

## Second Circuit Clarifies Current Insider Trading Law

Persons receiving inside information can be liable for securities fraud even if they are not corporate insiders and owe no direct duty to the source of the information. Last month, the Second Circuit reiterated how the misappropriation theory of insider trading applies to those receiving material, non-public information, more commonly known as tippees. In *SEC v. Obus*, the court stated that a hedge fund employee and principal, as tippees, could be liable for violations of the insider trading laws if they knew, or should have known, that the tipper breached a duty to his employer in passing along the tip.

### Background

In May 2001, Thomas Strickland was tasked with conducting due diligence for his employer's contemplated financing of the acquisition of SunSource, Inc. (SunSource). The SEC alleged that Strickland tipped off his college friend, Peter Black, about the acquisition. Black was an analyst at Wynnefield Capital, Inc. (Wynnefield), a large holder of SunSource stock. The SEC further alleged that Black told Wynnefield's principal, Nelson Obus, about the SunSource acquisition. Obus then called SunSource's CEO and indicated that he had learned about the acquisition from Strickland's employer. During the call, Black allegedly tried to signal Obus to stop talking and, after the call, told Obus that Strickland would be fired because of the information Obus had disclosed. In response, Obus became upset and agreed to offer Strickland a job if he was fired.

Two weeks later, Wynnefield increased its position by purchasing approximately an additional 5 percent of SunSource. Eleven days after that, the bid to acquire SunSource was publicly announced, SunSource's stock price increased by 91.5 percent, and Wynnefield made more than \$1.3 million in profits.

The SEC brought a civil enforcement action against Strickland, Black and Obus, alleging violations of section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 under both the classical and the misappropriation theories of insider trading. The District Court granted the defendants' summary judgment motion on both theories.

The SEC alleged that Strickland had a duty to his employer to keep confidential the information about the SunSource acquisition. Strickland allegedly breached that duty by tipping Black. The District Court instead adopted the finding of an internal investigation conducted by Strickland's employer, which concluded that Strickland did not breach a fiduciary duty. The District Court also noted that SunSource had not been placed on Strickland's employer's list of securities in which trading was restricted until after the deal was announced.

As for Black and Obus, because Strickland breached no duty to his employer in tipping Black, neither Black nor Obus could have inherited any duty from Strickland. The SEC appealed only the misappropriation theory.

### The Second Circuit Decision

The Second Circuit reversed and held that Strickland, Black and Obus could all be liable under the misappropriation theory of insider trading. The misappropriation theory provides that people who are not corporate insiders can nevertheless be liable for insider trading if: (1) they are entrusted with material non-public information; (2) in confidence; and (3) they breach a duty to the source of the information; (4) for personal gain.

The Court found that if Strickland breached a duty to his employer to keep the SunSource acquisition confidential, he could be held liable for passing that information along to Black. In addition, if Black and Obus knew, or should have known, that Strickland was breaching his duty to his employer, they too could be held liable.

The Second Circuit explained that, unlike the classical theory of insider trading, the misappropriation theory targets persons who are not corporate insiders but who have received material nonpublic

information in confidence, and who breach a duty to the source of the information to gain personal profit. A person who obtains information in this manner has a duty to the source of the information to abstain from trading or disclose to the source of the information.

The Second Circuit held that there was sufficient evidence in the record for a jury to conclude that Strickland breached a duty to his employer to keep confidential the pending SunSource acquisition. The Court cited: (1) Strickland's testimony that he understood the SunSource acquisition was confidential; (2) the fact that each page of the deal book, which Strickland received, was marked "extremely confidential"; and (3) the fact that Strickland had signed an employee code of conduct, which required him to "safeguard ... confidential information about an upcoming deal." The Second Circuit also rejected the District Court's basis for concluding that Strickland did not breach a duty to his employer, finding that the conclusion reached by the employer's internal investigation was not entitled to the weight accorded it by the District Court.

Lastly, the Second Circuit noted that the personal gain element can be satisfied by a "'reputational benefit' or the benefit one would obtain from simply 'making a gift of confidential information to a trading relative or friend.'" Thus, the Court held, this element can be satisfied by the simple fact that Strickland tipped his friend Black.

Turning to Black and Obus, the Court held that they, as tippees, would be liable if they knew or should have known that the material, nonpublic information was received from someone (Strickland) who, in disclosing that information to them, breached a fiduciary duty. Again, the Second Circuit concluded that there was sufficient evidence in the record for a jury to so find. The Court cited: (1) the fact that Black and Obus were sophisticated financial analysts; (2) Black's testimony that "information about a non-public acquisition would be material inside information that would preclude someone from buying stock" and; (3) Obus's call to SunSource's CEO and his conversation with Black that immediately followed. Interestingly, the Second Circuit identified, but did not opine as to whether "Obus's bare knowledge that Strickland worked for [an entity that finances acquisitions] ... along with Obus's status as a sophisticated financial player, was enough for Obus to have had reason to know that Strickland breached a duty to [his employer] by talking to Black."

## Conclusions

Traders should consider the source of material information they acquire before trading. While liability will attach only if the trader knows, or should know, that the tipper is breaching a fiduciary duty in conveying the information, this requirement has been interpreted broadly and can be inferred from circumstantial evidence. Sophisticated tippees, such as a hedge-fund employee and manager (e.g., Black and Obus), may be presumed to know that a tipper has breached a fiduciary duty. Moreover, the more credible and valuable the information, the more likely it is that the tippee will know it was conveyed in breach of a fiduciary duty. This very fact was present here, as only one with access to confidential information would have known about the pending SunSource acquisition.

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