

OUTSIDE COUNSEL

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The Tipper Benefit Test Under the Misappropriation Theory

In *Dirks v. SEC*,¹ the U.S. Supreme Court ruled that an insider of a public company breaches his duty to shareholders — and violates Section 10(b) and Rule 10b-5 of the Securities Exchange Act — when, for his own “personal benefit,” he tips material nonpublic information about his company to an outsider who trades the company’s securities on the basis of such information. Because the Securities and Exchange Commission prosecuted *Dirks* under the “classical theory” of insider trading, the Supreme Court did not address whether the personal benefit test also applied to prosecutions under the burgeoning “misappropriation theory” of insider trading.²

After *Dirks*, the SEC has argued that the “misappropriation theory,” unlike the “classical theory,” does not require proof that the tipper personally benefitted from his tip, because the tipper in a misappropriation case is an outsider who owes no duty to the shareholders of the company whose securities were traded as a result of the tip. Instead, the SEC has argued, the tipper in a misappropriation case owes a duty of trust only to the source of the information, and his intentional or reckless disclosure of the information to third parties, alone, is sufficient to establish a breach of that duty.

‘Yun’

The SEC has been moderately successful with this approach. In April, however, the U.S. Court of Appeals for the Eleventh Circuit, in *SEC v. Yun*,³ handed the commission its first significant defeat with respect to this issue. The *Yun*, court flatly rejected the SEC’s position that personal benefit is not

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required in misappropriation cases, because it could find no principled basis upon which to distinguish tipper liability depending on whether the tipper breached a duty to shareholders or to the source of the information.

It remains to be seen whether the SEC, in

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the wake of *Yun*, will continue to pursue its argument that the personal benefit test is inapplicable to misappropriation cases. This author believes the commission should abandon the argument because the *Yun* decision correctly interprets and applies Supreme Court precedent concerning the personal benefit requirement in insider trading cases.

In 1983, the *Dirks* Court set forth the “personal benefit” test for tippees in “classical” insider trading cases. It ruled that a corporate

insider who tips material nonpublic information to outsiders (resulting in a trade of the corporation’s securities by the tippee or a remote tippee), breaches a duty to shareholders only if his motivation for providing the tip was “pecuniary gain” or “reputational benefit that will translate into future earnings,” or to make “a gift of confidential information to a trading relative or friend.”

After *Dirks*, the SEC has taken the aggressive position that the personal benefit test in “classical theory” insider trading cases does not apply to “misappropriation theory” cases, because the latter theory does not depend on a breach of duty to shareholders.

In 1989, in *SEC v. Musella*,⁴ a federal judge in the Southern District of New York first endorsed the SEC’s argument. The *Musella* court, in dicta, without outlining the SEC’s argument, without any analysis, and without any citation to authority, opined in a footnote: “The misappropriation theory of liability does not require a showing of a benefit to the tipper.”

The court nonetheless noted that “the tippees here benefitted from their actions,” because one tipper received a share of the tippee’s trading profits, and the other tipper made “gift” of the misappropriated information to a long time friend.

Similarly, in each case where a court has cited approvingly to the *Musella* dicta, that same court made a finding that personal benefit to the tipper had been sufficiently established.⁵

‘O’Hagan’

In 1997, the U.S. Supreme Court in *U.S. v. O’Hagan*⁶ fully endorsed the misappropriation theory for the first time. O’Hagan, a lawyer, was found guilty after trial of insider trading under Rule 10b-5, because he purchased shares of the target company of a proposed acquisition based on information he misappropriated from his law firm and its client, the company seeking to acquire the target.

The Court upheld the conviction, ruling that, under the misappropriation theory, “a fiduciary’s undisclosed, self-serving use of a principal’s information to purchase or sell securities, in breach of a duty of loyalty and confidentiality, defrauds the principal of the exclusive use of that information.”

Despite *O’Hagan’s* holding that Rule 10b-5 is violated where the defendant’s undisclosed “use” of his principal’s information is “self-serving” (i.e., for his own “personal benefit”), the SEC has continued to insist that no showing of personal benefit to the tipper is required in misappropriation cases. The SEC’s argument was put to the test in *Yun*.

The operative facts in *Yun* were as follows. Donna Yun was married to the chief financial officer of a publicly traded company, who told her in confidence that the company would soon be making a public announcement revising its earnings estimates downward. Yun tipped Jerry Burch, her co-worker in a real estate office, who purchased put options in the company one day before the public announcement of the company’s earnings revision, and sold the options the day after the announcement, realizing a profit of \$269,000.⁶

The SEC specifically alleged in its complaint that Yun had breached her duty to her husband to keep the information confidential “for her direct and/or indirect benefit because of her business relationship and friendship with” Burch. But on a motion for summary judgment, the trial court ruled that the SEC was not legally required to prove that Yun “benefitted” from Burch’s trades.⁷

The trial court then rejected the defendants’ proposed jury instruction that the SEC was required to prove that Yun’s breach of her duty to her husband was motivated by “personal benefit.”⁸ The jury found both defendants liable for violations of Rule 10b-5 under the misappropriation theory.

Post-Trial Motion

On a post-trial motion, the defendants argued, pursuant to *O’Hagan*, that the SEC was required to show that Yun’s disclosure in breach of her duty to her husband was “self-serving.” The trial court, based on *Musella* and its progeny, disagreed. The trial court noted, however, that although the jury was not instructed on the personal benefit test, “sufficient evidence was presented at trial for a reasonable juror to conclude that there was some ‘self-serving use’ for the alleged tip. ... [A] reasonable jury could conclude that Yun’s tip to Burch was some gift between co-workers, or used to maintain a good relationship between frequent partners in numerous real estate deals.”

On defendants’ appeal to the Eleventh Circuit, the SEC again argued that the personal benefit test had no application in misappropriation theory cases, because an “outsider owes no duty to corporate shareholders.”

The court rejected the SEC’s argument, ruling that it “constructs an arbitrary fence between insider trading liability based upon classical and misappropriation theories.”

The court opined:

Since under both theories of liability the tipper is breaching a duty of loyalty and confidentiality by disclosing confidential information, and since the harm to marketplace traders is identical under either breach, it ... makes ‘scant sense’ to impose liability more readily on a tipping outsider who breaches a duty to a source of information than on a tipping insider who breaches a duty to corporate shareholders.

The Eleventh Circuit addressed the illogic of the SEC’s argument:

[O’Hagan] explicitly states or implicitly assumes that a misappropriator must gain personally from his trading on the confidential information. If we were to hold that a misappropriator who tips — rather than trades — is liable even though he intends no personal benefit from his tip, then we would impose liability more readily for tipping than trading. Such a result would be absurd, and would undermine the Supreme Court’s rationale for imposing the benefit requirement in the first place: the desire to ensure that a tip rises to the level of a trade.

With a goal to “develop consistency in insider trading case law,” the court ruled that the misappropriation theory required the SEC to establish that a tipper intended to benefit from his tip.

The court vacated the judgment, and remanded the case for a new trial, because it was “likely that whether [Yun] disclosed the information for her personal benefit was not a factor in [the jury’s] deliberations.”

Ironically, the circuit court agreed with the district court that the SEC had “presented evidence ... sufficient for a jury reasonably to conclude that Donna [Yun] expected to benefit from her tip to Burch by maintaining a good relationship between a friend and frequent partner in real estate deals.”

It remains to be seen what impact *Yun* will have on the SEC in pending and future cases. In the *Martha Stewart* case, the SEC’s most recent misappropriation theory case, the complaint does allege that the non-trading tipper personally benefitted from the tip.⁹ However, as discussed above, even though

the SEC’s complaint in *Yun* also alleged personal benefit to the tipper, the SEC later argued that such allegation was gratuitous as a matter of law.

Conclusion

Yun logically establishes a uniform liability standard for tipplers in insider trading cases under the classical and misappropriation theories. *Yun’s* ruling is consistent with, and properly harmonizes, the Supreme Court’s rulings in *Dirks* and *O’Hagan*.

In light of *Yun*, the SEC should consider abandoning its long-running campaign to eliminate the tipper benefit requirement from misappropriation theory cases.

(1) 463 U.S. 646, 103 S. Ct. 3255 (1983).

(2) For the distinction between the classical and misappropriation theories of insider trading, see generally *United States v. O’Hagan*, 521 U.S. 642, 651-52, 117 S. Ct. 2199, 2207 (1997).

(3) 327 F.3d 1263 (11th Cir. 2003).

(4) 748 F. Supp. 1028 (S.D.N.Y. 1989), *aff’d*, 898 F.2d 138 (2d Cir.), *cert. denied*, 498 U.S. 816, 111 S. Ct. 57 (1990).

(5) See *SEC v. Sargent*, 229 F.3d 68, 77 (1st Cir. 2000); *SEC v. Yun*, 130 F. Supp.2d 1348, 1353-53 (M.D. Fla. 2001), *vacated*, 327 F.3d 1263 (11th Cir. 2003); *SEC v. Willis*, 777 F. Supp. 1165, 1172 n.7 (S.D.N.Y. 1991). Other courts, without discussion, have assumed that the *Dirks* personal benefit test extended to misappropriation cases. See, e.g., *SEC v. Gonzalez de Castilla*, 184 F. Supp.2d 365, 375 (S.D.N.Y. 2002); *SEC v. Gaspar*, 1985 WL 521 at *16-17 (S.D.N.Y. Apr. 16, 1985).

(6) 327 F.3d at 1267-68. The SEC framed the *Yun* case as a “misappropriation theory” case, rather than a “classical theory” case, apparently because Yun’s husband had disclosed the material nonpublic information to Yun in confidence for a legitimate purpose, that is, to explain why, during their negotiation of a post-nuptial division of assets, he had assigned a below current market value to his options listed on the asset statement. Rather than argue that Yun owed a derivative duty to the company’s shareholders (e.g. as a tippee or quasi-insider), the SEC argued that Yun owed her husband a duty to maintain confidentiality, which she breached by tipping Burch.

(7) See 130 F. Supp.2d at 1353.

(8) *Id.* at 1281. The court instead instructed the jury that the SEC must establish that Yun breached a fiduciary or other duty of trust and confidence to her husband by disclosing material nonpublic information to Burch, and that Yun’s disclosure was intentional or severely reckless. The court further instructed the jury that Yun’s disclosure to Burch must have been “for an improper purpose.”

(9) See Complaint, *SEC v. Stewart*, 03 CV 4070 (NRB) (S.D.N.Y. June 4, 2003), available at www.sec.gov/litigation/complaints/comp18169.htm (“Bacanovic [the tipper] benefitted from his illegal tip by, for example, improving his relationship with Stewart, an important client of Bacanovic.”).