GOVERNMENT'S BURDEN IN INSIDER TRADING CASES CLARIFIED

A recent decision in the Southern District of New York interpreted two important elements in a tipper-tippee insider trading case.

First, the court addressed the requirement in insider trading cases that the Government prove that an inside source disclosed information in exchange for some personal benefit. In a "remote tipper-tippee" scenario, where material nonpublic information is not received directly from a "company insider," but through an intermediary, it was disputed whether the Government had to prove that the person who trades on the information *knew* that the inside information was disclosed in anticipation of personal benefit to the insider. The Supreme Court in *Dirks v. SEC* found that the Government must prove the insider's disclosure breached a fiduciary duty to the corporation and its shareholders, which is demonstrated through a disclosure of confidential information in exchange for personal benefit.[1] *Dirks* left open the question, however, of whether the Government needs to prove that a remote tippee *knows* that the source received some personal benefit.

In instructing the jury in *United States v. Whitman*, the Honorable Jed S. Rakoff concluded that the Government must prove that a tippee knew the company insider received some personal benefit in exchange for disclosing confidential information.[2] But, Judge Rakoff clarified, the tippee need not know exactly what that benefit was, and the Government can satisfy its burden of proving knowledge of a personal benefit by showing that the tippee purposefully blinded himself to obtaining actual knowledge about this benefit.

Second, Judge Rakoff found that insider trading charges can be predicated upon disclosure of confidential information by *any* company insider who owes a duty to keep company information in confidence, and not just—as argued by the defense—officers, directors or other authorized agents of a company.

Background

Doug Whitman is the founder of Whitman Capital LLC, a small California hedge fund. On February 8, 2012, the United States Attorney's Office for the Southern District of New York charged Whitman with participating in two insider trading schemes that netted nearly $1 million in profits.

The Indictment alleged that Whitman traded Marvell Technology Group Ltd. securities based on material nonpublic information ("inside information") received from Karl Motey, an independent research analyst. Two Marvell employees allegedly passed inside information to Motey in violation of their fiduciary duties to Marvell in exchange for personal benefit.

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1 463 U.S. 646 (1983).

2 Transcript of Jury Charge, *United States v. Whitman*, No. 12-cr-00125 (JSR) (S.D.N.Y. Aug. 17, 2012) ("Whitman Tr. __").

The Indictment also alleged that Whitman obtained inside information pertaining to Polycom, Inc. and Google Inc. from Roomy Khan, a former Intel Corp. executive who worked in the hedge fund industry. Khan allegedly obtained the Polycom inside information from a Polycom employee in violation of his fiduciary duty to Polycom in exchange for personal benefit. Khan obtained the Google inside information from an employee of a firm that provided investor relations services to Google. The Google source also was alleged to have disclosed the inside information to Khan in violation of her fiduciary duty to Google and in exchange for personal benefit.

Khan and Motey pleaded guilty to insider trading charges and are cooperating with the Government. They both testified against Whitman during the trial. On August 20, 2012, the jury returned a verdict finding Whitman guilty of all alleged insider trading charges.

Personal Benefit Element

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 under certain circumstances, trading based on inside information disclosed in violation of a company insider's fiduciary duty may constitute securities fraud.

In *Dirks*, the Supreme Court found that the mere disclosure of material, nonpublic information by itself is insufficient to constitute a breach of an insider's fiduciary duties.[3] Rather, to determine whether an insider breached a fiduciary duty, courts are required 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."[4]

Following *Dirks*, two judges in the Southern District of New York—Judge Holwell and Judge Sweet—held that the Government is required to prove "tippee knowledge of *each element*, including the personal benefit, of the [insider's] breach."[5] At the *Rajaratnam* trial, Judge Holwell instructed the jury that "[t]he government must show that [the defendant] knew that . . . an insider would directly or indirectly obtain some personal benefit from the disclosure [of material, nonpublic information]."[6]

During the *Whitman* trial, the defense argued that Judge Rakoff should follow Judge Sweet and Judge Holwell's lead and find that the Government is required to prove that Whitman *knew* that the information at issue had been disclosed by a company insider in exchange for or in anticipation of personal benefit.

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3 463 U.S. 646 (1983).

4 *Id.* at 663.

5 *United States v. Rajaratnam*, 802 F. Supp. 2d 491, 498-99 (S.D.N.Y. 2011) (quoting *State Teachers Ret. Bd. v. Fluor Corp.*, 592 F. Supp. 592, 594 (S.D.N.Y. 1984)).

6 Transcript of Jury Charge at 5623:9-12, *United States v. Rajaratnam*, No. 09 CR 1184 (RJH) (S.D.N.Y. Apr. 25, 2011).

The Government, in response, maintained that it need not prove that Whitman knew that the alleged inside information was procured in exchange for personal benefit. Instead, the Government argued, to prove insider trading, it need only demonstrate that Whitman knew or should have known that in disclosing the confidential information, the alleged insider breached his or her fiduciary duty to his or her company.[7]

Like Judge Holwell and Judge Sweet, Judge Rakoff instructed the jury that for Whitman—a remote tippee—to be found guilty of insider trading, the Government must prove that he had a "general understanding" that the insider improperly "disclosed inside information to an outsider" for some actual or anticipated personal benefit.[8] In other words, the Government must show that the insider is disclosing inside information to a tippee "for some personal reason, rather than a company-approved purpose, and is obtaining some personal benefit."[9]

The Government's obligation to satisfy this burden, as construed by Judge Rakoff, may not be onerous in many cases. Judge Rakoff ruled that the Government need not prove that the tippee had actual knowledge of the particular type of benefit conveyed.[10] Moreover, the benefit "does not need to be financial or tangible in nature"; rather, it could be "obtaining a useful networking contact, improving the witness's reputation or power within the company, obtaining future financial benefits, or just maintaining or furthering a friendship."[11]

Judge Rakoff further explained that the tippee's knowledge of the personal benefit can be established through proof of the tippee's willful blindness regarding or conscious avoidance of, such knowledge. Judge Rakoff instructed the jury that the Government can prove knowledge of such facts "by proof that the defendant was aware of a high probability that an insider was improperly disclosing inside information for personal benefit, and not actually believing otherwise, deliberately avoided learning the truth; in other words . . . [that the tippee] purposely blinded himself to obtaining actual knowledge of an obvious fact because he had a conscious purpose to avoid learning the truth."[12]

Judge Rakoff's instructions could be confusing in circumstances where a jury concludes that the insider disclosed the information neither for a personal reason nor for a company-approved purpose. The instructions appear to give juries a choice between finding that a disclosure was made for "personal reasons" or for "a company-approved purpose," when disclosures may in fact

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7 In its briefing, the Government argued that *Fluor* and *Rajaratnam* were wrongly decided. *See* Government's Response To The Defense Motion In Limine For A Ruling And Jury Instruction On Knowledge Of Personal Benefit at 8, *United States v. Whitman*, No. 12-cr-00125 (S.D.N.Y. July 23, 2012) (Dkt No. 81).

8 Whitman Tr. 2952:17-25.

9 Whitman Tr. 2952:13-16.

10 Whitman Tr. 2952:19-23.

11 Whitman Tr. 2952:8-12.

12 Whitman Tr. 2953:2-9.

be made for neither reason. For example, an insider may make a disclosure by mistake, or because he or she incorrectly believed the disclosed information was already public. Although somewhat confusing, Judge Rakoff's instructions arguably would not permit conviction under such a circumstance. The instructions require the Government to prove that the insider obtained some personal benefit and that the defendant had knowledge of, or willfully blinded him or herself to, that benefit. If an insider's disclosure was inadvertent, it arguably was not made for personal benefit and therefore could not result in liability.

Nevertheless, Judge Rakoff's instructions should serve as a warning to all investors that the recipient of arguably confidential information about a public company must always be careful to consider the ultimate source of that information, how it was obtained, and whether there were any red flags or other facts suggesting that it may have been procured in exchange for some personal benefit.

Who Is An Insider?

Because the liability of a tippee hinges on the existence of an insider's breach of a duty of trust or confidence, the definition of the scope of the duty owed by the alleged insider to the company is crucial. Prior to trial, Whitman's counsel argued that, to establish a breach of fiduciary duty by a company insider, the court should look to state law for a definition of who owes that duty. Under California law, which the defense maintained should apply, not all company employees owe a fiduciary duty to the company; rather, this duty applies only to an officer, director, or authorized agent of the company or a person who otherwise had a legal obligation to keep company information in confidence. Thus, under the defense's theory, confidential information received from a lower-level company employee trading without an express confidentiality obligation may not constitute insider information.

Judge Rakoff rejected this argument and found that *any* company "insider," which he defined as "an officer, employee, or agent of a company who has access to nonpublic information," has a legal duty of "trust and confidence not to disclose to anyone outside the company financial or other nonpublic information about the company that the company treats as confidential and has informed the insider should be treated as confidential."[13] Whether the company considers certain information confidential turns on "written company policies, employee training, measures the company has taken to guard the information's secrecy, the extent (if any) to which the information has already been disclosed to outsiders, the ways (if any) in which the company has authorized other employees to disclose the information, and any other relevant facts and circumstances."[14]

Thus, Judge Rakoff's ruling makes clear that, at least in the Southern District of New York, a tippee can be found guilty of insider trading for receiving confidential information from *any* company insider, no matter his or her role, who has disclosed confidential information in violation of a confidentiality policy, employee handbook or other legal obligation not to disclose confidential information.

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[13] Whitman Tr. 2950:23-25; 2951:1-4.

[14] Whitman Tr. 2951:7-12.

Conclusion

These two rulings are significant for investors who receive information from third parties about public companies and make trading decisions based in whole or in part on this information. Investors must be careful, upon receiving any potentially material, nonpublic information, to assess whether the facts and circumstances suggest that the information was disclosed in exchange for some personal benefit, which may be something as insignificant as furthering the insider's interest in networking or friendship. Investors should also be aware that it does not matter whether confidential information comes from a low-level employee or CEO—all company insiders owe a duty to safeguard information that is treated by the company as confidential.

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