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Watch the Napkin: First Circuit Affirms Insider-Trading Conviction

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In what appears to be the first appellate decision since the Supreme Court's December 2016 ruling in *Salman v. United States*, the U.S. Court of Appeals for the First Circuit affirmed an insider-trading conviction based on a tip of material, nonpublic information. The February 24, 2017 decision in *United States v. Bray* held that the jury had sufficient evidence to conclude that, in soliciting and receiving a trading tip surreptitiously written on a pub-room napkin, the tippee had known that the tipper had provided the information in breach of his duty of confidentiality and in expectation of a personal benefit.

However, the court also made clear that a tippee cannot be criminally convicted for insider trading if he merely "should have known" of the tipper's breach of duty. The court further held that a "willful blindness" or "conscious avoidance" standard cannot be based on mere negligence (at least in a criminal case).

Factual Background

The *Bray* case arose out of the relationship between a bank executive (the tipper) and a contractor and real-estate developer (the tippee). The two were members of the same country club and had known each other for 15 years. They often socialized together at the club and elsewhere. The tippee knew the tipper's family and had taken "a particular liking" and provided gifts to the tipper's son. The tipper used some of the tippee's business associates to refurbish his house, and the tippee regularly asked the tipper for trading advice about bank stocks. The tipper routinely answered those questions by providing advice based solely on public information.

However, on one occasion, the tippee told the tipper that he (the tippee) needed to make a "big score" to finance a real-estate project, and he asked the tipper for any "bank stock tips." The tipper again provided some public information, but he also wrote the name of a local bank on a napkin and gave it to the tippee, saying "'[t]his could be a good one,' or at least 'something to that effect.'"

The tipper knew about the local bank because his employer had told him to do due diligence on it as a potential acquisition target, and he had signed an agreement requiring him to keep confidential any nonpublic information he learned. The tipper did not "explicitly" tell the tippee about the confidentiality agreement or the source of his tip. The tippee later offered the tipper a free stake in the

real-estate project that he had hoped to finance through the “big score.”

The tippee placed large trades in the local bank’s stock, which was thinly traded – and which his broker tried to convince him not to buy in such substantial amounts. Approximately two weeks later, the tipper’s employer announced an agreement to buy the local bank at almost double the previous day’s closing stock price.

The Government prosecuted the tippee under the misappropriation theory of insider trading, which posits that individuals (such as the tipper) who are “entrusted with confidential information about a corporation cannot secretly us[e] such information for their personal advantage even when they do not owe any direct fiduciary duty to [the issuer] or its shareholders.” The tippee’s liability is derivative of the tipper’s. Tippee liability “hinges on whether the tipper breached a duty of trust and confidence by disclosing the inside information, which in turn depends on whether the tipper personally will benefit, directly or indirectly, from [the] disclosure.” The tippee inherits the tipper’s duty “if the tippee knows the information was disclosed in breach of the tipper’s duty.”

The jury convicted the tippee of insider trading, and the First Circuit affirmed the conviction, rejecting the tippee’s challenges to the sufficiency of the evidence and holding that the jury instructions – although erroneous in certain respects – had not constituted “plain error.”

First Circuit’s Decision

Sufficiency of the Evidence

The court first held that, based on the evidence at trial, the jury could have concluded that the tipper had given the inside information to the tippee with the purpose of obtaining a personal benefit. Under the Supreme Court’s decisions in *Dirks v. SEC* and *Salman v. United States*, the personal-benefit element requires the court to “focus on objective criteria, *i.e.*, whether the insider receives a direct or indirect personal benefit from the disclosure, such as a pecuniary gain or a reputational benefit that will translate into future earnings.” But “a personal benefit can often be inferred where a relationship between the [tipper] and the recipient . . . suggests a *quid pro quo* from the latter, or an intention to benefit the particular recipient. . . . A personal benefit can likewise be inferred where a tipper makes a gift of inside information to a trading relative or friend.”

In this case, the evidence “showed that it is at least ‘plausible’ that [the tipper] and [the tippee] had a close relationship.” Moreover, the tipper had testified that, in giving the tip, he had “‘figured [the tip] would enhance’ his reputation with [the tippee].” A reasonable jury could therefore have inferred that the tipper had “expected a benefit down the road” – and he in fact received one, when the tippee later offered him a free stake in the real-estate project.

The court further concluded that a reasonable jury could have found that the tippee had known that the tipper had tipped him in expectation of a personal benefit. The pair’s “close relationship” could have led the jury to infer that the tipper had intended to benefit the tippee, and the tippee’s two offers of a free stake in the real-estate project could have bolstered that conclusion. A reasonable jury could also have concluded that the tippee had known of the tipper’s breach of his duty of confidentiality: the tippee had known “what the tipper did for a living” and had been aware that the tipper had surreptitiously provided the inside information in response to the tippee’s request for “a ‘tip’ on which he could make a ‘big score.’”

Jury Instructions

The tippee fared somewhat better with his challenges to the jury instructions.

First, the appellate court held that the District Court had "clearly erred" by instructing the jury that it could convict the tippee if it found that he "'knew or . . . should have known' that [the tipper] had breached a duty of confidentiality by giving him the [bank] tip." A "should have known" standard – which can be negligence-based – is inconsistent with the state of mind required for criminal liability.

Second, the First Circuit found clear error in the jury instruction equating "willful blindness" with negligence. The willful-blindness standard allows imposition of criminal liability "on people who, recognizing the likelihood of wrongdoing, nonetheless consciously refuse to take basic investigatory steps." A negligence standard is inconsistent with a requirement of conscious and deliberate avoidance of knowledge.

However, the First Circuit ultimately affirmed the conviction despite the erroneous jury instructions because the tippee had not objected to them at trial and was unable to prevail under the rigorous "plain error" standard of appellate review.

What the Court Did *Not* Decide

The *Bray* decision flagged several potentially important issues that the court did *not* resolve – and that will undoubtedly continue to arise in insider-trading cases.

First, the First Circuit did not decide whether the personal-benefit requirement – which was developed in classical-theory insider-trading cases (involving breaches of duty by the issuer's insiders) – also applies to misappropriation-theory cases such as this one. The court saw no need to resolve the issue because the record contained evidence that the tipper-misappropriator had expected a personal benefit in exchange for disclosing material, nonpublic information.

Second, the First Circuit did not decide whether a personal benefit can be inferred in the absence of a *quid pro quo* or some other objective, consequential exchange if the tipper and the tippee did *not* share a "meaningfully close personal relationship." The Supreme Court's *Salman* decision had not addressed that issue because the tipper and the initial tippee in that case were brothers. The First Circuit saw no need to decide that question, either, because "the record's evidence of [the tipper's] and [the tippee's] friendship, coupled with [the tipper's] testimony that the tip might lead to certain future benefits, provided a sufficient basis for a reasonable jury to conclude that [the tipper] had acted in expectation of a personal benefit." This issue – the interconnection (if any) between the nature of the tipper's and the tippee's personal relationship and the tangibility of the tipper's personal benefit – will likely remain a battleground in insider-trading cases.

Third, the First Circuit did not decide whether a tippee must actually *know* (at least in a criminal case) that the tipper disclosed confidential information in exchange for a personal benefit, or whether some lesser degree of awareness might suffice. The Supreme Court had expressly declined to address that issue in *Salman*, and the parties in *Bray* had assumed that a knowledge standard applied. The First Circuit found the issue to be "of no consequence" because the jury could reasonably have concluded that the tippee had possessed the requisite knowledge even under the most stringent standard.

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