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The Personal Benefit Test in Misappropriation Cases

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Like many aspects of insider trading law, the personal benefit test is deceptively straightforward. In tipping cases brought under the "classical" theory of insider trading, corporate insiders who disclose material nonpublic information, and persons who receive the information and trade based on it, are liable for securities fraud only if the tipper received a personal benefit in exchange for sharing the information. But almost 30 years after the test was first articulated, questions remain: Is the benefit test a separate element of liability or an aspect of another element, like breach of duty or scienter? And what counts as a sufficient "benefit"?

Those uncertainties have contributed to a greater controversy: whether the benefit test applies in tipping cases brought under the misappropriation theory. Prosecutors and regulators argue that it does not, and some courts have agreed. But careful examination of the purpose for the test and the requirements of misappropriation liability suggests that the government's opposition is misguided.

Origins of the Personal Benefit Test

The personal benefit test was adopted by the Supreme Court in *Dirks v. SEC*, 463 U.S. 646 (1983), a tipping case brought under the classical theory. Under that theory, a corporate insider who exploits material nonpublic corporate information by trading on it without disclosing the information to the corporation's shareholders commits fraud in violation of the federal securities law. The insider's trading is fraudulent because of the "'inherent unfairness involved where one takes advantage' of 'information intended to be available only for a corporate benefit and not for the personal benefit of anyone.'" This principle imposes a duty on insiders to disclose the information or abstain from trading. *Id*. at 654.

Dirks addressed the liability of a corporate insider who does not trade but discloses corporate information to others who do. Raymond Dirks was a securities broker whose clients invested in insurance companies. Employees of one of those insurance companies, who were corporate insiders with a disclose-or-abstain duty, told Dirks that the company was engaging in fraud, in the hope that Dirks' clients would sell their shares in the company, causing a drop in share price that would lead to the fraud's discovery. The employees also urged Dirks to disclose the fraud publicly. In response, Dirks asked a reporter for the *Wall Street Journal* to write a story about the fraud allegations, and he passed the information to his clients, who sold their shares. The SEC charged Dirks with insider trading on the theory that, by receiving nonpublic information from the employee-insiders, Dirks had "inherited" their disclose-or-abstain duty.

The Supreme Court agreed that a "tippee" like Dirks could inherit an insider's duty, but only if the insider's disclosure of information itself constituted a breach of the duty to disclose or abstain from trading. According to the Court, some disclosures are consistent with an insider's duty to shareholders. For example, the insider may not realize that the information is "material enough to affect the market," or may mistakenly believe it is already public. *Id*. at 662. Or, as with the employee-insiders in *Dirks*, disclosure may be motivated by a desire to expose a fraud. Insiders therefore need a "guiding principle" so they can determine whether a disclosure complies with the securities laws. To give them one, the Court held that disclosure breaches the insider's disclose-or-abstain duty only if the insider "personally will benefit" from the disclosure, which was not the case with the insiders in *Dirks*. *Id*. at 662, 664-67.

Tipping Liability in Misappropriation Cases

When it decided *Dirks*, the Supreme Court had not yet endorsed the misappropriation theory of insider trading. It did so in *United States v. O'Hagan*, 521 U.S. 649 (1997). In misappropriation cases, a person trades in breach of a duty owed not to the shareholders of the issuer, but to the source of the information. James O'Hagan himself, for example, was a lawyer who traded on information he obtained not from a traditional corporate insider, but from his law firm and one of his firm's clients, in the securities of a company the client planned to acquire. As a lawyer, he owed both his firm and its client fiduciary duties of loyalty and confidentiality. In upholding his conviction, the Court explained that "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." *Id*. at 652. The fiduciary's trading is fraudu-

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lent because he has "'[pretended] loyalty to the principal while secretly converting the principal's information for personal gain.'" *Id*. at 653-54.

Because *O'Hagan* was not a tipping case, the Court did not expressly address whether *Dirks* and the personal benefit test applies to tipping cases brought under the misappropriation theory. But *O'Hagan's* explanation that misappropriation is conversion for "personal gain" would seem to suggest that a personal benefit is required under either theory. Nevertheless, the government has argued that the benefit test does not apply in misappropriation cases because the fiduciary duties underlying the misappropriation theory are broader than the disclose-or-abstain duty underlying the classical theory. Because the duty in classical cases is based on a corporate insider's obligation not to take advantage of corporate information, mere unauthorized disclosure of information by the insider does not breach that duty. In a misappropriation case, however, a fiduciary owes duties to the source of the information based on the source's right to the exclusive use of its information. Trading on the information (and thus personally profiting) is one way a fiduciary can deprive the source of its right to exclusive use, but not the only way. Any unauthorized use by the fiduciary of the information, including unauthorized disclosure — especially disclosure that might harm the source if the recipients trade on the information — breaches the fiduciary's duties. *See, e.g.*, Govt's Opp. to Motion to Dismiss in *United States v. Gansman*, 08 Cr. 471 (S.D.N.Y. 2009); Brief of the Securities and Exchange Commission in *SEC v. Yun*, No. 01-14490-HH (11th Cir. 2001).

The government's position conflicts with a fundamental principle of securities law: Breach of a fiduciary duty alone does not constitute securities fraud. *See Dirks*, 463 U.S. at 654. *Dirks* held that a breach of an insider's disclose-or-abstain duty violated Section 10(b) and Rule 10b-5 because breach of that duty necessarily involves "manipulation or deception." That is because an insider breaches the disclose-or-abstain duty only if he "take[s] advantage" of corporate information for his "personal benefit." *Id*. at 654. The government is thus right that the disclose-or-abstain duty is narrower than the loyalty and confidentiality duties at issue in misappropriation cases. But that should not mean that any breach of those duties is equivalent to deception. To be deceptive, a breach must involve "personal gain." *O'Hagan*, 521 U.S. at 653. The Supreme Court confirmed that merely violating an information source's right to exclusive use is not fraud by noting that, if the fiduciary tells the information source he is going to trade, he is not liable for securities fraud, even though his trading still breaches his duties. *Id*. at 655. Read together, *Dirks* and *O'Hagan* suggest that the benefit test does apply in misappropriation cases.

Division in the Courts

Even after *O'Hagan*, some courts are still inclined to agree with the government that the benefit test applies only in classical cases. *See, e.g.*, *SEC v. Lyon*, 605 F. Supp. 2d 531, 548 & n. 7 (S.D.N.Y. 2009). This is based partly on the view that, in *United States v. Libera*, the Second Circuit implied that an affirmative showing of benefit is not required in misappropriation cases by stating that two elements, "without more," define tipping liability: breach of a duty by the tipper and the tippee's knowledge of the breach. 989 F.2d 596, 600 (2d Cir. 1993). But *Libera* never discussed the issue of benefit because it was undisputed: The tipper whose culpability mattered had been paid for information. *Id*. at 598-599. The issue in *Libera* was whether, to be liable, a tipper must "specifically know" that the tippee intends to trade on the tip. *Id*. at 600.

Other courts have rejected the government's position. In *SEC v. Yun*, the Eleventh Circuit held that, to establish tipping liability in a misappropriation case, the government "must prove that a misappropriator expected to benefit from the tip." 327 F.3d 1263, 1275 (11th Cir. 2003). The court noted that it makes "scant sense" for the elements of tipping liability to depend on which theory the government chooses to assert. Either theory must satisfy Section 10(b) and Rule 10b-5, which require more than a breach of a fiduciary duty. *Id*. at 1278. Also, because nearly all classical-theory cases can be characterized as misappropriations, not applying the benefit test in misappropriation cases "would essentially render *Dirks* a dead letter." *Id*. at 1279.

The Fifth and Seventh Circuits have also suggested that the benefit test applies in misappropriation cases. *See SEC v. Cuban*, 620 F.3d 551, 557 n. 38 (5th Cir. 2010), citing *Yun*; *United States v. Evans*, 486 F.3d 315 (7th Cir. 2007). Indeed, although the Seventh Circuit sees all tipping liability as a "species of the 'misappropriation' theory," it has explained that liability requires a tip to have been made "with the expectation of a benefit." *Evans*, 486 F.3d at 322, 325.

Will Supreme Court Clarification Matter?

Despite the government's view, it nevertheless often alleges that a misappropriating tipper received a benefit. *See, e.g.*, Complaint, *SEC v. Kluger*, 11 Civ. 1936 (D.N.J.) ("Kluger misappropriated and disclosed…information to reap personal benefit"). Until the Supreme Court resolves the issue, however, the government will likely continue to argue that it doesn't need to prove a benefit. Given the broad definition of benefit, and the fact that benefit no doubt helps the government prove scienter or demonstrate motive, it's hard to see why the government cares. *Dirks* explained that a "personal benefit" can be direct or indirect, and even includes a "reputational benefit that will translate into future earnings." A personal benefit can also be inferred if the disclosure was a "gift" to a relative or friend. *Id*. at 663-664. This means the government will be unable to prove a benefit only in unusual cases. *See SEC v. Maxwell*, 341 F. Supp.2d 941 (S.D. Ohio 2004) (benefit not proven where executive disclosed information to his barber). To provide true clarity, the Court should not only confirm that the benefit test applies in misappropriation cases, it should strengthen it.

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