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# A 1st Look At Potential Reach Of 2nd Circ. Newman Decision

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On Jan. 22, 2015, a district judge in the Southern District of New York vacated previously accepted guilty pleas in an insider trading prosecution brought under the "misappropriation" theory. The district court's short order in United States v. Conradt[1] provides an initial look at the potential reach of the Second Circuit's recent decision in United States v. Newman.[2] Newman itself is now the subject of a motion by the government for rehearing and rehearing en banc that was filed just one day after the order in Conradt.

In Newman, a "classical" insider trading case, the Second Circuit held that a defendant who receives material nonpublic information and trades on the basis of it is not guilty of insider trading unless he knew that the insider who disclosed the inside information did so in exchange for a personal benefit. Newman also stated 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."[3]

As the doctrinal lines have developed, "classical theory" cases are ones in which an insider trades on material nonpublic information in breach of his fiduciary duty owed to shareholders not to take advantage of information that is to be used only for a legitimate corporate purpose.[4] By contrast, under a "misappropriation theory," the insider misappropriates, or wrongfully takes, material nonpublic information from an entity to which he owes a duty of loyalty or confidence (such as an employer or a client), and that information is then used to trade securities of another corporation in violation of the duty owed to the source of the information.[5] The Second Circuit's decision in Newman left open the question as to whether the court's holding is limited to classical theory cases or whether it also applies in misappropriation cases.

Soon after the Newman decision, four defendants in a misappropriation theory insider trading case brought by the U.S. Attorney's Office for the Southern District of New York tested that open question by moving to withdraw their guilty pleas. The Conradt case arose out of an insider trading scheme involving at least five individuals. Four of the five defendants — Thomas Conradt, David Weishaus, Daryl Payton and Trent Martin — pleaded guilty to several of the crimes charged in their respective indictments.[6] A fifth defendant — Benjamin Durant — who worked with Conradt, Weishaus and Payton, did not plead guilty and was scheduled to begin trial on Feb. 23, 2015. Since Newman, Durant has moved to dismiss

the indictment, and his motion is pending.[7]

According to the government's allegations, four of the defendants (Conradt, Weishaus, Durant and Payton) worked as colleagues at Euro Pacific Capital, a securities firm; Martin was Conradt's roommate.[8] Martin, who worked as an analyst for Royal Bank of Scotland, obtained inside information from an attorney at Cravath Swaine & Moore LLP about an upcoming transaction in which IBM was to acquire SPSS Inc., a smaller software company.[9]

The confidential information shared included the parties involved in the transaction and the price at which IBM proposed to purchase shares of SPSS. Martin passed this information along to Conradt, who in turn shared the information with Durant, Payton and Weishaus, as well as an unnamed co-conspirator. All five defendants and the sixth co-conspirator then purchased SPSS common stock or call options.[10] The transaction went forward as the defendants believed it would, and the share price of SPSS increased by 40 percent over the prior day's closing price, allowing the defendants to reap profits in excess of $1 million.[11] When Euro Pacific Capital conducted an internal investigation into the suspicious trading, Durant, Payton, and Weishaus failed to admit any wrongdoing.[12]

In the wake of Newman, the defendants who pleaded guilty stated that they did not have any knowledge that the Cravath attorney who provided the inside information had done so in exchange for a personal benefit.[13] The indictment of Martin alleged that he and the Cravath attorney were "close friends" who "sought advice from each other and shared common interests, a common cultural background, and the common experience of being single men who worked in demanding industries and lived far from their home countries." The two men "exchanged personal confidences as well as non-public information concerning their jobs."[14] The disclosure by the Cravath attorney to Martin of the inside information about the IBM transaction was not alleged to have been made in exchange for any pecuniary benefit, but rather was shared by the attorney "[i]n the course of describing his personal and professional concerns to [Martin]."[15] Nor was there any allegation of a receipt of a personal benefit when Martin provided this information to Conradt, or when the information was further communicated to the other co-defendants.[16]

In light of Newman and its dictum concerning the misappropriation theory, Judge Andrew L. Carter in the Southern District of New York stated his intention to vacate the guilty pleas of Conradt, Weishaus, Payton and Martin, but he gave the government an opportunity to brief the issue. The government relied heavily on the Second Circuit's 1993 decision in United States v. Libera,[17] in which the court stated that breach of a duty and the tippee's knowledge of the breach of the duty were "without more ... sufficient for tippee liability." The government also cited a decision in a recent misappropriation case, in which Judge Jed Rakoff ruled that "the tippee's knowledge that disclosure of the inside information was unauthorized is sufficient for liability in a misappropriation case."[18] The government acknowledged the language in Newman cited by the defense, but contended that "[i]t would be incorrect to read more into this one sentence than it can logically bear."[19]

The district court disagreed and vacated the guilty pleas. It held that Newman's statement that the elements of insider trading are the same for both misappropriation cases and classical cases was controlling. Even if it is read as dicta, "it is not just any dicta, but emphatic dicta which must be given the utmost consideration."[20] The district court further held that it agreed with Newman's articulation of the law and would have ruled as Newman suggested even in the absence of the Second Circuit's recent decision.[21] In response to the government's reliance on Libera, the district court held that Newman is now the controlling law and stated that the language in Libera that the government relied upon was itself dictum.[22] With the guilty pleas now withdrawn, the district court next will entertain a motion to

dismiss the indictment made by several defendants.

It is counterintuitive to think that the defendants' alleged conduct in this case did not constitute insider trading. The defendants took information that they knew did not belong to them, put on securities trades, and profited from the trades. But the law of insider trading is not always intuitive. In the absence of an "insider trading" statute, we have a common law of insider trading in which each court builds upon the many prior decisions that have been rendered. The requirement that the person who discloses inside information do so for a personal benefit rather than a corporate purpose is not new; it dates back more than 30 years to the U.S. Supreme Court's decision in Dirks.[23] The Newman panel built upon Dirks when it reasoned that the personal benefit must encompass "a potential gain of a pecuniary or similarly valuable nature."[24] Newman represents an extension and tightening of the law, but it is not lacking in precedent. Moreover, since nothing in Newman limits its scope to classical theory cases or suggests that the elements should be different depending on which "branch" of the law the case stems from, the Conradt order is not terribly surprising.

It is reasonable to expect that more defendants who pleaded guilty in insider trading cases but have not yet been sentenced will come forward and ask to withdraw their guilty pleas; those who have been sentenced may seek other post-conviction relief. This decision in Conradt also heightens the stakes in the motion for rehearing in Newman, in part because there is now an increased likelihood that Newman will be read by other judges to apply to cases brought under both the classical and misappropriation theories.

Whether the potential impact of Newman and Conradt is enough to convince the Second Circuit to grant rehearing or rehearing en banc remains to be seen. But for the many defendants who have been charged with insider trading as tippees of material nonpublic information — and for Preet Bharara, the United States attorney whose reputation was in large part built by his overwhelming success in prosecuting insider trading cases — the stakes are undoubtedly high.

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[1] United States v. Conradt, No. 12-cr-887 (ALC) (S.D.N.Y. Jan. 22, 2015), ECF 166 ("Conradt Order").

[2] Nos. 13-1837, 13-1917 (2d Cir. Dec. 10, 2014).

[3] Id. at 11 (citing SEC v. Obus, 693 F.3d 276, 285-86 (2d Cir. 2012)).

[4] Dirks v. SEC, 463 U.S. 646, 654 (1983).

[5] United States v. O'Hagan, 521 U.S. 642, 652 (1997).

[6] Conradt Order at 1.

[7] Id. at 3; Government's Mem. of Law in Support of the Sufficiency of the Defs.' Guilty Pleas at 1, 4, United States v. Durant, No. 12-cr-887 (ALC) (S.D.N.Y. Jan. 12, 2015), ECF No. 153 ("Government Brief").

[8] Indictment at 1-2, United States v. Durant, No. 12-cr-887 (ALC) (S.D.N.Y. June 25, 2014), ECF No. 58 ("Durant Indictment"); Indictment at 1, United States v. Martin, No. 12-cr-887 (ALC) (S.D.N.Y. Dec. 26, 2012), ECF No. 18 ("Martin Indictment")

[9] Government Brief at 2.

[10] Id.

[11] Id. at 3-4.

[12] Id. at 4.

[13] Max Stendahl, Newman Ruling Jeopardizes IBM Insider Trading Pleas: Judge, Law360 (Dec. 18, 2014, 2:08 PM), http://www.law360.com/articles/606019.

[14] Martin Indictment at 2-3.

[15] Id. at 5.

[16] Id.; Durant Indictment at 3-4; Indictment at 4-5, United States v. Conradt, No. 12-cr-887 (ALC) (S.D.N.Y. Nov. 28, 2012), ECF No. 3 ("Conradt Indictment").

[17] 989 F.2d 596, 600 (2d Cir. 1993).

[18] United States v. Whitman, 904 F. Supp. 2d 363, 370 (S.D.N.Y. 2012).

[19] Government Brief at 14.

[20] Conradt Order at 2.

[21] Id. at 3.

[22] Id. at 3 n.1.

[23] Dirks, 463 U.S. at 662.

[24] Newman, slip opn. at 22.

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