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WHITE-COLLAR CRIME

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Fiduciary Duty Not Always Easy to Determine

Fiduciary duty and its breach underlie many if not most white-collar fraud prosecutions—particularly those arising from alleged violations of the federal securities laws.

Neither the words fiduciary duty nor their definitions appear in the most commonly used federal fraud statutes. Thus, to discover whether a fiduciary relationship is present in any given situation requires the participants to become familiar with case law discussing the concept. The existence of a fiduciary duty is not always easy to discern.

Several somewhat recently decided cases have rejected its applicability to fact situations in which a charge of fraud was premised on the existence of such a duty.

• ***Breach of Fiduciary Duty Under the Misappropriation Theory.*** A securities fraud violation under §10(b) and Rule 10b-5 may arise under either the classical theory of insider trading[1] or the misappropriation theory. Under the misappropriation theory, a person commits fraud "in connection with" a securities transaction "when he misappropriates confidential information for securities trading purposes, in breach of a duty owed to the source of the information." The individual charged under this theory must have owed "a fiduciary duty or similar relationship of trust and confidence" to the source of the material, nonpublic information.[2]

'United States v. Cassese'

In *United States v. Cassese*,[3] the defendant was charged with securities fraud

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in connection with a tender offer based upon the misappropriation theory. Mr. Cassese was the chairman and president of Computer Horizons Corp., a company that provided temporary staffing of computer and information technology personnel. During 1999, Mr. Cassese participated in discussions with representatives of Compuware Corp. regarding the possible acquisition of Computer Horizons by Compuware. On June 21, 1999, Compuware's CEO, Mr. Karmanos, contacted Mr. Cassese and informed him that Compuware intended to acquire a third company, Data Processing Resources Corp. (DPRC), instead of Computer Horizons. On June 22, Mr. Cassese purchased 15,000 shares of DPRC. On June 23, DPRC and Compuware announced the acquisition, resulting in a substantial increase in the value of DPRC's stock. On June 24, Mr. Cassese sold his 15,000 shares, profiting more than $150,000.

Mr. Cassese argued that the government's securities fraud claim was insufficient as a matter of law. According to the defense, even if the allegations in the indictment were true, they failed to establish a securities fraud violation under the misappropriation theory because Mr. Cassese owed no duty to Compuware with respect to the nonpublic information regarding Compuware's acquisition of DPRC.

District Court Judge Robert Sweet held that a fiduciary duty or similar relationship is not created by the mere divulgence or receipt of confidential information. Rather, the duty must exist prior to the sharing of confidentialities. Citing the U.S. Court of Appeals for the Second Circuit's opinion in *United States v. Chestman*,[4] Judge Sweet noted that the essence of such a relationship is reliance and de facto control and dominance. As stated by the Second Circuit, "'Qualifying relationships are marked by the fact that the party in whom confidence is reposed has entered into a relationship in which he or she acts to serve the interests of the party entrusting him or her with such information.'"[5]

Mr. Cassese and Mr. Karmanos were merely potential business partners engaged in arm's-length negotiations. Noting that fiduciary-like dominance required "1) disparate knowledge and expertise, 2) a persuasive need to share the confidential information, and 3) a legal duty to render competent aid," the court found that no such elements existed in the relationship between Mr. Cassese and Mr. Karmanos. Specifically, Mr. Cassese was under no legal duty to aid Mr. Karmanos and Mr. Karmanos did not turn to Mr. Cassese for advice or the use of his particular knowledge or skill.

In examining the relationship between Mr. Cassese and Mr. Karmanos, the court compared other misappropriation cases. In *United States v. Kim*,[6] a case that Judge Sweet believed closely resembled the *Cassese* case, the court rejected the existence of a fiduciary-like relationship where two CEOs shared confidences as members of a social and professional club, even though the individuals had executed a confidentiality agreement as part of their membership into the club. Rather, the

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relationship was characterized as one between peers or equals, lacking in the necessary superiority, dominance or control found to exist in relationships that lead to criminal liability. Judge Sweet also likened the *Cassese* case to the one at issue in *Walton v. Morgan Stanley & Co.*, where the Second Circuit held that where the management of two corporations were "at all times responsible for different interests, and…had no relationship to each other before or other than in the acquisition discussions," they must be "presumed to have dealt, absent evidence of an extraordinary relationship, at arm's length."[7] Accordingly, the court held that the securities fraud count as contained in the indictment was insufficient and dismissed the securities fraud count against Cassese. Judge Sweet's opinion was affirmed by the Second Circuit.

This series of cases raises an interesting question as to how someone coming into possession of confidential information is supposed to determine whether action on his or her part will be unlawful when even prosecutors are unable to comprehend the boundaries of fiduciary duty.

'SEC v. Talbot'[8]

Earlier this year, a District Judge in the U.S. District Court for the Central District of California addressed a similar issue in a civil enforcement action brought by the Securities Exchange Commission against J. Thomas Talbot alleging violations of §10(b) and Rule 10b-5. Mr. Talbot was a director of Fidelity National Financial Inc., a national title insurance company. During the relevant period of time, Fidelity held an ownership interest in LendingTree Inc., an on-line lending and realty services exchange.

At an April 22, 2003 meeting of Fidelity's board of directors, the CEO and chairman of Fidelity, William Foley, noted that negotiations were under way between LendingTree and an unnamed third party for the acquisition of LendingTree and that Fidelity likely would benefit from such an acquisition. The subject was not on the meeting's agenda and the comments by Mr. Foley were made at the end of a lengthy board meeting with no further discussion by the board.

On April 24, Mr. Talbot purchased 5,000 shares of LendingTree stock. On April 25, LendingTree's CEO, Douglas Lebda, contacted Fidelity's executive vice president, Brent Bickett, providing him with the status of a proposed tender offer for LendingTree and a Voting Agreement for Fidelity's execution. On the same day, Fidelity and LendingTree entered into a written letter agreement restricting Fidelity's use of confidential information regarding the proposed acquisition. On April 30, Mr. Talbot purchased an additional 5,000 shares of LendingTree. On May 5, LendingTree and USA Interactive issued a joint press release announcing USAI's acquisition of LendingTree. Soon thereafter, Mr. Talbot sold all 10,000 of his LendingTree shares at $20.94 per share, realizing a profit of almost $68,000.[9]

In 'Skelly,' the theory of liability was that the defendant principals of a registered broker/dealer used a pump-and-dump scheme to inflate securities prices in which they held an interest,….

In its complaint, the SEC asserted that as a director of Fidelity, Mr. Talbot learned material nonpublic information regarding LendingTree's possible acquisition and traded on this information in violation of the securities laws. The SEC sought disgorgement of Mr. Talbot's profits and civil penalties, as well as an injunction prohibiting Mr. Talbot's future service as an officer or director of a public company. Both the SEC and Mr. Talbot filed motions for summary judgment.

The district court set forth the various elements of the SEC's claim, noting that to succeed the SEC would have to show that Mr. Talbot misappropriated material, nonpublic information in breach of a duty arising from a relationship of trust and confidence and that he knowingly used or possessed that information in his purchase of LendingTree stock. In assessing whether Mr. Talbot breached a fiduciary-like duty, the court first needed to determine the source of the confidential information regarding LendingTree's acquisition, which flowed from Mr. Lebda (LendingTree's CEO) to Mr. Bickett (Fidelity's executive vice president) to Mr. Foley (Fidelity's chairman) to the directors of Fidelity, including Mr. Talbot. Mr. Talbot contended that the "operative source" was Mr. Foley, acting in his individual capacity, or Mr. Lebda, who prematurely revealed the information to Fidelity without a confidentiality agreement. The SEC claimed that the source was Fidelity to which Mr. Talbot owed a duty as a director. Finding that the disclosure occurred within the context of an authorized Fidelity board meeting and that Mr. Foley was acting in his official capacity and with the purpose, at least in part, to serve Fidelity by advising the board of an event that might significantly impact the company, the court found that Fidelity was the immediate source of the information.

Mr. Talbot argued, however, that even if he owed a duty to Fidelity as a director and Fidelity was the source of the information, he had no duty to maintain the confidentiality of the information because Fidelity owed no such duty to LendingTree. He asserted that "it would be incongruous to find that [he] breached a duty to Fidelity because he received the…information from…Fidelity [and traded on it]" when Fidelity itself could have traded on the LendingTree information without incurring liability under the securities laws. Accordingly, the court turned to the issue of whether Fidelity owed LendingTree a duty to maintain the acquisition news confidentially. Because the nondisclosure agreement between LendingTree and Fidelity was executed three days after the board meeting in which the disclosure occurred, it did not apply at the time in question and could not be used as evidence of an explicit confidentiality agreement between Fidelity and LendingTree. Thus, any duty owed by Fidelity to LendingTree would be implicit.

An implicit duty could arise from a fiduciary or similar relationship between the companies. Although Fidelity had a fiduciary relationship with LendingTree because of its status as a shareholder of LendingTree, the duty of confidentiality flowed from LendingTree to Fidelity, not the other way. Thus, no fiduciary obligation existed by Fidelity to keep the information confidential. The case turned, therefore, on whether Fidelity had a "similar relationship of trust and confidence" with LendingTree that would have required Fidelity to maintain LendingTree's confidences. Relying on the same language set forth in the *Cassese* opinion, the court considered whether a relationship existed between Fidelity and LendingTree characterized by "reliance, and de facto control and dominance, such that confidence is reposed on one side and there is resulting superiority and influence on the other." The SEC provided no evidence of a history of shared confidences between the companies, a disparity of knowledge or expertise between the companies, or a persuasive need for LendingTree to disclose the information to Fidelity.

Accordingly, the court found no evidence from which a reasonable fact finder could find that Fidelity and its directors owed a duty of confidentiality to LendingTree. Without such evidence, the SEC's misappropriation claim could not succeed and summary judgment was granted to Mr. Talbot.[10]

Broker Liability

• ***Broker Liability for Securities Fraud Resulting From Breach of a Fiduciary Duty.*** A March 2006 opinion from the Second Circuit similarly examines the contours of fiduciary duty and liability for securities fraud arising from a breach of that duty within the context of a broker-customer relationship. In *United States v. Skelly*,[11] the defendants were brokers convicted of three counts of securities fraud and one count of conspiracy to commit securities fraud and wire fraud. The government's primary theory of liability was that the defendants, as principals of Walsh Manning Securities Inc. and Walsh Manning Securities LLC, a registered broker/dealer, engaged in a pump-and-dump scheme to artificially inflate the price of securities in which they held a substantial interest, and then used fraudulent and high-pressure tactics to unload the securities on unsuspecting customers. During summations, however, the prosecutor asserted another theory of liability, arguing that the brokers' failure to disclose to their customers the fact that Walsh Manning paid its brokers more if they sold the manipulated securities also amounted to securities fraud. In response to this argument by the government, the district court instructed the jury that "an intentional failure to disclose a material fact could give rise to liability for securities fraud if the broker had a fiduciary duty to disclose the information."

The jury found the defendants guilty and the defendants appealed arguing that the jury's conviction based on the latter theory was invalid. As an initial matter, the defendants argued that the government's theory violated a fundamental tenet of commercial law that "neither a seller nor a middleman has an obligation to disclose his financial incentives for selling a particular commodity." Further, the defendants noted that although SEC rules require the broker/dealer to disclose to its customers the amount it receives for executing their trades, no SEC rule requires brokers to disclose their own compensation to customers. Finally, the defendants argued the general antifraud provisions of the securities laws, as charged in the indictment, only hold a broker liable for fraud if he or she lies or tells misleading half-truths to a customer, not if he or she fails to disclose information he or she is under no obligation to reveal.

In reviewing the case, the Second Circuit noted that the district court's instructions did not violate any of these basic principles, but made clear to the jury that it could only convict the defendants on a "failure to disclose" theory if the defendants had assumed a fiduciary duty to disclose such information. Although no such duty is part of an ordinary broker-customer relationship, "'a relationship of trust and confidence does exist between a broker and a customer with respect to those matters that have been entrusted to the broker.'"[12] The court observed that it had recognized such a duty in certain factual circumstances, such as when a broker has discretionary authority over a customers account, yet emphasized that a fiduciary obligation should not be "lightly implied" as it imposes additional obligations which often are contrary to the ordinary obligations that govern commercial transactions.

Thus, the court turned its attention to the district court's jury instructions defining a fiduciary duty. The district court limited the defining instruction to a single sentence, stating that "[o]ne acts in a fiduciary capacity when the business he transacts or the money or property that he handles is not his or for his own benefit, but is for the benefit of another person as to who[m] he stands in relation implied and necessitating great confidence and trust on one part, and a high degree of good faith on the other part."

The Second Circuit found this charge to be insufficient, stating that it failed to include the elements of "reliance and de facto control and dominance" required to establish a fiduciary relationship. Because both defendants failed to properly object to the charge, however, the argument was deemed waived by the defendants and did not constitute grounds for reversal unless there was plain error. Finding that overwhelming evidence was submitted on the government's first theory of liability regarding the defendants' pump-and-dump scheme, the court found no such error and affirmed the defendants' convictions.[13]

Conclusion

The ordinary businessman or investor is at a substantial disadvantage in recognizing when a fiduciary duty exists. As the above cases indicate, the concept is often complicated and far from free of doubt. It would be fairer if all were put on equal footing by incorporating some definition of fiduciary duty in fraud statutes.

1. *Dirks v. SEC*, 463 US 646 (1983).
2. See *United States v. O'Hagen* 521 U.S. 642, 652 (1997); *United States v. Chestman*, 947 F.2d 551, 566 (2d Cir. 1991).
3. 273 F.Supp2d 481 (SDNY), aff'd, 428 F.3d 92 (2d Cir. 2005).
4. 947 F.2d 551 (2d Cir. 1991).
5. Id. at 486 (citing *Chestman*, 947 F.2d at 567; *United States v. Falcone*, 257 F.3d 226, 234-35 (2d Cir. 2001)).
6. 184 F. Supp.2d 1006 (N.D. Cal. 2002).
7. 623 F.2d 796, 798 (2d Cir. 1980).
8. *SEC v. Talbot*, __F.Supp.2d__, 2006 WL 1216719 (C.D.Cal. Feb. 14, 2006).
9. 2006 WL 1216719 at **1-2.
10. Id. at **11-25.
11. 442 F.3d 94 (2d Cir. 2006).
12. Id. at 98 (citing *United States v. Szur*, 289 F.3d 200, 211 (2d Cir. 2002)).
13. Id. at 99.