ATTORNEY PROFESSIONALISM FORUM

To the Forum:

I am an associate in the M&A group at an Am Law 100 firm. After a deal my team and I had been working on for months closed, a few of the associates and I decided to go out to a bar to celebrate. "Work hard, play hard," as they say in big law. Because I had been so tied up on this deal and had not had much time out of the office to socialize, I decided to invite a few of my non-lawyer friends out to the bar to meet us.

It only took a few drinks in before the lawyers and non-lawyers alike in our group were all having a great time. Just before 2 a.m., as I was getting ready to leave, I overheard an associate sitting next to me talking to one of my non-lawyer friends. The associate was slurring his words and sounded like he had a few too many drinks. What I overheard was alarming – the associate was talking to my non-lawyer friend about a major and highly confidential M&A deal that the firm was currently engaged in. I was tired and ready to call it a night, so I decided not to interrupt the conversation and I grabbed my coat and left. I didn't think much more about the incident.

Two weeks later, I met up with my non-lawyer friend for lunch. During our lunch, he casually mentioned to me that after the conversation he had two weeks ago with the associate at the bar, he had decided to invest in the stock of the company being purchased in the major deal the associate in my group had told him about.

Now I'm starting to worry about the serious implications of this bar night! Should I report the associate in my group, and if so, to whom? Does the firm, the associate or my non-lawyer friend have potential liability for insider trading? What policies should my law firm have in place regarding divulging such insider information?

Sincerely,

N. O. Insider

Dear N.O. Insider:

The answer to your question requires several levels of analysis. Based on your description of your night at the bar, both your non-lawyer friend and the associate in your group may have violated the laws prohibiting insider trading; the rules governing attorneys' professional conduct also may have been violated. "Insider trading" refers to the purchase or sale of a security while in possession of improperly obtained material, nonpublic information about a company whose shares are traded. The term "tipping" refers to the improper disclosure of material non-public information to another person or entity that trades in the security. The anti-fraud provisions of the federal securities laws and SEC regulations promulgated thereunder are the provisions which govern insider trading. *Recent Developments in Insider Trading*, 41 The Lawyer's Brief, Oct. 15, 2011.

Except in the limited case of trading on information concerning tender offers, an essential element of such liability is that the parties engage in fraud. Courts have held that the tipping of inside information must involve a breach of fiduciary duty. In the context of insider trading, the elements of such a breach are: (a) a duty not to disclose the information; (b) knowledge, or acting in reckless disregard that the tippee will trade on the information; and (c) receipt of a benefit in exchange for such disclosure. *See U.S. v. Newman*, 773 F.3d 438 (2d Cir. 2014); *S.E.C. v. Obus*, 693 F.3d 276 (2d Cir. 2012). Clearly, the associate-tipper was under an obligation not to disclose the information about the deal. The associate's liability also depends on whether the associate knew or acted in reckless disregard that your non-lawyer friend would use the information to trade in securities.

The associate's liability also requires a showing that the associate received a "benefit" by making the tip, since that is an element of breach of fiduciary duty. What constitutes a "benefit" is an issue that is currently before the U.S. Supreme Court in *U.S. v. Salmon*, 792 F.3d 1087 (9th Cir. 2015). The Ninth Circuit's opinion in *Salmon* has been viewed as marking a split with the Second Circuit's decision in *U.S. v. Newman*, 773 F.3d 438 (2d Cir. 2014).

In *Newman*, the Second Circuit stated that the tipper must stand to benefit from transmitting the insider information to the tippee in order for a jury to conclude that the tipper has breached his fiduciary duty, and the tippee must have actual knowledge that the tipper received such a benefit and that the information they have received is confidential insider information. *Id*. at 452. The Court expressed the view that the benefit must be more concrete than just a relationship of casual friends, and must involve actual or potential pecuniary gain or something similarly valuable in nature. *Id*.

In *Salmon*, the Court took a very different track and focused on the close familial relationship between the parties. The defendant was trading on information he received from a friend, who in turn received information from his brother, a trader at Citigroup. The trader brother testified at trial that he

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did not receive any "benefit" in return for providing his brother with the inside information, and only did it out of brotherly love. The Ninth Circuit (in an opinion written by Judge Rakoff sitting by designation) held that the familial ties between the tipper and the tippee made it unnecessary to show the tipper received a tangible benefit, inferring that a benefit can be assumed based on the familial relationship. But now that *Salmon* is before the Supreme Court that may not be the end of the story. Hopefully, the Court will clarify how the "benefit" standard should be interpreted.

In the situation that you describe, the associate was likely acting with knowledge, or at the least, acting in reckless disregard that the non-lawyer friend would trade on the inside information he revealed. The associate was discussing the details of a non-public merger and had to know that he was revealing client confidences in the process. We think that he should have known that he was taking a high risk that the non-lawyer friend might trade on the information being revealed to him. With respect to the benefit requirement articulated in *Newman* and *Salmon,* however, it is not clear that the associate received a "benefit." Maybe it is possible that the associate was in the spirit of the moment simply talking about the deal to show off in front of friends. It is uncertain whether he received any kind of pecuniary benefit.

But assuming that there was some kind of benefit, then your non-lawyer friend (the "tippee") could also face insider trading liability, especially if it can be shown that the friend knew or should have known that the disclosure by the associate constituted a breach of a duty. Several years ago, the Second Circuit issued a decision that gives us some guidance on the requirements of scienter as they apply to tipper and tippee liability in a civil case brought by the SEC. In *S.E.C. v. Obus*, 693 F.3d 276 (2d Cir. 2012), the Second Circuit considered an appeal of a dismissal of insider trading claims following a grant of summary judgment by the District Court. In reversing the dismissal, the Second Circuit had to reconcile two apparently inconsistent definitions of scienter, both articulated by the Supreme Court: *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193, n.12 (1976), where the Court defined scienter as "a mental state embracing intent to deceive, manipulate, or defraud" and *Dirks v. S.E.C.*, 463 U.S. 646, 660 (1983), where the Court indicated that scienter could be satisfied by establishing not only what a tippee actually knew, but also what he "should have known." Attempting to reconcile the two cases, in *Obus*, the Second Circuit held that a tippee need not have actual knowledge of (or be reckless with respect to) the existence of the tipper's duty, the breach of that duty, or the confidentiality of the information. Rather, the SEC now need only show that a tippee knew or should have known of these things, allowing courts to impose liability for something closer to negligence. However, we note that the level and standard of knowledge by the tippee for liability is different between a criminal case and an SEC case, with the standard in a criminal case being higher. *United States v. Whitman*, 904 F. Supp. 2d 363, 365, 2012 WL 5505080, at *1 (S.D.N.Y. Nov. 19, 2012).

Looking at the non-lawyer friend's conduct, he would probably satisfy the scienter requirements articulated in *Obus* because at the time he received the insider information, he knew or should have known that the associate had a duty of confidentiality that he was breaching by sharing details of the M&A deal.

Turning now to the associate in your group, in addition to being possibly guilty of insider trading and facing liability under the federal securities laws, the associate may have also violated the New York Rules of Professional Conduct (NYRPC) and could face disciplinary action. It is important to note that a lawyer who engages in insider trading breaches two basic elements of the attorney-client relationship – attorney loyalty and confidentiality. A violation of either of these duties raises issues about a lawyer's fitness to practice. *See* Kathryn W. Tate, *The Boundaries of Professional Self-Policing: Must a Law Firm Prevent and Report a Firm Member's Securities Trading on the Basis of Client Confidences?*, 40 U. Kan. L. Rev. 807, 837 (1992).

Generally speaking, violations of state corporate securities acts, blue sky laws, or federal securities laws and regulations, are grounds for disciplinary action against an attorney. J.P. Ludington, Annotation, *Violation of securities regulations as ground of disciplinary action against attorney*, 18 A.L.R.3d 1408 (1968). In a recent case, *In re Kluger*, 102 A.D.3d 168, 169 (1st Dep't 2013), an attorney was automatically disbarred on the ground that he was convicted of a crime which would be a felony if committed in New York. Respondent Matthew Kluger pleaded guilty to conspiracy to commit securities fraud and other crimes for participating in an insider trading scheme in which he stole confidential nonpublic information related to approximately 30 corporate mergers and acquisition transactions being handled by the law firms that employed him. The First Department held that because Kluger's criminal offenses would be felonies if charged under New York law, they were a proper predicate for automatic disbarment. *Id*. at 170.

Insider trading is a violation of Rule 1.6 of the NYRPC, which provides: "A lawyer shall not knowingly reveal confidential information, as defined in this Rule, or use such information to the disadvantage of a client or for the advantage of the lawyer or a third person. . . ." In addition to violating client confidences, insider trading is also illegal conduct, and therefore, it is a violation of Rule 8.4, Misconduct, which provides that a lawyer or law firm shall not "(b) engage in illegal conduct that adversely reflects on the lawyer's honesty, trustworthiness or fitness as a lawyer; (c) engage in conduct involving dishonesty, fraud, deceit or misrepresentation."

The next question is whether the law firm has potential liability. Rule

5.1, Responsibilities of Law Firms, Partners, Managers and Supervisory Lawyers, holds, in relevant part, that "(a) A law firm shall make reasonable efforts to ensure that all lawyers in the firm conform to these Rules. (b) (1) A lawyer with management responsibility in a law firm shall make reasonable efforts to ensure that other lawyers in the law firm conform to these Rules."

When it comes to liability for insider trading, if the law firm has procedures in place that are reasonably designed to prevent insider trading, then the firm has a defense to liability. Jonathan Eisenberg, *Protecting Against Insider Trading Liability*, 22 Securities & Commodities Regulation 87, 87 (1989). In fact, the SEC has promulgated a regulation which creates an affirmative defense to insider trading if the person or company has "implemented reasonable policies and procedures, taking into consideration the nature of the person's business, to ensure that individuals making investment decisions would not violate the laws prohibiting trading on the basis of material nonpublic information." 17 C.F.R. § 240.10b5-1.

The goals of insider trading preventative policies are twofold – to both make it less likely that insider trading will occur and also, if it does occur, to provide the law firm employer with a defense to derivative liability. Daniel L. Goelzer, et al., *Insider Trading and Section 16 Compliance Procedures for Corporations and Law Firms*, The American Law Institute, May 2, 1991, at 130. There is no one catch-all policy or procedure that every law firm should follow. Law firm managers should tailor policies to fit the unique circumstances of his or her respective firm. For example, a firm that regularly handles mergers and acquisitions involving exchange-traded securities should have more extensive policies than a matrimonial firm. *Id.* at 147. Depending on the nature and extent of a law firm's practice involving publicly traded securities, some specific policies to consider are: (1) prohibiting trading in client securities about which the firm has inside information, (2) prohibiting all trading in client securities, (3) prohibiting all equity trading, (4) applying policies to non-client securities, (5) maintaining restricted lists that law firm personnel are required to consult before engaging in trading, (6) circulating periodic reminders to all firm employees about the laws against insider trading and the duty not to disclose confidential information, and (7) circulating carefully worded new matter/new client information around the firm in order to avoid disclosure of material inside information about clients and other corporations. *Id*. at 148–49. Such policies should be designed to prevent trading not only in securities of the law firm's clients, but also of the companies which the law firm does not represent but are involved in the subject transactions. A law firm that does not have internal policies and procedures in place to prevent insider trading can face enormous consequences – including negative publicity, professional embarrassment, and permanent damage to a firm's reputation as a repository for client confidences, as well as disciplinary action against individual attorneys. *Id*. at 146.

Finally, let us talk about you. First, it is important to point out that Rule 5.1(d), Responsibilities of Law Firms, Partners, Managers and Supervisory Lawyer, holds that: "A lawyer shall be responsible for a violation of these Rules by another lawyer if: (1) the lawyer orders or directs the specific conduct or, with knowledge of the specific conduct, ratifies it; or (2) the lawyer is a partner in a law firm or is a lawyer who individually or together with other lawyers possesses comparable managerial responsibility in a law firm in which the other lawyer practices or is a lawyer who has supervisory authority over the other lawyer. . . ."

We do not believe that this rule applies to you since you are not in a supervisory position and have not ratified or sanctioned the other associate's behavior. If we were in your shoes, we would want to confront our fellow associate about the bar night. But the real question is – should you do more? Rule 8.3, Reporting Professional Misconduct, tells us that "(a) A lawyer who knows that another lawyer has committed a violation of the Rules of Professional Conduct that raises a substantial question as to that lawyer's honesty, trustworthiness or fitness as a lawyer shall report such knowledge to a tribunal or other authority empowered to investigate or act upon such violation." However, an attorney should use professional judgment and discretion when determining whether and how to report a colleague. Specifically, an attorney should evaluate whether there is sufficient knowledge as to fraudulent conduct that triggers a reporting obligation. Moreover, if an attorney merely has a suspicion of a violation of the Rules of Professional Conduct, then reporting is optional. *See Threatening Disciplinary Action Against Attorneys in New York*, 1 NYSBA NYLitigator 47, 48 (Spring 2016) (discussing Nassau Cnty. Bar Ass'n Ethics Op. 1998-12 (1998)). As stated in one source, "[a]cts involving fraud, deception, misrepresentation, or lack of trust (e.g., lying, backdating documents, creating false evidence, stealing from an attorney trust account) should always trigger a reporting obligation." Roy D. Simon, Simon's New York Rules of Professional Conduct Annotated 1913 (2016). Although some may see this as a close question, from the facts that you have described, we do not believe that your fellow associate's behavior creates an obligation on your part to report him.

Sincerely,

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