within the ambit of Rule 10b-5,<sup>31</sup> the court would have had little problem finding liability.<sup>32</sup> In fact, the court drew an analogy between the kind of liability imposed upon the defendants and that imposed on defendants in 10b-5 actions.<sup>33</sup>

31. 17 C.F.R. 240.10b-5 (1973). Rule 10b-5 is the hub of antifraud actions. It reads:

It shall be unlawful for any person, directly or indirectly, by use of any means or instrumentality of interstate commerce, or of the mails or of any facility of a national exchange,

- (a) To employ any device, scheme, or artifice to defraud,
- (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
- (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security.

32. The court analogized the liability of remote "tippees" to a number of 10b-5 decisions:

In passing we note decisions dealing with violations of the federal securities laws which involve the imposition of liability on defendants who have occupied statuses similar to statuses occupied by defendants in this case . . . . Furthermore, "tippee liability," which is analogous to the liability being imposed upon Diversified and Investors, has been established in federal cases involving violations of the securities laws.

478 F.2d at 824 n.8. The court made reference to: *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968); *List v. Fashion Park, Inc.*, 340 F.2d 457 (2d Cir. 1965); *Wohl v. Blair & Co.*, 50 F.R.D. 89 (S.D.N.Y. 1970); *Speed v. Transamerica Corp.*, 99 F. Supp. 808 (D. Del. 1951).

33. Special note was made of *In re Cady, Roberts & Co.*, 40 S.E.C. 907 (1961), and *Ross v. Licht*, 263 F. Supp. 395 (S.D.N.Y. 1967). In *Cady*, the probable beginning of "tippee" liability under Rule 10b-5, a proceeding by the SEC against the brokerage firm of Cady, Roberts & Co. applied an "access test" to persons who were in a position to receive and exploit inside information. A partner in the brokerage received a "tip" from a co-employee who also happened to be a di-

Once again, however, *Schein's* use as a barometer in determining the court's attitude toward 10b-5 litigants depends upon the joint and common enterprise/notice distinction. Should mere constructive notice be sufficient to establish remote "tippee" liability, there may indeed be marked changes in store for existing 10b-5 liability.

Unhappily, much of *Schein's* import rests with the court's off-hand reference to a joint and common enterprise and the decision's precedential value may very well turn on the interpretation given to the court's use of the Restatement (Second) of Agency Section 312 and its attendant comment c.

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rector of the Curtiss-Wright Corporation. The "tip" stated that Curtiss-Wright soon would announce a reduction in its quarterly dividend. Before the announcement could be made public, the partner sold portions of his wife's and other stockholders' Curtiss-Wright holdings. The SEC emphasized the existence of a relationship which gave the partner access to confidential information. Noting that the wording of Rule 10b-5 is phrased in terms of "any person," the Commission determined that the position of an insider was not necessarily limited to actual corporate structure.

These three groups [officers, directors and controlling stockholders], however, do not exhaust the classes of persons upon whom there is such an obligation. Analytically, the obligation rests on two principal elements; first, the existence of a relationship giving access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone, and second, the inherent unfairness involved where a party takes advantage of such information knowing it is unavailable to those with whom he is dealing.

40 S.E.C. at 912.

Ross expanded the *Cady* view by determining that certain defendants could be classified as insiders because of their access to inside information or "tippees" because of their knowledge that a fiduciary duty was breached. The interesting thing about Ross is the dual role it gave to the defendants. *Accord*, *Kuehnert v. Texstar Corp.*, 412 F.2d 700 (5th Cir. 1969).

34. Of course, remote "tippee" liability is already existent in the 10b-5 area by virtue of Investors Management Co., Inc., [1970-1971 Transfer Binder] CCH FED. SEC. L. REP. ¶ 78,163 (SEC 1971). There the SEC recognized that remote "tippees" were within the scope of Rule 10b-5 and set forth certain required elements dispositive of liability:

We consider those elements to be that the information in question be material and non-public; that the tippee, whether he receives the information directly or indirectly, know or have reason to know that it was non-public and had been obtained improperly or by selective revelation or otherwise, and that the information be a factor in his decision to effect the transaction.

*Id.* at 80,519. *Schein* indicates that through some interpretations of its application of the Restatement of Agency, remote "tippee" liability can be virtually unlimited.

In any event, future unhappy purchasers in the securities market will have new common law ammunition without the complexity of 10b-5 and the limitations of prior common law decisions. The flexibility of interpretation will ensure a place of importance for *Schein*.

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