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Expert Analysis

The Accidental Tipper: Personal Benefit Requirement for Insider Trading

The highly publicized *Galleon* insider trading case has brought to the forefront questions about liability in insider trading cases. Robert Moffat, an executive at IBM, allegedly disclosed material, nonpublic information to Danielle Chiesi of New Castle Partners hedge fund, and she allegedly traded on the basis of that information. Both were arrested on that basis, and Mr. Moffat has since pleaded guilty to insider trading charges and received a six-month prison sentence. But immediately following Mr. Moffat's and Ms. Chiesi's arrests last October, their lawyers each asserted that neither could be held liable, in part because Mr. Moffat never received a personal benefit in exchange for the information he conveyed. Ms. Chiesi's lawyer commented that the complaint failed to allege that she gave anything of value to Mr. Moffat, while Mr. Moffat's lawyer noted that "the government didn't allege he profited" from the disclosure.¹

This article examines insider trading law through the lens of a hypothetical scenario. The discussion focuses on the personal benefit test, which is designed to ensure that insider trading laws ensnare only the culpable: those who seek to use inside information for their personal advantage. While courts have diluted the personal benefit requirement over the years, limiting the ability to distinguish malevolence from carelessness in the eyes of the law, the negligent or "accidental" tipper should still be able to avoid liability for insider trading.

The Story of Lucy and Rita

Lucy works at Computergy, a publicly traded software company. She occasionally has lunch with Rita, a friend from business school. Lucy and Rita rarely discuss work, prefer-

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ring that their time together be removed from the pressures of professional life. During one particular lunch date, Lucy is distracted by concerns that Computergy has become the target of an acquisition by a larger software firm. No public announcement of a merger has been made, but Lucy is too distressed to keep the news under wraps. Lucy tells Rita about the takeover, which Lucy believes will jeopardize her position at Computergy. Neither Rita nor Lucy say anything about the potential effect of the news on Computergy's stock price. Rita attempts to console Lucy, and the conversation eventually shifts to other topics.

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That afternoon Rita calls her stock broker and directs him to buy shares of Computergy. The broker questions the wisdom of Rita's actions, saying that he has not heard news that would portend a favorable change in Computergy's stock price, but Rita goes ahead with the purchase. When the merger is announced, Computergy's stock price soars, and Rita quickly sells her shares.

Following an investigation by the Securities and Exchange Commission, Lucy and Rita are charged with insider trading. In her defense, Lucy asserts that the material, nonpublic information she divulged to Rita was not provided for securities

trading purposes, and that she did not know that Rita intended to trade on it. Rather, Lucy argues, the information was provided inadvertently and with no intent to garner a personal benefit as is required in order for liability to attach in tipper-tippee trading cases under the Supreme Court's decision in *Dirks v. SEC*.² Rita contends that she cannot be held liable because tippee liability is derivative of, and dependent upon, the liability of the tipper. Because Lucy received no benefit for tipping and did not know Rita would trade, Rita argues that Lucy did not intend to defraud Computergy's shareholders, and Rita therefore cannot be held derivatively liable.

Legal Framework

Insider trading is not expressly forbidden by a specific statute, but is instead treated as securities fraud prohibited under SEC Rule 10b-5. Courts have found that insider trading may constitute securities fraud under two theories, referred to as the classical and misappropriation theories. The classical theory covers the use of material, nonpublic information in trading by corporate insiders. Under the classical theory, insiders violate Rule 10b-5 by using material, nonpublic information for personal gain in breach of their fiduciary duties. The misappropriation theory fills a loophole left open by the classical theory, extending Rule 10b-5 to cover corporate outsiders who ordinarily owe no fiduciary duty to the shareholders who may be wronged by the outsider's trading.

Both the classical and misappropriation theories of 10b-5 liability also extend to cases in which the insider or misappropriator does not personally trade, but reveals material, nonpublic information to another individual who does trade. The purpose of so-called "tipper-tippee" liability is to prevent insiders from circumventing securities laws by giving inside information to individuals who are not restrained by fiduciary obligations to a company's shareholders.

Tipper liability has two elements: (1) disclosure of material, nonpublic information by the tipper

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in breach of a fiduciary duty, and (2) receipt of a personal benefit as a result of the disclosure. Tippee liability is derivative of tipper liability. Tippees can be held liable only if the tipper breaches a fiduciary duty and the tippee knows (or should know) that the disclosure constitutes a breach.

Personal Benefit Requirement

Under *Dirks*, the mere disclosure of material, nonpublic information by itself is insufficient to constitute a breach of an insider's fiduciary duties. The purpose of the disclosure is determinative as to whether a breach has occurred. Because the policy underlying insider trading laws is rooted in stopping the use of inside information for personal gain, an insider does not run afoul of those laws or fiduciary duties to shareholders unless the insider receives a personal benefit.

Some debate still exists as to whether the *Dirks* personal benefit test applies to misappropriating tippers as well as corporate insiders. *Dirks* did not address this point because the case was brought under the classical theory. The SEC has argued in the past that the test should not apply to misappropriating tippers because misappropriation of material, nonpublic information is presumptively improper. In *United States v. Libera*,³ the court noted that even if a misappropriating tipper does not know a tippee intends to trade, misappropriation carries a conclusive presumption of a personal benefit, because the tippee's interest is likely "not for nothing."

But *Libera* does not reflect the majority rule. Most courts considering the issue have held that the personal benefit test does apply in misappropriation cases for policy reasons. The U.S. Court of Appeals for the Eleventh Circuit noted in *SEC v. Yun*⁴ that attaching different requirements "constructs an arbitrary fence" between the two theories, while the harm to the securities market would be the same in both cases. Additionally, because insiders who tip are often misappropriating information as well, employing different tests for liability would, according to *Yun*, "essentially render *Dirks* a dead letter" by creating a loophole for the government to avoid the personal benefit test in many cases involving corporate insiders.

Although the personal benefit test was intended to separate benign and unintended disclosures from self-interested and wrongful ones, some courts have been unduly lax in applying it. "Personal benefit" has been defined expansively, requiring only minimal proof by the government. Proof that the tipper made a gift of information to a trading relative or friend has been found a sufficient benefit to the tipper.⁵ In *Yun*, evidence that the tipper and tippee were friends, worked together as realtors and split commissions

on sales was sufficient for a jury reasonably to conclude that the tipper expected to benefit through maintaining a good relationship with the tippee. Similarly, in *SEC v. Maio*,⁶ the court accepted an inference of a personal benefit based solely on the close friendship between the tipper and the tippee, and the "hypothetical benefits" that may have been derived from it.

Not all courts, however, have been so undemanding in their application of the personal benefit test. *SEC v. Switzer*⁷ and *SEC v. Maxwell*⁸ both offer hope to inadvertent tippers and tippees. In *Switzer*, the University of Oklahoma's football coach was accused of illicitly trading on a tip he overheard from George Platt, the chairman and CEO of Texas International Company, while at a high school track meet. Mr. Platt and Barry Switzer knew each other but were not close friends. At the meet, Mr. Platt had been discussing material, nonpublic information with his wife, without the intent that it be used to trade, and without knowledge that Mr. Switzer was listening. Mr. Switzer traded on the basis of that information and reaped substantial profits. Mr. Platt did not receive a share in Mr. Switzer's profits, nor did he receive any other form of compensation from Mr. Switzer.

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The court concluded that Mr. Platt received no personal benefit from the disclosure, and therefore did not breach his fiduciary duties to Texas International. Absent a fiduciary breach by Mr. Platt, Mr. Switzer could not be held liable.

In *Maxwell*, the SEC alleged that David Maxwell, a senior executive at Worthington Foods, disclosed material, nonpublic information concerning an impending merger to his barber, Elton Jehn. Mr. Jehn traded in Worthington stock and reaped substantial profits. The court examined an exhaustive list of possible benefits that Mr. Maxwell could have received, ultimately holding that despite a 15-year association, Mr. Maxwell received no benefit and therefore his disclosure did not violate his fiduciary obligations. Mr. Jehn was also absolved of liability because his liability was derivative of Mr. Maxwell's.

Contrasted with *Maxwell*, *SEC v. Sargent*⁹ illustrates the point that no clear bright-line test exists to assess liability based on the closeness of the

tipper/tippee relationship. Michael Sargent was a dentist held liable after he received material, nonpublic information from one of his clients, Dennis Shepard, and then traded on the information. Unlike Mr. Jehn and Mr. Maxwell, whose relationship was more strictly barber/client, Mr. Sargent and Mr. Shepard were "friendly," and the two socialized and relied on each other for help with their respective businesses. The difference between *Sargent* and *Maxwell* is a matter of degree, but the courts came to different conclusions. These results provide guideposts for future cases, but they lay out no clear bright line to indicate how close is too close for purposes of inferring liability.

A recent case from the Southern District of New York, *SEC v. Rorech*,¹⁰ confirms that courts still have an appetite for a strong personal benefit test, even if they have so far failed to define a clear bright line for its application. *Rorech* involved allegations that the defendant tipper at Deutsche Bank Securities misappropriated and divulged material, nonpublic information concerning a forthcoming bond issuance. The tippee then allegedly purchased credit-default swaps, which increased in value once the bonds were issued. The court issued a judgment dismissing the complaint for several reasons, including the fact that the tipper had not received a personal benefit from the disclosure. The court reasoned that the tipper's relationship with the tippee was "exclusively professional" and that the tipper received no direct financial benefit from the trade.

Applying the Law

Returning to Lucy and Rita, the case law provides guidance but no definitive answers. If Lucy simply argues that she did not know that Rita would trade based on the information Lucy shared, her defense is likely to fall flat. Courts have rejected the argument that tippers' knowledge of tippees' intent to trade is a prerequisite for liability. In *Libera*, the court concluded that "such a requirement would serve no purpose other than to create a loophole for...misuse" of material, nonpublic information.¹¹ But Lucy's argument that she received no personal benefit in exchange for the disclosure may provide a defense.

An analysis of Lucy and Rita's case under the personal benefit test begins with a look at the nature of their relationship. The SEC could claim that the close nature of their friendship, absent any other considerations, supports an inference that Lucy received some form of personal benefit in return for divulging material, nonpublic information to Rita. That benefit could come in any form, including from the mere sense of satisfaction derived from giving a gift to a friend. Lucy and Rita's relationship mirrors the relationships in *Yun* and *Maio*.

In both of those cases, the courts accepted that circumstantial evidence of friendship could be used to infer fraud. But employing such a weak personal benefit test is a flawed approach and a misapplication of *Dirks*. The fact that Lucy and Rita shared a close relationship does not reveal whether Lucy's motivation for disclosing information to Rita was fraudulent, i.e., that Lucy intended to personally benefit from the disclosure. Mere disclosure of material information in the context of a warm personal relationship does not prove that the tipper's intent was securities fraud. Disclosure for personal benefit, however, is the element that transforms careless conversation into securities fraud.

Despite adverse rulings in *Yun* and *Maio*, the case law provides hope for Lucy and Rita. If Lucy was merely discussing important news related to her career, her case is analogous to *Switzer*, in which an inadvertent tipper was absolved based on the fact that he did not intend the information to be used for trading purposes and thus received no personal benefit. As noted in *Switzer*, "Rule 10b-5 does not bar trading on the basis of information inadvertently revealed by an insider."¹²

Switzer is not precisely on point. Unlike Lucy and Rita, the tipper and tippee in *Switzer* were not close friends, and the tippee was not the intended recipient of the information. In contrast, Lucy does not dispute that she willingly disclosed the information to a close friend, and unlike Mr. Switzer, Rita was not a bystander who merely happened to overhear. However, like that of the speaker in *Switzer*, Lucy's motivation was innocent; she had no expectation that Rita would trade following her disclosure and contemplated no benefit from it.

The recent *Rorech* case also helps to substanti-

ate Lucy's argument. Although the relationship between the tipper and tippee in *Rorech* was professional rather than personal, the court highlights the lack of any direct financial benefit to the tipper as a crucial missing element in the SEC's case. Like the tipper in *Rorech*, Lucy received no direct financial benefit from her disclosure. Even an allegation that Lucy received an indirect financial benefit would appear farfetched, meaning that *Rorech* arguably presents a closer question on one dimension of the personal benefit test.

Turning to Rita's liability, even though she indisputably profited from the disclosure, she too may have a defense based on the absence of a personal benefit to Lucy. Rita's liability as a tipper is derivative of, and thus dependent upon, Lucy's liability. If Lucy gained no personal benefit and thus did not commit securities fraud by her disclosure, Rita cannot be held liable.

Conclusion

A casual conversation between friends, during which material, nonpublic information is divulged for a purpose unrelated to securities trading, and without the tipper's expectation of a personal benefit, seems a poor case for the imposition of liability under Rule 10b-5. Lucy's naiveté about how her disclosure could and would be used by Rita casts doubt on her receipt of a benefit, as *Dirks* requires for liability. Moreover, the inference of a personal benefit, often credited by courts in cases involving a disclosure between close friends, is unpersuasive when the information is not disclosed for trading purposes. Lucy should not have to pay the same price for her carelessness that the law demands of those who tip others for personal gain.

The lax manner in which many courts have applied the personal benefit test has fostered an environment in which even an accidental tipper may face criminal prosecution or civil liability. But the prospects for defendants caught in such an unenviable position are not entirely bleak. Support for a strong personal benefit test that promotes fidelity to the law, while sparing those like Lucy who commit innocent mistakes, remains alive in some courts, and fundamental notions of justice and fairness dictate that others should follow their lead.



1. Susan Pulliam, "How Associates Helped Build Case," Wall Street Journal, Oct. 20, 2009, at A20.
2. 463 U.S. 646 (1983).
3. 989 F.2d 596 (2d Cir. 1993).
4. 327 F.3d 1263 (11th Cir. 2003).
5. SEC v. *Warde*, 151 F.3d 42 (2d Cir. 1998).
6. 51 F.3d 623 (7th Cir. 1995).
7. 590 F. Supp. 756 (W.D. Okla. 1984).
8. SEC v. *Maxwell*, 341 F.Supp.2d 941 (S.D. Ohio 2004).
9. SEC v. *Sargent*, 229 F.3d 68, 72-73 (1st Cir. 2000).
10. No. 09 Civ. 4329 2010 WL 2595111 (S.D.N.Y. June 25, 2010).
11. *Libera*, 989 F.2d at 600.
12. *Switzer*, 590 F.Supp. at 766.

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