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SECURITIES LAW—ALL IN THE FAMILY—UNITED STATES v. CHESTMAN: FINDING A FIDUCIARY OR OTHER SIMILAR RELATION OF TRUST AND CONFIDENCE UNDER RULE 10b-5 FOR FAMILY MEMBERS OF A FAMILY-CONTROLLED PUBLICLY TRADED CORPORATION

William A. Snider

NOTES

SECURITIES LAW—ALL IN THE FAMILY—*UNITED STATES V. CHESTMAN*: FINDING A FIDUCIARY OR OTHER SIMILAR RELATION OF TRUST AND CONFIDENCE UNDER RULE 10b-5 FOR FAMILY MEMBERS OF A FAMILY-CONTROLLED PUBLICLY TRADED CORPORATION

INTRODUCTION

Section 10(b)[1] and Rule 10b-5[2] compose the government's most effective weapon against insider trading.[3] While many arguments can be made as to their suitability for such a function, due to

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1. Manipulative and deceptive devices, 15 U.S.C. § 78j (1988).

Text of section 10(b) states as follows: "It shall be unlawful for any person, directly or indirectly . . . . (b) To use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe . . . ." *Id.*

2. Employment of manipulative and deceptive devices, 17 C.F.R. § 240.10b-5 (1993).

Rule 10b-5 reads as follows:

> It shall be unlawful for any person, directly or indirectly . . .
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> (a) To employ any device, scheme, or artifice to defraud,
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> (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
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> (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.

Id.

3. Some of the other tools in the government's arsenal in the fight against insider trading include section 14(e) of the Securities and Exchange Act of 1934, 15 U.S.C. § 78n(e) (1988); Rule 14e-3(a), transactions in securities on the basis of material, nonpublic information in the context of tender offers, 17 C.F.R. § 240.14e-3(a) (1993); Insider Trading Sanctions Act of 1984, Pub. L. No. 98-376, 98 Stat. 1264 (codified *as amended at* 15 U.S.C. §§ 78c, 78o, 78t, 78u, 78ff (1988 & Supp. 1993)); Insider Trading and Securities Fraud Enforcement Act of 1988, Pub. L. No. 100-704, 102 Stat. 4677 (codified *as amended at* 15 U.S.C. §§ 78c, 78o, 78t-1, 78u, 78u-1, 78ff, 78kk (1988 & Supp. 1993)); Mail Fraud Act, ch. 5, §§ 300, 301, 17 Stat. 283 (1872), ch. 321, § 215, 35 Stat. 1088 (1909) (current version at 18 U.S.C. §§ 1341-1342 (1988 & Supp. 1993)); Wire, Radio, Television Fraud Act, ch. 879, § 18, 66 Stat. 711 (1952) (current version at 18 U.S.C. § 1343 (1988 & Supp. 1993)).

the current state of the law, no argument can be made against the statement that section 10(b) and Rule 10b-5 are the best tools the government possesses in the fight against insider trading.

Yet in *United States v. Chestman*,[4] the Court of Appeals for the Second Circuit has created a gaping loophole in the law regarding section 10(b) and Rule 10b-5 cases, which affects the ability of the government to successfully prosecute *all* insider trading activities on an equal footing.

In *United States v. Chestman*[5] the Second Circuit, sitting en banc, reversed the defendant's conviction on ten counts of securities fraud in violation of section 10(b) and Rule 10b-5, but affirmed the conviction on ten counts of fraudulent trading in connection with a tender offer in violation of section 14(e)[6] and Rule 14e-3(a).[7] The defendant, Robert Chestman, was a stockbroker. Upon receiving inside information about the pending sale of the publicly traded Waldbaum Corporation, Chestman performed trades that personally benefitted his clients and himself.[8]

In reversing Chestman's 10b-5 convictions, the Second Circuit held that material nonpublic information transferred between family members within the context of a family-controlled publicly traded corporation does not create a "fiduciary or similar relation of trust and confidence."[9] The decision has the effect of giving family members in family-controlled corporations and their tippees carte blanche to tip and trade on inside information with no restrictions.[10] In his dissent, Judge Winter proposed a rule to fill the gap

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4. 903 F.2d 75, 78-80 (2d Cir. 1990), *vacated*, 947 F.2d 551 (2d Cir. 1991) (en banc), *cert. denied*, 112 S. Ct. 1759 (1992).

5. 947 F.2d 551 (2d Cir. 1991) (en banc), *cert. denied*, 112 S. Ct. 1759 (1992).

6. 15 U.S.C. § 78n(e) (1988).

7. Transactions in securities on the basis of material, nonpublic information in the context of tender offers, 17 C.F.R. § 240.14e-3(a) (1993). The section 14(e) and Rule 14e-3(a) violations in *Chestman* will not be discussed in this Note. For a consideration of the section 14(e) and Rule 14e-3(a) aspect of *Chestman* see William J. Cook, Note, *From Insider Trading to Unfair Trading: Chestman II and Rule 14e-3*, 22 STETSON L. REV. 171 (1992).

In the district court, Chestman had also been convicted of ten counts of mail fraud in violation of 18 U.S.C. §§ 1341-1342 (1988), and one count of perjury in violation of 18 U.S.C. § 1621 (1988). *Chestman*, 903 F.2d at 76. In the en banc consideration by the Second Circuit, the mail fraud convictions were reversed, the perjury count was not under consideration, thus the panel's reversal of that conviction stood. *Chestman*, 947 F.2d at 554.

8. *See infra* text accompanying notes 79-93.

9. *Chestman*, 947 F.2d at 567. *See also infra* note 97 and accompanying text; *infra* text accompanying notes 101-19.

10. The impact of this decision can be seen by looking at the abundance of family-

and successfully net family-members and their tippees involved in insider trading.[11] Although Judge Winter's rule may be an effective tool against insider trading, it is unnecessary because the answer lies within a proper analysis of the case law in the area.

Section I of this Note discusses the traditional and misappropriation theories of liability under section 10(b) and Rule 10b-5, as well as explaining tippee liability. In Section II there is a consideration of the *Chestman* decision, including the dissenting opinion of Judge Winter. Section III contains a discussion of the circumstances under which family relationships are or should be considered fiduciary or confidential in nature, and whether there is a distinction between a fiduciary and confidential relationship and concludes that there is such a distinction.

I. BACKGROUND

A. *Legislative History of Section 10(b) and Rule 10b-5*

Section 10(b) was a part of the landmark legislation, "The Securities Exchange Act of 1934;"[12] however, it is unclear whether Congress intended section 10(b) to be used as a weapon against insider trading.[13] In the article *The Original Conception of Section 10(b) of the Securities Exchange Act*, the author argues that section 10(b) "was intended to empower the Securities and Exchange Com-

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controlled corporations in existence, and by looking at the number of insider trading cases involving family relations in recent years. *See* United States v. Chestman, 903 F.2d 75 (2d Cir. 1990), *vacated*, 947 F.2d 551 (2d Cir. 1991) (en banc), *cert. denied*, 112 S. Ct. 1759 (1992); United States v. Reed, 601 F. Supp. 685 (S.D.N.Y.), *rev'd on other grounds*, 773 F.2d 477 (2d Cir. 1985); United States v. Willis, 737 F. Supp. 269 (S.D.N.Y. 1990); SEC v. Hurton, 739 F. Supp. 704 (D. Mass. 1990); SEC v. Saul, No. CIV.A.90-C-2633, 50 SEC Doc. 1171, 1992 WL 22730 (N.D. Ill. Jan. 27, 1992); SEC v. Hellberg, No. CIV.A.89-C-648-A, 1990 WL 321967 (D. Utah Oct. 29, 1990); SEC v. Raab, No. CIV.A.90-C-3291, 47 SEC Doc. 975, 1990 WL 322278 (N.D. Cal. Nov. 20, 1990); SEC v. Karcher, No. CIV.A.88-2021, 40 SEC Doc. 950, 1988 WL 237180 (C.D. Cal. Apr. 14, 1988).

The number of insider trading cases involving family relationships led one critic of the *Chestman* decision to observe that "the 'family fact pattern' is standard fare in the law of insider trading." Karl A. Groskaufmanis, *Chestman Revisited: The Slow Death of Fraud*, 6 INSIGHTS 12, 19 (1992).

11. See *infra* text accompanying note 124 for the text of Judge Winter's proposed rule.

12. 15 U.S.C. §§ 78a-78*ll* (1988 & Supp. 1993).

13. Michael P. Dooley, *Enforcement of Insider Trading Restrictions*, 66 VA. L. REV. 1, 55-69 (1980) (concluding that the legislative history of the 1934 Act indicates that Congress was not concerned with insider trading); Steve Thel, *The Original Conception of Section 10(b) of the Securities Exchange Act*, 42 STAN. L. REV. 385 (1990) (history of section 10(b) including legislative history).

mission (SEC) to regulate any practice that might contribute to speculation in securities or tend to move security prices away from investment value."[14] A different position has been proclaimed in the article *Enforcement of Insider Trading Restrictions*.[15] The author argues that "in regulating insider trading under Rule 10b-5 the lower federal courts and the SEC have been operating without benefit of support from the legislative history of the 1934 Act or from the language of section 10(b)."[16]

Even if the 1934 Act did not intend section 10(b) to deal with insider trading, certain events that have taken place since have demonstrated that Congress has endorsed just such a purpose for section 10(b). In *The Insider Trading Sanctions Act of 1984 and Its Effect on Existing Law*[17] this position is espoused. While an examination of the legislative history suggests Congress did not intend the Act to apply to a violation along the lines of Rule 10b-5;[18]

> [a] familiar canon of statutory construction, however, is that when a statute fails to change the prevailing judicial construction of some prior enacted provision, that failure constitutes an implied endorsement of judicial interpretation, at least to the extent that Congress was aware of the construction and there was a natural opportunity for revision.[19] That maxim applies to the 1984 Act, a fortiori.[20]

The promulgation of Rule 10b-5 by the SEC in 1948 was prompted by the need for a rule to stop the wrongful behavior of a corporate president in Boston. The president of the company was fraudulently misrepresenting the financial outlook of the company to shareholders and then purchasing their shares, having full knowledge that the company was in fact doing very well.[21] The SEC

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14. Thel, *supra* note 13, at 385-86. The author comes to this conclusion by examining "an extensive published record of congressional and popular debate over stock exchange legislation. . . . together with documents left by those who wrote the Exchange Act." *Id.* at 385.

15. Dooley, *supra* note 13.

16. *Id.* at 59.

17. Donald C. Langevoort, *The Insider Trading Sanctions Act of 1984 and Its Effect on Existing Law*, 37 VAND. L. REV. 1273, 1274 (1984).

18. *Id.*

19. *Id.* at 1273 (citing Herman & MacLean v. Huddleston, 459 U.S. 375, 385-87 (1983); Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Curran, 456 U.S. 353, 382 n.66 (1982); Lorillard v. Pons, 434 U.S. 575, 580-81 (1978); *see also* 2A C. SANDS, STATUTES AND STATUTORY CONSTRUCTION § 49.09 (4th ed. 1973)).

20. *Id.* at 1274.

21. Milton V. Freeman, then a commissioner of the SEC explains the story behind the creation of Rule 10b-5:

quickly adopted Rule 10b-5 to combat this and similar types of behavior.

It is unclear that the intention of section 10(b) was to fight insider trading. However, it is evident, that Rule 10b-5, promulgated under section 10(b), was adopted with that purpose in mind, and has been used to battle insider trading ever since.

B. *Traditional Theory of Insider Trading Liability*

The traditional or classic theory of insider trading liability as envisioned by the Supreme Court[22] finds its roots in two cases, *Chiarella v. United States*[23] and *Dirks v. SEC*.[24] According to the

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> It was one day in the year 1943, I believe. I was sitting in my office in the S.E.C. building in Philadelphia and I received a call from Jim Treanor who was then the Director of the Trading and Exchange Division. He said, "I have just been on the telephone with Paul Rowen," who was then the S.E.C. Regional Administrator in Boston, "and he has told me about the president of some company in Boston who is going around buying up the stock of his company from his own shareholders at $4.00 a share, and he has been telling them that the company is doing very badly, whereas, in fact, the earnings are going to be quadrupled and will be $2.00 a share for this coming year. Is there anything we can do about it?" So he came upstairs and I called in my secretary and I looked at Section 10(b) and I looked at Section 17, and I put them together, and the only discussion we had there was where "in connection with the purchase or sale" should be, and we decided it should be at the end.
>
> We called the Commission and we got on the calendar, and I don't remember whether we got there that morning or after lunch. We passed a piece of paper around to all the commissioners. All the commissioners read the rule and they tossed it on the table, indicating approval. Nobody said anything except Sumner Pike who said, "Well," he said, "we are against fraud, aren't we?" That is how it happened.

Milton V. Freeman, Remarks at the Meeting of the A.B.A. Section of Corporation, Banking and Business Law, *reprinted in Conference on Codification of the Federal Securities Laws*, 22 BUS. LAW. 793, 922 (1967).

22. Prior to any Supreme Court cases on the topic, the traditional or classic theory had its beginnings in Cady, Roberts & Co., 40 S.E.C. 907 (1961), and SEC v. Texas Gulf Sulphur, 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969).

23. 445 U.S. 222 (1980). Chiarella was a markup man for a financial printer. His employer prepared soliciting materials for bidders in tender offers. Chiarella was able to break the company codes for the material to be printed and he discovered who the target companies were. He purchased shares in the target companies before the bid was made public. The announcement of the bid increased the price of shares, and Chiarella sold his shares for a profit. Chiarella was convicted under Rule 10b-5. United States v. Chiarella, 450 F. Supp. 95 (S.D.N.Y.), *aff'd*, 588 F.2d 1358 (2d Cir. 1978), *rev'd*, 445 U.S. 222 (1980). This conviction was affirmed by the Second Circuit. United States v. Chiarella, 588 F.2d 1358 (2d Cir. 1978), *rev'd*, 445 U.S. 222 (1980). The Supreme Court of the United States reversed the conviction, finding no fiduciary duty between Chiarella and the companies whose stock he had traded. *Chiarella*, 445 U.S. at 237.

24. 463 U.S. 646 (1983). Dirks was an investment analyst. He received information from a former employee of Equity Funding of America that Equity Funding was

classic theory, "a person violates Rule 10b-5 by trading on material nonpublic information without disclosing that information to the marketplace — the essence of the abstain or disclose theory — if (and presumably only if) he owes a fiduciary duty to marketplace traders [buyers and sellers of the securities involved in the wrongful trade]."[25]

In *Chiarella*, the Supreme Court of the United States held that "one who fails to disclose material information prior to the consummation of a transaction commits fraud only when he is under a duty to do so."[26] The duty the Court is referring to is "[t]he obligation to disclose or abstain" from trading,[27] which comes from *Cady, Roberts & Co.*[28] The disclose-or-abstain duty, or the *Cady, Roberts* rule, holds that one in possession of confidential, nonpublic information must either abstain from trading on the information or make the information available to the marketplace before trading.[29] In *Cady, Roberts* the Securities and Exchange Commission determined that:

[a]n affirmative duty to disclose material information has been

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being fraudulently managed and that its assets had been grossly overstated. The employee wanted Dirks to expose the fraud and Dirks succeeded in publicizing the information. However, before publication Dirks told some of his clients to sell their shares in Equity Funding. The SEC instituted an administrative proceeding against Dirks. Dirks, Release No. 17,480, 21 SEC Doc. 1401 (Jan. 22, 1981). The SEC suggested adoption of a theory under which the tippee of the confidential information "stands in the shoes" of the tipper, and assumes the tipper's duty not to misuse the information to his or her own advantage. The Commission's finding that Dirks had violated Rule 10b-5 was affirmed by the District of Columbia Court of Appeals. Dirks v. SEC, 681 F.2d 824, 846 (D.C. Cir. 1982). The Supreme Court reversed, reiterating its position from *Chiarella*, that a fiduciary duty must exist from the defendant to one or more marketplace traders to establish Rule 10b-5 liability. Dirks was not liable because he did not benefit personally from the trading on the inside information.

See Robert B. Titus & Peter G. Carroll, *Netting the Outsider: The Need for a Broader Restatement of Insider Trading Doctrine*, 8 W. NEW ENG. L. REV. 127 (1986) for a discussion of the development of the traditional or classic theory.

25. DONALD C. LANGEVOORT, INSIDER TRADING REGULATION, § 1.03(1)(a) at 18 (1991).

26. *Chiarella*, 445 U.S. at 228. The Court held that the disclose-or-abstain duty only arises when a fiduciary or other similar relation of trust and confidence exists. Possession and use of inside information giving one an advantage over other market participants is not enough to trigger Rule 10b-5 liability. *Id.* at 228-29.

27. *Id.* at 227.

28. 40 S.E.C. 907 (1961). In *Cady, Roberts & Co.*, the SEC imposed sanctions against a broker who, upon receiving "confidential, nonpublic information" about a reduction in the dividends of a publicly traded security, told his clients to sell their holdings. The Commission held that the broker's behavior was in violation of Rule 10b-5 "as a practice which operated as a fraud or deceit upon the purchasers." *Id.* at 913.

29. *Id.* at 912-13.

> traditionally imposed on corporate "insiders," particularly officers, directors, or controlling stockholders. We, and the courts have consistently held that insiders must disclose material facts which are known to them by virtue of their position but which are not known to persons with whom they deal and which, if known, would affect their investment judgment.[30]

In *Chiarella*, the Supreme Court determined that the *Cady, Roberts* "duty to disclose arises when one party has information 'that the other [party] is entitled to know because of a fiduciary or other similar relation of trust and confidence between them.'"[31] Thus, those who are found not to have a fiduciary relationship to either the buyer or seller of stocks are free to trade for personal benefit, even though they possess confidential, inside information. The duty to disclose does not arise "from mere possession of nonpublic market information;" there must be a special relationship between the person possessing the inside information and the buyer or seller of the securities giving rise to the duty.[32] The Court in *Chiarella* reversed the convictions, holding that Chiarella was not an insider because he received no confidential information from the companies whose stocks he purchased, and thus he owed no duty to the stockholders of these corporations.[33]

If a fiduciary relationship is found between the person who trades on the inside information and the stockholders of the corporation on which the person has traded, there is a breach of the fiduciary duty and Rule 10b-5 liability may attach.[34] This traditional or classic theory enunciated in *Chiarella* serves an important function in the war against insider trading. However, in order to bring more activity under the insider trading umbrella, such as trading by tippees[35] and remote tippees,[36] there was a need to enlarge the *Chiarella* formula. The traditional theory was expanded three years

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30. *Id.* at 911 (discussing the disclosure aspect of the disclose-or-abstain duty).

31. *Chiarella*, 445 U.S. at 228 (quoting RESTATEMENT (SECOND) OF TORTS § 551(2)(a) (1976)).

32. *Id.* at 235.

33. *Id.* at 231-35. The Court rejected the "equal access" theory from *Cady, Roberts* which states that anyone with inside information owes a general duty to disclose-or-abstain not just to the stockholders of the corporation being traded, but to the entire marketplace. According to the theory, liability is based on unfairness to the market and all traders should have "equal access" to information. *Cady, Roberts*, 40 S.E.C. at 912.

34. *Chiarella*, 445 U.S. at 228-29.

35. "Tippee" is defined as any person "who receive[s] material nonpublic information from a corporate insider [and] may, under certain circumstances, be subject to abstain or disclose liability under Rule 10b-5." LANGEVOORT, *supra* note 25, § 4.01 at 101 (1991).

later in *Dirks v. SEC*,[37] when the Court illuminated the problem of tippee liability.[38]

C. *Tippee Liability*

The liability of the tippee[39] is based upon the tipper's breach of a fiduciary duty. The *Chiarella* Court stated, "[t]he tippee's obligation has been viewed as arising from his role as a participant after the fact in the insider's breach of a fiduciary duty."[40] For the tippee to be liable, the tipper must have committed a wrongful act by disclosing the inside information to the tippee.

The concept of tippee liability was clarified in *Dirks v. SEC*.[41] The *Dirks* Court announced a test to determine tippee liability.[42] A tippee will only be held liable if: (1) the insider (tipper) breached a fiduciary duty and (2) the outsider (tippee) knew or should have known about the tipper's breach.[43] In effect, *Dirks* made the extension of section 10(b) and Rule 10b-5 liability to tippees more practical by enunciating an applicable rule.

Under the *Dirks* test, to find the insider, and thus the outsider, liable for a breach of a fiduciary duty, there must be a personal benefit to the insider from the disclosure.[44] In *Dirks*, the Court found no such personal benefit or gain from the breach; therefore,

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36. A remote tippee is anyone who obtains confidential inside information from a tippee beyond the original tip by the insider. *See id.* at § 4.04(3).

37. 463 U.S. 646 (1983).

38. *Id.* at 655-67.

39. See *supra* note 35 for definition of tippee.

40. Chiarella v. United States, 445 U.S. 222, 230 n.12 (1980).

41. 463 U.S. 646 (1983). See *supra* note 24 for the facts of *Dirks*.

42. *Id.* at 660. The Court stated:

> Thus, the test is whether the insider personally will benefit, directly or indirectly, from his disclosure. Absent some personal gain, there has been no breach of duty to stockholders. And absent a breach by the insider, there is no derivative breach . . . . This requires courts to focus on objective criteria, *i.e.*, whether the insider receives a direct or indirect personal benefit from the disclosure, such as a pecuniary gain or a reputational benefit that will translate into future earnings . . . . There are objective facts and circumstances that often justify such an inference. For example, there may be a relationship between the insider and the recipient that suggests a *quid pro quo* from the latter, or an intention to benefit the particular recipient. The elements of fiduciary duty and exploitation of nonpublic information also exist when an insider makes a gift of confidential information to a trading relative or friend. The tip and trade resemble trading by the insider himself followed by a gift of the profits to the recipient.

Id. at 662-64 (citations omitted); *see* LANGEVOORT, *supra* note 25, § 4.01-04.

43. *Dirks*, 463 U.S. at 660.

44. *See supra* note 42.

no liability attached to either the insider or his tippee.[45] Mere possession of the inside information is not enough, tippees are only derivatively liable if the information "has been made available to them *improperly*" by breach of a fiduciary duty by the insider to the shareholders.[46]

Dirks built upon the *Chiarella v. United States*[47] decision by following the Court's "requirement of a specific relationship between the shareholders and the individual trading on inside information."[48] However, the *Dirks* Court expanded this rule to allow a tippee to derive a disclose-or-abstain duty to the corporation's shareholders even when no specific relationship exists between the tippee and the shareholder. The Court recognized that "the tippee's duty to disclose or abstain is derivative from that of the insider's duty."[49] As to the tippee, the Court held that

> a tippee assumes a fiduciary duty to the shareholders of a corporation not to trade on material nonpublic information only when the insider has breached his fiduciary duty to the shareholders by disclosing the information to the tippee and the tippee knows or should know that there has been a breach.[50]

When a tippee relays the information to another outsider, the original tippee becomes, in a sense, a tipper and the one receiving the information is referred to as a remote tippee.[51] According to the chain theory of remote tippees, a tippee with a derivative fiduciary duty is capable of bringing others into the scheme beyond the intent or awareness of the original insider.[52] The chain theory creates a chain of persons with a duty to disclose, provided it can be proven that each person in the chain

> (1) was given the information expressly for the purpose of facilitating trading based on inside information, (2) knew that the information was material and not public, and (3) knew or had

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45. *Dirks*, 463 U.S. at 667. Dirks received no personal gain from the disclosure; he was just trying to publicize the fraud of Equity Funding. Thus, the Court found no breach of a fiduciary duty. This case is the exception to the rule. See *supra* note 42 for the minimal requirements to be satisfied as to personal gain. Usually it is very easy to find personal benefit or gain on the part of the insider. Courts require as little as an increase in reputation, or the good feeling one gets from helping a friend.

46. *Dirks*, 463 U.S. at 660.

47. 445 U.S. 222 (1980).

48. *Dirks*, 463 U.S. at 655.

49. *Id.* at 659.

50. *Id.* at 660.

51. See *supra* note 36 for a definition of remote tippee.

52. LANGEVOORT, *supra* note 25, § 4.04 at 124-25.

reason to know that it came to him as a result of some breach of duty by an insider.[53]

However, even with the expansion of insider trading prosecutions under the *Dirks* theory, courts were having difficulty regulating certain behavior that appeared to be culpable, but did not fit within the *Chiarella-Dirks* formula. This predicament led the Second Circuit to adopt the misappropriation theory.[54]

D. *Misappropriation Theory*

The misappropriation theory provides that a Rule 10b-5 violation occurs "when a person (1) misappropriates material nonpublic information (2) by breaching a duty arising out of a relationship of trust and confidence and (3) uses that information in a securities transaction, (4) regardless of whether he owed any duties to the shareholders of the traded stock."[55] The misappropriation theory had its beginnings in a dissent by Chief Justice Burger in *Chiarella v. United States*.[56] Chief Justice Burger believed that section 10(b) and Rule 10b-5 liability should have attached to the defendant and stated that Chiarella "misappropriated—stole to put it bluntly—valuable nonpublic information entrusted to him in the utmost confidence."[57]

The Second Circuit took the Chief Justice's lead and put the misappropriation theory into effect.[58] Focusing on the language "fraud or deceit upon any person" from the text of Rule 10b-5,[59] the Second Circuit held that the "fraud and deceit" may be perpetrated on the source of the nonpublic information, even though the

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53. *Id.*

54. *See, e.g.*, SEC v. Materia, 745 F.2d 197 (2d Cir. 1984), *cert. denied*, 471 U.S. 1053 (1985).

55. SEC v. Clark, 915 F.2d 439, 443 (9th Cir. 1990). See Robert B. Titus & Peter G. Carroll, *supra* note 24, at 127 for a discussion of the development of the misappropriation theory.

56. 445 U.S. 222, 239-45 (1980) (Burger, C.J., dissenting).

57. *Id.* at 245; *see* Mark A. Clayton, Comment, *The Misappropriation Theory in Light of* Carpenter *and the Insider Trading and Securities Fraud Enforcement Act of 1988*, 17 PEPP. L. REV. 185, 192 (1989) ("Although criticized, Chief Justice Burger's dissenting opinion stimulated the development of the misappropriation theory." *Id.* (footnote omitted)).

58. The misappropriation theory was first applied in the cases United States v. Newman, 664 F.2d 12, 13 (2d Cir. 1981), *aff'd*, 722 F.2d 729 (2d Cir.), *cert. denied*, 464 U.S. 863 (1983) and SEC v. Materia, 745 F.2d 197, 201 (2d Cir. 1984), *cert. denied*, 471 U.S. 1053 (1985).

59. See *supra* note 2 for the text of Rule 10b-5.

source may be unconnected to the buyer or seller of the securities.[60] Thus, unlike the traditional theory of insider trading liability, also known as the disclose-or-abstain theory, under the misappropriation theory, the fraud is not premised upon a duty to disclose to the shareholders of the traded stock or abstain from trading; "[i]nstead, the [Second Circuit in *SEC v. Materia*[61]] found that the misappropriation of confidential information which defrauds the source [insider] satisfies Rule 10b-5's requirement that the fraud operate 'on any person.'"[62] "These holdings were consistent with the language of Rule 10b-5, which contains no specific requirement that fraud be perpetrated upon the seller or buyer of securities."[63] Thus, under the misappropriation theory, it is not necessary for the fraud to be against the buyer or seller of securities; just so long as there is fraud perpetrated against the source [insider] of the inside information, a breach exists under Rule 10b-5.

The misappropriation theory has applications in the cases of remote tippees[64] also. Most courts that have treated the issue of remote tippees under the misappropriation theory have applied the same approach the *Dirks* Court used under the disclose-or-abstain theory.[65] "[O]utsiders who participate with a fiduciary in a 'co-venture' to breach a duty are held responsible for all the consequences flowing therefrom as if they were fiduciaries themselves."[66] Thus, tippees are treated as inheriting a derivative fiduciary duty from the tipper, whether under the misappropriation or classic theory; "the only difference is that under the misappropriation theory the tippee is part of a fraud on the source [insider] of the information, rather than any marketplace traders."[67]

The Second Circuit has applied the misappropriation theory in the employment relations context only, involving situations in which an employee has misappropriated information from an em-

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60. *See* United States v. Carpenter, 791 F.2d 1024, 1032 (2d Cir. 1986), *aff'd*, 484 U.S. 19 (1987); *see also* United States v. Chestman, 947 F.2d 551, 566 (2d Cir. 1991) (en banc), *cert. denied*, 112 S. Ct. 1759 (1992).

61. 745 F.2d 197 (2d Cir. 1984).

62. Jill E. Fisch, *Start Making Sense: An Analysis and Proposal for Insider Trading Regulation*, 26 GA. L. REV. 179, 200 (1991) (footnote omitted).

63. United States v. Newman, 664 F.2d 12, 17 (2d Cir. 1981). See *supra* note 2 for the text of Rule 10b-5.

64. See *supra* note 36 and accompanying text for a definition and discussion of remote tippees.

65. *See, e.g.*, United States v. Chestman, 947 F.2d 551, 567 (2d Cir. 1991) (en banc), *cert. denied*, 112 S. Ct. 1759 (1992).

66. LANGEVOORT, *supra* note 25, § 6.07 at 197.

67. *Id.* at 197-98.

ployer.[68] However, district courts in the Second Circuit have extended the theory to non-employment relationships.[69]

Since the *Chiarella* decision, *United States v. Carpenter*[70] is the only case in which the Supreme Court of the United States has dealt with the misappropriation theory. The securities fraud convictions brought pursuant to the misappropriation theory were affirmed by an evenly divided Court.[71] Since an affirmance by an evenly divided court is "[not] entitled to precedential weight,"[72] it is not clear whether the Supreme Court endorses the misappropriation theory.[73] There is some evidence that the Supreme Court may have, at least tacitly, through dicta, endorsed the misappropriation theory in *Bateman Eichler, Hill Richards, Inc. v. Berner*.[74] The Second Circuit noted that three other circuits have adopted the misappropriation theory.[75]

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68. United States v. Chestman, 947 F.2d 551, 566 (2d Cir. 1991) (en banc), *cert. denied*, 112 S. Ct. 1759 (1992); *see* United States v. Carpenter, 791 F.2d 1024, 1032 (2d Cir. 1986) (finding breach of duty by financial columnist to employer newspaper), *aff'd by an equally divided Court*, 484 U.S. 19 (1987); SEC v. Materia, 745 F.2d 197, 202 (2d Cir. 1984), *cert. denied*, 471 U.S. 1053 (1985) (finding breach of duty by copyholder to employer printing company); United States v. Newman, 664 F.2d 12, 17 (2d Cir. 1981), *aff'd*, 722 F.2d 729 (2d Cir.), *cert. denied*, 464 U.S. 863 (1983) (finding breach of duty by investment banker to employer firm).

69. *Chestman*, 947 F.2d at 566; *see, e.g.*, United States v. Willis, 737 F. Supp. 269 (S.D.N.Y. 1990) (denying motion to dismiss where psychiatrist's breach of duty arising from confidential relationship between psychiatrist and patient resulted in psychiatrist performing trades based on information obtained from patient); United States v. Reed, 601 F. Supp. 685 (S.D.N.Y.) (denying motion to dismiss where son allegedly breached fiduciary duty to his father, a corporate director), *rev'd on other grounds*, 773 F.2d 477 (2d Cir. 1985); SEC v. Musella, 578 F. Supp. 425 (S.D.N.Y. 1984) (office services manager breached duty to employer law firm and its clients by trading on inside information obtained while in course of his employment).

70. 791 F.2d 1024 (2d Cir. 1986), *aff'd by an equally divided Court*, 484 U.S. 19 (1987). In *Carpenter*, Foster Winans, a columnist for the *Wall Street Journal*, along with some of his tippees, traded on inside information Winans had obtained for a column containing stock market tips. *Id.* at 1026.

71. *Carpenter*, 484 U.S. at 24.

72. Neil v. Biggers, 409 U.S. 188, 192 (1972) (citing Ohio *ex rel.* Eaton v. Price, 364 U.S. 263, 264 (1960)).

73. See United States v. Chestman, 947 F.2d 551, 566 n.3 (2d Cir. 1991) (en banc), *cert. denied*, 112 S. Ct. 1759 (1992) for an indication whether the Supreme Court has endorsed the misappropriation theory.

74. 472 U.S. 299 (1985). "We also have noted that a tippee may be liable if he otherwise 'misappropriate[s] or illegally obtain[s] the information.'" *Id.* at 313, n.22 (citing Dirks v. SEC, 463 U.S. 646, 665 (1983)).

75. *Chestman*, 947 F.2d at 566; *see, e.g.*, SEC v. Cherif, 933 F.2d 403, 404 (7th Cir. 1991), *cert. denied*, 112 S. Ct. 966 (1992); SEC v. Clark, 915 F.2d 439, 440 (9th Cir. 1990); Rothberg v. Rosenbloom, 771 F.2d 818 (3d Cir. 1985), *rev'd on other grounds after remand*, 808 F.2d 252 (3d Cir. 1986), *cert. denied*, 481 U.S. 1017 (1987).

Although the Supreme Court has not clearly endorsed the misappropriation theory,[76] it enjoys continued use throughout a number of the circuits,[77] including the Second Circuit in *United States v. Chestman*.[78]

II. *UNITED STATES V. CHESTMAN*[79]

A. *Facts*

Chestman centers around the takeover of the Waldbaum Corporation ("Waldbaum") by the Great Atlantic and Pacific Tea Company ("A & P"). Waldbaum was a publicly traded company.

Robert Chestman was Keith Loeb's stockbroker. Keith Loeb's wife, Susan, was the granddaughter of Julia Waldbaum. Julia Waldbaum was a member of the board of directors of Waldbaum, Inc., and the wife of its founder.[80] In November of 1986, Julia's son, Ira Waldbaum, president and controlling shareholder of Waldbaum, agreed to sell Waldbaum to A & P. The purchase called for Ira to tender a controlling block of shares of Waldbaum to A & P, at a higher than market price.[81]

Ira told some family members about the pending sale, warning them to keep it quiet until it went public. Among those whom Ira told was his sister, Shirley Witkin. Shirley did not intend to tell Susan, her daughter, about the sale, but was forced to due to unforeseeable circumstances.[82]

Susan was concerned for her mother's health when she was not at home on a certain day. To dispel Susan's fears, Shirley disregarded her brother's order, and told her daughter she was not at home because she had to get her shares to Ira so he could tender them for her.[83] Shirley warned Susan not to disclose this fact to anyone but her husband. Susan told her husband, Keith Loeb, about the sale and warned him not to say anything because "it could possibly ruin the sale."[84]

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76. See *supra* text accompanying notes 70-74 for a discussion of whether the Supreme Court has endorsed the misappropriation theory.

77. See *supra* note 75 for a list of cases employing the misappropriation theory in the circuits.

78. 947 F.2d at 564.

79. 947 F.2d 551 (2d Cir. 1991) (en banc), *cert. denied*, 112 S. Ct. 1759 (1992).

80. *Id.* at 555.

81. *Id.*

82. *Id.* at 579.

83. *Id.*

84. *Id.*

Keith alleged he contacted his broker, Robert Chestman, on November 26, and told him about the sale. That same day, Chestman executed several purchases of Waldbaum stock, including 1,000 shares for Keith Loeb's account.[85] Chestman claimed he bought the stock based on his own independent research. He also denied having spoken to Keith Loeb on that day.[86] Keith Loeb agreed to cooperate with the government. In so doing, Keith was required to disgorge the $25,000 profit from the purchase and sale of the stock, and pay an additional $25,000 fine.[87]

On July 20, 1988 Chestman was indicted on thirty-one counts of insider trading and perjury, among these were ten counts of securities fraud in violation of Rule 10b-5.[88] At trial, a jury found Chestman guilty on all counts.[89] On appeal, a panel of the Second Circuit Court of Appeals reversed the convictions on all thirty-one counts.[90] The court held that a fiduciary duty did not exist as required under Rule 10b-5.[91] The Second Circuit reheard the case en banc and upheld the reversal of the Rule 10b-5 convictions.[92] The Supreme Court of the United States denied the case further review.[93]

B. *Majority Opinion*[94]

Robert Chestman's Rule 10b-5 convictions were based on the misappropriation theory.[95] Chestman was convicted as the tippee of Keith Loeb. Thus, Keith Loeb was the alleged misappropriator of the nonpublic information. For this reason, the court's analysis focuses on the existence or non-existence of a fiduciary relationship

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85. *Id.* at 555.
86. *Id.*
87. *Id.* at 556.
88. *Id.*
89. *Id.*
90. United States v. Chestman, 903 F.2d 75, 84-86 (2d Cir. 1990), *vacated*, 947 F.2d 551 (2d Cir. 1991) (en banc) (holding that the evidence did not support a conviction), *cert. denied*, 112 S. Ct. 1759 (1992).
91. See *infra* text accompanying notes 94-119 discussing the en banc opinion in *Chestman*, which upheld the finding of the panel, that a fiduciary duty did not exist.
92. United States v. Chestman, 947 F.2d 551, 554 (2d Cir. 1991) (en banc), *cert. denied*, 112 S. Ct. 1759 (1992). The court affirmed the convictions in violation of section 14(e) and Rule 14e-3(a), reversed the convictions of mail fraud, and did not consider the perjury conviction. *Id.*
93. Chestman v. United States, 112 S. Ct. 1759 (1992).
94. United States v. Chestman, 947 F.2d 551, 554 (2d Cir. 1991) (en banc), *cert. denied*, 112 S. Ct. 1759 (1992).
95. *See id.* at 564. See *supra* text accompanying notes 55-78 for a discussion of the misappropriation theory.

between Keith Loeb and either his wife Susan, or between Keith and the Waldbaum family.[96]

The en banc opinion centered around the meaning of a fiduciary duty. The court asked the question, "what constitutes a fiduciary or similar relationship of trust and confidence in the context of Rule 10b-5 criminal liability?"[97] The court made clear that a fiduciary duty cannot be imposed on an insider for merely being entrusted with confidential information.[98] Relying on its decision in *Walton v. Morgan Stanley & Co.*,[99] the court concluded that "[r]eposing confidential information in another, then, does not by itself create a fiduciary relationship."[100]

As to the family relationship involved, the court went on to find that "marriage does not, without more, create a fiduciary relationship."[101] Citing *United States v. Reed*,[102] the court acknowledged that "'mere kinship does not of itself establish a confidential relation.' . . . Rather, the existence of a confidential relationship must be determined independently of a preexisting family relationship."[103] The court recognized that under certain circumstances spouses may become fiduciaries, however, "the marriage relationship alone does not impose fiduciary status."[104]

Concluding that the relationships between Keith and Susan

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96. *See id.* at 570-71.

97. *Id.* at 567. See note 31 and accompanying text for the source of the phrase being interpreted by the *Chestman* court.

98. *Chestman*, 947 F.2d at 567 (referring to Walton v. Morgan Stanley & Co., 623 F.2d 796, 799 (2d Cir. 1980) (applying Delaware law)). In the *Walton* case, Morgan Stanley was an investment bank that obtained confidential material concerning possible takeover targets for one of its clients. The material was obtained from Olinkraft, one of the targets. *Walton*, 623 F.2d at 797. When the planned takeover was abandoned by its client, Morgan Stanley was charged with trading on the Olinkraft stock, based on the confidential information. *Id.* at 797-98. The Second Circuit found that Morgan Stanley in fact owed Olinkraft no fiduciary duty. *Id.* at 799. Although Olinkraft gave the information to Morgan Stanley intending that they keep it confidential, Morgan Stanley was under no duty to do so. *Id.*

99. 623 F.2d 796 (2d Cir. 1980).

100. *Chestman*, 947 F.2d at 568.

101. *Id.*

102. 601 F. Supp. 685 (S.D.N.Y.), *rev'd on other grounds*, 773 F.2d 477 (2d Cir. 1985). *Reed* involved the passing of inside information from a father to his son. The father, the corporate director of a company, was designated the insider while the son was the one to whom the information was tipped. *Id.*

103. *Chestman*, 947 F.2d at 568 (citing *Reed*, 601 F. Supp. at 706 (quoting GEORGE G. BOGERT, THE LAW OF TRUSTS AND TRUSTEES § 482, at 300-11 (rev. 2d ed. 1978))) (other citations omitted).

104. *Id.* The court did not elaborate as to what circumstances may give rise to spouses being considered fiduciaries.

and between Keith and the Waldbaum family were not fiduciary, the court inquired whether a "similar relationship of trust and confidence" existed under Rule 10b-5.[105] The court reasoned that the word "similar" suggested that a relationship of trust and confidence must have the same characteristics as a fiduciary relationship.[106] The court claimed that to ignore the significance of the word "similar" would leave the possible interpretations of a relationship of trust and confidence too expansive. The court noted that this interpretation would bring it back to the standard rejected in *Walton v. Morgan Stanley & Co.*:[107] that the mere possession of confidential information could result in Rule 10b-5 liability.[108] The court concluded, "[a] 'similar relationship of trust and confidence,' therefore, must be the functional equivalent of a fiduciary relationship."[109]

In examining whether a similar relationship of trust or confidence existed, the court inquired into the characteristics of a fiduciary relationship. According to the court, "[a] fiduciary relationship involves discretionary authority and dependency: One person depends on another—the fiduciary—to serve his interests."[110]

The *Chestman* court distinguished *United States v. Reed*[111] from the facts before it.[112] Without such a distinction, *Reed* could

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105. *Id.*

106. *Id.*

107. 623 F.2d 796 (2d Cir. 1980).

108. *Id.* See *supra* note 98 and accompanying text for a discussion of *Walton*.

109. *Chestman*, 947 F.2d at 568.

110. *Id.* at 569. The court explained:

> In relying on a fiduciary to act for his benefit, the beneficiary of the relation may entrust the fiduciary with custody over property of one sort or another. Because the fiduciary obtains access to this property to serve the ends of the fiduciary relationship, he becomes duty-bound not to appropriate the property for his own use. What has been said of an agent's duty of confidentiality applies with equal force to other fiduciary relations: "an agent is subject to a duty to the principal not to use or to communicate information confidentially given him by the principal or acquired by him during the course of or on account of his agency." RESTATEMENT (SECOND) OF AGENCY § 395 (1958). These characteristics represent the measure of the paradigmatic fiduciary relationship. A similar relationship of trust and confidence consequently must share these qualities.

Id.

111. 601 F. Supp. 685 (S.D.N.Y.), *rev'd on other grounds*, 773 F.2d 477 (2d Cir. 1985).

112. 947 F.2d at 569. Both *Reed* and *Chestman* involve insider trading tippee liability in the family relationship context. Since the district court in *Reed* had found that a fiduciary relationship did exist between the father and son, the Second Circuit in *Chestman* distinguished the *Reed* holding, because the court found no such relationship present in *Chestman*. *Id.* at 570.

be interpreted as lending support to the finding of a fiduciary or similar relationship of trust and confidence in all situations involving family relationships. Instead, the *Chestman* court chose to limit *Reed* to its essential holding:

> [T]he repeated disclosure of business secrets between family members may substitute for a factual finding of dependence and influence and thereby sustain a finding of the functional equivalent of a fiduciary relationship. We note, in this regard, that *Reed* repeatedly emphasized that the father and son "frequently discussed business affairs."[113]

The *Chestman* court recognized that "equity has occasionally established a less rigorous threshold for a fiduciary-like relationship[,]"[114] but declined to do so, observing that "[u]seful 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."[115] The court concluded that to apply an equity standard "for determining the presence of criminal fraud would offend not only the rule of lenity but due process as well."[116]

The court applied its interpretation of the fiduciary duty law to the facts of the case. The government needed to prove two elements: (1) Keith Loeb breached a fiduciary duty to Susan or to the Waldbaum family and (2) Robert Chestman knew that Loeb had done so.[117] On the first element, the court found the evidence was insufficient to show that a "fiduciary relationship or its functional equivalent" existed between Loeb and the Waldbaum family or between Loeb and Susan.[118] Alternatively, the court held that the government failed to meet its burden in proving the second element that Chestman knew or should have known about the breach of

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113. *Chestman*, 947 F.2d at 569 (quoting *Reed*, 601 F. Supp. at 690); *see also Reed*, 601 F. Supp. at 705, 709, 717-18.

114. *Chestman*, 947 F.2d at 569.

115. *Id.* at 570.

116. *Id.*; *see* Chiarella v. United States, 445 U.S. 222, 235 n.20 (1980). The *Chestman* court recognized "that equity has occasionally established a less rigorous threshold for a fiduciary-like relationship in order to right civil wrongs." *Chestman*, 947 F.2d at 569. The court also observed that equity has tended to invoke the confidential relation doctrine "whenever . . . a suitable occasion has arisen." *Id.* (quoting United States v. Reed, 601 F. Supp. 685, 712 n.38 (S.D.N.Y. 1985) (quoting GEORGE G. BOGERT, THE LAW OF TRUSTS AND TRUSTEES § 482, at 284-86)). Despite the previous use of this test, the Second Circuit in *Chestman* refused to apply the "suitable occasion" test, claiming it had no place in the criminal law. *Id.* at 570.

117. *Chestman*, 947 F.2d at 570.

118. *Id.* at 570-71.

fiduciary duty.[119]

C. *Dissenting Opinion*[120]

Judge Winter found *the best way* to understand the Supreme Court's decisions in insider trading cases was in terms of a "business-property" rationale:[121]

> Information is perhaps the most precious commodity in commercial markets. It is expensive to produce, and, because it involves facts and ideas that can be easily photocopied or carried in one's head, there is a ubiquitous risk that those who pay to produce information will see others reap the profit from it.[122]

In applying this analysis to the family-controlled corporation context, Judge Winter concluded "that family members who have benefitted from the family's control of the corporation are under a duty not to disclose confidential corporate information that comes to them in the ordinary course of family affairs."[123]

Judge Winter proposed a test to apply to the family relationship in the family-controlled corporation context to find a fiduciary relationship as required by section 10(b) and Rule 10b-5:

> I thus believe that a family member (i) who has received or expects (e.g., through inheritance) benefits from family control of a corporation, here gifts of stock, (ii) who is in a position to learn confidential corporate information through ordinary family interactions, and (iii) who knows that under the circumstances both the corporation and the family desire confidentiality, has a duty not to use information so obtained for personal profit where the use risks disclosure.[124]

In applying his test to the facts of *Chestman*, Judge Winter found that the relationship between Keith Loeb and Susan Loeb and between Keith Loeb and the Waldbaum family met the requirements

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119. *Id.* at 570. The second requirement, that the tippee knew or had reason to know, has not been entirely consistent in its application. Sometimes the standard appears to be something closer to actual knowledge than "reason to know." *Compare* SEC v. Musella, 578 F. Supp. 425, 434-36 (S.D.N.Y. 1984) *with* SEC v. Materia, 745 F.2d 197, 202 (2d Cir. 1984), *cert. denied*, 471 U.S. 1053 (1985). See Groskaufmanis, *supra* note 10, at 19 for a proposition that the *Chestman* court changed the standard to actual knowledge.

120. *Chestman*, 947 F.2d at 571 (Winter, J., dissenting).

121. *Id.* at 576; *see* Frank H. Easterbrook, *Insider Trading, Secret Agents, Evidentiary Privileges, and the Production of Information*, 1981 SUP. CT. REV. 309-39.

122. *Chestman*, 947 F.2d at 576-77 (citing Easterbrook, *supra* note 121, at 313).

123. *Id.* at 579.

124. *Id.* at 580.

and would result in the finding of a fiduciary duty and liability under Rule 10b-5.[125]

III. ANALYSIS

A. *Fiduciary v. Trust and Confidence: Is There a Distinction?*

A fiduciary relationship is a relationship that has been given special status by the law. In such relationships the law imposes a fiduciary duty on persons with certain legal relationships to one another regardless of their factual relationship.[126] Whereas trust and confidence relations depend on the facts of a situation and are found only if there is an actual relationship of dependence between the parties despite the absence of any formal legal relationship that would qualify as a fiduciary relationship.[127]

The court in *Chestman* incorrectly concluded that there is no distinction between a fiduciary relation and a relation of trust and confidence.[128] It states that "[a] 'similar relationship of trust and confidence,' therefore, must be the functional equivalent of a fiduciary relationship."[129] The court's conclusion turns on the use of the word "similar" in the phrase being interpreted.[130] As discussed earlier, the phrase "fiduciary or other similar relation of trust and confidence" can be traced back to the *Restatement (Second) of Torts*.[131] The problem is that somewhere between *Chiarella* and *Chestman* the configuration of this phrase changed. In *Chiarella* the phrase was "fiduciary or *other* similar relation of trust and confidence,"[132] while in *Chestman* the phrase was "fiduciary duty or similar relationship of trust and confidence."[133] Somewhere between the two cases, the word "other" mysteriously disappeared from the phrase. Although *Chiarella* dealt with the classic theory and *Chestman* dealt with the misappropriation theory, *Chiarella*, by way of the *Restatement (Second) of Torts*, is the source of the phrase, and courts have applied the phrase in cases dealing with

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125. *Id.* at 580-81.

126. GEORGE G. BOGERT, THE LAW OF TRUSTS AND TRUSTEES § 481, at 225 (rev. 2d ed. 1978).

127. *Id.* § 482, at 280.

128. *Chestman*, 947 F.2d at 568.

129. *Id.*

130. See *supra* text accompanying notes 97-100 for the *Chestman* court's analysis of a fiduciary duty.

131. *See supra* note 31 and accompanying text.

132. Chiarella v. United States, 445 U.S. 222, 228 (1980) (emphasis added) (quoting RESTATEMENT (SECOND) OF TORTS § 551(2)(a) (1976)).

133. *Chestman*, 947 F.2d at 566.

both the classic and misappropriation theories.[134]

Once the word "other" is reintroduced, the phrase "fiduciary or other similar relation of trust and confidence"[135] is open to new interpretations. The use of the word "other" suggests that there is a distinction between fiduciary and trust and confidence relations. The phrase could be interpreted to mean that if trust and confidence relations have the same characteristics as fiduciary relations then it would follow that all fiduciary relations could be considered of trust and confidence. However, because of the special designation of fiduciary relations, not all trust and confidence relations can be called fiduciary.[136] The *Chestman* interpretation creates a problem because it would be redundant for the Restatement to use both terms, fiduciary and trust and confidence, if they have the same meaning. If fiduciary and trust and confidence are truly functional equivalents, it is both repetitive and confusing to use both terms. If indeed they are synonymous, it would add nothing to the Restatement rule to have the term trust and confidence even mentioned.

When the *Chestman* court erroneously concluded that marriage alone fails to create a fiduciary relationship, it relied primarily on a quote from *United States v. Reed*.[137] "'[M]ere kinship does not of itself establish a confidential relation.' Rather, the existence of a confidential relationship must be determined independently of a preexisting family relationship."[138]

The *Reed* court's authority in concluding that a family relation is not fiduciary in nature was G.G. Bogert, *The Law of Trusts and Trustees*.[139] When the court quotes from Bogert, it purports to be discussing fiduciary duties, but the quote actually comes from Section 482, titled "Abuse of Confidential Relationship," which discusses trust and confidence relations.[140] Section 481 from Bogert is the section that discusses fiduciary obligations.[141] Thus, even

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134. *See, e.g., Chestman*, 947 F.2d at 567.

135. *Chiarella*, 445 U.S. at 228 (quoting RESTATEMENT (SECOND) OF TORTS § 551(2)(a) (1976)).

136. This interpretation comports with some of the distinctions that have been suggested by previous courts. *See infra* text accompanying notes 137-61.

137. *Chestman*, 947 F.2d at 568 (citing United States v. Reed, 601 F. Supp. 685, 706 (S.D.N.Y.), *rev'd on other grounds*, 773 F.2d 477 (2d Cir. 1985)).

138. *Reed*, 601 F. Supp. at 706 (citations omitted) (quoting BOGERT, *supra* note 126, § 482 at 300-11).

139. *See id.*

140. *Reed*, 601 F. Supp. at 706 (discussing BOGERT, *supra* note 126) (emphasis added).

141. BOGERT, *supra* note 126, § 481 at 225 (this section is titled, "Breach of a Fiduciary Obligation").

before reaching the discussion of trust and confidence relations,[142] the court uses a quote discussing *confidential relations* to determine that a *fiduciary relation* fails to exist. The court's muddled analysis demonstrates the confusion which exists in dealing with the terms fiduciary and confidential. It also shows that the Second Circuit was operating under the presupposition that a distinction between the terms "fiduciary" and "confidential" did not exist, and thus, was unable to keep their definitions separate and distinct.

Even Bogert recognizes that a distinction between fiduciary and confidential relations exists. Bogert points out that "[i]n many decisions the words [fiduciary relation and confidential relation] are used as synonyms."[143] Bogert goes on to say, "[i]n most cases, however, the latter phrase [confidential relation] is employed to indicate a relationship of a character similar to . . . fiduciary relations, but not falling into any well-defined category of the law."[144] Bogert cites two cases that help delineate this distinction.[145]

The court in *Roberts v. Parsons*[146] held that a distinction between a fiduciary and confidential relation does exist.[147] The court found that although some courts treat the two as synonymous,

> [t]here is, however, a technical distinction between the two terms,

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142. *See* United States v. Chestman, 947 F.2d 551, 568 (2d Cir. 1991) (en banc), *cert. denied*, 112 S. Ct. 1759 (1992).

143. BOGERT, *supra* note 126, § 482 at 280.

144. *Id.* Bogert continues:

> The relations of trustee and beneficiary, executor or administrator and creditors, next of kin or legatees, guardian and ward, principal and agent, attorney and client, corporate director and corporation, and the like are easily placed into distinct subdivisions of the law. They have distinctive names. The term "fiduciary" might well be reserved for such relations.
>
> There are other cases where there is just as great intimacy, disclosure of secrets, entrusting of power, and superiority of position in the case of the representative, but where the law has no special designation for the position of the parties. It cannot be called trust or executorship, and yet it is so similar in its creation and operation that it should have like results.

Id. at 280-81.

Bogert recognizes a distinction exists between fiduciary and confidential relations, and comments that where "great intimacy, disclosure of secrets, entrusting of power, and superiority of position" exist, it is a confidential relationship, and similar results as those in a fiduciary relation should occur upon a breach. *Id.*

145. BOGERT, *supra* note 126, § 481 at 280-81 n.53 (citing Roberts v. Parsons, 242 S.W. 594 (Ky. Ct. App. 1922); Oehler v. Hoffman, 113 N.W.2d 254 (Iowa 1962) (citing Richard S. Hudson, *Contracts in Iowa Revisited—Fraud and Misrepresentation, Duress and Undue Influence*, 9 DRAKE L. REV. 3 (1959))).

146. 242 S.W. 594 (Ky. Ct. App. 1922) (invalidating and canceling deeds and contracts between relatives in which a confidential relation existed).

147. *Id.* at 596.

> the former [fiduciary relation] being more correctly applicable to legal relationships between the parties . . . while the latter [confidential relation] might include them and also every other relationship wherein confidence is rightfully reposed and is exercised, among which, as we have seen, is superiority of knowledge on the part of the one seeking to uphold the contract and confidence reposed in him by the other.[148]

The court goes on to say, "it is not necessary that the relationship should be of that legal nature in order to raise one of trust and confidence, but that it may under certain circumstances exist between mere relatives . . . ."[149]

The court in *Oehler v. Hoffman*[150] also recognizes the distinction between fiduciary and confidential relations. The court found that a confidential relation "may exist although there is no fiduciary relation. It exists when one person has gained the confidence of another and purports to act or advise with the other's interest in mind."[151] The court concluded that a confidential relationship is embodied by "the presence of a dominant influence" that the one party has over the other.[152] The *Oehler* court cites a *Drake Law Review* article,[153] and Bogert also makes reference to it in his citation to *Oehler*.[154]

The article cited by *Oehler*, "*Contracts in Iowa Revisited—Fraud and Misrepresentation, Duress and Undue Influence*"[155] recognizes the distinction. The author explained that Iowa courts had taken the position of treating confidential relationships covered by section 497 of the *Restatement of Contracts* in the same manner as fiduciary relationships referred to in section 498.[156] Hudson made reference to the distinction between fiduciary and confidential, as illustrated in the *Restatement of Contracts*.[157] Hudson correctly

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148. *Id.*

149. *Id.* (referring to JOHN W. SMITH, LAW OF FRAUD, § 23 (1907)). See *infra* text accompanying notes 172-204 for a discussion of family relations as fiduciary or confidential.

150. 113 N.W.2d 254 (Iowa 1962). The court found a confidential relation did not exist that would render a deed invalid. The relationship was between an elderly woman, and a married couple that did her errands, and were friends with her. *Id.*

151. *Id.* at 256.

152. *Id.*

153. *Id.*; *see also* Richard S. Hudson, *Contracts in Iowa Revisited—Fraud and Misrepresentation, Duress and Undue Influence,* 9 DRAKE L. REV. 3 (1959).

154. *See* BOGERT, *supra* note 126, § 482 at 280-81 n.53.

155. Hudson, *supra* note 153.

156. *See* Hudson, *supra* note 153, at 14-15.

157. RESTATEMENT OF CONTRACTS §§ 497, 498, at 954-57 (1932).

identifies section 497 as covering confidential relationships, and section 498 as covering fiduciary relationships. Comment *a* to section 497 states: "[t]he relationships that ordinarily fall within the rule are those of parent and child, guardian and ward, *husband and wife* . . . ."[158] This comment suggests that in order to determine if a confidential relationship exists, each relationship must be examined on a case-by-case basis. "[I]t is a question of fact whether the relationship in a particular case is such as to give one party dominance over the other, or put him in a position where words of persuasion have undue weight . . . ."[159]

Thus, section 497 of the Restatement identifies a confidential relation as one characterized by domination or influence. Section 498 covers fiduciary relationships. Comment *a* to section 498 states "[t]he rule is more severe than that applicable generally where there is a *confidential relationship*."[160] This may have to do with the fact that the law imposes a special duty on fiduciaries, and the consequences would be more severe if the fiduciary violated the obligation. Sections 497 and 498 make clear that the Restatement distinguishes fiduciary from confidential relationships, and comment *a* to section 498 reinforces this distinction by making "the rule . . . more severe" if the relationship is fiduciary rather than confidential.[161]

Given the preceding material, a fiduciary relation is viewed as a relationship, and consequently, a duty the law recognizes through

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158. RESTATEMENT OF CONTRACTS § 497 cmt. a, at 954 (1932) (emphasis added). See *infra* text accompanying notes 172-204 for a discussion of marriage constituting a confidential relationship.

159. RESTATEMENT OF CONTRACTS § 497 cmt. a, at 955 (1932).

160. *Id.* § 498 cmt. a (emphasis added).

161. *Id.* This same distinction in the Restatement of Contracts is carried over in the Restatement of Contracts, Second. Section 177 in Restatement Second is based on former § 497. *See* RESTATEMENT (SECOND) OF CONTRACTS § 177 reporter's note (1979). Section 177 is essentially the same rule as § 497. Comment a to § 177 explains as follows: "[r]elations that often fall within the rule include those of *parent and child, husband and wife*, clergyman and parishioner, and physician and patient." RESTATEMENT (SECOND) OF CONTRACTS § 177 cmt. a (emphasis added). Notice that some of the relationships enumerated in former § 497 have been dropped, but that of husband and wife and parent and child have been kept intact. See *supra* text accompanying notes 172-204 for a discussion of family relations being fiduciary or confidential.

Section 173 of Restatement Second of Contracts is based on former § 498. *See* RESTATEMENT (SECOND) OF CONTRACTS § 173 reporter's note (1979). Comment a highlights the distinction between fiduciary and confidential relationships; "[the fiduciary rule] is more severe than the rule relating to non-disclosure in the case of one who stands in a relation of trust and confidence but who is not a fiduciary." Thus, the distinction enunciated in Restatement of Contracts continues to survive in the Restatement of Contracts, Second. *Id.* at cmt. a.

certain enumerated relationships, such as trustee and beneficiary. Whereas, a confidential relation, born in equity, defies a precise definition, but is one where trust and confidence is reposed by one in another and is marked by reliance and control by the receiver of the information over the giver of the information. There is a distinction between fiduciary and confidential, and for the Second Circuit to ignore it by claiming that a confidential relation is the functional equivalent of a fiduciary relation is to play fast and loose with the law in the area. The Second Circuit's analysis also ignores the intent both of the American Law Institute in drafting the *Restatement (Second) of Torts* and the Supreme Court, which adopted the Restatement definition in *Chiarella v. United States*.[162]

In going to the very roots of the phrase, "fiduciary or other similar relation of trust and confidence,"[163] it becomes apparent that a distinction between the two terms does exist. For courts to ignore one aspect of the analysis by claiming that it is the same as a separate part of analysis is to disregard the true meaning of the terms being used. The effect of such a tainted analysis is to create a loophole in the law of insider trading. Family members and their tippees involved in family-controlled corporations may evade the consequences of their wrongful conduct, unlike other market participants engaging in similar behavior. To ignore the confidential relationship aspect of the analysis is to leave the inquiry incomplete. The result is this loophole in insider trading laws involving family-controlled corporations that ultimately leads to ineffective enforcement of insider trading laws. Although Judge Winter's proposed rule[164] could be used as a weapon against insider trading perpetrated by family members of family-controlled corporations and their tippees, the rule may be too expansive and is also unnecessary. Judge Winter's intent was to plug the hole that the majority opinion created. While Judge Winter's rule may plug the hole effectively, it may also cause a backlash of water to sweep over the dam. In the words of Judge Miner, if the proposed rule were adopted "[t]he net would be spread wider than appropriate in a criminal context."[165] Judge Miner is referring to the possibility that the proposed rule would sweep in family members undeserving of such treatment,

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162. 445 U.S. 222, 228 (1980).

163. *See supra* note 31 and accompanying text.

164. See *supra* text accompanying note 124 for Judge Winter's proposed rule.

165. United States v. Chestman, 947 F.2d 551, 582 (2d Cir. 1991) (en banc) (Miner, J., concurring), *cert. denied*, 112 S. Ct. 1759 (1992).

such as "minor children."[166] Aside from the possibility that the rule would bring in more people than it should, the rule is unnecessary.

Judge Winter's intent was to create a test in order to identify certain relationships as fiduciary-at-law. Judge Winter recognizes the problem created by the majority, but his solution is a judge-made rule that is unnecessary when the answer can be found within the case law interpreting Rule 10b-5.

The courts need only look to the neglected analysis of trust and confidence relations to deal with the problem involving family-controlled corporations. If the court were to use a case-by-case factual inquiry into the existence of a relationship of trust and confidence in addition to the usual search for a fiduciary relationship, Rule 10b-5 would be more effective in the context of family-controlled corporations specifically, as well as prosecutions in general.

The majority in *Chestman* refused to apply equity standards to the situation.[167] An in depth inquiry into the law in the area would have revealed to the court that such a standard is not only proper, but required. The trust and confidence relationship comes from equity and has always been more flexible than the stricter fiduciary relationship analysis at law. It follows from the case law that the Supreme Court would not have adopted the phrase, "fiduciary or other similar relation of trust and confidence" from the *Restatement (Second) of Torts* in *Chiarella v. United States*[168] unless it intended that the phrase be used in its entirety. This includes an analysis of the existence of a relation of trust and confidence using equity standards under which it was established.

In applying a trust and confidence relationship analysis to the facts of *Chestman*, the conclusion is reached that the relationship between Keith Loeb and his wife Susan was sufficient to support a finding of a confidential relationship. There was confidence and dependence on the part of Keith over Susan when Susan disclosed the inside information to Keith. As the *Chestman* court indicated, the mere entrusting of information with another is not enough to create a fiduciary relationship.[169] However, when this entrusting of information is combined with other factors, it does create the existence of a relation of trust and confidence. One such factor is that both Susan and Keith were family members in a family-controlled corpo-

166. *Id.* at 583 (Miner, J., concurring).

167. See *supra* notes 114-16 and accompanying text for a discussion of the court's refusal to apply equity standards in *Chestman*. *See Chestman*, 947 F.2d at 569-70.

168. 445 U.S. 222, 228 (1980).

169. *Chestman*, 947 F.2d at 567.

ration setting. The family-controlled corporation element makes the family member's situation require more loyalty and confidence than in a normal family setting.

The evidence also indicated that Keith and Susan had shared secrets in the past and these confidences were maintained.[170] This displays that their relationship was one where there was both confidence and dependence. Also of significance was Susan's directive that Keith not disclose the information to anyone. This demonstrates that there was also an element of reliance in Susan and Keith's relationship. Analyzing the facts of *Chestman* under a trust and confidence relationship standard demonstrates that the relationship between Susan and Keith was one of trust and confidence.

The *Chestman* court was mistaken in looking only for a fiduciary relationship or its functional equivalent. An examination of *Chiarella v. United States*[171] and the sources upon which it relied indicate that a distinction between fiduciary and trust and confidence relations does exist, thereby demonstrating the need to perform a separate inquiry into the existence of a relation of trust and confidence. And because trust and confidence relations originate from an equity background, it is appropriate to use such a standard in performing a trust and confidence relation analysis.

B. *An Analysis of Family Relationships as Either a Fiduciary or Similar Relation of Trust and Confidence*

The court in *Chestman* found it necessary not only to look for a fiduciary relationship, but also a similar relationship of trust and confidence as part of its 10b-5 inquiry.[172] The analysis of the Second Circuit included this inquiry because when the Supreme Court first dealt with the insider trading issue in *Chiarella*,[173] it determined that the disclose-or-abstain duty "arises when one [party] has information 'that the other [party] is entitled to know because of a fiduciary or *other similar relation of trust and confidence* between them.'"[174] Because the Supreme Court chose to tie the disclose-or-abstain duty to a "fiduciary or other similar relation of trust and

170. *Id.* at 579.

171. 445 U.S. 222 (1980).

172. *Chestman*, 947 F.2d at 568.

173. 445 U.S. 222 (1980).

174. *Id.* at 228 (emphasis added) (quoting RESTATEMENT (SECOND) OF TORTS § 551(2)(a) (1976)). See *supra* note 31 and accompanying text for the source of the phrase "fiduciary or other similar relation of trust and confidence."

confidence,"[175] anytime a question of Rule 10b-5 liability arises, the court must determine if *either* of these relationships is present.

Since the heart of the court's analysis in *Chestman*[176] is an inquiry into the presence of a fiduciary or similar relation of trust and confidence,[177] it is important to understand what relationships these terms encompass. When the Supreme Court used the phrase "fiduciary or other similar relation of trust and confidence" in *Chiarella*,[178] it actually quoted from the *Restatement (Second) of Torts*,[179] and included a reference to a law review article on misrepresentation.[180]

The *Restatement (Second) of Torts* Section 551 deals with "[l]iability for [n]ondisclosure."[181] As can be seen from the text,[182] section 551(2)(a) suggests a duty to disclose when a fiduciary or similar relation of trust and confidence exists between the parties. Comment f on clause (a) lends some insight as to what constitutes a fiduciary or trust and confidence relation.[183] The comment states:

> [m]embers of the same family normally stand in a fiduciary relation to one another, although it is of course obvious that the fact that two men are brothers does not establish relation of trust and confidence when they have become estranged and have not spoken to one another for many years.[184]

The comment demonstrates that the original source of the phrase "fiduciary or other similar relation of trust and confidence"[185] recognized that a family relation "normally" is fiduci-

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175. *Id.*

176. United States v. Chestman, 947 F.2d 551 (2d Cir. 1991) (en banc), *cert. denied*, 112 S. Ct. 1759 (1992).

177. *Id.* at 567. "[W]e turn to our central inquiry—what constitutes a fiduciary or similar relationship of trust and confidence in the context of Rule 10b-5 criminal liability?" *Id.*

178. *Chiarella*, 445 U.S. at 228.

179. RESTATEMENT (SECOND) OF TORTS § 551(2)(a) (1976).

180. Flemming James Jr. & Oscar S. Gray, *Misrepresentation—Part II*, 37 MD. L. REV. 488, 525 (1978).

181. RESTATEMENT (SECOND) OF TORTS § 551(2)(a) (1976) states as follows:

> (2) One party to a business transaction is under a duty to exercise reasonable care to disclose to the other before the transaction is consummated, (a) matters known to him that the other is entitled to know because of a fiduciary or other similar relation of trust and confidence between them.

Id.

182. *See id.*

183. RESTATEMENT (SECOND) OF TORTS § 551(2)(a) cmt. f (1976).

184. *Id.*

185. RESTATEMENT (SECOND) OF TORTS § 551(2)(a) (1976).

ary.[186] A family relation may also be of trust and confidence, however, this depends on a factual inquiry.

In the Reporter's Note for section 551 a case is cited as support for the comment; the case supports the premise that a family relationship is normally fiduciary or confidential.[187] In the *Enyart* case, the Supreme Court of Nebraska held that even between a future husband and wife a confidential relationship existed.[188] "It is also a well-established rule that, in view of the close and *confidential relation* existing between affianced persons, it is the duty of the prospective husband to make a full and fair disclosure . . . ."[189] This case lends further support for the Restatement's conclusion that a familial relationship is normally fiduciary or confidential. Despite this, the *Chestman* court determined that a husband-wife relationship was not fiduciary, nor confidential.[190] It is of significance that the *Chestman* court selectively relies on the authority of the Restatement, but refuses to accept all the ramifications of such reliance.

The Restatement and the case it cites tend to contradict the authority cited by the Second Circuit in *Chestman*, which held that a family relation is not fiduciary.[191] These authorities, in turn, lend support for finding a fiduciary relation among family members of a family-controlled corporation. This support is based on the fact that if family relations have been deemed fiduciary by past case law, it would follow that a family relation with an added element of a family-controlled corporation could support a finding of a fiduciary or similar relation of trust and confidence even more so than a simple family relationship. In fact, Judge Winter points out that it is this family-controlled corporation context that is so important to the analysis and that is entirely ignored by the majority opinion.[192]

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186. *Id.* at cmt. f.

187. *In re* Enyart's Estate, 160 N.W. 120 (Neb. 1916), *overruled in part* by Kingsley v. Noble, 263 N.W. 222 (Neb. 1935). The court held that a future husband and wife stood in a confidential relation, which imposed a duty of full disclosure on the husband to tell of his true net worth before having his wife sign an antenuptial agreement. The court allowed the wife to cancel the agreement and receive what she was allowed under law because the husband failed to disclose such information. *Id.*

188. *Enyart*, 160 N.W. at 120.

189. *Id.* at 123 (emphasis added).

190. United States v. Chestman, 947 F.2d 551, 568-70 (2d Cir. 1991) (en banc), *cert. denied*, 112 S. Ct. 1759 (1992).

191. *Id.* at 568 ("Kinship alone does not create the necessary relationship." *Id.*) (citing United States v. Reed, 601 F. Supp. 685, 706 (S.D.N.Y.), *rev'd on other grounds*, 773 F.2d 477 (2d Cir. 1985) (quoting BOGERT, *supra* note 126, § 482 at 300-11)).

192. *Id.* at 580 (Winter, J., dissenting).

Further support for the contention that a family relation is one of trust and confidence is found in the law review article cited by the Supreme Court in *Chiarella*.[193] The James & Gray article on misrepresentation states that the duty to disclose "has been extended to relations of trust and confidence beyond technical trusts."[194] In the footnote supporting this assertion, it says, "[m]embers of the same family often stand in such a relationship to each other that full disclosure is required, but this may be varied by circumstances."[195] It seems to follow that in a family-controlled corporation context there is no need to vary the finding of a fiduciary or similar relation of trust and confidence. In fact, it is this added element which calls for the finding of a fiduciary or other similar relation of trust and confidence beyond that found in a normal family relationship. Thus, both sources cited by the Supreme Court in *Chiarella* for the proposition that a duty to disclose arises when "a fiduciary or other similar relation of trust and confidence" exists,[196] lend support to the contention that a family relation may qualify as either fiduciary or confidential.[197]

In *Appeal of Darlington*,[198] a case cited by the James & Gray article, the Supreme Court of Pennsylvania attempted to define a confidential relation, and in so doing listed some accepted examples.

> The confidential relation is not at all confined to any specific association of the parties to it. While its more frequent illustrations are between persons who are related as trustee and *cestui que trust*, guardian and ward, attorney and client, *parent and child, husband and wife*, it embraces partners and copartners, principal and agent, master and servant, physician and patient, and gener-

193. Chiarella v. United States, 445 U.S. 222, 228 n.9 (1980) (citing James & Gray, *supra* note 180, at 523-27).

194. James & Gray, *supra* note 180, at 525.

195. *Id.* at n.11. In this same footnote the authors cite other sources for "[l]ists of confidential relationships." *Id.* These sources include: Appeal of Darlington, 23 A. 1046, 1047 (Pa. 1892); David Berger & Joanne Hirsch, *Pennsylvania Tort Liability for Concealment and Nondisclosure in Business Transactions*, 21 TEMP. L.Q. 368, 371 n.17 (1948); William B. Goldfarb, *Fraud and Nondisclosure in the Vendor-Purchaser Relation*, 8 W. RES. L. REV. 5, 32 (1956).

196. The sources cited by the Supreme Court are RESTATEMENT (SECOND) OF TORTS § 551(2)(a) (1976) and James & Gray, *supra* note 180.

197. *Chiarella*, 445 U.S. at 228. See *supra* text accompanying notes 172-95 for a discussion showing that the sources cited by the *Chiarella* Court support the proposition that a family relationship can be either fiduciary or confidential.

198. 23 A. 1046 (Pa. 1892). In *Appeal of Darlington*, the court invalidated a note for $7,000, signed by an uncle to his nephew, because of the existence of a confidential relation between the two, created by a close, dependency relationship. *Id.*

> ally all persons who are associated by any relation of trust and confidence.[199]

The James & Gray article cited a *Western Reserve Law Review* article titled *Fraud and Nondisclosure in the Vendor-Purchaser Relation* for support.[200] The article, written by William B. Goldfarb, identifies some specific trust and confidence relations. "Certain relationships may be called fiduciary-in-law. They are the classical relationships of trust and confidence. They include, among others, attorney and client, officers of a corporation and shareholders . . . and *siblings* [to each other]."[201]

Applying *Appeal of Darlington* and the Goldfarb article to *Chestman*, it seems to follow that a fiduciary or similar relation of trust and confidence can be found between either Keith and Susan, as husband and wife, or between Keith and the Waldbaum family, as family members in a family-controlled corporation. There is a plethora of authority from the common law that points to the conclusion that a family relationship in certain contexts can be of a fiduciary quality.[202] When this family relation is put into a family-controlled corporation context, it is even more compelling to find a fiduciary or other similar relation of trust and confidence.

The Securities and Exchange Commission expressed a similar position in its *amicus curiae* brief in support of the rehearing en banc in *Chestman*. "[F]amily members, and especially husbands and wives, do not typically deal with each other at arm's length, and the characteristics of family relationships do not resemble those of companies dealing with each other in the general business world . . . ."[203] Family members should know, when they are privy to inside information solely because of their relationship within the family, that such information should stay within the family, and it is not something they should be allowed to pass on to others with no accountability for such actions. Thus, the *Chestman* court failed to consider the added element of a family-controlled corporation and incorrectly concluded that a family relation within the context of a family-controlled corporation is not fiduciary or confidential in nature.

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199. *Id.* at 1047 (emphasis added).

200. Goldfarb, *supra* note 195.

201. *Id.* at 32 (footnotes omitted) (emphasis added).

202. See *supra* text accompanying notes 172-201 for authorities supporting premise that a family relationship is fiduciary.

203. Brief for the Securities and Exchange Commission at 14, United States v. Chestman, 947 F.2d 551 (2d Cir. 1991) (No. 89-1276).

The majority opinion says that a family relation is not fiduciary. What the majority opinion ignores is the surrounding circumstances. This is not just a family relation per se, it is a family relation within the context of a family-controlled corporation. The majority opened the door to this interpretation when it said, "[a]lthough spouses certainly may by their conduct become fiduciaries, the marriage relationship alone does not impose fiduciary status."[204] When this admission that spouses can become fiduciaries through their conduct is added to the inquiry, it makes it possible to find a fiduciary or other similar relation of trust and confidence under the facts involved, namely the added element of a family-controlled corporation. Therefore, there is support for the conclusion that a family relationship is fiduciary, in contrast to what the majority found. And when the family-controlled corporation context is added to the situation, a finding of a relationship of trust and confidence is all the more probable.

CONCLUSION

Family members of family-controlled, publicly traded corporations and their tippees should not be allowed to disclose information and perform trades that would be unlawful if in the hands of other market participants. The Second Circuit's decision in *Chestman* allows just such behavior on the part of family-controlled corporation family members and their tippees. Not only did the decision create this safe harbor for family members and their tippees, but the decision is not based on a credible canvass of the law in the area.

As demonstrated by the case law, a family relation is capable of being fiduciary or confidential in nature. When the family-controlled corporation context is added to the analysis, it makes even more sense to find a fiduciary or confidential relation. Also supported by the case law is the conclusion that a distinction between fiduciary and confidential relationships does exist. Confidential relations require an inquiry into the facts behind each relationship, unlike a fiduciary relationship which is given special designation by law. A factual inquiry into the existence of a confidential relationship on a case-by-case basis is both supported by the law in the area and represents the best method of netting family members and their tippees who deal in nonpublic inside information in the family-con-

204. United States v. Chestman, 947 F.2d 551, 568 (1991) (en banc), *cert. denied*, 112 S. Ct. 1759 (1992).

trolled corporation context. This is the best way to level the playing field and take away the unfair advantage family members and their tippees enjoy over the rest of the marketplace in dealing with inside information.

William A. Snider