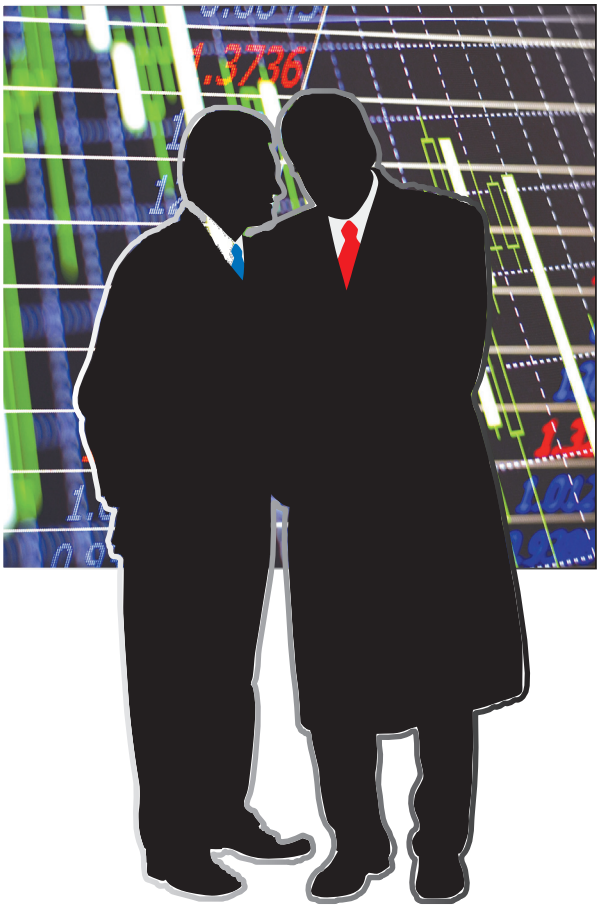
New York Law Journal
A NEW YORK LAW JOURNAL SPECIAL SECTION
An ALM Publication
White-Collar Crime
WWW.NYLJ.COM
MONDAY, JULY 7, 2014

'Newman' Addresses Divisive **Insider Trading** Question

BY BENJAMIN GRUENSTEIN AND JEFF IZANT

In *United States v. Newman*,[1] the U.S. Court of Appeals for the Second Circuit will likely answer a question that has divided courts in insider trading cases: whether, under the so-called "classical" theory of insider trading—in which a corporate insider breaches a duty owed to shareholders not to trade on material, nonpublic information or disclose such information to others who trade based on it—a tippee must have knowledge of the personal benefit the tipper derived from the scheme. As discussed below, this question ultimately turns on whether the tipper's personal benefit is what constitutes the breach of fiduciary duty by the tipper, or whether it is a separate element of the offense altogether. To answer that question, the court will have to resolve seemingly conflicting lines of precedent from cases that have arisen not only under the classical theory but also under the "misappropriation" theory of insider trading, in which an outsider who has been entrusted with material, nonpublic information breaches a duty owed to the source of that information by trading on it or disclosing it to others who trade.

Court-watchers have suggested that the panel in *Newman* expressed skepticism at oral argument towards the government's position that it was required to prove only that the tipper had received a personal benefit, but not that the tippee had knowledge of this benefit. If the court does rule that knowledge of the tipper's benefit is required to prove the tippee's guilt, questions will likely remain as district courts consider how to apply such a requirement in the future.



'United States v. Newman'

It is well-established that for a tippee to be guilty of insider trading, the alleged tipper must have breached a "duty to protect confidential information" and benefitted personally from providing the tip.[2] Moreover, courts agree that tippees must have knowledge of the tipper's duty and breach. But in *SEC v. Obus*, a civil case brought under the misappropriation theory, the Second Circuit articulated the elements of tippee liability without mentioning that the tippee must have knowledge of the tipper's personal benefit.[3] The question subsequently posed by *Newman*, however, is whether this knowledge is required in a criminal prosecution brought under the classical theory.

In another recent case, *United States v. Whitman*, Judge Jed S. Rakoff—who observed that the Second Circuit in *Obus* was "somewhat Delphic" on this point—distinguished *Obus* on the basis that, in classical cases, "the purpose of a prosecution … is to protect shareholders against self-dealing."[4] Therefore, in the case at hand, he held "the tippee must have knowledge that such self-dealing occurred, for, without such a knowledge requirement, the tippee does not know if there has been an 'improper' disclosure of inside information."[5] By contrast, Judge Richard J. Sullivan, the district judge in *Newman*, read *Obus* as making "clear that the tipper's breach of fiduciary duty and receipt of

BENJAMIN GRUENSTEIN *is a partner in the investigations and white-collar criminal defense practice at Cravath, Swaine & Moore.* JEFF IZANT *is an associate at the firm.* GREGG FISH, *a summer associate, assisted in the preparation of this article.*

a personal benefit are separate elements and that the tippee need know only of the former."[6] Noting further that "*Obus* strongly suggests that, at least with respect to tippee scienter, the difference between misappropriation and classical insider trading cases is immaterial," Sullivan held "*Obus* clearly applies" and does not require a tippee to have knowledge that the insider obtained a personal benefit.[7]

Although this disagreement between *Whitman* and *Newman* appears to center on the tippee's state of mind, what these and other cases illustrate is that the dispute ultimately boils down to the issue of what constitutes the tipper's *breach*. The fundamental question that appears to be dividing these courts, as well as the government and the defendants in these cases, is whether the tipper's derivation of a personal benefit is: (1) what creates the tipper's fiduciary breach; or (2) a separate element of the offense. If the tipper's personal benefit is what creates the breach of a fiduciary duty, then in order for the tippee to have knowledge of the breach, the tippee must have knowledge of the tipper's personal benefit. However, if the tipper's breach of fiduciary duty and personal benefit are separate elements of the crime, it does not necessarily follow that the tippee must have knowledge of the tipper's personal benefit to have knowledge of the breach.

On appeal in *Newman*, the appellants have argued for the first position (benefit as a requirement of the breach), while the government appears to support the second (benefit as a separate element). For example, Chiasson—Newman's co-defendant—has argued that "[a] tippee who does not know that the tipper has exchanged information for personal gain does not know that a fraudulent fiduciary breach has taken place, and therefore cannot be held liable as a knowing participant in such a breach."[8] By contrast, the government contends that "[e]stablishing that Newman and Chiasson understood their conduct was wrongful (and thus willful) required no more than showing that they traded on material, nonpublic information they knew insiders had disclosed in violation of a duty of confidentiality."[9]

In support of their arguments, both the government and the defendants rely on *Dirks v. SEC*,[10] the case in which the U.S. Supreme Court first set forth the elements of an insider trading violation under the classical theory. There, the court explained that "some tippees must assume an insider's duty to the shareholders not because they receive inside information, but rather because it has been made available to them *improperly*."[11] It explained:

> Whether disclosure is a breach of duty … depends in large part on the purposes of the disclosure. … [A] purpose of the securities laws was to eliminate "use of inside information for personal advantage." Thus, the test is whether the insider personally will benefit, directly or indirectly, from his disclosure. Absent some personal gain, there has been no breach of duty to stockholders. And absent a breach by the insider, there is no derivative breach.[12]

Justice Lewis F. Powell Jr. went on to write for the court that analyzing whether there has been such a breach "requires courts to focus on objective criteria, i.e., whether the insider receives a direct or indirect personal benefit from the disclosure, such as a pecuniary gain or a reputational benefit that will translate into future earnings."[13] Applying this rule, the court held that there had been no breach in *Dirks* because "[t]he tippers received no monetary or personal benefit for revealing [the corporation's] secrets, nor was their purpose to make a gift of valuable information" to the tippee.[14]

While Newman and Chiasson argue that *Dirks* strongly suggests that the tipper's personal benefit is what creates the breach, the government takes the opposite position, relying upon the Second Circuit's opinion in *Obus*, which interpreted *Dirks*. There, the court held:

> [T]ipper 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.[15]

Thus, while the court never explicitly held that a tippee need not have knowledge of the tipper's personal benefit to be liable, the government's position relies on the fact that *Obus*: (a) defined the elements of tipper liability in a manner that appeared to separate the tipper's personal benefit from the breach; and (b) stated a requirement that the tippee have knowledge of the tipper's breach to establish tippee liability, but omitted any requirement of knowledge of the tipper's personal benefit.

Accordingly, as the court in *Newman* considers whether knowledge of the tipper's personal benefit is required to prove the guilt of the tippee, the question will likely come down to the relationship between the tipper's derivation of a personal benefit and the breach of fiduciary duty: Is tipping for personal benefit itself the breach of fiduciary duty, as the defendants argue, or is it rather a separate element of the offense altogether, as the government contends?

Practical Implications of 'Newman'

If the Second Circuit rules in *Newman* that knowledge of the tipper's benefit is required to support the tippee's conviction, questions as to how this element will be applied in practice are likely to remain. Most importantly, how particular must this knowledge be? And consequently, to what extent will the requirement that the tippee have knowledge of the tipper's personal benefit actually constitute a meaningful issue for juries to consider in insider trading cases?

As discussed above, the Supreme Court in *Dirks* held that a tipper could benefit through either pecuniary or reputational gain. But significantly, the court also observed that the benefit could be proven from circumstantial evidence arising from the relationship between tipper and tippee "that suggests a quid pro quo from the latter, or an intention to benefit the particular recipient. The elements of fiduciary duty and exploitation of nonpublic information also exist when an insider makes a gift of confidential information to a trading relative or friend."[16] As a result, the Second Circuit observed in *Obus* that "[i]n light of the broad definition of personal benefit set forth in *Dirks*, this bar is not a high one."[17]

The question, then, is how high the bar should be for *knowledge* of this benefit by the tippee. In *Whitman*, where the court did require such knowledge, Rakoff appeared to lower the bar even further, ruling that "there is no reason to require that the tippee know the details of the benefit provided; it is sufficient if he understands that some benefit, however modest, is being provided in return for the information."[18] Accordingly, Rakoff charged the jury that it was not necessary that the defendant understand "the specific benefit given or anticipated by the insider in return for disclosure of inside information; rather, it [was] sufficient that the defendant had a general understanding that the insider was improperly disclosing inside information for personal benefit."[19]

But this instruction raises the question of just how vague the tippee's understand-

ing of the benefit can be. For example, can the tippee have a general understanding that the tipper benefited but be factually wrong as to the type of benefit received? For instance, would the knowledge requirement be satisfied if the tippee genuinely believed that the tipper was paid money in exchange for the tip, but it turned out that the tipper's benefit was merely reputational? *Dirks* makes clear that at least where there is no improper purpose—for example, when the tipper's purpose is to expose fraud—it is legally impossible for a tippee to have such knowledge. If, however, the tipper's purpose was improper, and the tippee was simply mistaken as to precisely why, it is unclear whether this would constitute an understanding of "some benefit."

In addition, courts will have to consider how much evidence will suffice to show tippee knowledge of the tipper's benefit. With respect to the tippee's knowledge of a breach of fiduciary duty, the Second Circuit has held that the standard is merely whether the tippee knew *or should have known* about the breach,[20] a finding that can be made based on circumstantial evidence.[21] If the same standard is applied to the question of knowledge of the tipper's benefit, one can only wonder whether this additional knowledge requirement would pose any real obstacle to guilt. For example, could the government argue to a jury that the defendant was a sophisticated investor who had to have known that the original tipper—whoever that was—had to have obtained a benefit—whatever that was—simply because the tipper would not have assumed the risks of tipping for free? In such a case, the leak itself could serve as circumstantial evidence of both the tipper's personal benefit and knowledge by the tippee of that benefit.

In fact, the government essentially made this argument in its Second Circuit brief in *Newman*, in which it asserted that "[g]iven the nature, specificity and timing of [the] disclosures, the jury had ample basis for its conclusion that Newman and Chiasson knew the insiders had disclosed the information in breach of a duty of trust and confidence."[22] On this basis, the government then argued:

> [T]he jury further would have found that the defendants inferred from the circumstances that some benefit was provided to (or anticipated by) the insiders. Given how the Supreme Court and [the Second Circuit] have defined benefit … the jury would have found that the defendants understood the insiders would not have undertaken the highly risky step of disclosing earnings information shortly before a quarterly announcement unless they expected to receive something in return. Put differently, the jury would have concluded that the defendants knew insiders disclosed the information for some personal reason rather than for no reason at all.[23]

But will the Second Circuit accept such highly circumstantial proof of knowledge? At oral argument in *Newman*, Judge Ralph K. Winter Jr. asked whether the government was arguing that the act of the disclosure itself provides evidence of the personal benefit, apparently reflecting a concern that the government had offered no principle for distinguishing routine corporate leaks—which would not serve as the basis for insider trading liability—from material, nonpublic information disclosed for personal benefit. The government distinguished the case on its facts, pointing out that the defendant-tippees had actively pressed for material, nonpublic information. Further, the government argued that the analysis should focus on the totality of the circumstances, which would include the specificity and timing of the information along with the behavior and sophistication of the trader. And indeed, the Second Circuit has already held that the tippee's sophistication is a factor that can be taken into account to show knowledge of a fiduciary breach.[24]

Accordingly, if the Second Circuit does hold in *Newman* that tippees must have knowledge of the tipper's personal benefit, the question remains how much evidence will be required to show that knowledge, and whether modest circumstantial evidence will suffice. If, ultimately, the answer is that the government can prove, based on the defendant's sophistication alone, that the defendant had to have known (or was willfully blind to the fact) that the original tipper personally benefited, the requirement of tippee knowledge will become an afterthought. This concern is not merely hypothetical, as Sullivan's recent decision in *United States v. Steinberg* illustrates. In that case, the court determined—based on the defendant's sophistication, among other factors—that once the jury found the defendant knew the disclosures were unauthorized, "it could also find that [he] either knew or was overwhelmingly suspicious that the original sources of that valuable information were receiving some benefit in return," as "[o]nly a Pollyanna could have believed otherwise."[25]

While *Newman* will answer the question of whether a tippee, to be found guilty, must know that his tipper derived a personal benefit, the ultimate import of that answer will lie in how district courts apply such a knowledge requirement in future cases.

1. Nos. 13-1837-cr(L), 13-1917-cr(con) (2d Cir.).
2. *United States v. Jiau*, 734 F.3d 147, 153 (2d Cir. 2013).
3. 693 F.3d 276, 289 (2d Cir. 2012).
4. 904 F. Supp. 2d 363, 370, 371 n.6 (S.D.N.Y. 2012). According to Rakoff, because the purpose in misappropriation prosecutions "is to protect property rights in information," "the tippee's knowledge that disclosure of the inside information was unauthorized is sufficient for liability." Id. at 370.
5. Id. at 371.
6. No. 12 Cr. 121, 2013 WL 1943342, at *2 (S.D.N.Y. May 7, 2013) (order denying bail) (emphasis omitted).
7. Id.
8. Reply Brief for Defendant-Appellant Anthony Chiasson at 12, *United States v. Newman*, Nos. 13-1837-cr(L), 13-1917-cr(con) (2d Cir. Dec. 18, 2013).
9. Brief for the United States of America at 53, *United States v. Newman*, Nos. 13-1837-cr(L), 13-1917-cr(con) (2d Cir. Nov. 14, 2013) [hereinafter Government Brief].
10. 463 U.S. 646 (1983).
11. Id. at 660.
12. Id. at 662 (citation omitted).
13. Id. at 663.
14. Id. at 667.
15. *SEC v. Obus*, 693 F.3d 276, 289 (2d Cir. 2012). In *United States v. Jiau*, which was handed down after Sullivan's decision in *Newman*, the Second Circuit applied the *Obus* court's articulation of the elements of an insider trading violation to a criminal prosecution under the classical theory. See 734 F.3d 147, 153 (2d Cir. 2013).
16. *Dirks*, 463 U.S. at 664.
17. 693 F.3d at 292.
18. *United States v. Whitman*, 904 F. Supp. 2d 363, 371 (S.D.N.Y. 2012).
19. Id. (quoting jury instructions).
20. See *United States v. Goffer*, 721 F.3d 113, 124 (2d Cir. 2013). The Second Circuit held in *Obus* that tippee knowledge could be established through demonstration of conscious avoidance, also known as willful blindness. See 693 F.3d at 288-89.
21. See *United States v. Mylett*, 97 F.3d 663, 668 (2d Cir. 1996).
22. Government Brief, supra note 9, at 61 (internal quotation marks omitted).
23. Id. at 64-65.
24. See *Obus*, 693 F.3d at 288 (noting that the "knows or should know standard" from *Dirks* "is a fact-specific inquiry turning on the tippee's own knowledge and sophistication").
25. No. 12 Cr. 121, 2014 WL 2011685, at *5 (S.D.N.Y. May 15, 2014) (noting the defendant was "(1) repeatedly receiving (2) valuable, material, nonpublic information (3) from a company insider (4) in violation of company policy (5) numerous times each quarter").