SMU | DEDMAN SCHOOL OF LAW

SMU Law Review

Volume 71
Issue 3 *Texas Gulf Sulphur 50th Anniversary Symposium Issue*

Article 10

2018

Personal Benefit Has No Place in Misappropriation Tipping Cases

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PERSONAL BENEFIT HAS NO PLACE IN MISAPPROPRIATION TIPPING CASES*

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ABSTRACT

The Supreme Court's decision in Salman v. United States *left unanswered an important issue concerning the reach of Rule 10b-5's prohibitions with respect to trades based on a tip of material inside information: in cases based on the misappropriation theory, is it necessary to show that the tipper enjoyed a personal benefit of which the trader was aware? The personal benefit test was originally developed in the context of tipping cases based on the classical theory of insider trading. The Supreme Court in* Salman *explicitly said that it was not reaching the matter of whether the test should be extended as well to tipping cases based on the misappropriation theory. And there is nothing in the language of* Chiarella, Dirks, and O'Hagan*—the earlier seminal Supreme Court cases relating to the reach of Rule 10b-5's prohibitions on insider trading—that calls for doing so. The lower courts, however, have split on the issue, and in recent years a number of them, through a set of statements unaccompanied by reasoned analysis, seem to be sleepwalking into inserting the personal benefit requirement into misappropriation-theory-based tipping cases. We show that this recent drift is seriously misguided as a matter of both doctrine and policy. Allowing this errant doctrine to become firmly lodged in the law would needlessly leave many socially undesirable trades unpunished and hence undeterred.*

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* An earlier version of this article appeared as a blog post on the Columbia Law School Blue Sky Blog.

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THE Supreme Court's decision in *Salman v. United States* settled important issues concerning the reach of Rule 10b-5's prohibitions with respect to trades based on a tip of confidential material information.[1] One important question, however, remains unanswered: In tipping cases based on the misappropriation theory, is it necessary, as some courts have stated, to show that the tipper enjoyed a personal benefit of which the trader was aware? There are commentators who assume the need for such a showing.[2] In fact, however, the lower courts have split on the issue, and the Supreme Court in *Salman* explicitly said that it was not reaching the matter.[3] In our view, inserting the personal benefit requirement into the misappropriation theory is seriously misguided as a matter of both doctrine and policy. Doing so needlessly leaves many socially undesirable trades unpunished and hence undeterred.

I. SUPREME COURT JURISPRUDENCE CONCERNING INSIDER TRADING

The necessary starting point to our inquiry is a brief trip back to the early days of Supreme Court jurisprudence concerning the application of Rule 10b-5 to insider trading cases, reviewing the origins of the classical

1. *See generally* Salman v. United States, 137 S. Ct. 420 (2016).

2. *See, e.g.*, Donald C. Langevoort, Tippers and Tippees, 18 INSIDER TRADING REGULATION, ENFORCEMENT AND PREVENTION § 6:13 (2017); Elizabeth Williams, Annotation, *Recipients of Corporate Information Other than Directors, Officers, Substantial Shareholders, or Associated Professionals as Subject to Liability for Trading on Material, Nonpublic Information, Sometimes Referred to as "Insider Trading," Within § 10(b) of the Securities Exchange Act of 1934 (15 U.S.C.A. §78j(b))—and SEC Rule 10b-5 Promulgated Thereunder—Making Unlawful Corporate Insider's Nondisclosure or Manipulation of Information to Seller or Purchaser of Corporation's Stock*, 14 A.L.R. Fed. 2d 401 (2006).

3. *Salman*, 137 S. Ct. at 425 n.2 ("We need not resolve the question [of whether the personal benefit test applies to the misappropriation theory]. The parties do not dispute that *Dirks*'s personal-benefit analysis applies in both classical and misappropriation cases, so we will proceed on the assumption that it does.").

and misappropriation theories and the personal benefit requirement. This review makes clear that the personal benefit test was developed in the context of the classical theory and that the reasons for its creation are related to features present only in those cases for which the classical theory is the relevant approach.

A. The Classical Theory and Its Relation to the Personal Benefit Test

The seminal Supreme Court case concerning when trading on non-public material information violates Rule 10b-5 is *Chiarella v. United States*,[4] in which Justice Powell's opinion sets out the so-called "classical theory." This theory applies " 'when a corporate insider' or his tippee 'trades in the securities of [the tipper's] corporation on the basis of material, nonpublic information.' "[5] It is premised upon "a relationship of trust and confidence between the parties to a transaction,"[6] which Powell finds to exist between an insider of an issuer and its shareholders.[7]

This formulation poses a problem in a tipping case, even one involving information originating inside the corporation whose shares are being traded. Unlike a case where an issuer insider is the trader, the person doing the trading in a tipping case *has no special relationship of trust with the persons with whom he trades.* In his *Chiarella* opinion, Justice Powell, in dictum, finds an inventive workaround to this problem. He suggests that the insider tipper, who is deemed to be in such a relationship, breaches her duty to the issuer's shareholders by providing the information to an outsider likely to trade on it, and the recipient tippee, by trading on the information, becomes a "participant after the fact" in the source's breach.[8]

Three years after *Chiarella*, this participant-after-the-fact idea became the basis of the Supreme Court's holding in *Dirks v. SEC*,[9] a classical theory case based on information coming from within the corporation whose shares were being traded. But the majority opinion in *Dirks,* also authored by Powell, adds an additional wrinkle that goes beyond his dictum in *Chiarella*. Powell concludes that a breach of duty to the shareholders requires that the tipper "personally . . . benefit, directly or indirectly, from [her] disclosure,"[10] not just that the insider tipper's transfer of infor-

4. *See generally* Chiarella v. United States, 445 U.S. 222 (1980).

5. *Salman*, 137 S. Ct. at 425 n.2 (quoting United States v. O'Hagan, 521 U.S. 642, 651–52 (1997)).

6. *Chiarella*, 445 U.S. at 230.

7. *See id.*

8. *See id.* at 230 n.12.

9. *See* Dirks v. SEC, 463 U.S. 646, 660 (1983) ("[A] tippee assumes a fiduciary duty to the shareholders of a corporation not to trade on material nonpublic information only when the insider has breached his fiduciary duty to the shareholders by disclosing his information to the tippee and the tippee knows or should know that there has been a breach.").

10. *Id.* at 662. For an extensive discussion of the genesis of the personal benefit test, see Adam C. Pritchard, Dirks *and the Genesis of Personal Benefit*, 68 SMU L. Rev. 857 (2015).

mation was in violation of the issuer's determination that it be kept confidential.

Importantly, the Court indicated that it added the personal benefit requirement to avoid chilling analyst interviews with corporate insiders, which both the Court and the SEC regarded as socially beneficial and "necessary to the preservation of a healthy market."[11] The requirement that corporate insider tippers personally benefit in order to breach their duty to shareholders protects market analysts who can continue to meet and question corporate insiders in order to "ferret out and analyze information,"[12] without fear of liability.[13] At the same time, it would allow punishment of corporate insiders who provide information to outsiders in return for favors, or as a "gift" to a friend or relative, as well as punishment of the tippee who trades if she was aware of the breach including the personal benefit.[14]

B. The Misappropriation Theory and the Personal Benefit Test's Irrelevance

In contrast to the classical theory, where liability arises out of a duty of trust and confidence between the *trading parties*, the misappropriation theory, approved by the Supreme Court in *United States v. O'Hagan*,[15] premises liability on a "duty of trust and confidence" owed to the *source* of the material, non-public information.[16] The idea is that a misappropriating fiduciary deceives the source of the information by trading based on the confidential information, thereby "defraud[ing] the principal of the exclusive use of that information."[17] This deceit is a violation because, as required for a transaction to breach Rule 10b-5, it is "in connection with the purchase or sale of any security."[18]

This alternative to the classical theory allows application of the rule in situations where the information originally comes not from within the company whose shares are being traded, but from within some other entity. It permits, for example, the imposition of Rule 10b-5 liability on an insider who trades based on the knowledge that his company has a still-unannounced plan to acquire a target firm. The theory can also be used to impose such liability on an insider of this potential acquirer's law firm, investment bank, or financial printer. Where any of these insiders

11. *See Dirks*, 463 U.S. at 658–59.
12. *See id.*
13. The concern here appeared to relate to the possibility that, although an issuer would intend that only non-material non-public information be conveyed in such an interview, there is always the possibility that a material piece of information is accidentally included as well. If the issuer's spokesperson and the analyst feared that should this happen and the tip of, and trade on, the material piece of information were considered illegal under Rule 10b-5, the practice of analyst interviews would be chilled.
14. *See id.* at 664.
15. United States v. O'Hagan, 521 U.S. 642, 646–47 (1997).
16. *See id.* at 651–53; Salman v. United States, 137 S. Ct. 420, 423 (2016).
17. *O'Hagan*, 521 U.S. at 652.
18. *Id.* at 658 (quoting 15 U.S.C. § 78j(b) (2012); 17 C.F.R. § 240.10b-5 (2017)).

purchases shares of the target, liability cannot be based on the classical theory. This is because the purchaser is the insider of an entity different from the company whose shares are being traded. Hence, the counterparties to the purchaser's trade—the shareholders of the target company—are not the persons with whom the purchaser is in a relationship of trust and confidence.[19] Most relevant for the question being explored in this Article, the misappropriation theory also allows imposition of Rule 10b-5 liability on such an insider if she tips instead of trading and gives the information to someone she has reason to believe will trade on it. And, using the participant-after-the-fact rationale, it allows imposing such liability on her trading tippee as well.[20]

In this context, adding the requirement that the tipper must personally benefit in order to find a breach of a duty of trust and confidence does not make much sense. Suppose a tipper owes a duty of trust and confidence to the source of information, say through a written non-disclosure agreement. The tipper would breach the non-disclosure agreement (and thereby breaches a duty of trust and confidence) by simply telling the information to any unauthorized recipient, whether or not the tipper received a personal benefit. And if the tipper has reason to believe that the recipient will trade on the tip and in fact she does so, this breach is in connection with the purchase or sale of a security. By telling the information to the unauthorized recipient, the tipper has defrauded the principal of the exclusive use of that information.

The risk of chilling market analysts—the policy concern that drove the Court to adopt the personal benefit test in *Dirks*—is not applicable in the misappropriation setting. Market analysts frequently question and receive information about issuers from their corporate insiders. Such interviews are, as a general matter, beneficial for the source of the information—the issuer and, derivatively, its shareholders—and, by increasing share price accuracy, for society more generally. In contrast, stock analyst interviews involving confidential information concerning an issuer's stock value that are conducted with officials of a different entity are far less common. Where insiders of another entity possess material, non-public information about an issuer (for example, information relating to a potential future acquisition), it is usually highly contrary to the interest of the entity to share this information with market analysts, because their trading would drive up the share price of the potential target. More generally, entities such as financial printers, law firms, and investment banking firms do not give socially valuable interviews to market analysts

19. *See* Chiarella v. United States, 445 U.S. 222, 232–33 (1980) ("Second, the element required to make silence fraudulent—a duty to disclose—is absent in this case. No duty could arise from petitioner's relationship with the sellers of the target company's securities, for petitioner had no prior dealings with them. He was not their agent, he was not a fiduciary, he was not a person in whom the sellers had placed their trust and confidence. He was, in fact, a complete stranger who dealt with the sellers only through impersonal market transactions.").

20. *See, e.g.*, SEC v. Yun, 327 F.3d 1263, 1270 n.15 (11th Cir. 2003).

about the future prospects of companies about which they have confidential knowledge. Nor does a spouse sharing a confidence with her mate, another situation that can give rise to a misappropriation claim, have anything to do with analyst interviews. Moreover, adding the personal benefit test to the misappropriation theory involves a significant downside: It leaves many socially undesirable trades beyond the reach of Rule 10b-5's prohibitions for no good reason.

II. LOWER COURT TREATMENT OF THE PERSONAL BENEFIT TEST IN MISAPPROPRIATION CASES

The lower courts have been split on whether the personal benefit test needs to be inserted into tipping cases based on the misappropriation theory, but there appears to be an unfortunate drift toward imposing the test. Still, only the Eleventh Circuit has a clear holding, backed by real analysis, to the effect that the test must be met in such cases.

A. The Second and First Circuits

Much of the action with regard to this issue has been in the Second Circuit. In earlier years, the tendency of courts in the Second Circuit was toward not requiring a showing of personal benefit in misappropriation tipping cases. In *United States v. Musella*, a 1989 Southern District of New York case, the court stated that "[t]he misappropriation theory of liability does not require a showing of a benefit to the tipper."[21] Later, in *United States v. Chestman*, a 1990 misappropriation case involving a husband passing on non-public information that he learned from his wife to his broker, who predictably traded on it, the Second Circuit focused exclusively on whether a marital relationship by itself created a duty of confidentiality, which is breached when the recipient of the information uses it to tip.[22] The court made no mention that the husband needed a personal benefit for his tip to the broker to be a violation. In *United States v. Libera*, the Second Circuit suggested that *Chestman* supported the notion that the personal benefit was not required for misappropriation case.[23]

More recently, however, in *United States v. Newman*,[24] the circuit seems to have shifted. That opinion states, "[t]he elements of tipping lia-

21. SEC v. Musella, 748 F. Supp. 1028, 1038 n.4 (S.D.N.Y. 1989), *aff'd*, 898 F.2d 138 (2d Cir. 1990) (finding an indirect tippee liable without a finding as to whether the tipper enjoyed a personal benefit or whether the indirect tippee knew of a personal benefit); *see also* SEC v. Willis, 777 F. Supp. 1165, 1172 n.7 (S.D.N.Y. 1991) (another tipping case based on the misappropriation theory, rejecting a motion to dismiss without an analysis of whether the complaint alleged facts indicating that the tippee enjoyed a personal benefit).

22. *See* United States v. Chestman, 903 F.2d 75, 78–80 (2d Cir. 1990).

23. *See* United States v. Libera, 989 F.2d 596, 600 (2d Cir. 1993) ("In Chestman, we noted that the misappropriation theory requires the establishment of 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 these two elements, without more, are sufficient for tippee liability.").

24. United States v. Newman, 773 F.3d 438, 445–46 (2d Cir. 2014).

bility are the same, regardless of whether the tipper's duty arises under the 'classical' or the 'misappropriation' theory."[25] This statement is dicta, however, because the case was in fact based on the classical theory, not the misappropriation theory.[26] The opinion is also devoid of any analysis of why such a shift in position is called for. There is also *United States v. Martoma*, where, in a footnote, the Second Circuit states, "Although many of the cases refer to 'insiders' and 'fiduciary' duties because those cases involve the 'classical theory' of insider trading, the *Dirks* articulation of tipper and tippee liability also applies under the misappropriation theory, where the misappropriator violates some duty owed to the source of the information."[27] Unlike *Newman*, *Martoma* is properly viewed as a misappropriation case.[28] However, because the court finds that the evidence in the case was sufficient to show the existence of a personal benefit,[29] the outcome of the case does not turn on whether a personal benefit was required or not.

The language quoted above from *Newman* has led district courts in the Second Circuit to also state that tippee liability under the misappropriation theory requires the showing of a personal benefit. For example, in *SEC v. Payton*, a tipping case based on the misappropriation theory, the SEC, in its opposition to a motion to dismiss, argued that the personal

25. *Id.* at 446 (internal citations omitted).

26. The statement is dictum because the case involves information coming from within the issuer whose shares were being traded and there was no allegation that the tippee owed any duty of confidentiality to the tipper. Thus, the case is clearly based on the classical theory. Accordingly, the issue of whether or not the personal benefit test needs to be included in misappropriation based tipping actions was not an issue. *See also* SEC v. Obus, 693 F.3d 276, 285–86 (2d Cir. 2012). In *Obus*, another misappropriation tipping case, the court, while reversing the district court's grant of summary judgment for the defendant, stated, also in dictum, "[t]he Supreme Court's tipping liability doctrine was developed in a classical case, [*Dirks*], but the same analysis governs in a misappropriation case." *Id.* The court again provided no analysis in support of this statement, instead simply citing United States v. Falcone, 257 F.3d 226, 233 (2d Cir. 2001). While the opinion in *Falcone* mentions the personal benefit test in its review of *Dirks,* which it describes as involving a holding under the "traditional theory," i.e. classical theory, *id.* at 229, it does not, contrary to what is implied by the citation in *Obus*, address whether the personal benefit test should be imposed in misappropriation tipping cases.

27. United States v. Martoma, 869 F.3d. 58, 63 n.2 (2d Cir. 2017) (citing *Obus*, 693 F.3d at 286–88; *Newman*, 773 F.3d at 445–46).

28. The Second Circuit did not explicitly state whether the case was brought under the classical or misappropriation theory. *See Martoma*, 869 F.3d. at 74 n.1 (Pooler, C.J., dissenting) ("The majority notes, and I agree, that it is irrelevant for our purposes whether the source of the information is a true corporate 'insider' or instead a corporate outsider who has improperly shared information with which he was trusted under the 'misappropriation' theory of insider-trading liability . . . ."). The case involved two doctors tipping the results of a clinical trial of an experimental drug to a portfolio manager, in breach of a duty of confidentiality they owed to the testing company on behalf of which they were conducting the clinical trial. Because these doctors were not corporate insiders and not fiduciaries of the shareholders of the company, the case is correctly viewed as a misappropriation case.

29. *Id.* at 67. The tippee defendant appealed the jury's conviction on the grounds that the evidence presented at trial concerning personal benefit was not sufficient to support his conviction and that the district court erred in its jury instruction regard to the matter. *See id.* The court found that the evidence was sufficient to sustain the conviction, and that the jury instructions on the matter were consistent with the standards of what constitutes personal benefit under *Salman*. *See id.* at 67, 73.

benefit requirement did not apply to misappropriation cases. The SEC cited in its filings the older Second Circuit cases discussed above.[30] In doing so, it dismissed the brief discussion to the contrary in *Newman* as mere dictum,[31] and went on to say,

> A misappropriation case requires no showing of a personal benefit to the tipper, because the breach is inherent in the tipper's theft of confidential information. The theft alone, in violation of the source of information's property right to the information, is a breach of the person's duty to the source of the information.[32]

Judge Rakoff rejected the SEC's argument that a personal benefit was not necessary in a misappropriation case, stating "[w]hatever the abstract merits of this argument, the Second Circuit, in *Newman*, stated unequivocally 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.'"[33] Again, however, the outcome of the case ultimately did not turn on whether or not a personal benefit was required in a tipping case based on the misappropriation theory. After a jury trial in which the defendants were found civilly liable,[34] they filed a motion for judgment as a matter of law or for a new trial, arguing, among other things, that there was insufficient evidence of personal benefit. Judge Rakoff denied the motion, deciding there was sufficient evidence of personal benefit.[35] On appeal, the Second Circuit affirmed this decision in a summary order.[36]

The First Circuit has, in its own words, "dodged the question."[37] In each misappropriation tipping case where it identified the issue of whether or not the personal benefit test applied, the court found that it did not need to resolve the issue, because the evidence was sufficient to show that if the test should be applied, it was satisfied.[38]

B. The Eleventh Circuit

The Eleventh Circuit, however, has come down squarely in favor of applying the test in misappropriation cases, stating that "the SEC must

30. *See* Plaintiff Securities and Exchange Commission's Opposition to Defendants' Motion to Dismiss at 4–7, SEC v. Payton, 97 F. Supp. 3d 558, 562 (S.D.N.Y. 2015).

31. *See id.* at 6.

32. *Id.* at 4.

33. *See* SEC v. Payton, 97 F. Supp. 3d 558, 562 (S.D.N.Y. 2015) (internal citations omitted).

34. SEC v. Payton, No. 14 CIV. 4644, 2016 WL 3023151, at *1, *5 (S.D.N.Y. May 16, 2016). Martin, Conradt, Payton, Durant, and a fifth defendant Weishaus were indicted for criminal insider trading, but these charges were dropped in early 2015. *See* Nolle Prosequi, United States v. Conradt, No. 12 Cr. 887 (Feb. 3, 2015).

35. *See Payton*, 2016 WL 3023151, at *5.

36. SEC v. Payton, No. 17-290-CV, 2018 WL 832917, at *1 (2d Cir. Feb. 13, 2018) (summary order).

37. United States v. Parigian, 824 F.3d 5, 15 (1st Cir. 2016).

38. *See* SEC v. Sargent, 229 F.3d 68, 76–77 (1st Cir. 2000); SEC v. Rocklage, 470 F.3d 1, 7 n.4 (1st Cir. 2006).

prove that a misappropriator expected to benefit from the tip."[39] Unlike the Second Circuit's offhand dicta in *Newman,* this statement constituted a holding that was the basis of its decision to vacate the district court's judgment against the tipper and tippee defendants and to remand the case for a new trial.

Also unlike the Second Circuit in *Newman* and *Martoma*, the court in *Yun* engaged in a lengthy analysis of the issue. According to the court, the "perhaps most important" reason for inserting the personal benefit test in misappropriation tipping cases was "that nearly all violations under the classical theory of insider trading can be alternatively characterized as misappropriations."[40] Accordingly, it suggests, failing to do so "would essentially render *Dirks* a dead letter."[41] Beyond this concern, the theme of the court's arguments concerns the desirability of "consistency" in insider case law.[42] The court suggests that imposing the personal benefit test only in cases based on one of the two theories would construct an "arbitrary fence" between the classical and misappropriation theories.[43]

III. WHY INSERTING THE PERSONAL BENEFIT TEST IS A POOR IDEA

As will be discussed below, notwithstanding the Eleventh Circuit, no good reasons have been offered for inserting the personal benefit test into tipping cases based on the misappropriation theory. Rather, doing so will unambiguously have negative social results.

A. No Good Reasons Have Been Offered For Inserting the Test

There is nothing in the language of *Dirks*, a tipping case based on the classical theory, that calls for its extending the insertion of the personal benefit test to misappropriation tipping cases as well. Indeed, in *Dirks*, the Court stated Rule 10b-5 liability attaches "only when the insider has breached his fiduciary duty to the *shareholders* by disclosing the information to the tippee and the tippee knows or should know there has been a breach."[44] It then goes on to require a personal benefit to find such a breach.[45] In contrast, as discussed in Part I, the tipper in a misappropriation tipping case has no fiduciary duty to the shareholders of the issuer whose shares the tippee is trading. Rather, liability is based on a duty of

39. *See* SEC v. Yun, 327 F.3d 1263, 1275 (11th Cir. 2003). A California district court also implied that the personal benefit was required for misappropriation cases, but there is no serious analysis of the issue. *See* SEC v. Trikilis, No. CV 92-1336-RSWL(EEX), 1992 WL 301398, at *3 (C.D. Cal. July 28, 1992), *vacated sub nom*. SEC v. Trikilis, No. (EEX), 1993 WL 43571 (C.D. Cal. Jan. 22, 1993).

40. *Yun*, 327 F.3d at 1279.

41. *Id.*

42. *See id.* at 1276.

43. *See id.* at 1275–76.

44. *See* Dirks v. SEC, 463 U.S. 646, 660 (1983) (emphasis added).

45. *See id.* at 662.

trust and confidence to the source of the information. The tipper unambiguously breaches this duty simply by telling the information to an unauthorized recipient, personal benefit or no personal benefit. Moreover, the policy rationale for inserting the test in classical theory tipping cases—a concern about chilling analyst interviews—is not present in the situations giving rise to misappropriation theory based tipping cases.

The Eleventh Circuit in *Yun* attempted to provide some independent reasons for extending the test to misappropriation tipping cases: the potential for recharacterizing classical theory violations as misappropriation ones thereby rendering *Dirks* a dead letter, and the desirability of consistency across the two theories. As discussed in detail below, neither of these reasons is persuasive.

1. Failing to Extend the Test to Misappropriation Cases Would not Render Dirks *"a Dead Letter"*

As noted, the *Yun* court states that "nearly all violations under the classical theory of insider trading can be alternatively characterized as misappropriations."[46] Reasoning from this, the court claims that failing to extend the personal benefit test to misappropriation cases would essentially present an easy evasion of the test in cases where the Supreme Court wanted it applied. The court's logic is unconvincing. In resolving the issue of whether the personal benefit test needs to be inserted in such cases, it would be very simple for a court to rule that in any situation that fits under the classical theory, the personal benefit must be proven even if the situation could also be characterized as fitting under the misappropriation theory. Any situation that fits only under the misappropriation theory, however, would not require that the personal benefit test be satisfied.

Consider the application of this approach to tippee trades in three different situations, each involving an initial tipper who is an insider of Corporation A. In the first situation, the tip involves confidential information material to the value of the shares of Corporation B, and the potential defendant tippee, whether a direct or indirect recipient of the tip, trades in shares of B. This case can only be prosecuted under the misappropriation theory, because the original tipper— an insider of A—owed no duty to B's shareholders. Under the suggested approach, the personal benefit test would not need to be satisfied.

In the second situation, the tip instead involves confidential information material to the value of the A's shares, the potential defendant tippee, whether a direct or indirect recipient of the tip, trades in shares of A, and liability is based on the breach of the initial tipper, who is an insider of A. This case can be prosecuted under the classical theory, because the first tipper owes a duty to the shareholders of Corporation A, as explained in *Dirks*. Under the suggested approach, the personal benefit test

46. *Yun*, 327 F.3d at 1279.

would need to be satisfied, even though the breach by the initial tipper might also be characterized as a misappropriation.

The third situation is identical to the second except that liability is based on a breach of a duty of confidentiality owed by an indirect tippee to a preceding tippee in the chain. This case can only be prosecuted under the misappropriation theory because the breached duty is to another tippee, not to the shareholders.

2. Failing to Extend the Test to Misappropriation Cases Would not Create an "Arbitrary Fence" Between the Two Rule 10b-5 Theories

As also noted above, the court in *Yun* has a second argument: the desirability of consistency in insider cases.[47] It suggests that imposing the personal benefit test only in cases based on one of the two theories would construct an "arbitrary fence" between the two.[48] According to the court, the fence would be arbitrary because, in its view, each theory premises liability on breaching a duty of loyalty and confidence and the harm to the marketplace under each is identical.[49] The problems with this view are that the two theories in fact involve different kinds of breaches and that, contrary to what the court states, enforcement under the two theories protects against different harms. The core points are as follows. All trading based on non-public information is harmful to the trading public, who lack this information. We only make a fraction of such trades illegal under Rule 10b-5. These are ones that fit under the classical or misappropriation theories. The reason for doing so—the harm being protected against—differs depending on which theory applies.

To illustrate these points, consider three more scenarios. In the first, unknown to the public, Corporation C, through analysis, views Corporation D's shares as underpriced or its management inept. As a result, C plans a premium takeover bid for D. C authorizes U, an insider of C, to disclose these plans to an outsider V in return for good consideration. C has good reason to believe that V will trade on the information and V does.

In this first scenario, C would not have violated Rule 10b-5 if C itself had gone into the market and anonymously purchased shares of D.[50] For the same reason, there is no violation by C, U, or V where U, authorized by C, discloses the information to V and V trades upon it. Neither the classical nor misappropriation theory applies to the actions of C, U, or V. These legal outcomes make sense even though the trades, whether by C or V, come at the expense of other traders: C's expected gain from trad-

47. *See id.* at 1276.
48. *See id.* at 1275–76.
49. *See id.* at 1276–77.
50. Under the Exchange Act, its only constraint in doing so is the requirement under § 13(d), which requires that within 10 days of its reaching a 5 percent ownership in B, it must file with the SEC a form indicating this fact and setting out its intentions going forward. Filing of Schedules 13D and 13G, 17 C.F.R. § 240.13d-1 (2011).

ing itself, or from tipping, is a reward for engaging in the hard work of analysis that can help make share prices more informed or increase the likelihood that productive assets make their way into the hands of those who can use them to create the most value.[51]

In the second scenario, W, another insider of C, also learns through his job of this plan for a premium takeover of D. In this scenario, W, without C's authorization, discloses this information to X, who is an outsider. W has good reason to think that X will trade on it and he does. Under the misappropriation theory, it would be a violation of Rule 10b-5 if W had purchased the shares himself. The same is true of W's disclosure to X, and of X's trade if X knows that the disclosure involved a breach by W. The reason for imposing liability would *not* be because of the resulting harm to the trading public, which would be just as severe as when, in the preceding scenario, V traded after the tip from U. Rather, in the words of the majority opinion in *O'Hagan*, whether W trades himself or tips X, he "defrauds the principal of the exclusive use of that information,"[52] thereby eroding C's reward for its socially useful hard work and analysis.

In the third scenario, Y, an insider of E corporation, learns through his job that E is going to announce a substantial dividend increase. In advance of its public announcement, Y, without E's consent, tips news of the dividend increase to Z. Y has good reason to believe that Z will trade on it, and Z does trade on it. Under the classical theory, it would be a violation of Rule 10b-5 if Y had purchased the shares of E herself. The same would be true of Y's tipping the information to Z, and, if Z knew of Y's breach, of Z's trading. This time, though, the reason *would* be the harm to members of the trading public who do not know the information. This is because Y, as an insider, owes a duty to the persons with whom he trades, who are E shareholders.

In this third tipping scenario, involving the classical theory, settled law imposes an exception shielding the various parties from liability if Y enjoys no personal benefit from making the tip. The personal benefit test serves a purpose here, because it avoids chilling analyst interviews. Having E subject to such interviews can be of benefit to the shareholders of E, which is the group that Rule 10b-5 is intended to protect in classical theory cases. This is not so in the second scenario, the one involving the misappropriation theory. There, C corporation, the party that Rule 10b-5 is intended to protect in such a case, is just as damaged from the loss of its exclusive use of the information whether W, the insider tippee, gains a

51. Another example of a situation similar to this hypothetical is when an activist hedge fund tips other hedge funds in advance of a public announcement of its stake in a corporation, an announcement that can be expected to result in a price jump in the corporation's shares. The activist fund does so with the hope that the other funds will purchase shares on the news and will then be available to join the activist fund in forming a "wolf pack." Such tipping and purchases by the tippees do not violate insider-trading laws. *See* John C. Coffee, Jr. & Darius Palia, *The Wolf at the Door: The Impact of Hedge Fund Activism on Corporate Governance*, 1 ANNALS CORP. GOVERNANCE 1, 30 (2016).

52. Unites States v. O'Hagan, 521 U.S. 642, 652 (1997).

personal benefit or not. Unlike classical theory tipping cases, requiring a showing of personal benefit in misappropriation tipping cases serves no useful purpose that can improve the functioning of the capital market.

3. Extending the Test to Misappropriation Cases Imposes Unnecessary Evidentiary Burdens on the Government and Private Plaintiffs, Thereby Reducing Deterrence of Socially Undesirable Trades

In a Rule 10b-5 case against a tippee, the personal benefit test requires the government or private plaintiff to prove both that the tipper received a personal benefit and that the tippee knew of the tipper's personal benefit. This knowledge requirement adds an added layer of evidentiary complexity that reduces the number of successful prosecutions of tip-based insider trading cases, especially ones involving a chain of tippees. While civil cases only require proof that the defendants knew or had reason to know of the benefit to the tipper,[53] criminal cases, in order to meet mens rea requirements, require that the tippee actually knew that some personal benefit was being provided in return for the information.[54]

SEC v. Payton is a good illustration of the potential evidentiary difficulty posed by the knowledge requirement. This case involved a tip from Martin, an associate in a major law firm, to his roommate Conradt, and a subsequent tip from Conradt to his brokerage colleagues Payton and Durant.[55] The tip related to a pending unannounced acquisition of SPSS by IBM, which Martin's firm represented. The tippees Conradt, Payton, and Durant profited by purchasing shares of SPSS.[56]

At trial, a jury found Payton and Durant civilly liable. As discussed above, Judge Rakoff concluded that the personal benefit test extended to misappropriation cases, but he decided that there was sufficient evidence that indirect tippees Payton and Durant knew or had reason to know of Martin's personal benefit to support the jury's conviction. The evidence cited by Judge Rakoff with regard to whether the defendants knew or had reason to know of the personal benefit is instructive. This is evidence to the effect that (1) the defendants were experienced securities industry professionals who knew a great deal about insider trading law, (2) they made no inquiries about whether the initial source of the tip received a personal benefit, and (3) once they had traded and the SPSS acquisition was announced, they took precautions to try to avoid a successful legal action against them.[57] Based on this, Judge Rakoff concluded,

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53. *See* SEC v. Payton, 219 F. Supp. 3d 485, 492 (S.D.N.Y. 2016).

54. *See* United States v. Newman, 773 F.3d 438, 448–50, 449 n.3 (2d Cir. 2014).

55. SEC v. Payton, 219 F. Supp. 3d at 488; SEC v. Payton, 97 F. Supp. 3d 558, 560 (S.D.N.Y. 2015).

56. *Payton*, 219 F. Supp. 3d at 488; *see also* Brian Baxter, *Cravath, Mayer Brown Advise on IBM, SPSS Merger*, AmLaw Daily (July 28, 2009, 1:23 PM), http://amlawdaily.typepad.com/amlawdaily/2009/07/cravath-mayer-brown-advise-on-ibm-spss-merger.html.

57. *See Payton*, 219 F. Supp. 3d at 491–92.

> There was in short plentiful evidence from which the jury could have concluded defendants deliberately chose not to ask Conradt questions about the circumstances in which Martin told him about the confidential SPSS information, because they understood that there was a high probability that they would have learned of Martin's personal benefit.[58]

The fact that the case turns on this evidence with regard to tippee knowledge shows the difficulties that can arise from inserting the personal benefit test in misappropriation cases.[59] To start, not every jury in a case with this kind of evidence would necessarily find that the tippee knew or had reason to know that the tipper enjoyed a personal benefit just because the tippee did not inquire about the matter. Moreover, even where, as here, a jury in such a case does make this finding, it is not clear that every trial court judge, or every appellate court on appeal, would agree with Judge Rakoff that such evidence is sufficient to support the finding.[60] In any event, it is very unlikely that such evidence would support a finding of tippee knowledge of the tipper's personal benefit in a criminal proceeding, the threat of which provides much of Rule 10b-5's deterrent power with respect to insider trading.

The personal benefit test will often give rise to these sorts of evidentiary problems. These problems impose substantial obstacles in the way of imposing legal sanctions on both tippers and tippees. This is especially true of trading by indirect tippees, who will often have no knowledge of any arrangement between the original insider tipper and the initial tippee in the chain giving rise to a personal benefit. And even when the trading indirect tippee does have such knowledge, it will often be hard to prove. Yet, the trade by this indirect tippee is just as socially harmful as if the insider tipper or the original tippee had traded on the information. It is therefore just as important to deter.

Whether an unauthorized trade based on confidential information from inside an entity other than the issuer is made by the entity's own employee, or by a direct or indirect tippee of that employee, the entity is being deprived of its exclusive use of that information. In the cases of

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58. *Id.* at 492.

59. The evidence that he cites in reaching the decision concerning the sufficiency of the evidence with regard to Martin's personal benefit from making the tip is more straightforward. Specifically there was evidence at trial that Martin, the tipper, and Conradt, the initial tippee, were good friends and that Martin urged Conradt to buy SPSS stock. *See id.* at 490–91. From this evidence, a jury could infer that the tip was the equivalent of a cash gift. *See* Salman v. United States, 137 S. Ct. 420, 428 (2016). Where the tip is such a gift, it qualifies as a personal benefit to the tipper under *Dirks. See supra* note 14 and accompanying text. There was also evidence that Martin sought and obtained free legal advice from Conradt, from which the jury could conclude that the Martin received a quid pro quo for the tip, *see Payton*, 219 F.Supp. 3d at 490–91, another form of personal benefit under *Dirks.*

60. As noted above, the Second Circuit did affirm Judge Rakoff's decision with respect to the sufficiency of the evidence, but in a summary order that on its face says that its "ruling has no precedential value." *See* SEC v. Payton, No. 17-290-CV, 2018 WL 832917, at *1 (2d Cir. Feb. 13, 2018) (summary order).

trades by the direct or indirect tippee, this is just as true whether or not the employee received a benefit. The prospect of such trading diminishes the incentive of entities to develop the information in the first place. For example, the prospect that persons like Payton and Durant might trade on information concerning IBM's acquisition plans for SPSS would diminish IBM's incentives to search out firms that are good takeover targets because of mismanagement, undervaluation, or their synergy potential. This is because such trading can raise the price that the potential acquirer would have to pay. More generally, for no good reason, the prospect of such trading also decreases the incentive of stock analysts to expend resources to discover information about issuers with publicly traded stocks, because such trading results in analysts and their customers experiencing a higher cost of trading, thereby reducing the accuracy of share prices.[61] And in misappropriation cases, there is no countervailing consideration as there is in classical theory cases, where there is a concern over not chilling analyst interviews. This concern over chilling analyst interview was the policy driver for the insertion of the personal benefit test in *Dirks* in the first place. Again going back to *Payton* for illustration, it is difficult to imagine any socially beneficial scenario where a law firm associate shares material, non-public information about a future acquisition of a client that is subsequently traded upon by direct or indirect recipients. Why make such cases more difficult by insertion of the personal benefit test?

IV. CONCLUSION

Nothing in the language of *Chiarella*, *Dirks*, and *O'Hagan*—the seminal Supreme Court cases relating to the reach of Rule 10b-5's prohibitions on insider trading—calls for extending the personal benefit test to tipping cases based on the misappropriation cases. The earlier misappropriation tipping cases in fact did not do so. More recently, however, a number of courts, through a set of statements unaccompanied by reasoned analysis, seem to be sleepwalking into imposing such a requirement. It is important to note, however, that so far, outside of the Eleventh Circuit, the outcome has not turned on such a statement in any case where it has been made.

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61. *See* Merritt B. Fox, Lawrence R. Glosten & Gabriel V. Rauterberg, *The New Stock Market: Sense and Nonsense*, 65 DUKE L.J. 191, 238 n.106 (2015) ("Persons trading on the basis of confidential nonpublic information neither worked to develop the information, nor paid someone else to work to develop it. Whether these trades are legal or not depends on the circumstances, but legality aside, the gain the trader enjoys at the expense of other investors would be hard to justify as representing a socially useful incentive. Such information usually becomes public relatively quickly and thus would have been reflected in price soon anyway. Yet, as we have seen, the existence of the practice of trading on its basis decreases liquidity, which discourages the activities of those who trade on the basis of information that does take work to develop. So, on a net basis, trading on the basis of nonpublic confidential information that took no work to develop is, if anything, likely to be socially harmful.").

In the Eleventh Circuit case *SEC v. Yun*, the outcome of the case does turn on such a statement and the court engages in an extended discussion as to why it believes that the test should be extended to misappropriation theory tipping cases. As discussed above, however, we find the reasons offered by the court unconvincing.

It is time to wake up. This recent drift toward inserting the personal benefit requirement into misappropriation cases is seriously misguided as a matter of both doctrine and policy. Allowing this errant doctrine to become firmly lodged in the law would needlessly leave many socially undesirable trades unpunished and hence undeterred.