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When Is a Promise Enough? Contractual Duties and Insider Trading

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Imagine this: A man takes a job as a security guard for a wealthy executive. His duties include answering phone calls and printing emails containing information about the executive's company. So he enters into a confidentiality agreement, which prohibits him from disclosing or using such information for matters outside his employment. But one day he sees a confidential email saying the executive's company is going to be acquired at a premium. He decides to buy stock and call options, all of which he sells at a substantial profit when the information becomes public.

For those who follow the law of insider trading, this seems like an open and shut case. The guard breached a duty by misappropriating material nonpublic information and used it to trade securities. The SEC likely thought this elementary when they brought an enforcement action in 2017 against an individual named Todd Alpert in the Southern District of New York. *See, Securities and Exchange Commission v. Todd David Alpert*, No. 17-Civ-1879 (S.D.N.Y. filed Mar. 15, 2017)

But an interesting issue soon arose: What *kind* of duty did Alpert breach? Insider trading cases traditionally turned on breaches of fiduciary duties. But that wasn't quite the case here. After all, Alpert was a contractor. And whatever duty he owed the executive was purely a creature of contract. Was a breach of a contractual duty sufficient to create insider trading liability? And if so, what kind of contractual duty?

The issue temporarily disappeared when the *Alpert* case settled before trial. But now it has returned in two criminal appeals before the Second Circuit. Taken together, the cases require the Court of Appeals to decide whether the violation of a fiduciary relationship is required to create insider trading liability or if a breach of contract is sufficient. Or more simply: When is a promise to keep information secret enough?

Alpert: Confidentiality Agreements and Quasi-Fiduciary Duties

Before considering the appeals in the Circuit, it is useful to pause on *Alpert*. Although *Alpert* ultimately settled, the court first denied his motion to dismiss and addressed many of the arguments now being advanced by the Department of Justice. In so doing, the opinion illuminates important distinctions between the cases pending before the Court of Appeals.

Alpert's position was simple: The confidentiality agreement at issue was insufficient as a matter of law to establish a relationship of trust and confidence necessary to create a duty under the Exchange Act. Since he was not a fiduciary, there could be no liability for insider trading. The court rejected that argument, relying on decisions suggesting that liability can attach for the breach of any fiduciary duty or its "functional equivalent, " which can be found whenever there is "explicit acceptance of a duty of confidentiality." The court concluded that the confidentiality agreement created the "functional equivalent" of a fiduciary duty be-

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cause Alpert had misused information given to him in a relationship in which he should have acted "to serve the interests of the party entrusting him" with the information.

Two things to note here.

First, the confidentiality agreement explicitly prohibited "using" information in addition to "disclosing" information.

Second, the court found a quasi-fiduciary duty flowing from the confidentiality agreement because Alpert should have been acting in the counterparty's best interests. The relevance of each of these facts is now being tested in the Circuit.

Kosinski and *Chow*: A Retreat from Breach to Duty

In the wake of *United States v. Newman*, 773 F.3d 438 (2d Cir. 2014), much ink has been spilled on what constitutes a *breach* of duty for insider trading liability. With that issue now largely sorted out in the aftermath of *Salman* and *Martoma*, the Second Circuit can return to an antecedent question: What kind of duty are we talking about anyway? The twin cases of *United States v. Kosinski*, No. 18-3065, and *United States v. Chow*, No. 19-325, should help provide an answer.

Kosinski was an investigator in an experimental drug trial for a publicly-traded pharmaceutical company. He was also an investor in the company. He signed two confidentiality agreements prior to his receipt of nonpublic information about the tests. The first prohibited the "use, disclosure, or exploit[ation]" of the information. The second — which explicitly superseded the first — only required that information be "maintain[ed] in strict confidence." After executing the second agreement, Kosinski received highly negative nonpublic information about the trial, including that a patient had died. Kosinski sold his entire investment and attempted to purchase put options before the results became public.

Chow was the managing director of a Chinese private equity fund seeking to purchase a semiconductor company called Lattice. Chow entered into a confidentiality agreement with Lattice as part of the secret negotiations, which required that each party neither "disclosure" nor "use" confidential information for any purpose other than evaluating the transaction. After several critical steps in the negotiation, including the submission of confidential purchase offers, Chow communicated with a friend who then traded profitably in Lattice stock.

The Court of Appeals will have to determine whether there was a duty of trust and confidence created by the confidentiality agreements in these cases, each of which presents a complication not found in *Alpert*. In *Kosinski*, the government relies on an agreement which provides no limits on the "use" of information beyond requiring that information be kept confidential. But Kosinsky told the information to no one; he simply traded on it. The government is therefore almost forced to argue that the contract created a duty that was breached even when the contract itself was not violated. In *Chow*, on the other hand, the parties to the confidentiality agreement are not as closely aligned in interest as in *Alpert*, being on opposite sides of a negotiation. It is not clear whether or how much this should matter, given that the parties agreed to keep the information confidential and were working toward the common goal of an acquisition.

Conclusion: Uncertainty and Democratic Solutions

Taken together, the *Kosinski* and *Chow* cases should give guidance not only on whether contracts can create insider trading duties but when and how. The SEC, for its part, could be forgiven for thinking this a dead issue, given that it long ago passed a regulation defining a duty of a trust or confidence to include "whenever a person agrees to maintain information in confidence." But the SEC's rulemaking authority in this area has been heavily criticized — including in *Kosinski* and *Chow* — and the *Alpert* decision went out of its way to avoid the rule.

A recent insider trading bill passed by the House of Representatives seeks to provide clarity by stating that any breach of a confidentiality agreement or contract is sufficient to create liability. But unless and until that bill is signed into law or the SEC rule is sanctioned by the federal courts, we will have to look to the forthcoming decisions in *Kosinski* and *Chow* for guidance on what kind of promises are sufficient to create duties under the Exchange Act.

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