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When Only The Tippee Is Guilty Of Insider Trading

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It is well understood that it is unlawful to trade on tips from someone with nonpublic, market-moving information. But what if the tip was not unlawful in the first place?

In other words, when someone receives a tip of confidential information from a source who has not engaged in insider trading, can the recipient of that information, the tippee, be guilty of insider trading?

Generally speaking, tippee liability is derivative of the claims against the tipper, so the answer should be no. However, a recent jury verdict came to a different conclusion in United States v. Klundt and Sargent in the U.S. District Court for the Northern District of Illinois in 2022.

After trial, a jury found an alleged tipper not guilty while simultaneously finding the alleged tippee guilty of insider trading. Further confusing the issue, the jury acquitted the tippee of conspiracy to commit insider trading.

In other words, the jury squarely found that the tippee committed the crime of insider trading alone. While this result seems inconsistent with basic principles of insider trading law, it finds some support in controlling authority from the U.S. Court of Appeals for the Seventh Circuit.

Background on Tippee Insider Trading

Tippee liability for insider trading — that is, liability for noninsider recipients of tips of confidential information who trade on that information — was first recognized by the U.S. Supreme Court in Dirks v. SEC in 1983.[1]

There, the court held that not all tippers and recipients of material, nonpublic information, or MNPI, face liability for subsequent trading.[2] Instead, a tippee assumes the tipper's fiduciary duty to the company, and thus is prohibited from trading, only where the tipper "has breached his fiduciary duty ... by disclosing the information to the tippee."[3]

Further, the tipper's tip is a breach of fiduciary duty only where the tipper receives a personal benefit from the disclosure.[4]

In articulating this standard, the Dirks court made clear that the liability of the tippee is derivative of the tipper:

> the test is whether the insider personally will benefit, directly or indirectly, from [the] disclosure. Absent some personal gain, there has been no breach of duty to stockholders. And absent a breach by the insider, there is no derivative breach [by the tippee.][5]

The court continued: "to determine whether the disclosure itself '[is deceptive],' ... the initial inquiry is whether there has been a breach of duty by the insider."[6]

The Klundt Case

On Jan. 10, 2022, the U.S. Attorney's Office for the Northern District of Illinois indicted two defendants — Christopher Klundt and David Sargent — for a combined seven counts centered around insider trading.[7]

Klundt and Sargent had been friends for years, and had even gone into business together investing in a company that was ultimately sold to Chegg Inc. After that company was sold, Klundt went to work for Chegg while Sargent did not.

The indictment alleged that on May 1, 2020, while working at Chegg, Klundt attended a company meeting during which MNPI about Chegg's first quarter 2020 earnings were discussed. These earnings were not scheduled to be released to the public until May 4, 2020. As is typical, Chegg had a policy against insider trading, which prohibited tipping others who might make an investment decision based on that information.

Prosecutors claimed that, after this May 1, 2020, company meeting, Klundt and Sargent spoke on the phone and thereafter Sargent — an attorney — purchased hundreds of shares and approximately 50 call options of Chegg stock. After Chegg's earnings were publicly released, Sargent sold his positions for a profit of approximately $110,000.

According to the government, after the public earnings call, Klundt texted Sargent an emoji face with dollar signs for eyes. The government also alleged that Klundt falsely responded to a Financial Industry Regulatory Authority inquiry that asked him to identify a list of persons he knew, which included Sargent. In January 2022, Klundt and Sargent were indicted.[8]

Count 1 of the indictment charged both Klundt and Sargent with conspiracy to commit insider trading in violation of Title 15 of the U.S. Code, Subsections 78(j)(b) and 78ff(a), and Rule 10b-5.

The government alleged that Klundt and Sargent "agreed to misappropriate for their own personal benefit material, non-public information" and that Klundt "received a personal benefit by providing this information to Sargent as a gift to a friend and with the intention to benefit Sargent."[9]

Counts 2-4 alleged the same basic facts and were brought for direct violations of Title 15 of the U.S. Code, Subsections 78j(b) and 78ff(a), as well as Rule 10b-5.

Counts 5-7 again included the same factual allegations and were brought under Title 18 of the U.S. Code, Section 1348(1), a securities fraud statute enacted in 2002 that prosecutors claim does not

require the same personal-benefit element required for insider trading claims under Title 15.

Notably, the indictment did not allege that Sargent breached a duty of trust and confidence to Klundt. Rather, the indictment alleged only that Klundt received a personal benefit by sharing this information with his friend, Sargent.

Put another way, there was no allegation that Sargent misappropriated the information from Klundt or otherwise induced Klundt to provide him with the inside information. The theory underlying the charges was that the two acted together to trade on insider information.

Following trial, the jury returned a rather unusual verdict. The jury acquitted Klundt completely and found Sargent not guilty of the conspiracy count. Notwithstanding these verdicts fully exonerating Klundt, the jury found Sargent guilty on all other counts of the indictment.

Following his conviction, Sargent filed a post-trial motion for a judgment of acquittal, or, in the alternative, a new trial.[10] This motion was fully briefed as of May 11, 2023.[11]

Seventh Circuit Law on Jury Verdicts for Tippers and Tippees

While the jury's verdict in Sargent appears inconsistent with the basic premise that tippee liability is derivative of the tipper's, it finds some support in the Seventh Circuit, namely, United States v. Evans, from 2007.

In Evans, Paul Gianamore, a financial analyst at an investment banking firm was alleged to have tipped his friend, Ryan Evans, who traded profitably on the tip.

At trial, the jury acquitted Gianamore — the tipper — in full, including on a conspiracy count. Evans was acquitted on the conspiracy count; however, the jury deadlocked on the substantive securities law counts and the court declared a mistrial. The government retried Evans on the deadlocked claims and succeeded — he was convicted on seven substantive securities violations.

Evans appealed his conviction arguing in part that, because the tipper was acquitted, his conviction should be reversed because collateral estoppel prevented the government from proceeding on a theory that Gianamore illegally tipped him.

The Seventh Circuit disagreed, holding that Gianamore's "acquittal did not foreclose Evan's own liability as a matter of law."[12] While the Evans decision acknowledged that "the tippee's duty to disclose or abstain is derivative from that of the insider's duty," the court, in affirming the lower court's judgment, explained:

> We do not know why the jury in the first trial was not convinced beyond a reasonable doubt that Evans and Gianamore had conspired with one another, or why it chose to acquit Gianamore on the substantive counts. The important point here is that those acquittals did not prevent a properly instructed second jury from finding both that Gianamore's tips were unlawful and that Evans, by knowingly trading on that information, violated the law.[13]

In reaching its decision, the Seventh Circuit acknowledged that "it may be the rare case where the tipper is acquitted and yet the relationship between the tipper and the tippee is such that the tippee may yet be prosecuted for acting upon the tipper's breach."[14]

The court explained that one such circumstance may be when a tippee "induces a tipper to breach her corporate duty, even if the tipper does not do so knowingly or willfully."[15]

Takeaways

While the jury's verdict finds some support in Evans, it is important to note that, unlike in Evans, the same jury in Sargent reached the seemingly inconsistent verdicts itself. Thus, unlike in Evans, it was not possible for the Sargent jury to have found "that [the tipper's] tips were unlawful."[16]

While Evans makes clear that it will be the rare case where a tipper is acquitted while a tippee is nevertheless convicted, there is nothing about Sargent that suggests that it is such a case.

The government did not charge Sargent with acting alone or inducing Klundt to reveal confidential information, nor did it evidently argue that he did. Indeed, such an argument would have been inconsistent with the government's decision to charge Sargent and Klundt with conspiracy.

The Government Advocates for an Expansion of Tippee Liability

In supporting the verdict, the government has argued that a tippee can be criminally liable even where the tipper is not. The government has put forth various theories defending the seemingly inconsistent verdicts.

For example, the government explains that "the jury could have found that the government did not meet its burden of proof as to Klundt's mental state," or more generally that the jury may have found that Klundt did not act willfully.[17]

But if the jury found that Klundt did not intend to break the law, and there was no argument, evidence or jury instruction relating to inducement, then the jury must have found that a tippee can be criminally liable based on the noncriminal tipping of information.

And in supporting this result, the government suggests that tippee liability is in fact not derivative of tipper liability. Not only is this position inconsistent with the fundamental premise of tipper and tippee liability, but it is not supported by the limited facts of Evans and represents an expansive interpretation of tippee liability.

The Importance of Jury Instructions

Critically, the jury instructions seem to not allow for the inconsistent verdicts here. Looking specifically at the instruction for insider trading, for the jury to find Sargent guilty, it had to find, beyond a reasonable doubt, that, in relevant respect:

1. A corporate insider, or tipper, obtained MNPI under a duty of trust and confidence to keep that information confidential; and

2. In violation of that duty, the insider disclosed the MNPI to a tippee, so that the tippee could trade using the information; and

3. The tipper personally benefited in some way, directly or indirectly, from the disclosure of the MNPI;

and

4. The tippee received the MNPI and knew that the information had been disclosed in violation of a duty of trust and confidence; and

5. The tippee knew that the tipper personally benefitted from the disclosure of the MNPI; and

6. The tippee used the MNPI to purchase securities using the internet.[18]

By acquitting Klundt of insider trading, the jury necessarily determined that there was not proof beyond a reasonable doubt to support elements one, two and three.

If that is what the jury determined, then per the jury instructions, the jury should not have been able to convict Sargent, given that his liability was derivative of the tipper's. But this seems to be what happened.

Even if the jury found that evidence established that Sargent received material nonpublic information, used that information to purchase securities via the internet, and benefited, the jury instructions clearly require all six elements be met beyond a reasonable doubt.

Thus, for tippees, a clear instruction indicating that the tippee cannot be liable without a finding of guilt against the tipper may help prevent such an inconsistent, and legally impossible, verdict.

Conclusion

The government's theory in Sargent was that the tipper and tippee worked together to commit insider trading, and the jury rejected that theory. The government, however, is supporting the jury's verdict on a theory it did not charge, argue or attempt to prove, one that represents an expansion of tippee insider trading liability.

Whether this result — should the convictions be upheld — is a one-off anomaly or will lead the government to aggressively pursue tippees with or without a theory of tipper culpability, remains to be seen.

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[1] Dirks v. SEC, 463 U.S. 646 (1983).

[2] Id. at 659.

[3] Id. at 660.

[4] Id. at 662.

[5] Id.

[6] Id.

[7] United States v. Klundt and Sargent, 1:22-cr-00015 (N.D. Ill. 2022), ECF No. 1 ("Indictment").

[8] See generally the Indictment.

[9] Indictment at ¶3.

[10] United States v. Klundt and Sargent, 1:22-cr-00015 (N.D. Ill. 2022), ECF No. 101.

[11] See United States v. Klundt and Sargent, 1:22-cr-00015 (N.D. Ill. 2022), ECF No. 108.

[12] United States v. Evans, 486 F.3d 315, 319 (7th Cir. 2007).

[13] Id. at 322.

[14] Id. at 324.

[15] Id. at 323-24.

[16] Evans, 486 F.3d at 322.

[17] See United States v. Klundt and Sargent, 1:22-cr-00015 (N.D. Ill. 2022), ECF No. 105, at 41-42.

[18] See United States v. Klundt and Sargent, 1:22-cr-00015 (N.D. Ill. 2022), ECF No. 80 ("Jury Instructions"), at 24.