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## WHY MARTHA STEWART DID NOT VIOLATE RULE 10B-5: ON TIPPING, PIGGYBACKING, FRONT-RUNNING AND THE FIDUCIARY DUTIES OF SECURITIES BROKERS<sup>©</sup>

*Ray J. Grzebielski\**

### I. INTRODUCTION

On December 27, 2001, Martha Stewart sold all her shares in ImClone Systems Corp. (“ImClone”) after her securities broker told her ImClone’s president was trying to sell all his ImClone stock and one of his family members sold all her stock.<sup>1</sup> The next day, ImClone announced that the Food and Drug Administration had refused ImClone’s Biologics Licensing Application for approval of the cancer drug Erbitux.<sup>2</sup> After this press release, ImClone’s stock declined precipitously from \$55.25 to \$45.39.<sup>3</sup>

Subsequently, the United States Department of Justice (“DOJ”) and the Securities and Exchange Commission (“SEC”) investigated Martha

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1. Superseding Indictment, *United States v. Martha Stewart and Peter Bacanovic*, 305 F. Supp. 2d 368 (S.D.N.Y. 2004), reprinted in 36th Annual Institute on Securities Regulation, 1401, 1407-08 (PLI Corp. Law & Practice Course Handbook Series No. 3303, 2004), WL 1455 PLI/Corp 1357 [hereinafter *Superseding Indictment*] (reprinting a copy of the superseding indictment, from which many of the factual statements about Martha Stewart’s trading in ImClone’s stock are taken).

2. *Id.* at 1408. According to the indictment:

On or about October 31, 2001, ImClone submitted to the United States Food and Drug Administration . . . a Biologics Licensing Application . . . for approval of Erbitux. . . Pursuant to FDA regulations, within 60 days following the submission of [an Application], the FDA must decide whether [it] is administratively and scientifically complete to be accepted for FDA review. Only if [an Application] is accepted for filing does the FDA review the application to determine whether the proposed treatment will be approved.

*Id.* at 1405-06.

3. *Id.* at 1408.

Stewart's sale of ImClone stock.<sup>4</sup> The DOJ indicted Martha Stewart for conspiracy to obstruct justice in the course of the investigation and for making false statements,<sup>5</sup> but did not charge her with insider trading.<sup>6</sup> The SEC brought civil charges against Martha Stewart, including a charge for insider trading in ImClone stock.<sup>7</sup> Subsequently, a jury convicted Martha Stewart on four counts of perjury and obstruction of justice.<sup>8</sup>

This article will set out to show that Martha Stewart did not engage in insider trading. First, the article will present the legal standards for insider trading. Then, the article will examine whether Martha Stewart received an improper tip from Sam Waksal, the president of ImClone and a personal friend of Martha Stewart. The article will then proceed to look at whether Martha Stewart's knowledge of Waksal's attempted

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4. *Id.* 1409-35 (identifying the indictment's allegations as to Martha Stewart's and Peter Bacanovic's statements and behavior in the course of the investigation).

5. *Id.* Since Martha Stewart apparently feared her trading in ImClone stock was illegal, she did not have to cooperate with federal investigators. Without her statements to investigators, there was no basis for her conviction.

6. There is some evidence in the indictment that DOJ seriously considered charging Martha Stewart with insider trading but then thought better of it. *See id.* at 1403-05. For example, the indictment contains excerpts of Merrill Lynch's policies prohibiting its employees from disclosing information about customers' trades. *Id.* *See infra* note 150 for an excerpt of Merrill Lynch's policies. That indictment also includes statements that Martha Stewart was licensed by the National Association of Securities Dealers and worked as a securities broker before forming Martha Stewart Living, Omnimedia, Inc. Superseding Indictment, *supra* note 1, at 1402. Yet, it would not be necessary to include these statements in a charge for either the obstruction of justice or for making false statements. While the DOJ did not indict Martha Stewart for insider trading in ImClone stock, it did indict her on one count of securities fraud for publicly reiterating statements to the SEC, FBI, and the United States Attorney's Office in press releases issued on behalf of her company, Martha Stewart Living Omnimedia, Inc. *Id.* at 1436-42 (listing count nine of the indictment). Those statements were alleged to be false and material to traders in Stewart's company's stock. *Id.* The district court ultimately directed a verdict of acquittal in Martha Stewart's favor on the basis that the prosecution had not made a sufficient showing that a jury could conclude beyond a reasonable doubt that Stewart had the requisite state of mind to be found guilty of securities fraud. *United States v. Stewart*, 305 F. Supp. 2d 368, 369-70 (S.D.N.Y. 2004). Like the obstruction of justice charges, had Martha Stewart said nothing or merely "no comment," there would have been no basis for the securities charge.

7. Complaint at para. 1, *SEC v. Stewart*, No. 03 CV 4070 (NRB) (S.D.N.Y. filed June 4, 2003), available at <http://www.sec.gov/litigation/complaints/comp18169.htm>. On August 7, 2006, the SEC announced it had reached a settlement of the insider trading charges against Martha Stewart. SEC Lit. Rel. No. 19794 (August 7, 2006). Stewart agreed to disgorge \$45,673, which includes the losses she avoided trading ImClone stock, plus prejudgment interest for a total of \$58,062. She also agreed to a civil penalty of \$137,019, a five year bar from serving as a director of a public company, and a five year limitation prohibiting her from participating in certain financial reporting activities. *See*, <http://www.sec.gov/litigation/litreleases/2006/lr19794.htm>. As of the date of this article, the SEC charges are still pending.

8. *See United States v. Stewart*, 433 F.3d 273, 279 (2d Cir. 2006) (affirming both Martha Stewart's and Peter Bacanovic's convictions).

trading constituted material nonpublic information on which she improperly traded. Lastly, the article will examine whether Peter Bacanovic's breach of Merrill Lynch's confidentiality policy in telling Martha Stewart of another customer's trading provided a basis for a rule 10b-5 violation.

The conclusion of this article is that there are no established facts that Martha Stewart owed anyone a fiduciary duty, nor that she inherited anyone else's duty, which should result in a violation of rule 10b-5. When Martha Stewart misled investigators about her trading, she feared wrongly that her trading was illegal.

## II. THE SUPREME COURT'S INTERPRETATION OF THE LAW OF INSIDER TRADING

Neither section 10(b)<sup>9</sup> nor rule 10b-5<sup>10</sup> under the 1934 Securities Exchange Act<sup>11</sup> ("1934 Act") explicitly forbid trading on material<sup>12</sup> nonpublic information.<sup>13</sup> In three cases, the Supreme Court established

9. Section 10(b) of the Securities Exchange Act of 1934 provides:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange. . . . To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, or any securities-based swap agreement (as defined in section 206B of the Gramm-Leach-Bliley Act), any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

15 U.S.C. § 78j(b) (2000).

10. Rule 10b-5 provides:

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

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

17 C.F.R. § 240.10b-5 (2007).

11. 15 U.S.C. §§ 78a-78mm (2000).

12. In *Basic Inc. v. Levinson*, the Supreme Court adopted a materiality standard for rule 10b-5. 485 U.S. 224, 232 (1988). Previously, in *TSC Industries, Inc. v. Northway, Inc.*, the Court said that "[a]n omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote." 426 U.S. 438, 449 (1976). In *Basic*, the Court adopted the same standard for purchases and sales under rule 10b-5. *Basic*, 485 U.S. at 232.

13. In fact, in the original 1934 Securities Exchange Act, only section 16(b) speaks directly to

the parameters for finding such a violation.

In the first case, *Chiarella v. United States*,<sup>14</sup> the Court held that anyone trading in securities must breach a fiduciary duty owed to the other party to the transaction in order to violate rule 10b-5 for failing to disclose material nonpublic information.<sup>15</sup> Chiarella was an employee of a financial printer.<sup>16</sup> While at work, Chiarella became aware of five corporate takeover bids.<sup>17</sup> Chiarella purchased stock in the targets of these takeovers before the public announcement of the bids.<sup>18</sup> Immediately after their announcement, he sold his stock and realized, in the aggregate, a profit of approximately \$30,000.<sup>19</sup>

The Court characterized the charges against Chiarella as involving “the legal effect of [his] silence.”<sup>20</sup> The district court’s jury instructions allowed Chiarella’s conviction for failing to tell the sellers of target company stock of the impending takeover bids.<sup>21</sup> After an examination of precedent, and resort to the common law of fraud,<sup>22</sup> the Court

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the abuse of information in securities trading. 15 U.S.C. § 78p(b) (2000). That section provides a civil remedy whereby officers, directors, and shareholders of more than ten percent of a class of equity securities registered under the 1934 Act may be liable to disgorge profits from any purchase and sale or sale and purchase of securities within six months to the issuer of securities. *Id.* Of course, with congressional amendments to the 1934 Act, Congress showed approval of the interpretation of section 10(b) and rule 10b-5 to prohibit some trading on material nonpublic information. See, for example, section 21A, 15 U.S.C. § 78u-1 (2000), where Congress explicitly gave the SEC the authority to seek disgorgement of profits made or losses avoided in insider trading and to obtain penalties for such trading up to three times such profits or losses.

14. 445 U.S. 222 (1980).

15. *Id.* at 224-35. The *Chiarella* Court focused on whether Chiarella owed any duty to the security holders who sold shares to him. *Id.* at 232-33.

16. *Id.* at 224.

17. *Id.* Four of the five takeover bids were tender offers, and one was a corporate merger. *Id.* at 224 n.1.

18. *Id.* at 224.

19. *Id.* Prior to the criminal charges in this case, Chiarella settled with the SEC and agreed to disgorge his profits. *Id.*

20. *Id.* at 226.

21. *Id.* In his dissent, Chief Justice Burger argued for a broader reading of the jury instructions. *Id.* at 243-44 (Burger, C.J., dissenting).

22. The Supreme Court has recognized that the common law developed around transactions, which differed greatly from securities traded on impersonal markets. In *SEC v. Capital Gains Research Bureau*, the Court said:

There has also been a growing recognition by common-law courts that the doctrines of fraud and deceit which developed around transactions involving land and other tangible items of wealth are ill-suited to the sale of such intangibles as advice and securities, and that, accordingly, the doctrines must be adapted to the merchandise in issue.

375 U.S. 180, 194 (1963).

Further, in *Herman & MacLean v. Huddleston*, the Court stated:

[T]he antifraud provisions of the securities laws are not coextensive with common-law doctrines of fraud. Indeed, an important purpose of the federal securities statutes was to

concluded that nondisclosure of material nonpublic information can violate rule 10b-5, but only if there is “a duty to disclose arising from a relationship of trust and confidence between parties to a transaction.”<sup>23</sup> The Court found “[t]hat the relationship between a corporate insider and the stockholders of his corporation gives rise to a disclosure obligation is not a novel twist of the law.”<sup>24</sup> The Court thereby accepted administrative and judicial developments prohibiting trading on material nonpublic information by persons with a corporate position.<sup>25</sup>

Since Chiarella was “a complete stranger who dealt with the sellers only through impersonal market transactions,” the Court reversed Chiarella’s conviction.<sup>26</sup> While corporate insiders always have a relationship of trust and confidence with the stockholders of their company, there is no general duty between traders in all market transactions to disclose material nonpublic information they possess or to refrain from trading.<sup>27</sup> The Court explicitly rejected the position that section 10(b) required equal access to material information.<sup>28</sup>

In the second Supreme Court case, *Dirks v. SEC*,<sup>29</sup> the Court clarified the manner in which “tippees” of material nonpublic information can violate rule 10b-5.<sup>30</sup> A former officer of Equity Funding of America told Dirks, an insurance company securities analyst,

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rectify perceived deficiencies in the available common-law protections by establishing higher standards of conduct in the securities industry. We therefore find reference to the common law in this instance unavailing.

459 U.S. 375, 388-89 (1983) (footnote and citations omitted). Yet, in *Chiarella*, the Supreme Court resorted to concepts of common law fraud without any explanation of how those doctrines served the purposes of the federal securities laws. See *Chiarella*, 445 U.S. at 225-37.

23. *Chiarella*, 445 U.S. at 230.

24. *Id.* at 227. The Supreme Court validated administrative and judicial developments in interpreting rule 10b-5 to forbid trading on corporate information by corporate insiders. *Id.* at 230. The Court ultimately left open whether trading on information not concerning the earning power or operations of the company – so-called “market information” – might violate rule 10b-5. See *id.* The Court did not decide if a breach of duty to a nontrading party connected to a securities transaction or misappropriation of someone’s information used in trading can violate rule 10b-5. *Id.* at 235-37. In other words, when the party defrauded did not trade in securities, can there be securities fraud? Chief Justice Burger argued in his dissent that the misappropriation of information gave rise to a duty between the parties to a transaction and, therefore, resulted in a violation of rule 10b-5. *Id.* at 240.

25. *Id.* at 230.

26. *Id.* at 232-33.

27. *Id.* at 233.

28. *Id.* at 231-33 (refusing to find that section 10b-5 prohibits any informational advantages that certain buyers or sellers might possess over other traders in a transaction).

29. 463 U.S. 646 (1983).

30. *Id.* at 661-65.

that the company's assets were "vastly overstated."<sup>31</sup> Dirks investigated what turned out to be a massive fraud.<sup>32</sup> As he discovered more facts, he shared what information he uncovered with clients and investors, some of whom sold their shares of Equity Funding stock.<sup>33</sup>

In an SEC administrative proceeding, the SEC concluded that "[w]here 'tippees'—regardless of their motivation or occupation—come into possession of material 'corporate information that they know is confidential and know or should know came from a corporate insider,' they must either publicly disclose that information or refrain from trading."<sup>34</sup> Even though the SEC merely censured Dirks, he appealed.<sup>35</sup> A divided panel for the Court of Appeals for the District of Columbia affirmed the censure.<sup>36</sup>

The Supreme Court reversed the court of appeals.<sup>37</sup> Previously, the Supreme Court held in *Chiarella v. United States*<sup>38</sup> that a fiduciary relationship between parties to a securities trade was a necessary element of a rule 10b-5 violation for insider trading.<sup>39</sup> As the Supreme Court observed, the "typical tippee has no such relationships [with shareholders]."<sup>40</sup> The SEC argued that, when Dirks received material, nonpublic information from Equity Funding insiders, he automatically inherited their duties to the company's shareholders.<sup>41</sup> The Court rightly rejected the SEC's position as no different from requiring equal access to material information, a position explicitly rejected in *Chiarella*.<sup>42</sup> The

31. *Id.* at 649. Other employees of Equity Funding confirmed this information. *Id.*

32. *Id.* at 649-50. Equity Funding itself went into receivership. *Id.* at 650. Twenty-two persons, including many Equity Funding officers and directors, were indicted and were found or pled guilty to at least one charge. *Id.* at 650 n.4.

33. *Dirks*, 463 U.S. at 649. In fact, before the SEC suspended trading in Equity Funding stock, Dirks' clients sold almost \$15 million of Equity Funding stock. *Id.* at 670 (Blackmun, C.J., dissenting). The majority gave Dirks some credit for exposing the fraud at Equity Funding. *Id.* at 652 n.8. The dissent, however, doubted whether Dirks played a substantial role in bringing the fraud to light. *Id.* at 677 (Blackmun, J., dissenting).

34. *Id.* at 651 (quoting 21 S.E.C. Docket 1401, 1407 (1981)).

35. *Dirks*, 463 U.S. at 652. The SEC gave credit to Dirks for a role in uncovering the fraud at Equity Funding when it only slapped his wrist with the censure. *Id.* at 651-52.

36. *Dirks v. SEC*, 681 F.2d 824, 846 (1982). In the single opinion issued by the Court of Appeals for the D.C. Circuit, the court offered two grounds to affirm Dirks' censure. *Id.* at 839-40. First, Dirks automatically assumed the fiduciary obligations of an insider when he used corporate information before general public dissemination. *Id.* at 839. Second, Dirks owed special duties due to his position in the market as an employee of a securities broker-dealer. *Id.* at 840.

37. *Dirks*, 463 U.S. at 652.

38. 445 U.S. 222 (1980).

39. *Dirks*, 463 U.S. at 654-55.

40. *Id.* at 655.

41. *Id.* at 655-56.

42. *Id.* at 657.

restrictions on insider trading do not come into play due to “one’s ability to acquire information because of his position in the market.”<sup>43</sup>

Although the Court rejected any automatically inherited fiduciary duty from insiders to tippees due to possession of nonpublic information, the Court said that “[t]he need for a ban on some tippee trading is clear.”<sup>44</sup> To hold otherwise would allow an insider to engage in “devious dealings in the name of others that the trustee could not conduct [on] his own.”<sup>45</sup> The Court stated that “[the] 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.”<sup>46</sup> Only if the insider breaches a fiduciary duty by disclosing information to a tippee for an improper purpose does a rule 10b-5 violation result.<sup>47</sup> For an improper purpose, the insider must personally benefit, directly or indirectly, from the disclosure,<sup>48</sup> although the benefit need not be pecuniary.<sup>49</sup> An insider’s gift of information to a tippee or the hope of some benefit to the tipper’s reputation that could translate into future earnings would qualify.<sup>50</sup> Since the Equity Funding insiders disclosed information to Dirks to expose fraud and not for personal gain, the Court found Dirks did not violate rule 10b-5 as a tippee who was a participant in an insider’s breach of duty.<sup>51</sup>

For a tippee to violate rule 10b-5, not only must the tipper breach a duty by disclosing the information to the tippee for an improper purpose, but the tippee must know of the breach.<sup>52</sup> Consequently, it is impossible for a tipper to violate rule 10b-5 if the tippee does not know that the tipper has breached any duty.

In the third and final case, the Supreme Court decided in *United States v. O’Hagan*<sup>53</sup> that misappropriation of information for use in

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43. *Id.* at 657-58 (quoting *Chiarella*, 445 U.S. at 231-32 n.14).

44. *Id.* at 659.

45. *Id.* at 659 (quoting *Mosser v. Darrow*, 341 U.S. 267, 271 (1951)).

46. *Id.* (quoting *Chiarella*, 445 U.S. at 230 n.12) (alteration in original).

47. *Dirks*, 463 U.S. at 661-62.

48. *Id.* at 662.

49. *Id.* at 663-64.

50. *Id.*

51. *Id.* at 667.

52. *Id.* at 660. In fact, the Court required that “the tippee knows or should know that there has been a breach.” *Id.* In the opinion, the test only reads that the tippee “know[s]” of the breach. *Id.* If the test includes the formulation that the tippee “should know,” the tippee could be found to violate rule 10b-5 on the basis of simple negligence. *See id.* Cf. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 194-214 (1976) (requiring more than simple negligence for a violation of rule 10b-5).

53. 521 U.S. 642 (1997). Between the Court’s decisions in *Dirks* and *O’Hagan*, the Court dealt with the question of insider trading in *Carpenter v. United States*, 484 U.S. 19 (1987). In that

trading securities in breach of a fiduciary duty owed to the source of the information violates rule 10b-5, even though the source of the information did not trade in the securities.<sup>54</sup> O'Hagan was a partner in the Minneapolis, Minnesota, law firm of Dorsey & Whitney.<sup>55</sup> In July 1988, Dorsey & Whitney represented Grand Metropolitan PLC ("Grand Met") in connection with a possible tender offer for the stock of Pillsbury Company.<sup>56</sup> O'Hagan bought call options on Pillsbury's stock and later purchased more call options and five thousand shares of Pillsbury common stock.<sup>57</sup> After Grand Met announced its tender offer, O'Hagan sold his Pillsbury holdings for a profit of \$4.3 million.<sup>58</sup>

The Supreme Court said that "[t]he 'misappropriation theory' holds that a person commits fraud 'in connection with' a securities transaction, and thereby violates [section] 10(b) and Rule 10b-5, when he misappropriates confidential information for securities trading purposes, in breach of a duty owed to the source of the information."<sup>59</sup> The misappropriation theory works as a necessary complement to the holding in *Chiarella* that corporate insiders could not trade on nonpublic information because they have a relationship of trust and confidence to

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case, a writer for the Wall Street Journal leaked to a broker what would be in several "Heard on the Street" columns before publication. *Carpenter*, 484 U.S. at 22-23. Trading on this information yielded significant profits. *Id.* at 23. The Supreme Court, equally divided on the issue, said nothing about whether this use of information violated rule 10b-5. *Id.* at 24. The Court did decide, however, that the misappropriation of Wall Street Journal proprietary information by one of its employees for stock trading violated federal mail and wire fraud statutes. *Id.* at 28. Although the Supreme Court failed to decide whether the misappropriation of information might violate rule 10b-5 and constitute federal securities fraud, the ruling gave the DOJ a significant victory because it criminalized the misappropriation of information under federal fraud statutes. *Id.* at 24. In *O'Hagan*, the Court also discussed the validity of a separate SEC rule, rule 14e-3, which prohibits the use of material nonpublic information in connection with tender offers. *O'Hagan*, 521 U.S. 666-78; 17 C.F.R. § 240.14e-3 (2006). The *O'Hagan* Court held that the SEC had the power to promulgate this rule even though the rule does not require a breach of fiduciary duty because the Congressional grant of authority to the SEC under § 14(e), 15 U.S.C. § 78n(e) (2000), includes the power to take action which is reasonably likely to prevent fraud. *O'Hagan*, 521 U.S. at 672. The SEC has the power to prevent, rather than merely define, fraud. *Id.* at 666-76. Since Martha Stewart's trading in no way related to a tender offer, there is no reason to discuss rule 14e-3 in this article.

54. *O'Hagan*, 521 U.S. at 652.

55. *Id.* at 647.

56. *Id.*

57. *Id.* at 647-48. O'Hagan remained free after the Supreme Court remanded his case to challenge the government's contention that he made these purchases on the basis of material nonpublic information. *Id.* at 648 n.1. O'Hagan claimed he bought the Pillsbury call options and stock due to two public news stories about Grand Met's interest in Pillsbury. *Id.*

58. *Id.* at 648.

59. *Id.* at 652.

stockholders.<sup>60</sup>

Since the misappropriation theory involves a breach of duty to someone who did not trade securities, the Court had difficulty showing how the theory fits with required elements for a rule 10b-5 violation. The Court labored to find deception, a necessary element,<sup>61</sup> separate and distinct from a state law claim of breach of fiduciary duty for an agent's misuse of a principal's property.<sup>62</sup> The Court found deception in that the misappropriator failed to disclose to the source of the information that the information would be used in trading securities.<sup>63</sup> Disclosure of intent to trade to the source of the information is all that rule 10b-5 requires.<sup>64</sup>

Any fraud under rule 10b-5 must also be "in connection with the purchase or sale of [a] security."<sup>65</sup> The misappropriation theory satisfies this requirement since the fraud is "consummated, not when the fiduciary gains the confidential information, but when, without disclosure to his principal, he uses the information to purchase or sell securities."<sup>66</sup>

Ultimately, the Court found that:

In sum, considering the inhibiting impact on market participation of trading on misappropriated information, and the congressional purposes underlying §10(b), it makes scant sense to hold a lawyer like O'Hagan as a §10(b) violator if he works for a law firm representing

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60. *Id.* at 651-53.

61. *Id.* at 653. *See also* *Carpenter v. United States*, 484 U.S. 19, 27 (1987) (finding that deception is a necessary element for mail fraud); *Santa Fe Industries, Inc. v. Green*, 430 U.S. 462, 477-78 (1977) (finding that full disclosure of all pertinent facts results in no deception and, therefore does not violate of rule 10b-5).

62. *O'Hagan*, 521 U.S. at 653-59.

63. *Id.* at 655-56. Disclosure of intended trading to the source of the information satisfies rule 10b-5. *Id.* at 655. Disclosure of impending trading almost certainly opens up the risk that the discloser might lose a job or be subject to suit under state law for stealing the information. While the Court attempts to distinguish the federal interest in disclosure from the state law claims, those claims in fact are inextricably intertwined. It will be a rare case where someone will disclose impending trading to the source of the information, satisfy the federal requirement, and feel fully confident that he can trade without exposing himself to any other legal claims or other sanctions.

64. *Id.*

65. 17 C.F.R. § 240.10b-5 (2007).

66. *O'Hagan*, 521 U.S. at 656. The Supreme Court opened the door to a very expansive interpretation of the requirement that fraud be in connection with the purchase or sale of securities. On the one hand, the Court has said rule 10b-5 provides a plaintiff a cause of action if it "suffer[s] an injury as a result of deceptive practices touching its sale [or purchase] of securities. . . ." *Superintendent of Ins. v. Bankers Life & Casualty Co.*, 404 U.S. 6, 12-13 (1971). On the other hand, the Court has also said, "Congress, in enacting the securities laws, did not intend to provide a broad federal remedy for all fraud." *Marine Bank v. Weaver*, 455 U.S. 551, 556 (1982).

the target of a tender offer, but not if he works for a law firm representing the bidder.<sup>67</sup>

The Court concluded that the use of the same material information in trading should violate Rule 10b-5 whether a duty was owed and breached to the other trader to the transaction or the source of the information.<sup>68</sup> That result is necessary to protect the integrity of the securities markets.<sup>69</sup> However, any violation of rule 10b-5 must entail a breach of fiduciary duty.<sup>70</sup> Consequently, the Court concluded that O'Hagan violated rule 10b-5 for insider trading since he breached a duty to his law firm or Grand Met when he did not tell them he intended to buy Pillsbury stock and options.<sup>71</sup>

In sum, there are several ways in which section 10(b) and rule 10b-5 may be violated for insider trading. The first is the classical theory espoused in *Chiarella* where the trader, for example, a corporate insider, has a relationship of trust and confidence to the party with whom he trades.<sup>72</sup> In those circumstances, trading on material nonpublic information without its disclosure would breach the fiduciary duty owed to the other side of the trade.<sup>73</sup> When, without its disclosure to the owner of the material information of his intention to trade securities, a person misappropriates such information for such trading, a rule 10b-5 violation also results.<sup>74</sup> Lastly, a person conveying material nonpublic information to another for trading purposes can violate rule 10b-5 if that disclosure breaches a duty and is for an improper purpose.<sup>75</sup> If the recipient of this information knows of the breach and trades, the recipient tippee can also violate rule 10b-5.<sup>76</sup>

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67. *O'Hagan*, 521 U.S. at 659.

68. *Id.* at 652.

69. *Id.* at 658.

70. *Id.* at 651-53. In upholding the SEC's power to promulgate rule 14e-3, 17 C.F.R. § 240.14e-3 (2006), the majority in *O'Hagan* failed to resolve the issue of whether the SEC's power under § 14(e) of the 1934 Act is broader than the SEC's power under § 10(b). *Id.* at 672. However, the SEC's power under § 14(e) includes the power to prescribe rules to prevent fraud in connection with tender offers. *Id.* at 673. Consequently, rule 14e-3 is a valid exercise of SEC authority even though to violate the rule there is no requirement that there be a breach of fiduciary duty. *Id.* at 666-67, 673.

71. *Id.* at 660.

72. *Id.* at 651-52.

73. See sources cited *supra* notes 14-28 and accompanying text.

74. See sources cited *supra* notes 52-72 and accompanying text.

75. See sources cited *supra* notes 29-51 and accompanying text.

76. See sources cited *supra* note 52 and accompanying text.

### III. MARTHA STEWART'S TRADING WAS NOT ON THE BASIS OF AN ILLEGAL TIP OF MATERIAL NONPUBLIC INFORMATION

#### A. No Proof That Martha Stewart Received a Tip of Material Corporate Information From Sam Waksal

No doubt the investigation of Martha Stewart's sale of ImClone stock on December 27, 2001, began on suspicion that she sold those shares because she had received nonpublic information about ImClone from Sam Waksal.<sup>77</sup> She and Sam Waksal shared the same broker at Merrill Lynch<sup>78</sup> and were friends with strong social ties.<sup>79</sup>

Martha Stewart herself was not an insider of ImClone since she had no corporate position with ImClone, whether as officer, director or employee.<sup>80</sup> Nor did she have any contractual relationship with ImClone that would have given her access to ImClone's information.<sup>81</sup>

Sam Waksal, the president, chief executive officer, and a director of ImClone,<sup>82</sup> was clearly a traditional corporate insider. Since Martha Stewart herself was not an insider of ImClone, one possible way for Martha Stewart to violate section 10(b) and rule 10b-5 for insider trading would be if she were a tippee at the time she sold her ImClone stock. If Sam Waksal told Martha Stewart of the impending FDA action before she sold her ImClone stock, she violated rule 10b-5.<sup>83</sup>

Sam Waksal, President of ImClone, clearly knew that the FDA failure to accept ImClone's application for its cancer drug, Erbitux, was

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77. After ImClone's announcement of the FDA decision on Erbitux and the resulting drop in ImClone stock price, Merrill Lynch discovered that a Waksal family member and Stewart sold ImClone stock before the announcement. *United States v. Stewart*, 433 F.3d 273, 283 (2d Cir. 2006).

78. *Id.* See also Complaint, *supra* note 7, at para. 7.

79. See Jeffrey Toobin, *Lunch at Martha's*, THE NEW YORKER, Feb. 3, 2003, at 38 (describing in some detail Martha Stewart's relationship with Sam Waksal).

80. See Complaint, *supra* note 7, at para. 1-13.

81. See *Dirks*, 463 U.S. at 655 n.14 (1982) (suggesting that underwriters, accountants, lawyers, or consultants can become the equivalent of insiders at least for the term of their services for a corporation.) Such individuals have been called "temporary insiders," a term first coined in *SEC v. Lund*, 570 F. Supp. 1397, 1403 (C.D. Cal. 1983). In fact, the defendant in that case was dealing with the corporation whose information he used to buy its securities on an arm's length basis and not as a fiduciary. See *id.* at 1399-1400. This case may have been decided incorrectly.

82. Superseding Indictment, *supra* note 1, at 1405.

83. Similarly, Martha Stewart would violate rule 10b-5 if Sam Waksal told Peter Bacanovic (or his assistant) of the FDA action and either told Martha Stewart about the pending FDA announcement. See *Dirks*, 463 U.S. at 657-61.

material nonpublic information.<sup>84</sup> Early in the morning on December 27, 2001, he contacted Merrill Lynch to sell all his shares.<sup>85</sup> He also told members of his family to sell their shares.<sup>86</sup> Before 10 a.m. that morning, a Waksal family member sold almost \$2.5 million in ImClone stock through Merrill Lynch.<sup>87</sup> Since Peter Bacanovic was on vacation, his assistant called him to tell him of the Waksal sales orders.<sup>88</sup>

Peter Bacanovic was also Martha Stewart's broker.<sup>89</sup> After talking to his assistant about the Waksal trading, Bacanovic left a message for Martha Stewart with her assistant that the assistant recorded as "Peter Bacanovic thinks ImClone is going to start trading downward."<sup>90</sup> In the early afternoon of December 27, Martha Stewart spoke to Peter Bacanovic's assistant.<sup>91</sup> He informed her that Waksal was trying to sell all his ImClone stock.<sup>92</sup> Martha Stewart directed Bacanovic's assistant to sell all her ImClone shares, which he did.<sup>93</sup>

Martha Stewart tried to reach Sam Waksal to learn why he was selling his stock, but she did not phone him until after she sold her stock.<sup>94</sup> Consequently, Sam Waksal did not tell Martha Stewart about the FDA action before she sold her stock. Nor did Sam Waksal tell

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84. Any conclusion that information is material for securities trading is reinforced by the trading of that person once he comes into possession of such information. See, for example, *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968) (en banc), where the court of Appeals expressly weighed the unusual trading by insiders in Texas Gulf Sulphur stock and options to bolster its conclusion that preliminary data on a mineral find was material. Sam Waksal was apparently so alarmed by the effect of the disclosure of the FDA's ruling that he tried to sell all his shares of ImClone. Constance L. Hays, *Ex-ImClone Chief Admits Some U.S. Charges*, N.Y. TIMES, Oct. 16, 2002, at C1. When Waksal pleaded guilty to some of the criminal charges brought against him on October 15, 2002, he told the judge that he worried the F.D.A. development "might depress the price of the stock." *Id.*

85. Superseding Indictment, *supra* note 1, at 1406. In fact, Peter Bacanovic was advised by his assistant, Douglas Faneuil, that Sam Waksal wished to sell all his shares. *Id.* Sam Waksal wanted Merrill Lynch to transfer his shares to his family member's account so they could be sold immediately. *Id.* Waksal's shares were subject to restrictions on sale. Hays, *supra* note 84. Waksal, as a probable controlling person of ImClone, could not sell his shares in a public distribution without compliance with the 1933 Securities Act. See 15 U.S.C. §§ 77a (2000).

86. Hays, *supra* note 84. In addition to his daughter, Waksal allegedly also told his father about the FDA decision although he did not plead guilty to charges of tipping his father. *Id.*

87. Superseding Indictment, *supra* note 1, at 1406.

88. *Id.* at 1407.

89. *Id.* at 1402. Martha Stewart was one of Bacanovic's most important brokerage clients due to the commissions generated from her accounts and from those accounts obtained due to Martha Stewart. *Id.*

90. *Id.* at 1407.

91. *Id.* at 1407-08.

92. *Id.*

93. *Id.*

94. Complaint, *supra* note 7, at para. 19.

Peter Bacanovic.<sup>95</sup> All Martha Stewart knew was that Sam Waksal was trying to sell all his shares.<sup>96</sup>

Therefore, Martha Stewart did not violate rule 10b-5 as a tippee who sold her stock after a traditional corporate insider improperly told her material nonpublic corporate information. There is no proof that Sam Waksal told either Peter Bacanovic or Martha Stewart that the FDA had not accepted ImClone's application for the cancer drug Erbitux. Sam Waksal apparently failed to breach any fiduciary duty that he owed to ImClone by improperly disclosing the FDA ruling on Erbitux to Peter Bacanovic or Martha Stewart.<sup>97</sup> All Martha Stewart knew was that Sam Waksal and his family were selling their stock.<sup>98</sup>

*B. Martha Stewart's Copying Waksal's Sale Order Did Not Violate Rule 10b-5*

While Sam Waksal apparently did not disclose to Peter Bacanovic or Martha Stewart why he was selling his ImClone stock, the very fact that he wanted to sell those shares had informational value. Waksal's attempt to sell his stock prompted Bacanovic's original call to Martha Stewart that Stewart's assistant recorded as "Peter Bacanovic thinks ImClone is going to start trading downward."<sup>99</sup> When Peter Bacanovic contacted Martha Stewart to tell her about Waksal's trading so that she would sell her ImClone stock, he employed a trading tactic popularly known as "piggybacking."<sup>100</sup>

When a trader learns of someone else's order or trade, a trader may mimic the other's trade. This may occur because the trader recognizes a

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95. See Superseding Indictment, *supra* note 1, at 1406. While the indictment of Martha Stewart and Peter Bacanovic reports that "[i]t had been publicly reported that the FDA's decision whether to accept the Erbitux [application] for filing was expected by the end of December 2001," the indictment never makes clear what either Martha Stewart or Peter Bacanovic knew of this timetable. *Id.*

96. *Id.* at 1407-08. In fact, the SEC complaint charging Martha Stewart with, *inter alia*, insider trading states that Martha Stewart sold her shares only with knowledge that Waksal was trying to sell his shares. Complaint, *supra* note 7, at para. 2. In the SEC Complaint, the SEC alleges that only after Martha Stewart sold her shares did she try to speak directly with Sam Waksal in order to learn why he was selling his shares. *Id.* at para. 19.

97. Waksal's use of ImClone information in attempting to sell his ImClone stock was a breach of his fiduciary duties to ImClone's stockholders, but he did not compound that breach by disclosing material nonpublic ImClone information to Peter Bacanovic or Martha Stewart.

98. Complaint, *supra* note 7, at para. 18-20.

99. Superseding Indictment, *supra* note 1, at 1407.

100. See *id.* at 1404 (excerpting Merrill Lynch's directive instructing its employees not to piggyback a client's trades).

profitable pattern of trading or believes that the person placing the order has special knowledge or information on which the trade is based. The trader does not know the reasons for the trade, just the existence of the trade itself. Anyone piggybacking on an insider's trade would not be knowingly participating in an insider's breach of duty. This is because the insider, by trading, would not be providing anyone with information for the insider's benefit. Therefore, policy dictates that the act of using knowledge of an insider's trade should not be treated as an illegal tip of material nonpublic information in violation of rule 10b-5.

A tippee only violates rule 10b-5 as a participant in an insider's breach of duty.<sup>101</sup> To do so, a tippee must know of the insider's breach.<sup>102</sup> Ordinarily, a rule 10b-5 action based on piggybacking would be difficult, if not impossible, to prove. Piggybacking is based on the trading itself as a tip of material nonpublic information. Knowledge that an insider is trading differs from knowledge that an insider is breaching a fiduciary duty. Corporate insiders may buy and sell stock in their company so long as they do so when they do not have material nonpublic information.<sup>103</sup> Consequently, anyone aware of an insider's trading cannot "know" that the insider is trading on material nonpublic information in breach of a fiduciary duty. The insider trading stock may not know any material nonpublic information. The trade may be motivated by estate or financial planning reasons rather than material nonpublic information. Or, the insider may think he knows material nonpublic information, but, upon ultimate disclosure, there may be no movement in the stock price. It is also possible that the insider may have material nonpublic information but that information never becomes public because the anticipated benefit or detriment never comes to pass. For example, the insider may become aware that the management of his corporation is engaged in serious negotiations to sell the company, but the talks may fail without any disclosure of the contemplated sale.

Not only must the tippee know of the insider's breach, but insiders

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101. *Dirks v. SEC*, 463 U.S. 646, 667 (1983).

102. *Id.* at 660 (describing how the tippee must know or "should know" of the breach).

103. See 17 C.F.R. § 240.10b5-1 (2006), which provides that rule 10b-5 is violated when someone trades while in possession of material nonpublic information. It also provides a safe harbor for transactions made pursuant to a pre-existing order or plan. *Id.* at § 240.10b5-1(c). The order, plan, or binding contract must be adopted before the person becomes aware of material nonpublic information. *Id.* And any such order, plan, or contract must have set terms concerning, among other things, the amount of securities to be bought or sold. *Id.* at § 240.10b5-1(c)(B). In fact, Martha Stewart and Peter Bacanovic both claimed that Stewart's sale of ImClone stock was pursuant to a standing order to sell if the stock price dropped below \$60. Complaint, *supra* note 7, at para. 23-25.

“. . . may not give [material nonpublic] information to an outsider for [the] improper purpose of exploiting the information for their personal gain.”<sup>104</sup> Even if the insider is trading on material nonpublic information, the insider only intends to benefit himself by the trade. The insider has no intention when trading in violation of rule 10b-5 to receive any direct or indirect personal benefit from anyone who mimics his trading. To say otherwise would automatically compound any violation of rule 10b-5 for insider trading when there is piggybacking into an additional violation of rule 10b-5 for tipping material nonpublic information. In fact, an insider would likely prefer that no one piggyback on his trades since detection of his violation would diminish.

The existing case law is consistent with these conclusions. The case law has always focused on the use of the actual nonpublic corporate information to trade in securities. In a seminal case, *In re Cady, Roberts & Co.*,<sup>105</sup> the SEC found that a corporate insider must disclose all material inside information or refrain from trading.<sup>106</sup> The duty to disclose this information is inextricably linked to the requirement to refrain from trading. The vice is “the unfairness of allowing a corporate insider to take advantage of that information by trading without disclosure.”<sup>107</sup> Tippees of insiders can violate rule 10b-5 if they improperly receive material nonpublic information, know of the tipper’s breach of duty, and then trade.<sup>108</sup> And misappropriators violate rule 10b-5 because they “secretly [convert] the principal’s information for personal gain.”<sup>109</sup> The actual use of the material nonpublic information to trade or its improper disclosure to enable another to trade constitutes the violation of rule 10b-5. An insider’s placing an order to buy or sell securities, even if on the basis of material nonpublic information, should not by itself constitute improper disclosure of material nonpublic information.

Nor should this legal doctrine be modified or expanded to find an

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104. *Dirks*, 463 U.S. at 659.

105. 40 S.E.C. 907 (1961).

106. *Id.* at 911. The statement of duties in the alternative may not reflect any ability for an insider to make an actual choice. Besides the difficulty an insider encounters in making effective disclosures to the public generally, the insider also might find his job in jeopardy. If a corporation discovers the trading, with its attendant risk of disclosure of confidential corporate information, the corporation may decide to terminate the insider.

107. *Chiarella*, 445 U.S. at 227 (1980).

108. *Dirks*, 463 U.S. at 657-65.

109. *United States v. O’Hagan*, 521 U.S. 642, 653 (1997) (quoting Brief for United States at 17).

insider's trade as the effective disclosure of corporate information and, consequently, an illegal tip. Each of the following propositions will be examined in turn. Should a broker who receives a sell order from an insider be treated as the equivalent of a tippee of valuable corporate information because he knows of the sell order? Alternatively, instead of a general rule prohibiting all copying of an insider's trading, should the particular circumstances accompanying a given order make it effectively an improper tip of material nonpublic corporate information?

The focus of the prohibitions on insider trading should be the actual use of the material nonpublic information to trade in securities and not any information which may be conveyed by the insider (or misappropriator's) trade.<sup>110</sup> There are many instances in the securities markets where traders have access to information about orders or market conditions and can trade for their own account. For example, specialists<sup>111</sup> on national stock exchanges have always had access to information about limit orders<sup>112</sup> in their order books. This information, along with the active trading at the specialist's post, can tell the specialist valuable information about the direction in the market price for the stock in which they make a market. Yet, they can trade for their own account.

Any regular participant in the securities markets may obtain information about the direction of markets from large transactions publicly reported or a surge in the volume of trading. Such knowledge gives those individuals an advantage over others, at least in the short-term, because certain orders, particularly large ones, can have an impact on the trading price for stock.<sup>113</sup> A securities professional, known as a

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110. Such "market information" does not directly concern the earnings power or operations of a corporation. See Arthur Fleischer, Jr., Robert H. Mundheim & John C. Murphy, Jr., *An Initial Inquiry into the Responsibility to Disclose Market Information*, 121 U. PA. L. REV. 798 (1973). Sometimes it is useful to discuss corporate information and market information (any information not sourced to the corporation) as separate classifications for rule 10b-5. However, the rule itself makes no such distinction. *Chiarella*, 445 U.S. at 240-41 n.1 (Burger, C.J., dissenting).

111. A specialist is a member of a national securities exchange who can both execute transactions as a broker on an agency basis or can buy or sell securities for his own account as a dealer. Such a registered specialist must engage in a course of dealing to assist in the maintenance of a fair and orderly market. See 17 C.F.R. § 240.11b-1(a)(2)(ii) (2006).

112. A limit order is an order with restriction on price. If the order is to sell a security, a limit order would have a restriction that the sale be consummated at or on above a certain price. Such orders may not be filled immediately since the market trading price may be away from the limit price of the order. On national securities exchanges, such orders are lodged with the specialist in the stock to be traded to be executed if the market price moves to the limit price of the order.

113. It is possible, in the short run, that the price change results from temporary disparities in supply and demand. Or the trades may have informational content which leads to a price change. A large sell order may suggest that the seller has information that the firm's future prospects are worse

block positioner, having received such an order, may even take a proprietary position ahead of the execution of the order to facilitate its execution.<sup>114</sup> As the Supreme Court has made clear, “. . . neither the Congress nor the [SEC] ever has adopted a parity-of-information rule.”<sup>115</sup> As exemplified by the rules permitting specialists and block positioners to trade on market information, circumstances viewed as misuse of such information have been addressed by detailed rules rather than the general prohibitions of rule 10b-5.

Additionally, forbidding a securities broker under rule 10b-5 from trading for his own account because he becomes aware of an insider’s order or telling another of the order is too broad a rule. Since trading by insiders may be entirely legal, the freezing of trading by the broker is not informationally efficient. So long as the broker knows a trader is an insider, the rule disables the broker from trading in the stock of the insider’s company for an indeterminate time. All information should flow into securities prices with as little friction as possible.<sup>116</sup>

While it will not appear from most insider trades that traders possessed nonpublic material information, the circumstances in certain trades may strongly suggest that an insider traded based on special knowledge. The question becomes whether the presence of such additional facts can be viewed as effective disclosure of a corporate development and should not be used by a securities broker to trade.

For example, Peter Bacanovic knew additional facts. He knew that Sam Waksal wanted to sell all, not some, of his stock in ImClone.<sup>117</sup> He also knew that Sam Waksal wanted those shares transferred to a family member’s account with the written directions “URGENT – IMMEDIATE ACTION REQUIRED.”<sup>118</sup> It was “imperative” that the requested transfer take place during the morning of December 27,

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than the current trading price indicates. See Frank H. Easterbrook, *Insider Trading, Secret Agents, Evidentiary Privileges, and the Production of Information*, 1981 SUP. CT. REV. 309, 335-37 (arguing for the latter view).

114. See NAT’L ASS’N OF SECURITIES DEALERS MANUAL, CONDUCT RULE 2110, IM-2110-3 Front Running Policy (2006). Otherwise knowledge of such an order can violate NASD rules. *Id.*

115. *Chiarella*, 445 U.S. at 233.

116. The SEC, in accommodating technological change under the federal securities, has applauded the increased availability of information on the Internet as promoting transparency, liquidity, and efficiency in U.S. capital markets. See SEC Interpretation: Use of Electronic Media, Release Nos. 33-7856, 34-42728, IC-24426 (Apr. 28, 2000).

117. Superseding Indictment, *supra* note 1, at 1406. Waksal’s account contained 79,797 shares of ImClone stock with a market value, before disclosure of the FDA action, of \$4.9 million. *Id.*

118. *Id.*

2001.<sup>119</sup> In addition, Peter Bacanovic knew that a Waksal family member had sold 39,472 shares of ImClone for almost \$2.5 million.<sup>120</sup> Far from a routine sale of some shares of ImClone stock by Sam Waksal, Waksal's frantic desire to unload all his ImClone stock strongly signaled that something unfortunate was going to happen to ImClone and its stock price.

The problem becomes one of line drawing. At what point should one conclude that the insider effectively conveyed material nonpublic corporate information? How many additional circumstances, above and beyond an insider placing an order, are needed to arrive at this result? Any rule that partially forbids use of knowledge about an insider's order will have a chilling effect. Any evaluation of additional circumstances will be made in hindsight. There will be material nonpublic information, which the insider used in trading, with a resulting price movement in corporate securities. Any facts of which the broker is aware besides the insider's order will, therefore, loom large if the insider violated rule 10b-5. But beforehand, it will not necessarily be clear whether additional facts effectively disclose material nonpublic corporate information. Even if no formal governmental action results, the broker bears the risk of a government investigation going into the trading. Due to the shifting line that defines illegal conduct, traders are forced to weigh the particular facts surrounding an order and rely on their own decision that there has been effective disclosure of material nonpublic information. Such a rule would chill a law abiding person from piggybacking on many insider trades even when the insider did not violate rule 10b-5 by trading on material nonpublic information.

The prohibition on the insider's trading on material nonpublic information is all that is necessary. A significant policy reason to prohibit insider trading is to protect the corporation's property rights in the information.<sup>121</sup> Premature disclosure of information can result in the corporation losing some or all the value of the information. But this statement of policy also sets its limits. Putting full responsibility on the insider is sufficient. There is no reason to extend the reach of the prohibition to anyone who merely mimics an insider's trades. In fact, piggybacking on an insider's trades can actually lead to discovery of illegal activity since the volume of trading may go up enough to warrant

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119. *Id.*

120. *Id.* Also, according to the indictment, "It had been publicly reported that the FDA's decision whether to accept the Erbitux [application] was expected by the end of December 2001." *Id.* It is not clear whether Peter Bacanovic knew of this scheduled announcement or not.

121. See Easterbrook, *supra* note 113, at 310.

an inquiry into the trading.<sup>122</sup>

There is no “general duty between all participants in market transactions to forego actions based on material, nonpublic information.”<sup>123</sup> After all, tipping is only illegal if for an improper purpose.<sup>124</sup> One trader can have an informational advantage over another.<sup>125</sup> Only where there is an actual improper personal benefit from disclosure of material nonpublic information should rule 10b-5 be violated.

#### IV. MARTHA STEWART DID NOT PARTICIPATE IN ANY BREACH OF FIDUCIARY DUTY BY HER BROKER, PETER BACANOVIC

There are, however, two other theories to explore before reaching a final conclusion on whether Martha Stewart engaged in insider trading in violation of rule 10b-5. If Peter Bacanovic misappropriated information belonging to either Sam Waksal, his client, or Merrill Lynch, his employer, when he told Martha Stewart about the Waksal family trading in order that she may sell her ImClone stock without disclosing to either what he was doing, there might be a rule 10b-5 violation. Whether Peter

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122. The SEC, the various self-regulatory organizations, such as the New York Stock Exchange and the National Association of Securities Dealers, as well as the compliance departments of securities broker/dealers all conduct surveillance over trading looking for anything unusual. In fact, the compliance department of Merrill Lynch originally investigated Martha Stewart's sale of ImClone stock. *United States v. Stewart*, 433 F.3d 273, 283 (2d Cir, 2006). Merrill Lynch turned over the results of its work to the SEC, which resulted in the governmental investigation of Martha Stewart and the resulting criminal charges. *Id.* at 284.

123. *Chiarella*, 445 U.S. at 233.

124. See *Dirks v. SEC*, where the Supreme Court stated, “In some situations, the insider will act consistently with his fiduciary duty to shareholders, and yet release of the information may affect the market.” 463 U.S. at 662. This statement is consistent with the Court's earlier concern that receipt of nonpublic information alone as a basis for a rule 10b-5 violation could inhibit securities analysts. *Id.* at 658. But see Regulation FD, 17 C.F.R. §§ 243.100-103 (2006), where the SEC has forbidden selective disclosure of material nonpublic corporate information to securities analysts in the exercise of its authority requiring mandatory disclosure by 1934 Act reporting companies. However, the SEC has expressly stated that failures to make public disclosure pursuant to Regulation FD will not be deemed to violate rule 10b-5. 17 C.F.R. § 243.102 (2006). Without Regulation FD, a corporate insider giving guidance to a securities analyst to adjust a faulty estimate of the corporation's performance would not violate rule 10b-5 since the disclosure was for a proper corporate purpose. But see *SEC v. Stevens*, Litigation Release No. 12,813, 48 SEC Docket 739 (Mar. 19,1991), where the SEC charged rule 10b-5 was violated on the basis of just such selective disclosure. Such an expansive interpretation of an insider's improper purpose, resulting in a reputational advantage for an insider essentially eliminates any requirement that a tippee only violates rules 10b-5 if the tippee knowingly participates in an insider's breach of fiduciary duty.

125. The Supreme Court has explicitly stated that “neither the Congress nor the [SEC] ever has adopted a parity-of-information rule.” *Chiarella*, 445 U.S. at 233.

Bacanovic breached a fiduciary duty in either circumstance will be examined in turn.

*A. Did Peter Bacanovic Breach a Fiduciary Duty Owed Sam Waksal in Disclosing His Trading to Martha Stewart?*

In addition to violating rule 10b-5 through a breach of duty, a person can violate rule 10b-5 by misappropriating another's information to trade in securities and failing to disclose to the owner such use.<sup>126</sup> The party whose information is stolen need not trade the securities.<sup>127</sup> In order to violate rule 10b-5, there must be a breach of fiduciary duty. This section will examine whether Peter Bacanovic breached a duty to Sam Waksal which should lead to a violation of rule 10b-5 when he disclosed his trading to Martha Stewart. This argument, however, is an attempt, in a different guise, to prohibit piggybacking, a practice which this Article has previously argued is permissible.

Sam Waksal wished to sell his ImClone stock through Merrill Lynch using Peter Bacanovic as his broker.<sup>128</sup> Peter Bacanovic was Sam Waksal's agent and, consequently, had a fiduciary relationship with him.<sup>129</sup> As Waksal's agent, Bacanovic owed duties of care and loyalty to his principal.<sup>130</sup> He could not use his position as Waksal's agent for

126. See sources cited *supra* notes 53-71 and accompanying text.

127. See source cited *supra* note 54 and accompanying text.

128. Superseding Indictment, *supra* note 1, at 1406. The sale appears unsolicited. If Peter Bacanovic had recommended the sale of ImClone stock to Sam Waksal, his status would still be fiduciary in nature.

129. "An agent has a fiduciary duty to act loyally for the principal's benefit in all matters connected with the agency relationship." RESTATEMENT (THIRD) OF AGENCY § 8.01 (Tentative Draft No. 6, 2005). "An agent is a fiduciary with respect to matters within the scope of his agency." RESTATEMENT (SECOND) OF AGENCY § 13 (1958).

The term 'fiduciary' has never been capable of precise definition. . . . In its broadest significance, it refers 'to any person who occupies a position of peculiar confidence towards another. It refers to integrity and fidelity.' We invariably think of the trustee as fiduciary vis a vis his cestui que trust. Similarly we must think of an agent as a fiduciary vis a vis his principal. The clear implication then is that an agent is under a duty to act solely and entirely for the benefit of his principal in every matter connected with his agency.

WILLIAM A. GREGORY, THE LAW OF AGENCY AND PARTNERSHIP 140 (3d ed. 2001) (footnotes omitted).

130. See RESTATEMENT (SECOND) OF AGENCY § 379 (1958). Section 379 provides:

Unless otherwise agreed, a paid agent is subject to a duty to the principal to act with standard care and with the skill which is standard in the locality for the kind of work which he is employed to perform and, in addition, to exercise any special skill that he has.

*Id.* Further, section 387 of the Restatement of Agency provides that "[u]nless otherwise agreed, an agent is subject to a duty to his principal to act solely for the benefit of the principal in all matters

personal profit without his principal's permission.<sup>131</sup> Further, he could not use or communicate his principal's confidential information.<sup>132</sup>

As an agent, Peter Bacanovic was entrusted with valuable information from his principal, Sam Waksal.<sup>133</sup> That information was the very fact that Sam Waksal had decided to try to sell his ImClone stock. Bacanovic used his principal's information for his own profit on two occasions: (1) when, without first disclosing to Waksal what he was doing, he told Martha Stewart's assistant that he thought ImClone would trade down, and (2) when he later instructed his assistant to tell Stewart that Sam Waksal was unloading his ImClone stock. The question is whether he used this information in breach of duties owed Waksal and, in doing so, violated rule 10b-5.

An agent owes fiduciary responsibilities to his principal and must not act contrary to the principal's interest.<sup>134</sup> Had Bacanovic used the information of Waksal's order to trade ahead of him or cause someone else to so trade, Bacanovic would be breaching a fiduciary duty to Waksal.<sup>135</sup> If an agent trades in front of his principal, his trading could

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connected with his agency." RESTATEMENT (SECOND) OF AGENCY § 387 (1958).

131. See RESTATEMENT (SECOND) OF AGENCY § 388 (1958) ("Unless otherwise agreed, an agent who makes a profit in connection with transactions conducted by him on behalf of the principal is under a duty to give such profit to the principal.").

132. RESTATEMENT (SECOND) OF AGENCY § 395 (1958). This provision states,

Unless otherwise agreed, 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 or in violation of his duties as agent, in competition with or to the injury of the principal, on his own account or on behalf of another, although such information does not relate to the transaction in which he is then employed, unless the information is a matter of general knowledge.

*Id.*

133. Section 16(a) of the 1934 Act, 15 U.S.C. § 78p(a) (2000), requires officers, directors, and holders of more than ten percent of a class of equity securities of a 1934 Act reporting company to disclose changes in their beneficial ownership. One purpose of this mandated disclosure is to permit outside investors to use it to evaluate the financial future of the company. Janet Gamer Feldman & Richard L. Teberg, *Beneficial Ownership Under Section 16 of the Securities Exchange Act of 1934*, 17 CASE W. RES. L. REV. 1054, 1064 (1966). "Undoubtedly, this investment information function of [section 16(a)] explains why the [SEC's] monthly summary of transactions reported under section 16(a) has become a perennial best seller." *Id.* at 1064-65. Today, of course, this disclosure is available electronically and, for changes in beneficial ownership, within two days of such change. 15 U.S.C. § 78p(a)(2)(C), (4).

134. See RESTATEMENT (SECOND) OF AGENCY § 387. See *supra* note 130 for full text. See also GREGORY, *supra* note 129, at 141-42 (discussing three cases as classic examples of breaches of fiduciary duties, all of which involve an agent who took a principal's information for his own use in direct competition with his principal).

135. Such trading is known as front-running. See NAT'L ASS'N OF SECURITIES DEALERS MANUAL, CONDUCT RULE 2110, IM-2110-3 Front-Running Policy (2006), where the interpretation prohibits trading with knowledge of a block transaction (*e.g.*, an order for 10,000 shares or options

have a price impact and cause the principal's trade to be made at a less advantageous price. As Waksal's agent, he would be competing with him.<sup>136</sup> Consequently, the agent's use of the information of the pending securities trade would breach a fiduciary duty and provide a basis for a violation of rule 10b-5. Such a result would be consistent with the policy served by the federal prohibitions on insider trading in preventing use of information by someone who would deprive another of the value of that information.<sup>137</sup> An agent trading in front of the principal could deprive the principal of some value if the agent's trading had a price impact which would be adverse to the principal.

However, once the principal makes his trade, the risk of the agent competing with him vanishes. At that point, the agency relationship to accomplish an assigned task is over. The agent's use of the information would not harm the principal. Waksal himself could not sell his stock. Stewart's sale followed the sale of stock by the member of Waksal's family. When Bacanovic informed Stewart of the Waksal trading, he breached no duty owed to Waksal not to compete with his principal.

In fact, trading that mimics the principal's may actually serve his interests. If the trading causes the price of the security to move in any direction, it should be in one favorable to the principal. For example, if the principal bought stock, and there was trading piggybacking on the purchase, the stock price may rise and thereby serve his interest.

An agent can also violate a duty to his principal if he takes his principal's property for his own use.<sup>138</sup> The liability exists even though the agent does not compete with the principal and the use benefits the

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covering a like amount of stock, before the transaction).

136. *But see* RESTATEMENT (SECOND) OF AGENCY § 393 (1958) ("Unless otherwise agreed, an agent is subject to a duty not to compete with the principal concerning the subject matter of his agency."). *See also* Brophy v. Cities Service Co., 70 A.2d 5, 7-8 (Del. Ch. 1949) (describing the duty an agent owes to his principal not to use confidential information obtained from the principal in order to compete with the principal).

137. *See* Easterbrook, *supra* note 113, at 339 n.116. *See also* Hunter v. Shell Oil Co., 198 F.2d 485 (5th Cir. 1952) (explaining how Shell could capture both the bribes its employee took and the employee's and his confidant's interests in mineral finds after the employee had used sensitive company information in a manner clearly in conflict with Shell's best interests).

138. RESTATEMENT (SECOND) OF AGENCY § 404 (1958). This section provides,

An agent who, in violation of duty to his principal, uses for his own purposes or those of a third person assets of the principal's business is subject to liability to the principal for the value of the use. If the use predominates in producing a profit he is subject to liability, at the principal's election, for such profit; he is not, however, liable for profits made by him merely by the use of time which he has contracted to devote to the principal unless he violates his duty not to act adversely or in competition with his principal.

*Id.*

principal.<sup>139</sup> As an example of such violation, the Restatement (Second) of Agency provides:

P employs A to take care of the horses which P uses for driving purposes. P does not use them for a month and during this period, without P's consent, A rents the horses to various persons who benefit the horses by the exercise thereby given them. A is subject to liability to P for the amount which he has received as rental.<sup>140</sup>

The principal is entitled to exclusive use of his property. The agent cannot benefit personally from use of the principal's property without his consent.

When Peter Bacanovic used the information he had about Waksal's trading to help Martha Stewart trade, he breached this duty to his principal under state law. His principal was entitled to exclusive use of his property, the information about his trading. Under state law, Waksal should be able to recover from Peter Bacanovic any benefit he received in the form of commissions from Martha Stewart's sale.<sup>141</sup> He should not be able to recover from his agent the losses Martha Stewart avoided by selling her ImClone stock ahead of an announcement of the FDA action.<sup>142</sup> Unlike an agent's use of a principal's information to compete with or damage his principal where a principal's recovery could extend to any benefits received by a third party who participates with the agent in the breach, a principal's recovery for unauthorized use of a principal's property would be the agent's benefits. The only benefit Bacanovic received in using the information about Waksal's trading was a commission from Martha Stewart.

This agent-principal duty is not directed at the third party's conduct, in this case, the trading. The purpose of the federal

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139. *Id.* at cmt. a.

140. *Id.* at cmt. a, illus. 1.

141. See RESTATEMENT (SECOND) OF AGENCY § 403 (1958) ("If an agent receives anything as a result of his violation of a duty of loyalty to the principal, he is subject to a liability to deliver it, its value, or its proceeds, to the principal."). See also *United States v. Drisko*, 303 F.Supp. 858, 860-61 (E.D. Va. 1969) (holding that the federal government was able to recover the bribes paid to the defendant, but not any profit made by the contractor who paid them); *La. Mortg. Corp. v. Pickens*, 167 So. 914, 915 (La. Ct. App. 1936) (finding that the plaintiff could recapture the hidden compensation paid to the defendant, but that there was no further recovery for any other benefit received by the payor of the compensation).

142. See *Delano v. Kitch*, 663 F.2d 990, 998-1004 (10th Cir. 1981) (permitting the recovery of a secret finder's fee but not any benefits from an employment agreement). Even if Martha Stewart knowingly participated in Bacanovic's breach of fiduciary duty, she also would only be potentially liable for the commission Bacanovic received.

prohibitions on use of material nonpublic information is to punish insider trading. Any recovery by the government or private parties for insider trading is measured by the profits or loss avoided by the insider trader.<sup>143</sup> Merely because there is a state law breach of fiduciary duty that is somehow related to trading in securities should not warrant a conclusion that federal law is violated. What this line of inquiry underscores is that a blind search for a breach of fiduciary duty under any body of law that somehow touches on a purchase or sale of a security is a formal exercise divorced from any policies underlying the federal securities laws. By finding a violation of rule 10b-5 by bringing “within the ambit of the Rule all breaches of fiduciary duty in connection with the securities transaction, [this] interpretation would . . . ‘add a gloss to the operative language of the statute quite different from its commonly accepted meaning.’”<sup>144</sup>

To find that Bacanovic breached a duty to Waksal by using his knowledge of Waksal’s trading is simply another cut at prohibiting piggybacking. Previously, the Article presented the proposition that piggybacking on an insider’s order should not violate rule 10b-5 since the trade cannot constitute an illegal tip of material nonpublic information.<sup>145</sup> To now conclude that Bacanovic misappropriated Waksal’s information in breach of a fiduciary duty makes that same conduct illegal under rule 10b-5. The outer limit of the violation should be the circumstance where the insider actually disclosed to the broker the material nonpublic information.

Therefore, when Bacanovic told Martha Stewart of the Waksal family trading, he may have misappropriated Waksal’s information. While he did not trade for his own account, he failed to disclose to Sam Waksal that he would use the information for his own personal benefit.<sup>146</sup> But such use of this information breached no duty to his principal which should result in a violation of rule 10b-5.

Holding Bacanovic to violate rule 10b-5 for misappropriation of

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143. See *Elkind v. Liggett & Myers, Inc.*, 635 F.2d 156, 168-73 (2d Cir. 1980), as codified in 15 U.S.C. § 78t-1 (2000), where recovery in private actions for insider trading violations is limited to profits or loss avoided and 15 U.S.C. § 78u-1 (2000), wherein the SEC can require disgorgement of insider trading profits and losses avoided along with the power to obtain civil penalties in an amount up to three times those profits or losses avoided.

144. *Santa Fe Industries, Inc. v. Green*, 430 U.S. 462, 472 (1977) (quoting *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 199 (1976)).

145. See sources cited *supra* notes 99-125 and accompanying text.

146. See *United States v. O’Hagan*, 521 U.S. 642, 657-60 (1997) (finding that rule 10b-5 would not be violated if an agent told a principal that the agent intended to use information for securities trading).

Waksal's information does not invariably result in Martha Stewart also violating rule 10b-5. Martha Stewart's trading would violate rule 10b-5 only if she were Bacanovic's tippee.<sup>147</sup> But in order to participate in Bacanovic's breach of duty, she would have to know of the breach.<sup>148</sup> Sam Waksal was a personal friend of Martha Stewart.<sup>149</sup> It might be possible that Sam Waksal allowed Bacanovic to inform Martha Stewart of his trading. In other words, Bacanovic could have tipped Martha Stewart of Waksal's trading, but Stewart herself did not knowingly participate in his breach.

*B. Martha Stewart Did Not Participate in a Breach of Fiduciary Duty  
Bacanovic Owed Merrill Lynch*

As is typical of securities broker/dealers, Merrill Lynch insists that its employees sign a confidentiality agreement not to disclose Merrill's customers' trading.<sup>150</sup> Clearly, Bacanovic breached this agreement when he instructed his assistant to tell Martha Stewart of the Waksal family trading. Earlier in her career, Martha Stewart had been a stockbroker.<sup>151</sup> She may have been aware of Merrill Lynch's confidentiality agreement

147. See sources cited *supra* note 52 and accompanying text.

148. *Id.*

149. Superseding Indictment, *supra* note 1, at 1405.

150. *Id.* at 1403. Merrill Lynch's written policies on confidentiality provided, in relevant part:

**Confidentiality of Client Information**

You may not discuss the business affairs of any client with anyone, including other employees except on a need-to-know basis. Information or records concerning the business of the Firm and/or its clients may not be released except to persons legally entitled to receive them.

**Client Information Privacy Policy**

Merrill Lynch protects the confidentiality and security of client information. Employees must understand the need for careful handling of this information. Merrill Lynch's client information privacy policy provides that - . . .

- Employees may not discuss the business affairs of any client with any other employee except on a strict need-to-know basis.
- We do not release client information, except upon a client's authorization or when permitted or required by law.

*Id.* By separate directive, Merrill Lynch warned its employees:

You should not "piggyback," that is, enter transactions after a client's trades to take advantage of perceived expertise or knowledge on the part of the client. If the client's successful trading pattern arose from an improper element such as inside information you (and the Firm) could be subject to a regulatory or criminal investigation or proceeding.

*Id.* at 1403-04.

151. *Id.* at 1402; Complaint, *supra* note 7, at para. 6 (alleging Martha Stewart was a registered representative with the broker-dealer, Pearlberg, Monness, Williams & Day in the late 1960s and early 1970s).

as a matter of industry practice.<sup>152</sup> When the SEC charged Martha Stewart with insider trading, the SEC charged that Bacanovic misappropriated Merrill Lynch's information about Waksal's trading when he breached the confidentiality agreement. The SEC charged that Bacanovic then improperly tipped Martha Stewart, and when she sold ImClone shares she violated rule 10b-5.<sup>153</sup>

When Bacanovic informed Martha Stewart of the Waksal trading, he violated rule 10b5-2.<sup>154</sup> That rule provides, in relevant part, that: "[f]or purposes of [Section [10(b)], a 'duty of trust or confidence' exists . . . [w]henever a person agrees to maintain information in confidence."<sup>155</sup> If Martha Stewart knew of Merrill's confidentiality

152. See Complaint, *supra* note 7, at para. 6 (outlining Martha Stewart's career and points out her time as stockbroker and that, at the time of her ImClone stock sale, she was a member of the Board of Directors of the New York Stock Exchange, Inc.). That information is relevant to showing Stewart's awareness that, when Bacanovic tipped her about Waksal's trading, she would know Bacanovic was breaching Merrill Lynch's confidentiality policy.

153. *Id.* at para. 18-21, 27-33. As previously indicated, the breach of Merrill Lynch's confidentiality agreement provided the basis for the SEC charges of insider trading against Peter Bacanovic and Martha Stewart. *Id.* at para. 16-17.

154. Rule 10b5-2 provides:

*Preliminary Note to § 240.10b5-2:* This section provides a non-exclusive definition of circumstances in which a person has a duty of trust or confidence for purposes of the "misappropriation" theory of insider trading under Section 10(b) of the Act and Rule 10b-5. The law of insider trading is otherwise defined by judicial opinions construing Rule 10b-5, and Rule 10b5-2 does not modify the scope of insider trading law in any other respect.

(a) *Scope of Rule.* This section shall apply to any violation of Section 10(b) of the Act (15 U.S.C. 78j(b)) and § 240.10b-5 there under that is based on the purchase or sale of securities on the basis of, or the communication of, material, nonpublic information misappropriated in breach of a duty of trust or confidence.

(b) *Enumerated "duties of trust or confidence."* For purposes of this section, a "duty of trust and confidence" exists in the following circumstances, among others:

- (1) Whenever a person agrees to maintain information in confidence;
- (2) Whenever the person communicating the material nonpublic information and the person to whom it is communicated have a history, pattern, or practice of sharing confidences, such that the recipient of the information knows or reasonably should know that the person communicating the material nonpublic information expects that the recipient will maintain its confidentiality; or
- (3) Whenever a person receives or obtains material nonpublic information from his or her spouse, parent, child, or sibling; *provided*, however, that the person receiving or obtaining the information may demonstrate that no duty of trust or confidence existed with respect to the information, by establishing that he or she neither knew nor reasonably should have known that the person who was the source of the information expected that the person would keep the information confidential, because the parties' history, pattern, or practice of sharing and maintaining confidences, and because there was no agreement or understanding to maintain the confidentiality of the information.

17 C.F.R. § 240.10b5-2 (2006) (emphasis added).

155. *Id.*

agreement, she knowingly participated in Bacanovic's breach of rule 10b5-2.<sup>156</sup> However, the question remains whether this portion of rule 10b5-2 captures conduct which can violate section 10(b).<sup>157</sup>

The Supreme Court has found that when a person trades on material nonpublic information without disclosure, a breach of fiduciary duty or other relationship of trust or confidence is a prerequisite to a violation of rule 10b-5.<sup>158</sup> Without more, a contractual confidentiality agreement need not give rise to a fiduciary duty.<sup>159</sup>

The confidentiality agreement Merrill Lynch included in its policies and which it distributed to its employees was contractual, not fiduciary, in nature. Fiduciary duties are meant to impose obligations on parties so that they serve the interests of the party to whom the duty is owed.<sup>160</sup> When Peter Bacanovic told Martha Stewart that Sam Waksal wanted to sell all his shares, he was serving Merrill Lynch's interest, not abusing it. Martha Stewart sold her shares through Merrill Lynch and paid Merrill a commission on the sale. Consequently, Merrill Lynch benefited from Bacanovic's disclosure to Martha Stewart of Sam Waksal's desire to sell his ImClone stock. There was a direct pecuniary benefit to Merrill. Bacanovic was serving Merrill's interest when Stewart sold her ImClone stock through Merrill.

It would be a different case if Martha Stewart were not a client of Merrill Lynch or did not sell her ImClone stock through Merrill Lynch. An illustration in the RESTATEMENT (SECOND) OF AGENCY underscores this point. The example provides:

A, the manager of P, a stockbroker, promises T that he will reveal to T for T's benefit the transactions for one of P's customers. A is not

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156. The DOJ's indictment of Martha Stewart states that "[p]rior to forming [Martha Stewart Living Omnimedia], [she] had been licensed by [the National Association of Securities Dealers], a national securities association, to sell securities and was employed as a securities broker from in or about 1968 through in or about 1973." Superseding Indictment, *supra* note 1, at 1402. This allegation only has relevance for Martha Stewart's knowledge of industry practice whereby brokers agreed to protect the confidentiality of customers' orders.

157. See generally Ray J. Grzebielski, *Friends, Family, Fiduciaries: Personal Relationships as a Basis for Insider Trading Violations*, 51 CATH. U. L. REV. 467, 491-93 (2002) (discussing this argument more generally).

158. See source cited *supra* notes 14-15 and accompanying text.

159. See, e.g. *Walton v. Morgan Stanley & Co.*, 623 F.2d 796, 799 (2d Cir. 1980), cited with approval in *Dirks v. SEC*, 463 U.S. 646, 663 n.22 (1983) (explaining that an investment banker's confidentiality agreement with a proposed takeover target created no fiduciary duty where the investment banker's client was dealing at arm's length with the target); *Frigitemps Corp. v. Financial Dynamics Fund, Inc.*, 524 F.2d 275, 283 (2d Cir. 1975).

160. See *supra* note 129.

authorized to make such a promise and if he thereafter performs it, he has committed a breach of duty to P.<sup>161</sup>

In this illustration, there would be a breach of duty to P only if T is not a client of P and/or does not effect the trade through P after A's disclosure. But if A tells a client of P and the trade is made through P, A is serving P's interest. Peter Bacanovic was furthering Merrill Lynch's interest.

Admittedly, Merrill Lynch suffered some adverse consequences from Peter Bacanovic's and Martha Stewart's actions. The SEC and the DOJ both investigated Merrill Lynch's employee's conduct. No doubt, Merrill Lynch incurred some cost in connection with this investigation such as legal expenses, as well as possible adverse publicity from disclosure of the investigation and the later public trial of Peter Bacanovic and Martha Stewart.

Such costs to Merrill are incidental and irrelevant. No agent can be held responsible as a matter of his fiduciary duties for such collateral consequences over which the agent has no control. Merrill's remedy lies in discharge of its agent since there are no legally recoverable damages.<sup>162</sup>

## V. CONCLUSION

Since Martha Stewart did not engage in insider trading when she sold her ImClone stock, her indictment and conviction were unnecessary and unfortunate. Had she never spoken with government investigators, the perjury and obstruction of justice charges also would have been unnecessary. Perhaps, although a somewhat riskier legal strategy, her cooperation and truthful disclosure of the circumstances of her sale of ImClone shares would have avoided her indictment. Ultimately, Martha Stewart settled the SEC insider trading charges. Oftentimes, even if there may be a good defense to SEC charges, it can be better to settle the

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161. RESTATEMENT (SECOND) OF AGENCY § 387, illus. 1 (1958). *See also* Merrill Lynch, Pierce, Fenner & Smith Inc., v. E.F. Hutton & Co., Inc., 403 F. Supp. 336, 340-41 (E.D. Mich. 1975) (determining that information about a client's account was the property of the client, not the brokerage concern).

162. RESTATEMENT (SECOND) OF AGENCY § 409 (1958). This section provides in part: A principal is privileged to discharge before the time fixed by the contract of employment an agent who has committed such a violation of duty that his conduct constitutes a material breach of contract or who, without committing a violation of duty, fails to perform or reasonably appears to be unable to perform a material part of the promised service because of physical or mental disability.

*Id.*

charges and bring the matter to a close.