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Second Circuit Clarifies Elements of Tippee Liability for Insider Trading

December 11, 2014

The U.S. Court of Appeals for the Second Circuit recently clarified the elements required to hold a tippee liable for insider trading: a tippee cannot be held liable unless the Government proves that the tippee *knew* both (*i*) that the initial tipper breached a fiduciary duty in disclosing material nonpublic information in exchange for a personal benefit *and* (*ii*) that the tipper had received a personal benefit for divulging the information. The court also held that the "personal benefit" that the tipper received must be "objective, consequential, and represent[ing] at least a potential gain of a pecuniary or similarly valuable nature."

The decision in *United States v. Newman*, issued on December 10, 2014,resolves a split among lower courts within the Second Circuit about whether a tippee needs to know that the tipper received a personal benefit in exchange for disclosing material nonpublic information. The decision also appears to narrow the definition of "personal benefit" by eliminating "the mere fact of a friendship, particularly of a casual or social nature."

Insider Trading and Tippee Liability

Two theories have been used to create liability for insider trading based on material non-public information: the "classical theory" and the "misappropriation theory." The classical theory focuses on corporate insiders and provides that an insider may not trade shares of his or her corporation based on material non-public information in violation of a duty of trust and confidence owed to *the corporation and its shareholders*. The misappropriation theory, in contrast, focuses on outsiders, who do not owe a duty to the issuer or its shareholders. Under this theory, outsiders who have obtained material non-public information can be liable for insider trading if they trade on that information in breach of a fiduciary duty owed to *the source of the information*.

Under either theory, "tippees" who receive material non-public information from "tippers" may also be held civilly and criminally liable for insider trading in certain circumstances. Tippee liability can extend throughout a potentially long chain of persons who receive such information. Courts thus have had to grapple with difficult questions that can arise in holding "remote" tippees – who might be many steps removed from the original source – liable for insider trading.

In its 2012 decision in *SEC v. Obus*, the Second Circuit – an influential court in securities litigation – attempted to clarify the standards for tipper and tippee liability.

- "Tipper liability requires that (1) the tipper had a duty to keep material non-public information confidential; (2) the tipper breached that duty by intentionally or recklessly relaying the information to a tippee who could use the information in connection with securities trading; and (3) the tipper received a personal benefit from the tip."
- "Tippee liability requires that (1) the tipper breached a duty by tipping confidential information; (2) the tippee knew or had reason to know that the tippee improperly obtained the information (i.e., that the information was obtained through the tipper's breach); and (3) the tippee, while in knowing possession of the material non-public information, used the information by trading or by tipping for his own benefit."

Although the *Obus* decision sought to resolve confusion about the standards for tippee liability, it failed to clarify an issue that had divided the district courts: even if a tippee must know (or have reason to know) that the tipper "improperly obtained the information," must the tippee also know (or have reason to know) that the tipper "*received a personal benefit* from the tip" (a requisite element of tipper liability)? The question is particularly important for remote tippees, who might not even know the identity of the tipper – much less whether he or she received a personal benefit for giving the tip to the original tippee.

Factual Background of *Newman/Chiasson*

The *Newman* and *Chiasson* cases involved hedge-fund portfolio managers who had allegedly traded on the basis of material nonpublic information. The Government alleged that employees at two technology companies had disclosed inside information about the companies' earnings before the numbers were released to the public and that the information had made its way through a "cohort of analysts," ultimately reaching the two defendants, who were three or four steps removed from the initial tippers.

The portfolio managers argued that the Government had not met its burden of proving that the original tippers had provided inside information in exchange for a personal benefit and that the portfolio managers had known about any such personal benefit. The District Court ruled that the Second Circuit's *Obus* decision "makes clear that the *tipper's* breach of fiduciary duty [#2 in the *Obus* formulation] and receipt of a personal benefit [#3 in *Obus*] are *separate* elements and that the *tippee* need know only of the former" – *i.e.*, the tippee needs to know that the tipper breached a duty by disclosing the information, but does not need to know that the tipper received a personal benefit for doing so.

The portfolio managers were convicted, and they appealed. The Second Circuit reversed the convictions and dismissed the indictments with prejudice.

The Second Circuit's Decision

The Second Circuit held that the District Court had erroneously instructed the jury that it could convict the portfolio managers without proof beyond a reasonable doubt that they "knew that an insider disclosed confidential information *and* that he did so in exchange for a personal benefit." The court also held that the evidence was insufficient to sustain a guilty verdict because (*i*) the evidence did not establish that the tippers had violated the securities laws and (*ii*) even if the evidence about the tippers' personal benefit had been sufficient, the Government had not established that the portfolio managers had known that they were trading on information obtained from insiders in breach of the insiders' own fiduciary duties.

Tippee Must Know Elements of Tipper's Breach of Duty

The Second Circuit based its analysis on a straightforward application of the Supreme Court's 1983 decision in *Dirks v. S.E.C. Dirks* had held that "[t]he test for determining whether the corporate insider has breached his fiduciary duty [by revealing material nonpublic information] is whether the insider personally will benefit, directly or indirectly, from his disclosure. Absent some personal gain, there has been no breach of duty." *Dirks* had also held that a tippee may be held liable for trading on a tipper's information "only when the insider has breached his fiduciary duty and the tippee knows or should know that there has been a breach."

Recognizing that its own decisions on tippee liability have been called "somewhat Delphic," the Second Circuit returned to *Dirks* and articulated three basic points: "*First*, the tippee's liability derives *only* from the tipper's breach of a fiduciary duty, *not* from trading on material, non-public information. . . . *Second*, the corporate insider has committed no breach of fiduciary duty unless he receives a personal benefit in exchange for the disclosure. *Third*, even in the presence of a tipper's breach, a tippee is liable only if he knows or should have known of the breach."

As for the critical question concerning the nature of "the breach," the Second Circuit pointed out that "the exchange of confidential information for personal benefit is not separate from an insider's fiduciary breach; it *is* the fiduciary breach that triggers liability . . . . Thus, without establishing that the tippee knows of the personal benefit received by the insider in exchange for the disclosure, the Government cannot meet its burden of showing that the tippee knew of a breach."

The Second Circuit summarized its holding in what it presumably intends will be the new test for tippee liability: "[W]e hold that to sustain an insider trading conviction against a tippee, the Government must prove each of the following elements beyond a reasonable doubt: that (1) the corporate insider was entrusted with a fiduciary duty; (2) the corporate insider breached his fiduciary duty by (a) disclosing confidential information to a tippee (b) in exchange for a personal benefit; (3) the tippee knew of the tipper's breach, that is, he knew the information was confidential and divulged for personal benefit; and (4) the tippee still used that information to trade in a security or tip another individual for personal benefit."

Nature of "Personal Benefit"

Perhaps more interesting than the Second Circuit's clarifying its *Dirks*-based jurisprudence is the court's effort to narrow the scope of the "personal benefit" that triggers the tipper's breach of duty. Once again, the Second Circuit needed to deal with its prior decisions, such as one (*United States v. Jiau*) holding that "[p]ersonal benefit is broadly defined to include not only pecuniary gain, but also, *inter alia*, any reputational benefit that will translate into future earnings and the benefit one would obtain from simply making a gift of confidential information to a trading relative or friend." Language such as this had led the Government to argue that even mere friendship can be a "personal benefit" under *Dirks.*

The Second Circuit retreated from these sweeping pronouncements and held that "the mere fact of friendship, particularly of a casual or social nature," does not prove receipt of a personal benefit. An inference of personal benefit based on a mere personal relationship between the tipper and the tippee "is impermissible in the absence of 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. In other words, . . . this requires evidence of a relationship between the insider and the recipient that suggests a *quid pro quo* from the latter, or an intention to benefit the [latter]." Thus, "the personal benefit received in exchange for confidential information must be of some consequence."

The Second Circuit held that the evidence of the tippers' personal benefits here did not meet this standard. The tippers and their original tippees did not have a close personal relationship, and the tippers did not receive anything resembling a *quid pro quo*. One of the tippers had known his tippee for years, having attended the same school and worked together at the same company. But he had received only "career advice" from the tippee – the kind of "encouragement one would generally expect of a fellow alumnus or casual acquaintance." The other tipper had even less of a relationship with his tippee: they were "merely casual acquaintances" – "family friends" who had met through church and "occasionally socialized together."

Application to the Two Portfolio Managers

The Second Circuit's definition of "personal benefit" led the court to conclude that the Government had not proven a primary violation of the securities laws by the alleged tippers. But in any event, the court held that the Government had presented "absolutely no" evidence that the portfolio managers had known "that they were trading on information obtained from insiders, or that those insiders [had] received any benefit in exchange for such disclosures, or even that [the portfolio managers had] consciously avoided learning these facts."

The court rejected an inference of knowledge based solely on "the specificity, timing, and frequency" of the updates that the portfolio managers – who were three or four steps removed from the sources of the information – had received about the companies' undisclosed earnings information. The court noted that hedge-fund analysts routinely estimate corporate metrics "through legitimate financial modeling using publicly available information and educated assumptions about industry and company trends" – and that analysts "routinely solicited information from companies in order to check assumptions in their models in advance of earnings announcements." The evidence also showed that the two companies' investor-relations personnel "routinely 'leaked' earnings data in advance of quarterly earnings." The court therefore concluded that, "where the financial information is of a nature regularly and accurately predicted by analyst modeling, and the tippees are several levels removed from the source, the inference that defendants knew, or should have known, that the information originated with a corporate insider is unwarranted."

But the Second Circuit also ruled that, "even if detail and specificity could support an inference as to the *nature* of the source, it cannot, without more, permit an inference as to that source's improper *motive* for such disclosure." Without proof that the tippees knew of the tippers' personal benefit, no tippee liability could exist.

Newman's Implications

The *Newman* decision clarifies the knowledge that the Government must establish to prove tippee liability: knowledge of the tipper's breach of fiduciary duty, *including* the tipper's receipt of a personal benefit. The decision also appears to narrow the scope of the personal benefit that can give rise to the tipper's breach of duty. But the Second Circuit's opinion raises some issues for future consideration.

First, the court's articulation of its new standard appears to require the tippee's *knowledge* of the tipper's breach of duty, including the tipper's receipt of a personal benefit. But in several other places, the court declares that tippee liability depends on whether the tippee "knew *or should have known*" of the tipper's breach – a formulation also mentioned in *Dirks*. And in other places, the court applies a "conscious avoidance" standard (which was not met in this case). Even if "conscious avoidance" might be considered a species of knowledge, "should have known" is generally construed as a mere negligence standard. The Second Circuit probably did not mean to water down the "knowledge" standard to include "should have known," although the two phrases do coexist in the decision.

Second, if the "should have known" standard has any viability, will future litigants argue that, to the extent the language came from *Dirks*, that case was an SEC enforcement action, not a criminal prosecution? As the Second Circuit noted, criminal liability for securities fraud requires willful misconduct, meaning "a realization on the defendant's part that he was doing a wrongful act under the securities laws."

Third, future cases will likely explore the line between actionable "personal benefits" and inactionable psychic gratification. School, church, and business friendships – without more – are apparently not enough. But can anything short of an exchange of money, gifts, or other specific favors permit an inference 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"?

Fourth, future cases might also grapple with the extent to which the Second Circuit's decision was influenced by the fact that the portfolio managers had been truly remote tippees, three or four steps removed from the tippers. Might certain inferences rejected in *Newman* be more acceptable if the tippee deals directly with the tipper?

Fifth, the court's citation of evidence that issuers sometimes confirm analysts' estimates and "leak" earnings data before publication might cause issuers to evaluate their own practices, including their obligations under Regulation FD to avoid selective disclosure of material nonpublic information.