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Expert Analysis

Impact of 'Newman' In Other Insider Trading Cases

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The recent insider trading decision in *United States v. Newman,* 2014 WL 6911278, has begun to impact cases and individuals beyond its caption. As has been widely reported, on Dec. 10, 2014, the U.S. Court of Appeals for the Second Circuit handed down an opinion that reaffirmed the teachings of the U.S. Supreme Court's landmark decision in *Dirks v. SEC*, to wit, that for tippee liability to exist in an insider trading case, the government must prove that the tippee knew of a personal benefit received by the tipper. The widely discussed decision has raised questions before at least one jurist about guilty pleas already taken in an insider trading matter completely unrelated to *Newman*. The question the court in *United States v. Durant* had to resolve: Does *Newman*, a case brought under the classical theory of insider trading, apply with equal force to cases brought under the misappropriation theory?

After several rounds of briefing by the relevant parties, on Jan. 22, 2015, Judge Andrew L. Carter vacated the guilty pleas of the defendants in *Durant* and reserved as to whether an outright dismissal of the indictment is warranted.

In the wake of the Newman decision, Judge Carter inquired of both the government and the defense whether *Newman* impacted the tippees in *Durant*. In that case, four defendants pleaded guilty and one remains to stand trial. Carter, however, questioned whether *Newman* obligated him to vacate the guilty pleas. At a December court appearance, the U.S. Attorney's Office for the Southern District of New York opposed as drastic such a remedy and sought the opportunity to file papers explaining why the Newman opinion did not impact the guilty pleas in *Durant*. (Co-author Gregory Morvillo represents Anthony Chiasson, a co-defendant in the Newman case. Subsequent to the writing of this article, Morvillo was retained by the defendant in *Durant* solely in a matter before the Securities and Exchange Commission.)

On Jan. 12, 2015, the U.S. Attorney's Office attempted to persuade Judge Carter to maintain the status quo when it filed a "Memorandum of Law in Support of the Sufficiency of the Defendants' Guilty Pleas" (government brief). The government's brief argued that because *Newman* is inapplicable to misappropriation cases it does not impact *Durant* at all.

Durant is an insider trading case brought under the misappropriation theory of insider trading. The government's articulated facts are that an attorney, uncharged in *Durant*, shared his clients' confidences with his friend, Trent Martin. The attorney allegedly informed Martin that the former had worked on a potential acquisition by IBM of a software company, SPSS, Inc.

According to the government's recent filings, Martin, an analyst at a financial services firm, allegedly learned and subsequently passed confidential information about IBM's corporate acquisition plans to his roommate, Thomas Conradt. The tips purportedly included the fact that IBM sought to acquire SPSS, and that IBM was set to offer a significant premium over the then current SPSS stock price. Conradt, and three other defendants the government avers Conradt tipped, worked at a securities trading firm, and allegedly purchased SPSS's stock and/or call options. The government has alleged that the individual defendants' profits varied between $2,500 and $625,000 in profits.

There are a number of reasons one might conclude that the Newman opinion impacts *Durant*. First, *Newman* specifically stated, referencing the previous Second Circuit decision *SEC v. Obus*, that "[t]he elements of tipping liability are the same, regardless of whether the tipper's duty arises under the 'classical' or the 'misappropriation' theory." 2014 WL 6911278 at *4. A judge might reasonably read that language to indicate that *Newman* controls *Durant*. Second, the evidence of personal benefit provided to the tipper, at least as characterized by the government's recent filings, consisted of "friendship" between Martin, the tipper, and Conradt, the first level tippee.[1]

The Newman court held that the mere fact of a friendship, without more, is an

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insufficient benefit to uphold insider trading liability. Even if the defendants' guilty pleas were deemed to be based on facts that involved sufficient proof of personal benefit to the tipper, some question would remain as to whether the pleas set forth proof demonstrating that the individual defendants knew of the personal benefit the tipper received in exchange for the information about IBM/SPSS.

Does 'Newman' Apply?

The government took the position that *Newman* does not apply to misappropriation cases, and therefore the guilty pleas were sufficient. The government brief argued that classical and misappropriation cases require different elements to prove insider trading liability. While the government conceded that the "personal benefit requirement has long been a feature of classical [insider trading cases]," it asserted that "[n]othing about a breach of the duty at issue in misappropriation cases requires the demonstration of a personal benefit to the tipper…." Government Brief at 7.

The government posited that neither Second Circuit nor district court authority requires a personal benefit in either tipper or tippee liability cases. In so contending, the government relied on language in *United States v. Libera* in which the Second Circuit stated "the misappropriation theory requires the government to prove two elements: (i) a breach by the tipper of a duty owed to the owner of the nonpublic information; and (ii) the tippee's knowledge that the tipper had breached the duty. We believe that these two elements, without more, are sufficient for tippee liability." 989 F.2d 596, 600 (1993). The Government Brief cited several district court cases, *SEC v. Musella*, *SEC v. Willis*, and *SEC v. Lyon* for the proposition that "the Second Circuit has declined to impose a 'benefit' requirement in misappropriation theory cases…." *Lyon*, 605 F.Supp.2d 531, 548 (S.D.N.Y. 2009)), Government Brief at 10.

In sum, the government argued that "neither the Supreme Court nor the Second Circuit's precedents require proof of a personal benefit to the tipper, or knowledge of such a benefit by the tippee, to find Section 10(b) liability in misappropriation cases…." Government Brief at 5. The government took this position notwithstanding the fact that the Newman opinion, on its face, seems to come out 180 degrees in the opposite direction, by noting explicitly that the elements of tipping liability are the same regardless of whether charges are brought under the classical or misappropriation theories. *Newman,* 2014 WL 6911278 at *4.

> Does 'Newman,' a case brought under the classical theory of insider trading, apply with equal force to cases brought under the misappropriation theory?

The question left unanswered by the government brief is: How can the government's position, that proof of personal benefit to the tipper is not required in misappropriation cases, be reconciled with the Second Circuit's explicit holding in *Obus*, that the elements of tipping liability are the same in both classical and misappropriation insider trading cases? *Obus* clearly states: "[t]o summarize our discussion of tipping liability, we hold that 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*." 693 F.3d 276, 289 (2d. Cir 2012) (emphasis added.) The Second Circuit did not appear to equivocate when it stated that a tipper must receive a personal benefit to be liable as a tipper in an insider trading case.

The government's brief recognized the tension between its asserted position and the Obus holding. It attempted to address the issue by maintaining that *Obus* relied on *United States v. Falcone*, 257 F.3d 226 (2d Cir. 2001), the latter of which, the government argued, did not require a benefit to the tipper for misappropriation liability. The Government Brief argued that although *Obus* speaks of benefit, the benefit of which it speaks is "inherent in the circumstance when the inside information is misappropriated." Government Brief at 11. Presumably this means that when a misappropriator embezzles information from the principal to which he owes a duty (either his own company or, in the instant case, an individual who confided confidential information in him), he is always acting in his own self-interest, or for his own benefit (and therefore with fraudulent purpose).

Irreconcilable Positions?

The tension the government's brief did not address is that which exists between its stated position in *Newman* as compared to its stated position in *Durant*. Durant, however, did not allow this tension to pass unnoticed. Seeking a dismissal of his indictment, Durant filed papers with Judge Carter on Jan. 5 and Jan. 21, 2015, articulating why the indictment should not stand. As a way of calling into question the government's rationale for preserving the Durant indictment (that misappropriation and classical insider trading cases are inherently different animals with different elements and legal requirements) Durant pointed out to the court that the government previously had taken the exact opposite position in *Newman*. Durant's filing stated that the government "affirmatively and repeatedly asserted throughout the litigation in *Newman* that the elements of classical and misappropriation insider trading are *the same* with respect to tippee liability." Durant Jan. 21 Filing 2 (emphasis added).

Durant noted that in the government's brief to the Second Circuit in *Newman*, the government argued that the fact that "*Falcone*, *Mylett*, and *Libera* (and *Obus*, for that matter) were misappropriation cases does not undermine their force as precedent [in

Newman]…. Indeed, this Court has explicitly recognized that, for purposes of tippee liability, there is no material difference between a classical insider-trading case and a misappropriation case." Durant Jan. 21 Filing at 2.

Durant argued that these two positions were irreconcilable: "Moreover—in direct contradiction to its position here—in *Newman* the government agreed that it was required to prove a personal benefit to the tipper in misappropriation cases. Compare Gov't Newman Br. at 54 (stating that it is "incorrect" to assert that proof of a benefit to the tipper is not required in misappropriation cases) with Gov't Jan 12 Mem. at 8-9 (denying that proof of benefit to the tipper is required in misappropriation cases)." Durant Jan. 21 Filing at 3.

To its credit, the government recognized that its viewpoint might not carry the day, and in that event, that *Durant* rests on a faulty legal theory. On Jan. 19, 2015, the government filed a letter with Judge Carter that addressed the Jan. 5 motion to dismiss made by Durant, the sole defendant scheduled for trial.

The letter reaffirmed the government's position that: (1) the Second Circuit erred in deciding *Newman*, and (2) that even if *Newman* was properly decided, it is inapplicable to *Durant* because personal benefit has never been required in misappropriation cases. However, the government's letter conceded that, should Judge Carter disagree with the government's position and determine that *Newman* applies to *Durant*, the government's proof as to benefit would be insufficient under *Newman*. In that case, the government informed the court, the appropriate remedy would be for the court to dismiss the indictment against Durant and the defendants who have previously pleaded guilty. Jan. 19 Letter at 1-2. This was no small concession.

Judge Carter's Order

On Jan. 22, Judge Carter issued an order vacating the defendants' guilty pleas. The order indicated that based on *Newman* and after reviewing the extensive briefing by the parties, the guilty pleas were insufficient.

Although the government argued to the contrary, Judge Carter concluded that the Second Circuit intended for 'Newman' to apply to misappropriation cases. In that case, it seems likely that Judge Carter will dismiss the Durant indictment in its entirety.

The order noted that "the Court was skeptical that the pleas were sufficient in light of *Newman's* clarification of the personal benefit and tippee knowledge requirements of tipping liability for insider trading." See 2014 WL 6911278, at *9-*13." Judge Carter's Order at 1-2. Judge Carter went further stating the following:

> Specifically, this Court finds that, as indicated in *Newman*, the controlling rule of law in the Second Circuit is that "the elements of tipping liability are the same, regardless of whether the tipper's duty arises under the 'classical' or the 'misappropriation' theory." 2014 WL 6911278, at *4 (citing *SEC v. Obus*, 693 F.3d 276, 285-86 (2d Cir. 2012)); see also *Obus*, 693 F.3d at 285-86 ("The Supreme Court's tipping liability doctrine was developed in a classical case, but the same analysis governs in a misappropriation case.") (citation omitted). Additionally, even if *Newman* did not specifically resolve the issue, the Court is swayed by the fact that *Newman's* unequivocal statement on the point is part of a meticulous and conscientious effort by the Second Circuit to clarify the state of insider-trading law in this Circuit. Accordingly, even assuming arguendo that the Government is correct that the cited language in *Newman* is dicta, it is not just any dicta, but emphatic dicta which must be given the utmost consideration. See *Jimenez v. Walker*, 453 F.3d 130, 142 (2d Cir. 2006) ("Dicta deserve close consideration; emphatic dicta, all the more."). Finally, the Court notes that it agrees with *Newman's* articulation of the requirements of tipping liability and its statement that such analysis applies equally in misappropriation cases. *Accord SEC v. Yun*, 327 F.3d 1263, 1274-80 (11th Cir. 2003).

Judge Carter's Jan. 22 order at 2 (internal citations omitted). The court continued to reserve on Durant's motion to dismiss and on the government's view that if *Newman* applies to misappropriation cases like this one, the court should dismiss the indictment as to all defendants.

Although the government argued to the contrary, Judge Carter concluded that the Second Circuit intended for *Newman* to apply to misappropriation cases. In that case, it seems likely that Judge Carter will dismiss the Durant indictment in its entirety, considering that all parties have indicated that if *Newman* applies to *Durant*, that the proffered evidence of personal benefit and knowledge thereof is insufficient as a matter of law. Judge Carter's decision to vacate the pleas underscores the notion that going forward, personal benefit and tippee knowledge of it will play significant roles in insider trading cases, whether brought under the classical or misappropriation theories.

1. The government did not charge the attorney as the tipper in *Durant*, despite the fact that he is the individual who allegedly violated his duty of confidentiality to his law firm and its client, IBM. The rationale appears to be that the attorney did not know or believe that Martin would tip others for trading purposes because the attorney and Martin had a relationship of trust and confidence such that the attorney expected that Martin would keep the information secret.

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