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Second Circuit Holds That Tipper/Tippee Liability Can Arise from a Gift of Inside Information Even Without a Close Personal Relationship

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The Second Circuit ruled today that a "meaningfully close personal relationship" is not required for insider-trading liability where a tipper discloses inside information as a gift or in exchange for some other type of nonpecuniary personal benefit. The requisite personal benefit exists "whenever the information was disclosed 'with the expectation that [the recipient] would trade on it' . . . and the disclosure 'resemble[s] trading by the insider followed by a gift of the profits to the recipient,' . . . whether or not there was a 'meaningfully close personal relationship' between the tipper and the tippee."The Second Circuit's decision in *United States v. Martoma* effectively overrules the portion of that court's 2014 decision in *United States v. Newman* refusing to infer a tipper's intent to benefit a tippee in the absence of a meaningfully close relationship and a pecuniary or similarly valuable benefit in exchange for the tip.

Background

The *Martoma* case arose out of the Government's investigation of S.A.C. Capital Advisors. Mathew Martoma, an S.A.C. portfolio manager, had had dealings with two doctors who had been involved in the clinical trial of a drug for Alzheimer's Disease.

The doctors had also entered into paid consulting arrangements with S.A.C. under contracts through expert-networking agencies.

The Government alleged that at least one of the doctors had shared confidential safety data about the drug with Martoma, leading Martoma and S.A.C. to build and maintain positions in the securities of the two companies that owned rights to the drug. The Government also alleged that the doctor had given Martoma advance information of the drug trial's failure – and that S.A.C. had then sold off its positions in the two drug companies' stock before the news became public. Martoma was convicted of insider trading and conspiracy to commit securities fraud.

Martoma appealed, claiming that the Government had not proven that the doctor had received a legally sufficient personal benefit in exchange for providing the confidential information. Martoma's argument focused on the interplay among the Supreme Court's 1983 decision in *Dirks v. SEC*, the Second Circuit's 2014 decision in Newman, and the Supreme Court's 2016 decision in *Salman v. United States*.

The *Dirks* case established the framework for tippee liability. The Supreme Court held that the liability of a tippee (such as Martoma) derives from the liability of his or her tipper (such as the doctor) – and that a tipper breaches a fiduciary duty by disclosing confidential information only if he or she benefits directly or indirectly from the disclosure. The Court defined the requisite "personal benefit" to the tipper as including "a pecuniary gain or a reputational benefit that will translate into future earnings." But the Court added: "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."

In 2014, the Second Circuit announced a more rigorous construction of *Dirks*'s personal-benefit requirement. The court ruled in Newman that, to the extent that "a personal benefit may be inferred from a personal relationship between the tipper and tippee, . . . such an inference is impermissible in the absence of proof of a *meaningfully close personal relationship that generates an exchange that is objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature*" (emphasis added).

The *Newman* ruling led to the Supreme Court's 2016 decision in the Salman case, which involved a family relationship. The tipper, who worked for an investment bank, had allegedly provided confidential business information to his brother, knowing that the brother would trade on it. The brother then tipped Salman, whose sister had become engaged to and later married the tipper. The Supreme Court reemphasized *Dirks'*s holding that "a tipper breaches a fiduciary duty by making a gift of confidential information to 'a trading relative,'" and added: "when a tipper gives inside information to 'a trading relative or friend,' the jury can infer that the tipper meant to provide the equivalent of a cash gift." The Court rejected Salman's reliance on *Newman* for the proposition that the tipper must receive an objective, consequential personal benefit representing an actual or potential pecuniary gain. The Court ruled that, "[t]o the extent the Second Circuit held that the tipper must also receive something of a 'pecuniary or similarly valuable nature' in exchange for a gift to family or friends, . . . this requirement is inconsistent with *Dirks*."

Martoma argued on appeal that the *Salman* case did not decide how close the relationship between a tipper and a tippee must be in order for the tipper to have breached his or her duty without receiving a concrete personal benefit such as the "potential gain of a pecuniary or similarly valuable nature" that *Newman* required. That issue, according to Martoma, did not arise in *Salman* because the tipper and the tippee had clearly shared a meaningfully close personal relationship: they were brothers. But Martoma contended that he and the doctor had not had a close personal relationship, so *Salman's* gift-giving analogy was inapposite, and a personal benefit more direct and consequential than mere friendship was required. He also claimed that, even though the doctor had been paid under the consulting arrangement with S.A.C., the doctor had not been paid for disclosing the drug-efficacy data.

The Second Circuit – in a 2-to-1 decision – affirmed the conviction.

Second Circuit's Decision

The court first ruled that the evidence was sufficient to sustain Martoma's conviction on a simple pecuniary-benefit theory. The doctor had been paid for his consultations with Martoma. Even if the doctor had not billed Martoma specifically for the meeting at which he had conveyed the nonpublic information about the drug trial's failure, "the tipper's gain need not be *immediately* pecuniary." "In the context of their ongoing relationship of *quid pro quo*, . . . where [the doctor] regularly disclosed confidential information in exchange for fees, a rational trier of fact could have found the essential elements of the crime [of insider trading] beyond a reasonable doubt under a pecuniary *quid pro quo* theory."

The majority spent most of its opinion discussing the nonpecuniary, gift-giving aspect of insider-trading liability because Martoma had challenged the jury instructions, which had described the personal-benefit theory in terms of both financial and non-financial benefits. The majority concluded that "the logic of *Salman* abrogated *Newman's* 'meaningfully close personal relationship' requirement" for a non-financial or non-*quid pro quo*personal benefit. The court held that "an insider or tipper personally benefits from a disclosure of inside information whenever [1] the information was disclosed 'with the expectation that [the recipient] would trade on it' . . . and [2] the disclosure 'resemble[s] trading by the insider followed by a gift of the profits to the recipient,' . . . whether or not there was a 'meaningfully close personal relationship' between the tipper and the tippee."

The majority derived its two-pronged standard from *Dirks*'s and *Salman*'s teaching that "the justification for construing gifts as involving a personal benefit is that '[t]he tip and trade resemble trading by the insider himself followed by a gift of the profits to the recipient.'" According to the majority, "nothing in . . . this logic supports a distinction between gifts to people with whom a tipper shares a 'meaningfully close personal relationship' . . . and gifts to those with whom a tipper does not share such a relationship. If the insider discloses inside information 'with the expectation that [the recipient] would trade on it,' . . . and the disclosure 'resemble[s] trading by the insider followed by a gift of the profits to the recipient,' . . . [the insider] personally benefits for the reasons described in Dirks and Salman."

Based on this formulation, the majority "reject[ed], in light of Salman, the categorical rule that an insider can never personally benefit from disclosing inside information as a gift without a ‘meaningfully close personal relationship.’”

Implications

The Martoma decision appears to have unraveled the second of the two limitations that the Second Circuit had sought to place on tippee liability in Newman. The Supreme Court’s Salman decision disagreed with the proposition that a tipper must receive something of a “pecuniary or similarly valuable nature” in exchange for a tip to family or friends. And the Martoma decision has now rejected Newman’s insistence that a “meaningfully close personal relationship” is required in order for a gift to constitute a personal benefit to the tipper.

The *Martoma* decision raises a number of issues for future cases, including the following:

> First, the court stressed that its holding “reaches only the insider who discloses inside information to someone *he expects will trade on the information*.” In contrast, for example, “disclosures for whistleblowing purposes to reveal a fraud” (as in *Dirks*) and “inadvertent disclosures . . . are not disclosures made ‘with the expectation that [the recipient] would trade on them’ and thus involve no personal benefit to the insider.” The court noted that the nature of the tipper/tippee relationship could be relevant to the questions whether the tipper expected the tippee to trade on the information and whether the disclosure “‘resemble[d] trading by the insider followed by a gift of the profits to the recipient.’” Thus, factual issues about the nature and closeness of the personal relationship will probably not disappear from future cases.

Second, the majority purported to reject only “the categorical rule that an insider can *never* personally benefit from disclosing inside information as a gift without a ‘meaningfully close personal relationship.’” The lack of a categorical rule could leave room for fact-specific explorations of how far the *Martoma* decision extends – and whether, under some circumstances, the lack of a meaningfully close relationship could defeat the Government’s claims.

Third, both the majority and the dissent reaffirmed that *Dirks*’s articulation of tipper/tippee liability – including the personal-benefit requirement – applies in misappropriation-theory cases (such as *Martoma*) as well as in classical-theory cases (where a corporate insider breaches a duty by tipping). The decision thus undercuts suggestions by the Government in other cases that a personal benefit is not required under the misappropriation theory.

Fourth, the court’s analysis of gifts rejected a blanket distinction between gifts given to *maintain* a friendship and gifts given to develop a *future* friendship. “Whether the recipient of the gift is an existing friend or a potential future friend whom a gift is intended to entice, the logic – that a tipper personally benefits by giving inside information in lieu of a cash gift – operates in a similar manner.” Because Martoma had not challenged the jury instruction at trial, the appellate court conducted its analysis of the jury charge on this issue under the “plain error” standard of review, which examined whether any error was “obvious.” Future cases might explore the extent to which the Second Circuit's statements apply at the trial-court level or under a more rigorous standard of review.

Fifth, although *Newman*'s personal-benefit ruling has now been undermined by *Salman* and *Martoma*, another – and critical – aspect of *Newman* remains intact: the requirement that a tippee must have *known* (or at least have had reason to know) that the tipper breached his or her duty by providing inside information in exchange for a personal benefit, whatever the nature of that benefit might be. Particularly in cases involving remote tippees, this requirement could be decisive – as it was in *Newman*.