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Expert Analysis

Same Facts, Different Results: Civil And Criminal Liability After 'Newman'

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The Second Circuit's decision in *United States v. Newman*[1] continues to have a significant impact on the litigation of civil and criminal insider trading cases.[2] The decision has led courts to look closely at what the government must prove to sustain charges against remote tippees—that is, tippees who are many steps removed from the ultimate source of material non-public information. Many high-profile prosecutions in recent years, including *Newman*, involved remote tippees who claimed that they were unfairly prosecuted for trading on information when they knew little or nothing about the source of the information.

The principal issue in *Newman* was what the government had to prove about the defendants' state of mind. In one view, held by the district court in *Newman*, the government was required to prove simply that the defendants knew that the source of the information had breached a fiduciary (or similar) duty giving rise to an obligation of confidentiality. In the view of judges presiding over other cases, the government had to prove not only knowledge of the breach of duty but also knowledge that the source of the information had received a personal benefit in exchange for divulging information. Relying on the decision in *Dirks v. SEC*,[3] the U.S. Court of Appeals for the Second Circuit held that the government was required to prove that a defendant knew both of the breach and of the exchange of benefit—a ruling that has cast doubt on the sufficiency of the evidence in a number of outstanding civil and criminal cases.

As clarified in *Newman*, the burden on the government has had an unusual impact on proceedings involving defendants Daryl Payton and Benjamin Durant. In a criminal case, the defendants moved to vacate their guilty pleas and dismiss the indictment on the ground that the government would not be able to prove the defendants' knowledge of a benefit conferred on the tipper. Citing *Newman*, Southern District Judge Andrew L. Carter Jr., vacated the defendants' guilty pleas, but denied the defendants' motion to dismiss.[4] The government followed by seeking an order of nolle prosequi and dismissal of the indictment, which was granted.[5]

In a parallel civil case brought by the Securites and Exchange Commission, the defendants moved to dismiss the complaint, but the commission opposed the motion. Judge Jed S. Rakoff denied the defendants' motion to dismiss, holding that under the mental state requirement applicable to a civil enforcement proceeding—"knowing or reckless"—the complaint was adequately pleaded, even if the Department of Justice might not be able to prove the mental state element of "willfulness" applicable in a criminal insider trading case.[6]

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In this article, after briefly discussing the facts involving Payton and Durant, we compare the mental state requirement in criminal and civil insider trading, a subject that was also addressed by Judge Rakoff in a speech at New York University Law School last month. His suggestion that in the realm of insider trading, and other bodies of law governing economic activity, statutes should be written differently and, above all, more clearly, has considerable appeal.

The Facts of 'SEC v. Payton'

Daryl Payton and Benjamin Durant were accused of using inside information to buy stock in 2009 in SPSS, Inc., target of a planned acquisition by IBM. As alleged in the SEC's complaint, the tipper, Trent Martin, provided material non-public information to his roommate Thomas Conradt. Martin and Conradt shared a "close, mutually-dependent financial relationship, and had a history of personal favors." Martin had received the information from a lawyer friend, Michael Dallas, an associate at a law firm assigned to work on the transaction.

Martin tipped Conradt, a registered representative with a New York broker-dealer, in violation of a duty of confidentiality to Dallas. Conradt, in turn, tipped Payton and Durant, two brokers who worked at the same brokerage firm with Conradt. Payton and Durant bought SPSS stock on the basis of the tip from Conradt. Conradt told Payton and Durant that his roommate Martin had told him about the SPSS acquisition; Payton and Durant did not ask why Martin gave the information to Conradt or how Martin came to be in possession of the information.

Judge Rakoff, after finding adequate allegations of benefit to Martin, addressed Payton's and Durant's state of mind. As to the defendants' awareness of a benefit to the tipper (Martin)—the key issue in *Newman*—Judge Rakoff found the allegations sufficient under a "knowing or reckless" standard. Specifically, the complaint alleged that the defendants (1) knew that Martin was the source of the tip to Conradt; (2) knew that Conradt and Martin were friends and roommates; and (3) knew of unrelated legal problems that Martin had and Conradt's assistance with those problems. Judge Rakoff wrote, "[t]his is enough to raise the reasonable inference that the defendants knew that Martin's relationship with Conradt involved reciprocal benefits."[7]

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Judge Rakoff distinguished the case against Payton and Durant from *Newman*, where the defendants "'knew next to nothing' about the tippers, were unaware of the circumstances of how the information was obtained, and 'did not know what the relationship between the [tipper] and the first-level tippee was.'" He noted the commission's allegations that Payton and Durant never asked why Martin shared inside information with Conradt or how Martin learned of the information in the first place. In light of Payton's and Durant's market sophistication and knowledge, Rakoff held that an adverse inference could be drawn that the defendants had recklessly avoided discovering additional details.[8]

Judge Rakoff suggested that two separate insider trading laws—a broad civil statute and a narrow criminal statute—are preferable to one provision construed differently in civil and criminal cases.…The criminal statute could be amended over time to incorporate prohibitions formulated under the broader civil statute.

Mental State Requirements

Both civil and criminal insider trading violations require that a defendant act with scienter, defined as "a mental state embracing intent to deceive, manipulate or defraud."[9] In the civil context, scienter may be established by showing that a defendant acted recklessly. "[T]he scienter required for securities fraud includes recklessness," which includes highly unreasonable conduct, "involving not merely simple, or even inexcusable negligence, but an extreme departure from the standards of ordinary care,… which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it.'"[10] Scienter in a civil case may be established by an individual's conscious avoidance of the truth, also referred to as "reckless disregard" for the truth, as suggested in *Payton*.

In a criminal case, "the Government must prove that a person 'willfully' violated the provision."[11] A First Circuit opinion authored by retired Supreme Court Justice David Souter, who was sitting by designation, referred to the term "willful" as a "chameleon…a word of many meanings whose construction is often dependent on the context in which it appears."[12] The standard definition of willfulness is "to act knowingly and purposely, with an intent to do something the law forbids, that is to say, with bad purpose either to disobey or to disregard the law," though in some contexts the standard has been heightened to include knowledge of violating a known legal duty.[13] The decision in *Newman* makes clear that willfulness in insider trading cases is defined in the same terms as in securities violations in general: "We have defined willfulness in this context 'as a realization on the defendant's part that he was doing a wrongful act under the securities laws.'"[14]

A defendant thus requires knowledge of certain underlying facts—"realization…that he was doing a wrongful act"—in order to act willfully. Because willfulness turns on a defendant's knowledge, it can incorporate concepts of conscious avoidance because conscious avoidance, by definition, is a method by which prosecutors seek to meet their burden of proving knowledge. Consequently, the requirement of willfulness in a criminal case can, if permitted by a trial court, be reduced as a practical matter to conscious avoidance of certain facts, e.g., a breach of duty or receipt of benefit by the tipper—arguably, a test not significantly different from the recklessness in a civil case.

In *Payton*, Judge Rakoff summed up the differences of intent in civil and criminal insider trading cases as follows: "[W]hile a person is guilty of criminal insider trading only if that person committed the offense 'willfuly,' i.e., knowingly and purposely, a person may be civilly liable if that person committed the offense recklessly, that is, in heedless disregard of the probable consequences."[15] In practice, however, it is not clear that the tests—knowing or reckless, and willfulness—are all that different.

Proposal for Greater Clarity

In a speech at New York University School of Law on April 17, 2015, Judge Rakoff addressed the lack of clarity in insider trading law. The prohibition ultimately derives from Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5. Rakoff refers to this and similar legal provisions as "hybrid statutes" that provide both civil and criminal penalties for the same misconduct.[16] Hybrid statutes also govern civil and criminal antitrust and racketeering liability.

In Rakoff's view, hybrid statutes lead to "material inconsistencies and strange results that both undercut [a statute's] effectiveness and create major legal headaches." This follows from the different rules for interpreting civil and criminal statutes. Civil statutes are read broadly in order to achieve a remedial or regulatory purpose, whereas criminal statutes are interpreted narrowly, "so as to provide fair notice, avoid over-criminalization, and protect the innocent." The problem of differing interpretations of the same prohibition is compounded by the nature of insider trading law: Its elements have been decided by judges interpreting an exceedingly broad prohibition on fraudulent and dishonest conduct.

Rakoff suggested that two separate insider trading laws—a broad civil statute and a narrow criminal statute—are preferable to one provision construed differently in civil and criminal cases. He argued that this construct would "prevent criminal prosecution of those who lacked fair notice of their transgressions, while allowing the SEC to step in and halt new, innovative forms of insider trading at the outset." The criminal statute could be amended over time to incorporate prohibitions formulated under the broader civil statute.[17] Following the Second Circuit's decision in *Newman*, several bills have been proposed to legislate a ban on insider trading, two of which would define civil and criminal liability differently.[18]

Conclusion

Because insider trading law, like common law, has developed through judicial decisions, important doctrines continue to be refined and clarified. This process raises serious concerns for individuals and companies trying earnestly to comply with the law. It will be interesting, and important, to see whether, following *Newman*, Congress and the SEC will provide clearer definitions of insider trading, including whether (and how) civil and criminal liability differ.

1. 773 F.3d 438 (2014).
2. Elkan Abramowitz and Jonathan Sack, "Implications of Second Circuit Reversal of Insider Trading Convictions," NYLJ (Jan. 6, 2014).
3. 463 U.S. 646 (1983).
4. Order, *United States v. Conradt*, 12-cr-887 (Jan. 22, 2015).
5. *Nolle Prosequi, United States v. Conradt*, 12-cr-887 (Feb. 3, 2015).
6. *SEC v. Payton*, ___ F. Supp.3d ___, 2015 WL 1538454, *1 (S.D.N.Y. April 6, 2015).
7. 2015 WL 1538454 at *5.
8. Id. at *6.
9. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 n.12 (1976).
10. *SEC v. Infinity Group Co.*, 212 F.3d 180, 192 (3d Cir. 2000) (quoting *McLean v. Alexander*, 599 F.2d 1190, 1197) (3d Cir. 1979) (internal citations omitted)).
11. 15 U.S.C. §78ff(a).
12. *United States v. Marshall*, No. 12-2441 (1st Cir. 2014) (citing *Bryan v. United States*, 524 U.S. 184, 191 (1998) (internal citations omitted)).
13. See *United States v. Peltz*, 433 F.2d 48, 55 (2d Cir. 1970); *Cheek v. United States*, 498 U.S. 192 (1991).
14. *Newman*, 773 F.3d at 447 (internal citations omitted).
15. 2015 WL 1538454 at *1.
16. Judge Jed S. Rakoff, Speech at Conference on Corporate Crime and Financial Misdealing at New York University Law School (April 17, 2015).
17. Nate Raymond, "Rakoff: Separate Insider Trading Laws Needed for Criminal, Civil Cases," Reuters Legal (April 20, 2015).
18. Stephanie Russell-Kraft, "Litigators Fear Congressional Fixes to Newman," Law360.com (March 31, 2015).