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Wachtell Lipton discusses Second Circuit Decision Overturning Insider Trading Convictions

By John F. Savarese, Wayne M. Carlin and David B. Anders
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[On December 10, 2014] the Second Circuit Court of Appeals issued an important decision overturning the insider trading convictions of two portfolio managers while clarifying what the government must prove to establish so-called "tippee liability." *United States v. Newman, et al., Nos. 13-1837-cr, 13-1917-cr (2d Cir. Dec. 10, 2014)*. The Court's decision leaves undisturbed the well-established principles that a corporate insider is criminally liable when the government proves he breached fiduciary duties owed to the company's shareholders by trading while in possession of material, non-public information, and that such a corporate insider can also be held liable if he discloses confidential corporate information to an outsider in exchange for a "personal benefit."

In reversing these convictions, however, the Court clarified that a "tippee" (*i.e.*, an outsider who receives confidential corporate information) can be found criminally liable only if the government establishes that he knew of the tipper's "personal benefit" and that the benefit is "objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature." In reaching this result, the Court chastised "the doctrinal novelty" of the government's recent insider trading prosecutions that have, in the Court's words, "increasingly targeted . . . remote tippees many levels removed from corporate insiders," and pointedly noted that the government had not been able to cite "a single case in which tippees as remote [as the two defendants] have been held criminally liable for insider trading."

The Court of Appeal's opinion sets forth a careful review of the Supreme Court's insider trading precedents, concluding that, in order to sustain an insider trading conviction, the government must prove beyond a reasonable doubt that the tippee knew not only (1) that an insider "disclosed confidential information," but also (2) that the insider "did so in exchange for a personal benefit." The Court rejected the government's theory that proof of the first element alone was sufficient to sustain a conviction. In the case of Messrs. Newman and Chiasson, the Court found the evidence presented at trial insufficient to sustain their convictions for two reasons: *first*, the government failed to show that the *tippers* themselves had received a personal benefit from which the tippees' liability could be derived; and *second*, the government failed to show that the defendants knew that the information obtained from insiders had been "divulged [in exchange] for personal benefit."

In a broad discussion that will certainly have an impact on other prosecutions, the Court emphatically rejected the various forms of proof of a supposed "personal benefit" offered by the government, including evidence that the corporate tipper and immediate tippee were "alumni of the same school," "attended the same church," or on occasion "swapped career advice." While recognizing that personal benefit is broadly defined to include "not only pecuniary gain," but also "reputational benefit," the Court made clear that this otherwise permissive standard does not enable the government to prove receipt of a personal benefit "by the mere fact of a friendship, particularly of a casual or social nature." As the Court explained, if that were enough, "practically anything would qualify." Rather, proof of "a relationship between the insider and the recipient that suggests a quid pro quo" or "an intention to benefit the [tippee]" is required.

The Court's decision narrows the universe of cases in which a successful insider trading prosecution may be brought against a tippee. At the same time, we caution against reading too much into this case. The defendants were third- and fourth-level tippees — that degree of attenuation between the source of information and the trading makes the government's burden in satisfying the standard articulated by the Court particularly difficult. Previous successful insider trading prosecutions have generally involved a closer connection between the source of information and the trading.

Notwithstanding the continuing development of the law of tippee liability, it is of course critical that companies and individuals in possession of confidential information maintain their vigilance with respect to insider trading compliance. The government remains intensely focused on cracking down on unlawful insider trading (see our prior memo, here), and that focus is unlikely to abate as a result of this setback.

The full and original memorandum was circulated by Wachtell, Lipton, Rosen & Katz on the day of the decision, December 10, 2014.