WILMER, CUTLER & PICKERING

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CONFIDENTIALITY AGREEMENTS AS A BASIS FOR INSIDER TRADING LIABILITY

In *United States v. Kim*,[1] the U.S. District Court for the Northern District of California examined the question of whether it was a criminal violation of Rule 10b-5 for a member of a young executives' club to buy stock based on another member's confidential disclosure that his company was in merger discussions. The court held that the members of the club were not in a "fiduciary-like" relationship and, despite their written confidentiality pledge, had no legal duty to refrain from trading on the basis of information that club members confidentially shared.

Factual Background

Mr. Kim was a member of the Young President's Organization ("YPO"), a national group of CEO's under 50 years old, whose members periodically met to discuss confidential matters with their peers. The YPO's "Forum Principles" stated that "[w]e operate in an atmosphere of absolute confidentiality. Nothing discussed in forum will be discussed with outsiders." As a condition of membership, members were also required to comply with a written "Confidentiality Commitment" that provides:

> I understand that . . . all information shared by the membership must be held in absolute confidence . . . . I understand that no Forum business can be discussed with anyone outside the Forum, including spouses, "significant others," other YPO or non-YPO members . . . . I understand that breaking this contract will result in my being asked to resign from the Forum. Most importantly, I understand that I have a major moral and ethical responsibility to my Forum friends who have entrusted me with their most personal feelings, problems and issues. To break this trust is to destroy all that Forum can mean to its members.

On March 1, 1999, the CEO of Meridian Data Inc., a YPO member, advised the forum moderator that he would be unable to attend the YPO's annual retreat because he was involved in merger discussions with another company, Quantum Corporation. He authorized the forum moderator to tell the others why he would be absent, but asked the moderator to emphasize the confidential nature of the information. The moderator relayed this information to the YPO members, including Kim.

Based on this confidential information, between March 1 and March 4, 1999, Mr. Kim purchased 187,300 Meridian shares for between $2 and $4.12 per share. On May 11, 1999, when Meridian announced its acquisition by Quantum, Meridian's stock price jumped to $7.56 per share. Mr. Kim realized a profit of $832,627 on an investment of $127,975.

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[1] 2002 WL 75846 (N.D. Cal. January 15, 2002).

Following an SEC investigation, Kim was arrested by the FBI and charged with, among other things, insider trading on the theory that he had traded on illegally misappropriated information. He was also charged civilly by the SEC, but the agency dropped its suit when the court declined to stay discovery pending resolution of the criminal charges. Mr. Kim moved to dismiss the criminal securities fraud charges, among others, against him.

The Court's Analysis

Under the "misappropriation theory" of insider trading, upheld in *United States v. O'Hagan*,[2] a person may be found criminally liable for trading on material, non-public information that the trader misappropriated from another person in breach of a traditional fiduciary duty of confidentiality owed to that other person.[3] In *O'Hagan*, the Supreme Court emphasized that the theory is limited to those who breach a *recognized* duty. Since the relationship presented in *O'Hagan* was a classic fiduciary relationship — that between a lawyer and his firm and client, the Supreme Court concluded it was appropriate to impose criminal liability.[4]

Because Mr. Kim's relationship with the other YPO members was not a classic fiduciary relationship, the *Kim* court turned its attention to *United States v. Chestman*,[5] which both parties agreed was the key case for examining the types of relationships that might support misappropriation liability.[6] *Chestman* involved the duty a husband owes to his wife and her family. Upon examining the specific relationship presented, the court concluded that it did not share the essential characteristics of a fiduciary relation and thus, did not give rise to misappropriation liability.

The *Chestman* court explained that a person may be found criminally liable when he misappropriates material nonpublic information in breach of a fiduciary *or similar relationship of trust and confidence* and uses that information in a securities transaction. Relying on the analysis in *Chestman*, the *Kim* court held that "a similar relationship of trust and confidence" must be characterized by superiority, dominance or control. The court then applied this standard to determine whether Mr. Kim's relationship with his fellow YPO members was sufficiently similar to a fiduciary relationship to support criminal liability.

The court explained that fiduciary dominance generally arises out of some combination of (1) disparate knowledge and expertise, (2) a persuasive need to share confidential information and (3) a legal duty to render competent aid. Applying these criteria to Mr. Kim's relationship, the court found that (1) the YPO members had similar levels of achievement, experience and expertise, (2) the Meridian CEO's communication regarding his merger discussions "was completely gratuitous" (no persuasive need to mention it when explaining his absence) and (3) the YPO members owed no legal duty to each other, nor did one arise out of their written "Confidentiality Commitment," which, at most, memorialized a moral and ethical duty. As a result, the court concluded that Mr. Kim's relationship with the club members was not the functional equivalent of a fiduciary relationship and thus, did not create a legal duty of confidentiality.[7] Accordingly, the court dismissed the securities fraud charges against him.

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[2] 521 U.S. 642 (1997).

[3] Misappropriation liability is different than the liability of a "tippee" of inside information. One who trades on a tip from a corporate insider, which is passed along for the purpose of trading, is liable because the "tippee" is deemed to inherit the fiduciary duty owed by the tipper to the issuer's shareholders. *Dirks v. SEC*, 463 U.S. 646, 660 (1983). In contrast, the misappropriation theory applies to corporate outsiders who obtain information from an insider whose disclosure was accidental, or otherwise not motivated by an intent that the information be used to trade. *U.S. v. O'Hagan*, 521 U.S. at 652-3.

[4] Other recognized fiduciary relationships are the employer-employee and psychiatrist-patient relationship. *See, e.g.*, *U.S. v. Falcone*, 257 F.3d 226 (2nd Cir. 2001) (employer-employee); *U.S. v. Willis*, 737 F.Supp. 269 (S.D.N.Y. 1990) (psychiatrist-patient).

[5] 947 F.2d 551 (2nd Cir. 1991).

[6] The court paid scant attention to *U.S. v. Reed*, 601 F.Supp. 685 (S.D.N.Y.), *rev'd on other grounds* 773 F.2d 477 (2d Cir. 1985), which addressed the identical issue. In *Reed*, the court held that a jury question existed as to whether a father-son relationship was sufficiently "fiduciary-like" to support criminal misappropriation liability. The *Chestman* court, while not overruling *Reed*, sharply limited its holding by clarifying that *Reed*'s "elastic and expedient definition of confidential relations" was inappropriate in a criminal proceeding, where a defendant must be given fair notice that he has engaged in illegal activity. *Chestman*, 947 F.2d at 570. The *Kim* court agreed. 2002 WL 75846 at *6.

[7] The court did not decide whether, or to what degree, each of these three characteristics must be present, because it concluded that Mr. Kim's relationship did not bear any of them.

The New SEC Regulations Governing Misappropriation Liability

Kim conceded that under current Rule 10b5-2 (which now governs misappropriation liability), his conduct could have been illegal. However, Kim's trading took place prior to the effective date of Rule 10b5-2 on August 24, 2000. After reviewing the legislative history of Rule 10b5-2,[8] the *Kim* court concluded that Rule 10b5-2 was intended to create new law, not clarify existing law. The SEC's perceived need to adopt this new rule bolstered the court's conclusion that existing law did not legally prohibit Mr. Kim's trades.

Under Rule 10b5-2, a person receiving confidential information owes a duty of trust or confidence, and thus could be liable under the misappropriation theory, if:

(1) the person agreed to keep information confidential;

(2) the parties had a history, pattern, or practice of sharing confidences such that the recipient knows or reasonably should know that the information was provided in confidence; or

(3) the person received or obtained material nonpublic information from his or her spouse, parent, child, or sibling (unless there was no reasonable expectation of confidentiality).[9]

The *Kim* court explained that scenarios (1) and (2) above might apply to Mr. Kim's conduct. With respect to clause (1), however, the court expressed doubt that every confidentiality agreement would provide a basis for misappropriation liability. The court noted that the SEC Release did not detail what type of agreement would suffice. Nevertheless, the court opined that any such agreement must set forth "a relationship with the hallmarks of a fiduciary relationship" (superiority, dominance or control).

The court seemed to intimate that the Confidentiality Commitment among Kim and his fellow CEO club members would not have satisfied this test. The court remarked that the Confidentiality Commitment appealed only to the members' ethics and morality and thus was not a legally enforceable contract giving rise to legal duties on the parts of the members.[10]

Future Governmental Enforcement Actions

The *Kim* court questioned whether subsection (1) of Rule 10b5-2 could properly be relied on to support a criminal charge of insider trading. The court suggested that "an express confidentiality agreement" could support criminal liability on a misappropriation theory only if embedded in a relationship with recognized or traditional "fiduciary" elements. The court's reasoning may even call into question the Rule's viability in a civil enforcement case. Allowing the use of novel or elastic duties as a basis for imposing liability might violate a defendant's due process right to fair notice that he has engaged in illegal activity.[11]

The court's analysis likewise opens an avenue of attack, at least for criminal defendants, on the second subsection of Rule 10b5-2. Rule 10b5-2(b)(2) attempts to create misappropriation liability where the parties have a "history" or "practice" of sharing confidential information and the party trading knew or "should have known" about the expectation

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[8] The stated purpose of the new rule was to address the "unsettled issue" of the circumstances under which certain non-business relationships may provide the duty of trust or confidence required under the misappropriation theory. *See* Exchange Act Release No. 42259, Securities Act Release No. 33-7787, IC Release No. 24209 (Dec. 20, 1999) (the "Release"), which may be found at <http://www.sec.gov/rules/proposed/34-42259.htm>. The Release voices the SEC's dissatisfaction with *Chestman*'s narrow approach to imposing misappropriation liability, and argues in favor of a broader approach, ostensibly to better protect investors and the securities markets.

[9] 17 C.F.R. §240.10b5-2.

[10] Our research has uncovered only one reported misappropriation case where a confidentiality agreement has served as the basis for finding a fiduciary duty. In that case, a civil action brought by the SEC, a partner in a small partnership misappropriated confidential information from a second partner relating to the second partner's individual consulting work for a company pursuing a friendly merger. *SEC v. Peters*, 735 F.Supp. 1505, 1508-09 (D. Kan. 1990). The court held that the defendant partner's partnership agreement obligated him to keep confidential any information relating to his partner's consulting work for the issuing company, even though such work was excluded from the work of the partnership. Although there was no "formal document" relating to the confidentiality of information coming into the partnership, the understanding and expectation of the parties was that all business matters of each partner would be held in trust and confidence. *Peters* is consistent with *Kim's* stated requirements for confidentiality agreements to the extent that *Peters* involved a written, legally enforceable agreement (the partnership agreement), and the agreement recites a traditional fiduciary relationship between the parties (partners).

[11] *See Chiarella v. U.S.*, 445 U.S. 222, 235 n. 20 (1980) ("a judicial holding that certain undefined activities 'generally are prohibited' by § 10(b) would raise questions whether either criminal or civil defendants would be given fair notice that they have engaged in illegal activity"); *cf. U.S. v. Mallas*,

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of confidentiality. These standards may be too vague for many courts to proceed to a criminal securities fraud conviction, and the possibility of a criminal conviction based effectively on a negligence standard is a departure that defendants will surely challenge.

Broker-dealers, investment advisers and other securities professionals nonetheless should take little comfort from the *Kim* decision. Few courts are likely to characterize the kinds of confidentiality agreements that permeate the business of investment banking and securities trading as intended mainly to reflect moral and ethical obligations rather than legally binding ones, and many of the relationships between securities firms and their clients tend toward the "traditional" end of the spectrum of fiduciary relations. The SEC is not bound to conform its enforcement program to the *Kim* court's views, and is likely to seek aggressively to enforce Rule 10b5-2, both because it is supposed to enforce its own rules and because the entire area of misappropriation law remains in need of the kind of clarity that adjudicated cases bring. Due process concerns are less acute when the government seeks to impose civil liabilities and, in any event, securities professionals in general are not in a good position to argue they lacked adequate "notice" of the nature of obligations spelled out in their own contracts.

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762 F.2d 361, 368 (4th Cir. 1985) ("Criminal prosecution for the violation of an unclear duty itself violates the clear constitutional duty of the government to warn citizens whether particular conduct is legal or illegal."); *U.S. v. Chestman*, 947 F.2d 551, 569 (2d Cir. 1991) ("Useful as such an elastic and expedient definition of confidential relations, *i.e.*, relations of trust and confidence, may be in the civil context, it has no place in the criminal law. A suitable occasion test for determining the presence of criminal fraud would offend not only the rule of lenity but due process as well."); *see also Dirks v. SEC*, 463 U.S. 646, 658 n. 17 (1983) (imprecision in SEC rules "prevents parties from ordering their actions in accord with legal requirements").

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