Portfolio Media. Inc. | 860 Broadway, 6th Floor | New York, NY 10003 | www.law360.com
Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

Newman Not An Ideal Case For Defining Tippee Liability

Law360, New York (August 7, 2015, 10:10 AM ET) --

Robert A. Horowitz Cathleen Donohoe

On July 30, the government filed a petition for writ of certiorari with the U.S. Supreme Courtseeking review of a portion of the Second Circuit Court of Appeals' decision in U.S. v. Newman, 773 F.3d 438 (2d Cir. 2014). The issue presented in the petition is whether the existence of a casual personal relationship between the corporate insider and a tippee alone can support a finding that the corporate insider derived a "personal benefit" from the disclosure of confidential information sufficient to support a conviction for insider trading.

In Newman, the Second Circuit Court of Appeals vacated the criminal insider trading convictions of two hedge fund portfolio managers. The convicted defendants were two "remote tippees" who were three or four steps removed from the corporate insiders who disclosed the confidential insider information. The trial court instructed the jury that to meet its burden under Dirks v. SEC, 463 U.S. 646 (1983), the government must prove beyond a reasonable doubt that (1) the corporate insiders owed their employers a fiduciary or other duty of trust and confidence, (2) the corporate insiders intentionally breached their duty by disclosing nonpublic information for their personal benefit, (3) the defendants knew the material, nonpublic information had been disclosed in breach of a duty of trust and confidence, and (4) defendants used the information to purchase a security. The trial court did not instruct the jury that the government also was required to prove the defendants knew the corporate insiders obtained a personal benefit from sharing the information.

On appeal, the defendants argued the trial court erred in failing to instruct the jury that the government had the burden to prove that the defendants knew the corporate insiders disclosed material nonpublic information for their own personal benefit and that the evidence was insufficient to find that the corporate insiders derived a personal benefit from the disclosure of the information. The Court of

Appeals agreed.

The Court of Appeals noted that a corporate insider breaches a fiduciary duty by disclosing material nonpublic information only if he or she derives a personal benefit in exchange for the disclosure. Because a tippee is liable only if he or she knows or should have known of the breach of fiduciary duty, the tippee necessarily must also know of the personal benefit received to be liable for trading on inside information. Thus, the court held that to support an insider trading conviction, the government must not only prove that the insider breached his or her fiduciary duty by disclosing confidential information to a tippee in exchange for a personal benefit and that the tippee knew the information was confidential, but also that the tippee knew the insider derived a personal benefit in exchange for the disclosure.

The court then proceeded to consider the extent to which a “personal benefit” may be inferred from a personal relationship between the corporate insider and his or her tippee. It held that to the extent Dirks suggests that a personal benefit may be inferred from a personal relationship “where the tippee’s trades ‘resemble trading by the insider himself followed by a gift of the proceeds to the recipient,’” such an inference is improper unless there is proof of a “meaningfully close personal relationship that generates an exchange that is objective, consequential, and represents at least a potential gain of a pecuniary or similar valuable nature.” The court noted that if the existence of a personal relationship alone were sufficient to prove the tippers derived some benefit from their disclosures, then “practically anything would qualify.”

Less than a month ago, the Ninth Circuit Court of Appeals in U.S. v. Salman, ___ F.3d. ___, (9th Cir. July 6, 2015) upheld an insider trading conviction after finding the personal relationship between the corporate insider and his tippee alone was sufficient to support the conclusion that the tipper received a personal benefit in exchange for the disclosure of confidential inside information.

In Salman, unlike Newman, the corporate insider and tippee had a close personal relationship. The Court of Appeals found the evidence at trial established that the corporate insider repeatedly provided confidential inside information to his brother in breach of his duty to his employer, knew his brother was trading on that information for his own personal financial benefit, and intended to benefit his brother with the information he provided. The tipper’s brother in turn shared the inside information he received with his friend, Salman, and the two of them proceeded to jointly profit thereby. The Court of Appeals held these facts were sufficient to find the disclosures from the corporate insider to his brother were intended as gifts of confidential information to a trading relative or friend which, under Dirks, constitutes a sufficient personal benefit to sustain the finding that the corporate insider breached his fiduciary duty to his employer by disclosing nonpublic information for his personal benefit.

The Court of Appeals detailed a number of ways in which it believed the facts in Salman differed materially from the facts in Newman, and therefore required a different result. However, the Ninth Circuit went on to state that to the extent the Newman decision can be read to require a reversal of the conviction in Salman, it declined to follow it because following Newman would require a departure from the Supreme Court’s binding precedent in Dirks with respect to whether the element of breach of fiduciary duty is met where an insider “makes a gift of confidential information to a trading relative or friend.”

On July 30, 2015, the government filed a petition for a writ of certiorari seeking Supreme Court review in Newman. The question presented in the petition is limited to whether the Court of Appeals erroneously departed from the Supreme Court’s decision in Dirks when it held that “liability under a gifting theory requires ‘proof of a meaningfully close personal relationship that generates an exchange that is objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature.’” The government does not seek review of the Court of Appeals' holding that to sustain a conviction for insider trading, the government has the burden to prove that defendants knew the corporate insiders disclosed material nonpublic information for their personal benefit.

The government argues that the Court of Appeals inappropriately reinterpreted the Supreme Court’s holding in Dirks that “an inference of a personal benefit to the insider arises in two situations: when the insider expects something in return for the disclosure of the confidential information, or when the insider freely gives a gift of information to a trading friend or relative without any expectation of receiving money or valuables as a result.” According to the government, by putting forth the novel requirement of a “meaningfully close relationship that generates an exchange that is objective, consequential, and represents at least a potential gain of a pecuniary or similar valuable nature,” the Court of Appeals in effect erased one of the forms of personal benefit the Supreme Court identified in Dirks, namely the personal benefit that may be inferred simply from a personal relationship between the tipper and tippee.

In support of its petition, the government cites a circuit split on the question of the type of “personal benefit” required to convict someone of insider trading (pointing specifically to the Ninth Circuit opinion in Salman, and a Seventh Circuit civil case SEC v. Maio (51 F.3d 623 (1995)), and argues that, if not addressed, this circuit split will lead to the unfortunate result of an uneven enforcement of the securities laws across the country.

As a matter of public policy, the government argues the Court of Appeals’ redefinition and narrowing of what constitutes a “personal benefit” for purposes of insider trading law will damage public confidence in the integrity of the markets. According to the government, because the majority of criminal securities cases are brought in the Second Circuit, allowing the Newman decision to stand would serve to embolden bad actors and cause wrongful conduct to proliferate.

Conclusion

The insider trading laws are murky and the Supreme Court may very well take this opportunity to address the boundaries of tippee liability for insider trading. However, for the reasons discussed below, Newman is not an ideal case for the Supreme Court to do so and for that reason the Supreme Court may deny the government’s petition.

First, the Court of Appeals set aside defendants’ convictions on three separate grounds, only one of which the government challenges in its petition. Separate and apart from its finding that the government failed to prove the corporate insiders derived a “personal benefit” from the disclosure, the Court of Appeals held that no reasonable jury could have found that the defendants knew or deliberately avoided knowing that the information originated from corporate insiders and what, if any, personal benefit the insiders may have derived from their disclosure of the information.

Second, the Newman decision could be read as a mere clarification of the broad language in Dirks, as opposed to a rejection or inappropriate narrowing of the holding in Dirks. In this regard, it is not at all clear that the Dirks court would have concluded that the “personal relationship” between the corporate insiders and their tippees in Newman was sufficiently close to infer that the corporate insiders derived a “personal benefit” by disclosing the nonpublic information.

Third, as the Ninth Circuit Court of Appeals noted in Salman, there is an open question as to whether there is in fact a circuit split regarding the extent to which a personal benefit may be inferred from the tipper's personal relationship with the tippee. In other words, where, as in Salman, there was a family relationship between the corporate insider and the tippee, the Second Circuit might very well come to the same conclusion as the Ninth Circuit.

If the Supreme Court agrees to hear the government's appeal, it presumably will clarify the extent to which a personal benefit may be inferred, if at all, solely because of a "personal relationship" between a tipper and tippee who are casual acquaintances but not close friends or relatives.

—By Robert A. Horowitz and Cathleen Donohoe, Greenberg Traurig LLP

Robert Horowitz is a shareholder in Greenberg Traurig's New York office and co-chairman of the firm's securities litigation practice. He focuses his practice primarily on the defense of claims brought under federal and state securities laws and consumer protection statutes, and on general commercial litigation.

Cathleen Donohoe is an associate with the firm's litigation practice in the East Palo Alto, California. She focuses on complex litigation matters.

The opinions expressed are those of the author(s) and do not necessarily reflect the views of the firm, its clients, or Portfolio Media Inc., or any of its or their respective affiliates. This article is for general information purposes and is not intended to be and should not be taken as legal advice.

All Content © 2003-2015, Portfolio Media, Inc.