

# Second Circuit Upholds Insider-Trading Conviction and Clarifies Scope of Requisite Fiduciary Relationship

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The Second Circuit yesterday affirmed the insider-trading conviction of a doctor who, in breach of a confidentiality agreement, had traded on nonpublic information about a drug trial in which he had been participating. The decision in [United States v. Kosinski \(2d Cir. Sept. 22, 2020\)](#) held that:

- A person can be convicted of insider trading under both the “classical theory” (as a temporary insider) and the “misappropriation theory”;
- A contractual agreement to keep information *confidential* can also create liability for *trading* on that information even if the agreement does not expressly prohibit *use* of the information;
- A contractual designation of “independent contractor” status does not preclude a fiduciary relationship, at least where a public policy is at stake (as for insider trading); and
- A fiduciary relationship does not require the fiduciary to have control and dominance over the other party.

## Background

The *Kosinski* case involved a doctor who was the principal investigator in a clinical trial for a drug developed by a drug company (Regado Biosciences). Before being retained to participate in the drug trial, the doctor had signed agreements promising both to maintain in “strict confidence” all information with which he would be provided and to file a financial disclosure form “promptly” disclosing to the company if the value of his holdings in company stock exceeded \$50,000.

The doctor began purchasing company stock after entering into the agreements, but he never made the required disclosure when the value of his holdings exceeded \$50,000. He also sold all of his stock (thereby avoiding a loss) after receiving a confidential email to principal investigators stating that the drug trial had been put on hold because of several patients' allergic reactions. And he bought put options on company stock after receiving another confidential email about a patient's death.

The doctor was convicted of insider trading under § 10(b) of the Securities Exchange Act. The Second Circuit affirmed the conviction.

## **Second Circuit's Decision**

### ***Classical- and Misappropriation-Theory Liability***

The court first ruled that the doctor could be convicted under the "classical theory" of insider trading, which recognizes a relationship of trust and confidence between a corporation's shareholders and those insiders who have obtained confidential information through their positions with the company. The doctor could be deemed a "temporary insider" under this theory because he had entered into a special confidential relationship to help conduct the company's business.

The doctor also could be convicted under the "misappropriation theory" of insider trading because he had used nonpublic corporate information for his own purposes in breach of his contractual duty to the source of that information (the company) to keep the information confidential.

### ***Confidentiality vs. Use***

The Second Circuit rejected the doctor's argument that he had agreed only to keep the drug-trial information confidential, not to refrain from using it. The court noted that the agreement covered more than confidentiality; it required the doctor to file disclosure forms about his stock holdings, which he had not submitted. But the court also held that a confidentiality commitment's "absence of an express prohibition on trading is not fatal here." "Whatever merit [the doctor's] argument might have had [the drug company] brought a civil action for breach of contract, it fails in the context of a criminal prosecution for trading on nonpublic inside information that was not available to those upon whom he unloaded his shares without making the requisite disclosure."

## ***Independent-Contractor Status***

The Second Circuit also rebuffed the contention that, because the doctor's contract had characterized the doctor as an "independent contractor," he could not be a fiduciary. The court noted that the Supreme Court had previously held that other types of independent contractors could be fiduciaries for insider-trading purposes, but it also declined to "afford the contractual term 'independent contractor' controlling effect where such a term, even in a private contract, implicates significant public policies." The doctor's "actions substantially undermined the policies underlying the Exchange Act relating to insider trading. Accordingly, whether or not the language of the contract would have provided a defense to a private breach of contract action by [the drug company], [the doctor's] designation as an independent contractor cannot control the legality of his trades."

## ***Prerequisites for Fiduciary Status***

The Second Circuit devoted significant attention to the doctor's argument that a fiduciary relation can exist only "when confidence is reposed on one side and there is resulting superiority and influence on the other." The court concluded that the doctor's relationship with the drug company was fiduciary even under the doctor's proffered three-part standard, but it also rejected the contention that the *only* appropriate standard for a fiduciary relationship involves "reliance, de facto dominance and control." Instead, the court emphasized that "a fiduciary relationship can arise so long as the party in whom confidence is reposed has entered into a relationship in which he or she acts to serve the interests of the party entrusting him or her with such information, . . . without a showing of 'de facto control and dominance.'"

## ***Implications***

The *Kosinski* decision does not appear to break new ground on the classical and misappropriation theories of insider trading, but it could undermine arguments that an agreement merely to keep information "confidential" does not include a commitment not to use that information for trading purposes. The Fifth Circuit addressed that issue some years ago, albeit only at the pleading stage, rather than after a trial.

The decision also makes clear that parties cannot insulate themselves from fiduciary status for insider-trading purposes through an “independent contractor” label – and that “de facto control and dominance” are not required for a fiduciary relationship if the alleged fiduciary agreed to serve the interests of the party that entrusted him or her with confidential information. The latter holding in particular might expand in some cases the type of relationship that can create fiduciary status for insider-trading purposes.

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