ESSAY

REFRAMING *UNITED STATES V. SALMAN*

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If a corporate insider breaches a confidence to his employer by passing along nonpublic information to a family member, who then uses it to profit in the stock market, can it be inferred that the insider must have received some sort of personal benefit in exchange for that tip? That's the issue in *United States v. Salman*,[1] a once-in-a-decade insider trading case that the Supreme Court will hear in its 2016 Term. If the issue sounds narrow, that's because it is. In part, however, this narrowness is the result of how the case has been framed thus far. All parties involved, including the Court, seem to assume that one must prove a personal benefit in order to establish liability when insider trading involves a tip. That was true once. But the Court's own insider trading jurisprudence has moved beyond the logic of that requirement. The Court would do well to acknowledge this fact, thereby bringing much needed clarity to a notoriously messy and unpredictable area of law.

Salman involves an investment banker, Maher Kara, who tipped off his brother, Michael, about upcoming transactions involving the bank's clients.[2] In addition to trading on that information himself, Michael passed it along to the Karas' future brother-in-law, Salman, who executed nearly identical trades.[3] The question on appeal to the Ninth Circuit was whether the brothers' close-knit relationship was alone sufficient to support the inference that Maher shared the information with Michael in exchange for a personal benefit.[4]

The answer to that question seemed to be "no"—at least if the Ninth Circuit were to rely on a recently decided Second Circuit case, *United States*

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1 792 F.3d 1087 (9th Cir. 2015), *cert. granted*, 136 S. Ct. 899 (2016) (mem.).

2 *Id.* at 1088-89.

3 *Id.*

4 *Id.* at 1090.

v. Newman.[5] In *Newman*, employees at Dell and NVIDIA shared information with friends and acquaintances, who then traded on that information.[6] The relationships between the tippers and tippees in *Newman* were neither familial nor were they characterized as particularly close, although one did apparently involve occasional socializing.[7] The Second Circuit held that the evidence presented at trial was insufficient to show that a personal benefit had accrued to the tippers, and it accordingly vacated the insider trading convictions.[8] The court expressed skepticism over whether a personal benefit could ever be proven by mere evidence of the parties' personal relationship.[9] But if it could, in the court's view, such a relationship would have to be a closer one than those at issue in the case, and the relationship would *also* have to represent "a potential gain of a pecuniary or similarly valuable nature."[10]

Nevertheless, the Ninth Circuit in *Salman* declined to follow *Newman*, at least to the extent that its holding foreclosed the possibility of finding a personal benefit based on evidence of a gift of confidential information made to a relative or friend.[11] The *Salman* court viewed this as the clear dictate of Supreme Court precedent, and it viewed the facts of the case before it as involving a gift between brothers.[12] Accordingly, the Ninth Circuit affirmed Salman's convictions,[13] and the Supreme Court later granted certiorari.[14]

The Ninth Circuit was right to reject the personal benefit test, as articulated by the Second Circuit in *Newman*. But the Ninth Circuit failed to go far enough. In reality, the personal benefit requirement is an obsolete vestige of a time when the Supreme Court's theory of insider trading was very different from what it is today. For this reason, the Supreme Court should eliminate the test altogether. Alternatively and less expansively, the Court could hold that the test applies only in those cases like *Newman* where the tipper is a true insider—in other words, an employee of the company whose stock is the subject of the trading in the case. Finally, the Court could simply affirm the *Newman* holding, which would be the narrowest ground for resolving the case. Although narrow holdings have their virtues, simply affirming the Ninth Circuit here without resolving the larger issue of the personal benefit requirement's continued validity would leave the doctrine in a state of persistent confusion. To understand these possibilities, let's consider a little history.

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5 773 F.3d 438 (2d Cir. 2014).

6 *Id.* at 443-44.

7 *Id.* at 443.

8 *Id.* at 447-55.

9 *Id.* at 452.

10 *Id.*

11 *Salman,* 792 F.3d at 1093-94.

12 *Id.* at 1093-94 (citing Dirks v. S.E.C., 463 U.S. 646, 664 (1983)).

13 *Id.* at 1094.

14 Salman v. United States, 136 S. Ct. 899 (2016) (mem.).

The personal benefit requirement at issue in *Salman* and *Newman* arose at a time when the Court had a singular view of why insider trading was illegal. Because liability turns on the anti-fraud provisions of federal securities law,[15] insider trading jurisprudence depends on theories about why insider trading is fraudulent. The Court's original theory, called the "classical theory," was that the fraud arises from a corporate insider's failure to disclose material information to his own shareholders, with whom he trades, in breach of his fiduciary duties.[16] Under that theory of insider trading, the fraud arises from the insider's failure to speak in the face of a duty to do so.[17] With deep roots in the common law, the classical theory was a fairly elegant judge-made response to the question of how insider trading was to be regulated under the securities laws.

Not surprisingly, when the Court in 1983 decided its first tipper–tippee case—a case, like *Salman*, where the insider does not trade on the information but instead passes it along to a friend—it analyzed the case through the lens of the classical theory. In that case, *Dirks v. S.E.C.*, the Court held that there is also liability in tipper–tippee cases, but only if the insider receives a personal benefit from the tip.[18] The reasoning went like this: under the classical theory, the tip—on its own—is not fraudulent. After all, under that theory, the insider's fraud only arises if he is actually transacting with someone to whom fiduciary duties are owed—in other words, one of his company's shareholders. It's only then that his duty to disclose arises. Yet, that is not at all what he is doing when he tips off a friend or acquaintance. Nevertheless, the Court explained in *Dirks* that if the tipper receives a personal benefit in exchange for the tip, then that looks enough like fraud to justify extending liability.[19]

There seems to be some confusion among the lower courts over the precise function of the "personal benefit" requirement of *Dirks*. For example, *Newman* gives the impression that the Second Circuit believes that there can be no fraud unless the defendant actually benefits.[20] But that is simply not true. Fraud is the result of an affirmative misstatement or nondisclosure in

15 *See, e.g.*, *Salman*, 792 F.3d at 1088 (noting that the defendant was indicted, *inter alia*, "of conspiracy to commit securities fraud in violation of 18 U.S.C. § 371").

16 *See* Chiarella v. United States, 445 U.S. 222, 225-30 (1980).

17 *Id.* at 228-29.

18 *See* 463 U.S. 646, 662 (1982) ("Whether disclosure [of material nonpublic information] is a breach of duty therefore depends in large part on the purpose of the disclosure. . . . [T]he test is whether the insider personally will benefit, directly or indirectly, from his disclosure. Absent some personal gain, there has been no breach of duty to stockholders. And absent a breach by the insider, there is no derivative breach.").

19 *See id*. at 659-64 (basing its finding in the fiduciary duties owed to shareholders).

20 *See* 773 F.3d at 446 ("Because the *tipper*'s breach of fiduciary duty requires that he personally will benefit, directly or indirectly, from his disclosure, a tippee may not be held liable in the absence of such benefit." (citation and internal quotation marks omitted)).

the face of a duty to disclose.[21] As long as the fraud causes a loss for the plaintiff, and provided that there is causation, then the defendant is liable.[22] What the Second Circuit seems to adopt in *Newman* is a view of insider trading that is based exclusively on principles of unjust enrichment, rather than tort principles. Under an unjust enrichment view of Rule 10b-5, there would indeed be no recovery where the defendant acquires no benefit.[23] While there is little question that courts have used unjust enrichment principles to determine recovery under Rule 10b-5,[24] the rule has never been thought to be based exclusively on notions of unjust enrichment.[25]

What then is the purpose of the personal benefit requirement in *Dirks*? The purpose is to bridge the gap that exists when trying to prove fraud in a tipper–tippee case under the classical theory. The classical theory's view of fraud turns on the nondisclosure of material information when transacting with shareholders to whom the trader owes fiduciary duties. But in a tipper–tippee case, the tipper is not transacting with shareholders—to whom he owes fiduciary duties—and therefore, no fraud occurs under the classical theory. The personal benefit requirement was an attempt to bridge this gap on the theory that if the tipper receives a personal benefit in exchange for the tip, then that looks enough like fraud if one squints hard enough.

If the evolution of insider trading law had ended with *Dirks*, then the personal benefit requirement might be a foregone conclusion, and the current framing of *Salman* would be entirely warranted. But that's not what happened. The problem was that the classical theory left significant gaps in insider trading liability. For example, what if the trader is not a classical insider at all? Specifically, what if a lawyer representing the acquirer in a tender offer trades on his client's information about the acquisition by purchasing the

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21 *See Fraud*, BLACK'S LAW DICTIONARY (10th ed. 2014) (defining fraud as "[a] knowing misrepresentation or knowing concealment of a material fact made to induce another to act to his or her detriment.").

22 *See* RESTATEMENT (SECOND) OF TORTS § 525 (AM. LAW INST. 1977) ("One who fraudulently makes a misrepresentation of fact, opinion, intention or law for the purpose of inducing another to act or to refrain from action in reliance upon it, is subject to liability to the other in deceit for pecuniary loss caused to him by his justifiable reliance upon the misrepresentation.").

23 *See* Robert B. Thompson, *The Measure of Recovery Under Rule 10b-5: A Restitution Alternative to Tort Damages*, 37 VAND. L. REV. 349, 382 (1984) ("Fundamental to recovery based on unjust enrichment is the requirement that a defendant acquire a benefit by reason of infringing another's interest or causing a plaintiff to suffer loss.").

24 *See, e.g.*, Speed v. Transamerica Corp., 135 F. Supp. 176, 186 (D. Del. 1955) (permitting the plaintiffs to recover in restitution to prevent the defendant from benefitting from its fraud), *aff'd in relevant part*, 235 F.2d 369 (3d Cir. 1956).

25 *See, e.g.*, Mitchell v. Tex. Gulf Sulphur Co., 446 F.2d 90, 97, 100-02 (10th Cir. 1971) (noting that the private right of action under Rule 10b-5 is based on tort law principles, while also rejecting the defendant's argument that a plaintiff can recover damages resulting from fraud only where the defendant participated in the market to some benefit).

stock of the target company—a company with which the lawyer has no relationship whatsoever? In that case, the classical theory doesn't help because the lawyer has no relationship with the shareholders against whom he's trading, let alone a fiduciary one. He has no duty to speak. Accordingly, under the classical theory, there is no fraud and no liability for that type of insider trading.

However, in *United States v. O'Hagan*—a 1997 case involving these very facts—the Court announced a new theory, holding that insider trading is illegal if it "misappropriates confidential information for securities trading purposes, in breach of a duty owed to the source of the information."[26] In that case, James O'Hagan, the lawyer-defendant, was held liable for insider trading because his trade constituted a secret breach of confidence that he owed to his client.[27] In other words, he was profiting from his client's information in breach of fiduciary duties owed to his client, and he failed to disclose this fact to his client. The fraud underlying the so-called "misappropriation theory" of insider trading is based on nondisclosure of a breach of the fiduciary's duty of trust and confidence, not nondisclosure of the material information that motivated the trade, as is the case under the classical theory.[28]

This makes for a crucial difference when proving tipper–tippee liability: while the classical theory might have required a personal benefit (because without it, why the tip is fraudulent is not obvious), that same logic does not apply to the misappropriation theory. After all, if our misappropriating lawyer shares the information he has misappropriated with a friend rather than trade on it himself, that tip is fraudulent under the misappropriation theory whether there is a personal benefit to the tipper or not. This is because the misappropriating tipper's tip itself constitutes the secret breach of confidence required by the misappropriation theory. In other words, the original logic supporting the personal benefit requirement under the classical theory is simply nonexistent under the misappropriation theory.

Thus, when the Ninth Circuit and the parties in *Salman* assume that a personal benefit is required to prove tipper–tippee liability, they are correct—but only if they focus exclusively on the state of the law when the Supreme Court last considered the issue nearly thirty years ago. And when the Second Circuit in *Newman* adheres mechanically to the *Dirks* Court's articulation of the test

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26 521 U.S. 642, 652-53 (1997).

27 *Id.* at 647-48, 665-66.

28 *See id.* at 652 (noting 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. In lieu of premising liability on a fiduciary relationship between company insider and purchaser or seller of the company's stock, the misappropriation theory premises liability on a fiduciary-turned-trader's deception of those who entrusted him with access to confidential information.").

for tipper–tippee liability, concluding there is no fraud in the absence of a personal benefit, they ignore the fact that the Court was speaking at a time when it had only endorsed a single theory of insider trading law. But that is no longer true. The Court has since developed a new theory of primary liability—the misappropriation theory—which eliminates the need for a personal benefit test when that theory is applied to tippers and tippees. The Court did not have the chance to clarify this point the last time around, but the *Salman* case finally provides an opportunity for it to do so.

That raises a question: how should the Court go about providing that clarification? The answer depends on two things: one's appetite for broad Supreme Court opinions to clarify federal common law, and one's view of the relationship between the classical and misappropriation theories of insider trading.

If one disfavors broad opinions, even if meant to clarify federal common law (of which insider trading law is one example), then the narrowest ground upon which the Court could decide *Salman*, consistent with the foregoing analysis, would be to simply affirm the Ninth Circuit. The Ninth Circuit in *Salman* adopted a fairly broad view of the personal benefit requirement: a "personal benefit" can include "a pecuniary gain," "a reputational benefit that will translate into future earnings," or "a gift of confidential information to a trading relative or friend."[29] The foregoing analysis suggests that the personal benefit requirement makes little sense anymore. But, in the absence of its elimination, a broad interpretation of the requirement, such as the one supplied by the Ninth Circuit, would constitute a second-best outcome.

However, it would be a distant second-best. Insider trading law is notoriously messy and unpredictable, and this narrow holding would do little to address that unpredictability. Given how rarely the Supreme Court takes the occasion to review its insider trading jurisprudence, this seems to be a wasted opportunity.

A preferable approach would be to eliminate the personal benefit requirement altogether. There are two ways the Court could do this, and which path it should take depends on how one views the relationship between the classical and misappropriation theories of insider trading.

The lower courts tend to view the classical and misappropriation theories as two distinct theories applicable to two distinct situations—one for cases involving classical insiders and one for cases involving everyone else (in other words, misappropriators).[30] If the Court were to maintain this distinction,

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29 792 F.3d 1087, 1092 (9th Cir. 2015) (quoting Dirks v. S.E.C., 463 U.S. 646, 663-64 (1983)).

30 *See, e.g.*, United States v. McGee, 763 F.3d 304, 310-11 (3d Cir. 2014) (drawing a distinction based on whether the insider owes a fiduciary duty to shareholders); Steginsky v. Xcelera Inc., 741 F.3d 365, 370 & n.4 (2d Cir. 2014) (noting the misappropriation theory's appropriateness for trading done by "non-insiders"); S.E.C. v. Talbot, 530 F.3d 1085, 1090-93 (9th Cir. 2008) (discussing the limits of the classical theory).

then under the foregoing analysis, the Court would eliminate the personal benefit requirement for misappropriation cases (like *Salman*) while maintaining it for classical insider cases (like *Newman*).[31] To be sure, such an outcome would make it easier to establish tipper–tippee liability in cases involving misappropriation, as opposed to cases involving a classical insider. That might seem troubling at first blush, but it's not. Each type of case is premised on a different view of fraud. It stands to reason that if the Court is going to maintain that distinction, the elements of establishing liability will be different as well.

There is an alternative, however. In reality, the distinction between classical and misappropriation cases is illusory. Every classical insider trading case can easily be recast as a misappropriation case. The classical insider who breaches a duty of disclosure when he trades with his own shareholders on the basis of material nonpublic information can also be said to misappropriate information that belongs to the corporation. In other words, it is the misappropriation theory that should be viewed as the single, unified theory of American insider trading law.[32] And the misappropriation theory, that unified theory of insider trading law, simply does not require a personal benefit test when applied to a tipper–tippee situation. If the Court were to adopt this view, then the result would be no personal benefit requirement in either *Salman* or *Newman*, or indeed in any insider trading case brought under Rule 10b-5.

One might argue that the rule that would result from this reframing is the same one that the SEC proposed in *Dirks*, which the Court rejected. But that is incorrect. In *Dirks*, the SEC proposed a rule that would have created liability for any tippee who receives "inside information from an insider."[33] In other words, the SEC proposed "the idea that the antifraud provisions require equal information among all traders."[34] And it is certainly true that the Court rejected that rule in *Dirks*.[35]

However, that is not the rule that would result from eliminating the personal benefit requirement—the *Dirks* Court's general holding would

31 Although it is true that Maher Kara, the original tipper in *Newman*, was an investment banker and, therefore, not a traditional employee of any of the companies whose information he was passing along, he would nevertheless be treated as a "temporary" or "constructive" insider. *See Dirks*, 463 U.S. at 655 n.14 ("Under certain circumstances, such as where corporate information is revealed legitimately to an underwriter, accountant, lawyer, or consultant working for the corporation, these outsiders may become fiduciaries of the shareholders. . . . When such a person breaches his fiduciary relationship, he may be treated more properly as a tipper than a tippee."). For this reason, *Newman* would probably be characterized as a classical insider case if one were to preserve such distinctions.

32 *See* Zachary J. Gubler, *A Unified Theory of Insider Trading Law*, GEO. L.J. (forthcoming 2016).

33 *Dirks*, 463 U.S. at 655.

34 *Id*. at 657.

35 *See id.* (noting a conflict between the SEC's proposed approach and established insider trading jurisprudence).

remain in force, even in the absence of a personal benefit requirement. That holding provides,

> [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 the information to the tippee and the tippee knows or should know that there has been a breach.[36]

Thus, in the absence of a personal benefit requirement, the tippee would not be liable simply because he possessed material nonpublic information. Rather, he would be liable if he possessed material nonpublic information *and* he knew or should have known that the tipper shared that information in breach of a duty.

This observation brings us to another potential objection: without a personal benefit requirement, stock analysts would not be able to perform their important function, either because they would hesitate to use information they receive or because corporate executives would hesitate to share such information with them. These fears are overblown, however. As noted above, the *Dirks* Court made it clear that knowledge (actual or constructive) of the tipper's breach is required for establishing tippee liability. Thus, under the rule being proposed here, the analyst would be allowed to use material nonpublic information so long as he does not know (or should not have known) that it was acquired as the result of a breach of confidence owed to the source of the information. Why should the result be otherwise? With respect to the executive worried about sharing information, all he has to do is get preauthorization from his board of directors. Then, whatever information he shares with analysts has not been misappropriated. There is thus no liability, although he would want to ensure that such disclosures comply with other rules.[37]

It is rare for an insider trading case to make its way to the Supreme Court. For that reason alone, *Salman* will be a consequential opinion. However, it would be a shame to allow the case to be decided based on the way in which it is currently being framed—in no small part because that framing makes an assumption about the law that is simply obsolete. This is not the Court's fault, but rather a natural feature of the ad hoc development of American insider trading law—which is a species of federal common law. The case, therefore, presents a valuable opportunity to clear the underbrush that has accumulated in the law. To this end, the Court should clarify that insider trading liability

36 *Id*. at 660.

37 For example, "Regulation Fair Disclosure" prohibits insiders from disclosing information "selectively" to only certain securities professionals and not others. *See generally* 17 C.F.R. §243.100 (2011).

results from the misappropriation of information, and under that theory of liability, tipper–tippee liability is not dependent on a personal benefit.

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