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2nd Circ. Ends Newman Relationship Test, But For How Long?

By **Carmen Germaine**

Law360, New York (August 23, 2017, 10:43 PM EDT) -- A Second Circuit panel jumped at the chance to flip a key part of the landmark Newman decision Wednesday in upholding the insider trading conviction of SAC Capital Advisors LPmanager Mathew Martoma, but experts say the change could be short-lived if the case is reviewed again by the appellate court — or even the U.S. Supreme Court.

Martoma had argued that the jury instructions in his case were erroneous in light of the Second Circuit's 2014 decision in U.S. v. Newman. That decision, which threw insider trading prosecutions in the circuit into disarray, held that tippers and tippees must have a "meaningfully close personal relationship" and have exchanged a pecuniary or similarly valuable benefit in order for an insider trading conviction to be sustained.

Mathew Martoma was convicted in February 2014 and later sentenced to nine years in prison, one of the longest jail terms ever imposed in an insider trading case. (AP)

The Supreme Court explicitly overturned Newman's pecuniary benefit language in its Salman v. U.S. decision in December, finding it was inconsistent with past high court precedent and that gifting information to a relative who trades on it is enough to satisfy the requirement that insiders receive a personal benefit for tipping traders — though the court did not expressly address how close the relationship needs to be.

But on Wednesday, the panel found — over a lengthy dissent — that the "logic" of Salman meant "Newman's 'meaningfully close personal relationship requirement' can no longer be sustained."

Morgan Lewis & Bockius LLP partner David Miller said the decision is "highly significant."

"The Salman decision clarified some ambiguity that resulted from the Newman opinion, and the

Martoma opinion appears to now eviscerate the ambiguity that remained from Newman," said Miller, a former federal prosecutor.

But Miller and other experts said the latest decision is far from set in stone, given that the majority opinion overturned a prior circuit precedent and attracted a dissent longer than the opinion itself.

"I think that it is very possible that the Second Circuit will convene an en banc panel to review this decision," said Baker McKenzie partner Elizabeth L. Yingling. "Even if that didn't happen, with this being a 2-1 decision and with it being related to a specific interpretation of the Salman decision, it wouldn't surprise me if it ended up in front of the Supreme Court again."

'A Big Change'

Martoma was convicted in February 2014 and later sentenced to nine years in prison, one of the longest jail terms ever imposed in an insider trading case. The government has alleged Martoma learned in July 2008 that a clinical trial for bapineuzumab, an experimental Alzheimer's drug being developed by Wyeth and Elan, had gone poorly. The tip allegedly came from two doctors who worked on the trial, Sidney Gilman and Joel Ross.

The tip allowed SAC, owned by billionaire Steve Cohen, to unwind its considerable holdings in Wyeth and Elan stock, generating profits and avoiding losses of $275 million after the shares plummeted in value on the bad news, according to prosecutors.

Martoma argued on appeal that the evidence against him was insufficient under Newman, which was released while his appeal was already pending, because Gilman was only a casual acquaintance and was not paid for two consulting meetings during which he allegedly delivered the tips.

The Newman decision, issued in December 2014, shook the securities bar and had a chilling effect on insider trading prosecutions in the Second Circuit, forcing Manhattan U.S. Attorney Preet Bharara and his office to drop insider trading cases against a number of defendants.

The decision, in part, effectively tightened the personal benefit requirement laid out in the Supreme Court's 1983 Dirks decision, which held that a company insider violates their fiduciary duty to shareholders — giving rise to liability for insider trading — when they will benefit, directly or indirectly, from passing material nonpublic information to a tippee.

While Dirks said the government could infer a benefit if the tipper "gifts" information to a trading relative or friend, the Second Circuit said in Newman that such an inference is possible only in the case of a "meaningfully close personal relationship" where the insider receives a gain "of a pecuniary or similarly valuable nature."

The second part of Newman's benefit holding was overturned in December, when the Supreme Court in Salman ruled that the government need not prove an insider received a pecuniary benefit if they gift

information to a relative.

The high court explicitly added that, to the extent the Second Circuit held in Newman that an insider must receive something of a "pecuniary or similarly valuable nature" in exchange for gifting information, that requirement "is inconsistent with Dirks."

The Salman decision didn't explicitly overrule Newman's "meaningfully close personal relationship" requirement. Indeed, the First Circuit in January noted that the Supreme Court had not discussed that language, and that Salman did not foreclose arguments that informational exchanges between casual friends do not meet Dirks' personal benefit requirement.

But the Second Circuit on Wednesday said the logic of Salman and Dirks supported the conclusion that corporate insiders benefit whenever they disclose information as a gift with the expectation that the tippee will trade on the tip, whether or not there was a close relationship.

"We respectfully conclude that Salman fundamentally altered the analysis underlying Newman's 'meaningfully close personal relationship' requirement such that the 'meaningfully close personal relationship' requirement is no longer good law," U.S. Circuit Judge Robert A. Katzmann wrote for the majority.

Miller noted that if the Martoma decision survives, all that appears to remain of the Newman decision is the Second Circuit's requirement that tippees need to know that the insider providing the information received a personal benefit in exchange for the tips. That portion of the 2014 opinion was also significant, as it made prosecuting downstream tippees difficult.

But without the "close personal relationship" requirement, experts said, much of the wind in Newman's sails has been knocked out.

"Some of the obstacles for prosecutors that some would argue were created by Newman and continued after Salman have now been erased, making certain insider trading cases easier to prosecute," Miller said.

Patterson Belknap Webb & Tyler LLP partner Harry Sandick, a former federal prosecutor, said the decision will make a difference in at least some cases, allowing prosecutions that may have been foreclosed if a meaningfully close relationship were required.

"There will be cases, and this may be one of them, where if there is a requirement of a meaningfully close personal relationship, a jury might say, 'Look at these two, they weren't friends, they weren't relatives, they had a purely business relationship, it wasn't meaningfully close,'" Sandick said.

Yingling said that the opinion may go beyond even Dirks, which connected the example of gifted information specifically to "a trading relative or friend."

By contrast, the Martoma majority found that insiders personally benefit any time they disclose information with the expectation that the tippee will trade on the information, where the disclosure "resemble[s] trading by the insider followed by a gift of the profits to the recipient."

"It seems to me that that is a big change," Yingling said.

Will It Last?

Dissenting U.S. Circuit Judge Rosemary Pooler saw the majority opinion as a significant change as well, arguing that the panel had gone beyond the limitations set out in Dirks, which she said were untouched in Salman.

"In rejecting those precedents, the majority opinion significantly diminishes the limiting power of the personal benefit rule, and radically alters insider-trading law for the worse," Judge Pooler said.

Considering that the decision attracted such a strong dissent — clocking in at 44 pages — experts said the Second Circuit could be persuaded to take up the case for en banc review, should Martoma seek it.

With 11 active judges on the Second Circuit, six would need to vote for review for the case to be taken up, Sandick noted. Martoma may already be partway there, he added.

"Any time that you have a dissenting opinion, there's at least one judge who's not happy with the panel," Sandick said. "I think you have a situation here where Judge [Peter W.] Hall, who was on the panel in Newman, may also not be happy with this."

The significance of the decision could persuade other judges to agree to en banc review, whether or not they disagree with the majority, said Ronald J. Colombo, a professor at Hofstra University's Maurice A. Deane School of Law.

"It really puts its finger on a key ambiguity in Salman and Dirks, and for that reason and because there's a dissenting judge, and because it implicates Second Circuit precedent in Newman, I would not be surprised if en banc were granted to get to the bottom of this," Colombo said.

Because Salman didn't explicitly abrogate Newman's "meaningfully close personal relationship" requirement, other circuit judges may also feel a panel of three judges lacked authority to overturn a past circuit precedent, or that the issue was too important to be decided by a divided panel vote, Sandick added.

If en banc review is denied or doesn't go Martoma's way, experts said they expect Martoma to apply for Supreme Court review. Sandick noted that two of Martoma's lawyers have Supreme Court pedigrees — Kirkland & Ellis LLPpartner Paul D. Clement is a former solicitor general and has argued more cases before the high court than any other lawyer in private practice, while Shapiro Arato LLP partner Alexandra A.E. Shapiro argued the Salman case last October.

Whether the Supreme Court accepts the case is another question.

Colombo said he doubts the high court will be tempted until a clearer circuit split develops, but other experts gave the case higher odds.

Miller said that it's always difficult to gauge whether the Supreme Court will grant certiorari, but noted that the issues in Martoma are important ones.

And while the justices declined to consider the same issue when they denied the government's petition for certiorari in Newman, Sandick said, they may have viewed the "meaningfully close personal relationship" as not dispositive in that case, and could be tempted if the issue were more squarely presented.

"They clearly are interested in the general subject," Sandick said. "That's why they took Salman."

If the case does go through another round of review, experts said the concerns raised in the dissent are legitimate ones that could persuade judges or justices to reach a different outcome on a second look.

Judge Pooler had argued that limiting the "gift theory" to gifts of information to relatives and friends had made it unlikely that people who share information with innocent intentions could be charged with insider trading, and that the majority's opinion will expand liability.

"In holding that someone who gives a gift always receives a personal benefit from doing so, the majority strips the long-standing personal benefit rule of its limiting power," Judge Pooler wrote. "What counts as a 'gift' is vague and subjective. Juries, and, more dangerously, prosecutors, can now seize on this vagueness and subjectivity."

Colombo said it may be that few cases would fall into the "crack" in Martoma where an insider gifts information to someone who isn't a close friend or relative, but that Judge Pooler's concerns were nonetheless valid.

"I think that's a legitimate concern, because whenever you expand criminal liability or civil liability for anything, you naturally catch within that some unintended behavior," Colombo said.

Yingling also noted that the majority's holding that insiders receive a benefit for tipping whenever they expect someone to trade could conflict with the Supreme Court's previous decisions rejecting the position that trading on material nonpublic information is in and of itself always illegal.

She said Judge Pooler also raised a fair point that the panel's opinion may go beyond the language in Dirks by removing any requirement that prosecutors provide objective evidence that the information was gifted to a relative or friend.

“If you’re now taking that away and all you’re doing is showing it’s a gift to somebody, what does that mean?” Yingling asked.

The government is represented by Robert Allen, Megan Gaffney, Michael A. Levy and Margaret Garnett.

Martoma is represented by Paul D. Clement, Erin E. Murphy, Harker Rhodes and Edmund G. LaCour Jr. of Kirkland & Ellis LLP, Alexandra A.E. Shapiro, Eric S. Olney and Jeremy Licht of Shapiro Arato LLP and Charles J. Ogletree Jr.

The case is U.S. v. Mathew Martoma, case number 14-3599, in the U.S. Court of Appeals for the Second Circuit.

--Editing by Mark Lebetkin and Aaron Pelc.