
RECENT CASES

CRIMINAL LAW — INSIDER TRADING — SECOND CIRCUIT REDEFINES PERSONAL BENEFIT REQUIREMENT FOR INSIDER TRADING. — *United States v. Martoma*, 894 F.3d 64 (2d Cir. 2018).

Stare decisis, a bedrock principle of the American legal system, is sometimes ignored. Stealth overrulings, where judges “disingenuous[ly] . . . depriv[e] precedents of their force” by “fail[ing] to extend a precedent to its logical conclusion,”¹ are seemingly a major problem for rule of law principles like notice, predictability, and legal legitimacy. Recently, in an amended opinion in *United States v. Martoma*² (*Martoma II*), the Second Circuit reinterpreted its precedent on the personal benefit element of insider trading, finding the element can be satisfied by proof of either a quid pro quo relationship or an insider’s intention to benefit a recipient of inside information.³ Although *Martoma II* did not explicitly overrule the circuit’s holding in *United States v. Newman*,⁴ the prior controlling decision on the personal benefit element, it circumscribed that holding to the point of stealth overruling it. *Newman*, however, was also a stealth overruling. Given the challenges of explicitly overruling wrongly decided circuit precedent, *Martoma II* may be proof that stealth overruling is the best outcome in some cases.

Mathew Martoma, a hedge fund portfolio manager, traded in two pharmaceutical companies that were developing an experimental drug.⁵ To learn about the drug, Martoma arranged paid consultations with experts, including Sidney Gilman, a doctor on the drug’s clinical trial team.⁶ In violation of his contractual requirement to keep clinical trial information secret, Gilman presented data regarding weaknesses in the drug’s performance to Martoma ten days before presenting that data to the public.⁷ The next trading day, Martoma’s hedge fund reduced its position in the companies’ stock and sold their stock short, resulting in “\$80.3 million in gains and \$194.6 million in averted losses” once the data became public.⁸ Martoma was charged with one count of conspiracy to commit securities fraud and two counts of securities fraud.⁹

¹ Barry Friedman, *The Wages of Stealth Overruling (With Particular Attention to Miranda v. Arizona)*, 99 GEO. L.J. 1, 9 (2010).

² 894 F.3d 64 (2d Cir. 2018).

³ *Id.* at 76.

⁴ 773 F.3d 438 (2d Cir. 2014).

⁵ *Martoma II*, 894 F.3d at 68–69.

⁶ *Id.* at 69 (detailing their \$1000-per-hour arrangement).

⁷ *Id.* at 69–70. Gilman did not bill for that specific consultation. *See id.* at 78.

⁸ *Id.* at 70.

⁹ Indictment at 1–11, *United States v. Martoma*, No. 12-cr-973 (S.D.N.Y. Jan. 9, 2014), ECF No. 7.

The relationship between the tippee (a person who trades on material nonpublic information obtained from a corporate insider) and the tipper (a corporate insider who supplies such information) is often paramount in insider trading cases. In *Dirks v. SEC*,¹⁰ the Supreme Court held that a tippee commits insider trading only if (1) the tipper breached a fiduciary duty to the corporation's shareholders by making the disclosure, and (2) the tippee knew or should have known of that breach.¹¹ To prove a breach, the government must show that the tipper "personally . . . benefit[ed], directly or indirectly, from [the] disclosure."¹² *Dirks* provided sets of facts that could allow for an inference of personal benefit: in addition to "a gift of confidential information to a trading relative or friend," *Dirks* identified "a relationship between the insider and the recipient that suggests a *quid pro quo* from the latter, or an intention to benefit the particular recipient."¹³ The *Martoma* trial court instructed the jury assuming that any one of these separate examples would be sufficient to establish personal benefit.¹⁴ The jury convicted Martoma and he appealed.¹⁵

While the appeal was pending, a pair of intervening cases changed the doctrinal landscape. First, the Second Circuit in *Newman* reanalyzed the gift theory of personal benefit — *Dirks*'s example of gifting insider information to a trading relative or friend¹⁶ — ruling that a tip and trade resembles a gift, and therefore a personal benefit, only where there is "proof of a meaningfully close personal relationship that generates an exchange that . . . represents at least a potential gain of a pecuniary or similarly valuable nature" to the tipper.¹⁷ In response, the Supreme Court in *Salman v. United States*¹⁸ overruled *Newman*'s pecuniary-gain requirement, holding it "inconsistent with *Dirks*."¹⁹ Notably, *Salman* did not expressly overrule *Newman*'s meaningfully-close-personal-relationship gloss on the personal benefit test. Given *Newman*, Martoma argued that his jury instructions were flawed because they did not convey *Newman*'s limitations on insider trading liability's scope.²⁰

In an initial opinion, the Second Circuit affirmed the conviction. Writing for the majority, Chief Judge Katzmann²¹ interpreted *Dirks* as

¹⁰ 463 U.S. 646 (1983).

¹¹ *Id.* at 660.

¹² *Id.* at 662.

¹³ *Id.* at 664.

¹⁴ See *Martoma II*, 894 F.3d at 70.

¹⁵ *Id.*

¹⁶ *United States v. Newman*, 773 F.3d 438, 452 (2d Cir. 2014) (citing *Dirks*, 463 U.S. at 664).

¹⁷ *Id.*

¹⁸ 137 S. Ct. 420 (2016).

¹⁹ *Id.* at 428.

²⁰ *United States v. Martoma (Martoma I)*, 869 F.3d 58, 65 (2d Cir. 2017).

²¹ Chief Judge Katzmann was joined by Judge Chin.

holding that the gift theory was just one answer to the personal benefit element's overarching inquiry: "whether the insider personally will benefit, directly or indirectly, from his disclosure."²² The court thus implied that *Newman* incorrectly interpreted *Dirks* as having established an exhaustive list of examples for when an inference of personal benefit can be made.²³ The majority recognized that any tension between *Newman* and *Dirks* did not justify overruling *Newman* without en banc review unless an intervening Supreme Court case undermined *Newman*.²⁴ The panel held that *Salman* did just that because it undermined the rationale of the meaningfully-close-personal-relationship test.²⁵ It offered an example of how the *Salman* test could be met in the absence of such a relationship: if a corporate insider gives a doorman information as a year-end tip, the insider has benefited even without a meaningfully close personal relationship.²⁶ In the majority's view, therefore, *Salman* overruled *Newman*'s meaningfully-close-personal-relationship requirement.

Judge Pooler dissented. She argued that the majority's rule left "gift" as a vague term, undermining the objectivity the personal benefit rule was supposed to supply.²⁷ Moreover, Judge Pooler rejected the majority's reading of *Salman* and *Dirks*. Why, she asked, would the *Salman* Court repeatedly refer to gifts to "trading relative[s] or friend[s]"²⁸ if it did not mean to limit the gift theory to a narrower group than all possible tippees?²⁹ Even if tension did exist between the *Dirks* Court's logic and the *Newman* panel's reasoning, that tension existed even before *Salman*: "Nothing in *Salman* breaks new ground on the point . . . [and] we should [not] reverse *Newman*'s decision without a hearing en banc."³⁰ Because *Newman* remained good law, the dissent argued, the jury charge was inadequate for not incorporating *Newman*.³¹

Martoma petitioned for en banc review.³² In June 2018, before any ruling on that petition, Chief Judge Katzmann issued an amended opinion.³³ *Martoma II* reinterpreted *Newman* instead of overruling it. The *Dirks* Court listed as indicators of a personal benefit the gift theory and "a relationship between the insider and the recipient that suggests a *quid*

²² *Martoma I*, 869 F.3d at 68 (quoting *Dirks v. SEC*, 463 U.S. 646, 662 (1983)).

²³ *Id.*

²⁴ *Id.*

²⁵ *Id.* at 69.

²⁶ *Id.* at 70 (using a very New York City example).

²⁷ See *id.* at 75–82 (Pooler, J., dissenting) ("Without the personal benefit rule, many insider-trading cases would require the government to show few objective facts." *Id.* at 76.).

²⁸ *Id.* at 83 (emphasis omitted) (quoting *Salman v. United States*, 137 S. Ct. 420, 428 (2018)).

²⁹ *Id.* at 83–84.

³⁰ *Id.* at 86.

³¹ *Id.* at 89.

³² Petition for Rehearing or Rehearing En Banc for Defendant-Appellant, *Martoma II*, 894 F.3d 64 (No. 14-3599).

³³ *Martoma II*, 894 F.3d at 64.

pro quo from the latter, or an intention to benefit the [tippee].”³⁴ The *Martoma II* majority held that the comma between “latter” and “or” suggested the phrases were separate, sufficient examples of situations proving a personal benefit.³⁵ Thus, *Martoma II* interpreted *Dirks* as allowing the government to prove a personal benefit through a gift, a relationship that suggests a quid pro quo, or an intention to benefit.³⁶

Martoma II further held that the government need not show a meaningfully close personal relationship when proving a personal benefit through an intention to benefit or a relationship suggesting a quid pro quo. Although the *Newman* court had applied the meaningfully-close-personal-relationship requirement to the gift theory, it had no power to overrule the Supreme Court’s decision in *Dirks*. Thus, *Dirks*’s relationship-suggesting-a-quid-pro-quo and intention-to-benefit theories were “unaffected by *Newman*’s interpretation of the gift theory.”³⁷ In addition to limiting the application of the meaningfully-close-personal-relationship test, *Martoma II* dictated how to apply it. *Newman* explained the test as follows: “In other words, as Judge Walker noted in [*United States v.*] *Jiau*,³⁸ this requires evidence of ‘a relationship between the insider and the recipient that suggests a *quid pro quo* from the latter, or an intention to benefit the [latter].”³⁹ Chief Judge Katzmann read this clause as “cabin[ing] the gift theory”;⁴⁰ proof of either scenario establishes a meaningfully close personal relationship.

Judge Pooler again dissented. She argued that the majority undermined the personal benefit element’s objective standard by allowing a jury to find a personal benefit whenever it finds that the tipper intended to benefit the tippee⁴¹ — an allowance that contradicts *Newman*’s holding.⁴² Although the majority no longer explicitly overruled *Newman*, its “undercut[ting]” of *Newman*’s test “[was] in derogation of circuit precedent” and “render[ed] *Newman* a relic.”⁴³

According to the dissent, then, *Martoma II* stealth overruled *Newman*.⁴⁴ But *Martoma II* represents a unique category of cases. Although *Martoma II* stealth overruled *Newman*, *Newman* had itself

³⁴ *Dirks v. SEC*, 463 U.S. 646, 664 (1983).

³⁵ *Martoma II*, 894 F.3d at 74 (citing *SEC v. Warde*, 151 F.3d 42, 48 (2d Cir. 1998)).

³⁶ *Id.* at 76.

³⁷ *Id.* at 78.

³⁸ 734 F.3d 147 (2d Cir. 2013).

³⁹ *United States v. Newman*, 773 F.3d 438, 452 (2d Cir. 2014) (quoting *Jiau*, 734 F.3d at 153 (second alteration in original)).

⁴⁰ *Martoma II*, 894 F.3d at 77.

⁴¹ *Id.* at 83–84 (Pooler, J., dissenting).

⁴² *Id.* at 80.

⁴³ *Id.*

⁴⁴ Friedman, *supra* note 1, at 9 (explaining the difference between explicit overruling and stealth overruling).

stealth overruled *Jiau* and other circuit precedent. Any stealth overruling is a seemingly major problem for rule of law principles like notice, predictability, and legal legitimacy.⁴⁵ Derogation of these principles is an especially potent threat in a quasi-common law area like insider trading, which attaches to statutory language only minimally. The *Martoma II* court, however, had limited options to respond to *Newman*'s stealth overruling: following the stealth overruling could itself undermine the rule of law, and en banc review was empirically unlikely. Given these alternatives, *Martoma II*'s choice to stealth overrule a stealth overruling may have been the best option. This case raises a question: Going forward, how can we identify good stealth overrulings?

Judge Pooler is correct: *Martoma II* stealth overruled *Newman*. It is hard to read *Martoma II* as upholding *Newman* when, in *Martoma I*, the same panel reached the same outcome with an express overruling. The *Martoma I* panel recognized that *Newman* effected a real change on the insider trading landscape by limiting permissible inferences of personal benefit,⁴⁶ and commentators agreed.⁴⁷ *Martoma II*'s treatment of the meaningfully-close-personal-relationship test negated *Newman*'s substantive effect: if any intention to benefit proves a meaningfully close personal relationship, *Newman*'s test limits almost nothing.⁴⁸ Because *Newman* would not have introduced a new limit just for that limit to become meaningless, *Martoma II* violated *Newman*'s spirit.

While ignoring *Newman*'s change makes *Martoma II* a stealth overruling, creating that change in the first place makes *Newman* one. Before *Newman*, the Second Circuit did not require any heightened level of relationship to apply the gift theory.⁴⁹ The new requirement derogated Second Circuit precedent, including *Jiau*, that had defined personal benefit "broadly."⁵⁰ Practitioners⁵¹ and academics⁵² saw *Newman*

⁴⁵ See generally Richard H. Fallon, Jr., "The Rule of Law" as a Concept in Constitutional Discourse, 97 COLUM. L. REV. 1, 48–53, 56 (1997).

⁴⁶ *Martoma I*, 869 F.3d 58, 68 (2d Cir. 2017).

⁴⁷ See, e.g., William K.S. Wang, *Application of the Federal Mail and Wire Fraud Statutes to Criminal Liability for Stock Market Insider Trading and Tipping*, 70 U. MIAMI L. REV. 220, 290 (2015); Antonia M. Apps, "U.S. v. Martoma": The End of the "Newman" Personal Benefit Test, N.Y. L.J., Aug. 31, 2017, at 4, 4 (noting *Newman*'s "additional hurdle").

⁴⁸ See United States v. Pinto-Thomaz, No. 18-CR-579, 2018 WL 6378118, at *4 (S.D.N.Y. Dec. 6, 2018) ("What remains of *Newman* [after *Martoma II*] applies in only the rarest of cases.").

⁴⁹ See Apps, *supra* note 47, at 4 & 7 n.1; Robert Hoff et al., *The Gift of "Newman"*, N.Y. L.J., Feb. 9, 2015, at S6, S6–S7; see also, e.g., SEC v. Obus, 693 F.3d 276, 291 (2d Cir. 2012) (sending a case to the jury under the gift theory where the tipper and tippee "were friends from college").

⁵⁰ See, e.g., United States v. Jiau, 734 F.3d 147, 153 (2d Cir. 2013) (quoting *Obus*, 693 F.3d at 285). *Newman* admitted the precedent but did not grapple with it. See United States v. Newman, 773 F.3d 438, 452 (2d Cir. 2014). *Martoma II*'s dissent did not mention it.

⁵¹ See, e.g., Ed Beeson, *SEC's White Calls 2nd Circ. Insider Ruling "Overly Narrow"*, LAW360 (Dec. 11, 2014), <https://www.law360.com/whitecollar/articles/603894/sec-s-white-calls-2nd-circ-insider-ruling-overly-narrow> [<https://perma.cc/L55D-PGEH>]; see also Hoff et al., *supra* note 49, at S6.

⁵² See, e.g., Wang, *supra* note 47, at 286, 290.

as a strict new limitation on insider trading prosecutions. *Newman*'s narrowing was extreme enough to elicit the introduction of three congressional bills attempting to return the law to its previously broad scope.⁵³ Though the court could have slightly narrowed the definition of personal benefit while keeping it generally broad, *Newman* failed to strike that balance. Moreover, in order to seem like it followed precedent, *Newman* mischaracterized *Jiau*. *Newman* stated that proof of a meaningfully close personal relationship "requires" a quid pro quo or an intention to benefit under *Jiau*;⁵⁴ *Jiau* stated that either situation "may be sufficient to justify an inference of personal benefit" on its own.⁵⁵

In general, stealth overruling is a problem for rule of law principles such as notice, predictability, and legitimacy. Stare decisis allows for advance notice for the public, who cannot understand the law well if it does not know what the law is.⁵⁶ When advance notice is too degraded, a criminal prohibition could violate defendants' constitutional right to "know in advance the law to which they are subject."⁵⁷ Moreover, if a person tries her best to respect the law but ends up breaking it because a court's interpretation changes, confidence in the legal system could be shaken.⁵⁸

The uncertainty caused by ignoring precedent is especially severe for insider trading. Insider trading is quasi-common law, arising from a vague statutory prohibition on "any manipulative or deceptive device or contrivance,"⁵⁹ with its contours filled in by the courts. For example, the personal benefit element that *Salman*, *Newman*, *Martoma I*, and *Martoma II* sparred over was created not by Congress but by the Supreme Court in *Dirks*.⁶⁰ Without strong statutory language to bind them, judges are more likely to make decisions according to their own predilections,⁶¹ reducing predictability. The bind of precedent can help

⁵³ H.R. 1625, 114th Cong. (2015); S. 702, 114th Cong. (2015); H.R. 1173, 114th Cong. (2015).

⁵⁴ *Newman*, 773 F.3d at 452.

⁵⁵ *Jiau*, 734 F.3d at 153 (emphasis added) (citing *Dirks v. SEC*, 463 U.S. 646, 664 (1983)). *Newman* also took *Jiau* out of context: while *Jiau* discussed quid pro quos and intention to benefit in relation to the personal benefit element as a whole, not just to the gift theory, see *id.*, *Newman* cabined its holding to this narrower context, see *Newman*, 773 F.3d at 452.

⁵⁶ See BRYAN A. GARNER ET AL., *THE LAW OF JUDICIAL PRECEDENT* 11 (2016).

⁵⁷ Jonathan Manes, *Secret Law*, 106 GEO. L.J. 803, 842 (2018) (discussing the Due Process Clause).

⁵⁸ See Randy J. Kozel, *Stare Decisis as Judicial Doctrine*, 67 WASH. & LEE L. REV. 411, 453–54 (2010).

⁵⁹ 15 U.S.C. § 78j(b) (2012). The governing regulatory language clarifies little. See 17 C.F.R. § 240.10b-5 (2018).

⁶⁰ *Dirks*, 463 U.S. at 663 (reasoning that the statute's manipulation/deception standard "requires courts to focus on . . . whether the insider receives a direct or indirect personal benefit from the disclosure").

⁶¹ See Caleb Nelson, *Stare Decisis and Demonstrably Erroneous Precedents*, 87 VA. L. REV. 1, 42 (2001).

fill that void.⁶² In addition, notice and predictability are particularly important in the insider trading context, which governs activity on the border of acceptability. As *Dirks* stated, interaction between analysts and corporate insiders is “necessary to the preservation of a healthy market,” but that interaction can go too far.⁶³ Legal uncertainty about the boundaries of insider trading, to say nothing of frequent changes in those boundaries, risks deterring desirable conduct by forcing overly cautious behavior and depriving the market of beneficial interaction.⁶⁴

Although stealth overruling usually undermines the rule of law and seems particularly risky in the insider trading context, *Martoma II*'s stealth overruling may be an exception. Given clearly applicable circuit precedent, a panel has three options: to follow that precedent, to seek to overrule it legitimately (through recourse to the en banc court), or to overrule it illegitimately (stealth overruling).⁶⁵ For *Martoma II*, stealth overruling was the most palatable option in part because following a previous stealth overruling could threaten the rule of law as much as overruling the errant precedent. If an initial stealth overruling is a bad action, then following it leaves that bad action unchecked and underdeterred.⁶⁶ If stealth overruling damages notice and predictability, creating more stealth overruling by following the precedent is an untenable option. *Martoma II*'s stealth overruling avoided this fate. Moreover, following *Newman* would have damaged legal legitimacy more than stealth overruling it did. Following *Newman* would have legitimized its rogue holding, weakening the view that insider trading law is a product of collective judicial expertise rather than of individual panels.⁶⁷ When *Martoma II* stealth overruled *Newman*, it returned to the broad interpretation of personal benefit adopted in earlier circuit decisions. Moving back helps reestablish the legitimacy gained from the accumulation of judicial knowledge.

⁶² *Id.* The Court has sometimes read vague language as a legislative delegation to the judiciary. See Lance McMillian, *The Proper Role of Courts: The Mistakes of the Supreme Court in Leegin*, 2008 WIS. L. REV. 405, 458. This reading runs into separation of powers issues: Can Congress legitimately delegate lawmaking power to the Court? *Id.* at 457–58. Even if vagueness is a delegation to the judiciary, it is a delegation to the Supreme Court, not to the courts of appeals. No circuit can bar other circuits or the Supreme Court from reaching a different interpretation, so a delegation of policymaking to a court of appeals would fail to fill statutory gaps. Cf. Amy Coney Barrett, *Statutory Stare Decisis in the Courts of Appeals*, 73 GEO. WASH. L. REV. 317, 350 (2005) (using the circuits' inability to make policy to justify limited circuit-level statutory stare decisis).

⁶³ *Dirks*, 463 U.S. at 658 (footnote omitted).

⁶⁴ Dan M. Kahan, *Lenity and Federal Common Law Crimes*, 1994 SUP. CT. REV. 345, 400–02.

⁶⁵ Where the application is obvious, distinguishing the case approximates overruling it.

⁶⁶ The intuition that undeterred overrulings will cause more overrulings has been formally analyzed in the context of repeated games. See, e.g., Erin O'Hara, *Social Constraint or Implicit Collusion?: Toward a Game Theoretic Analysis of Stare Decisis*, 24 SETON HALL L. REV. 736, 750–51 (1993); Eric Rasmusen, *Judicial Legitimacy as a Repeated Game*, 10 J.L. ECON. & ORG. 63, 72–73, 76–78 (1994).

⁶⁷ See GARNER ET AL., *supra* note 56, at 9 (“Precedent is a way of accumulating . . . established wisdom richer than what can be found in any single judge or panel of judges.”).

En banc overruling, on the other hand, is unlikely. En banc review does have rule of law advantages over stealth overruling. Although en banc overruling and stealth overruling both modify precedent, the law of the circuit rule followed by every circuit outlaws overruling intracircuit precedent without en banc review.⁶⁸ And while en banc review and stealth overruling both have large administrative and collegiality costs,⁶⁹ stealth overruling adds accountability and clarity costs;⁷⁰ an en banc court at least admits it is overruling. Whether or not en banc review is more desirable, it is descriptively unlikely. The Second Circuit has been historically and exceptionally averse to the procedure,⁷¹ applying such review in only “rare and exceptional circumstances.”⁷² Between 2011 and July 2016, the Second Circuit granted only two petitions for en banc review.⁷³ If Second Circuit panels are forced to wait for en banc review to deal with stealth overrulings, most stealth overrulings will be followed. The Second Circuit has proven more willing to use informal en banc procedures, in which “one federal circuit court panel circulates an opinion to the full court for acquiescence in an action as a substitute for formal en banc review.”⁷⁴ But the Second Circuit uses informal en banc only half-a-time more often per year than formal en banc,⁷⁵ and informal en banc fails to solve stealth overruling’s accountability problems.⁷⁶ It is neither good nor practical enough to replace stealth overruling.

Martoma II indicates that stealth overruling is sometimes the best option for advancing rule of law principles. Because some stealth overrulings are appropriate, it is unlikely that they are about to disappear. Indeed, courts may find stealth overruling a useful tool for disciplining other stealth overrulings. *Newman* and *Martoma II* provide helpful data points about what constitutes a good stealth overruling: it may be significant that *Martoma II* overruled a single case while *Newman* displaced broader circuit precedent, and that *Newman* is accused of contradicting a Supreme Court decision while *Martoma II* is accused of overruling only circuit precedent. A richer taxonomy of stealth overrulings could help to inform judicial action in cases like these.

⁶⁸ Amy E. Sloan, *The Dog that Didn't Bark: Stealth Procedures and the Erosion of Stare Decisis in the Federal Courts of Appeals*, 78 *FORDHAM L. REV.* 713, 718–19 (2009).

⁶⁹ See *id.* at 743.

⁷⁰ See Suzanna Sherry, *The Four Pillars of Constitutional Doctrine*, 32 *CARDOZO L. REV.* 969, 981 (2011).

⁷¹ See Tracey E. George, *The Dynamics and Determinants of the Decision to Grant En Banc Review*, 74 *WASH. L. REV.* 213, 250 n.170 (1999).

⁷² *Ricci v. DeStefano*, 530 F.3d 88, 90 (2d Cir. 2008) (Katzmann, J., concurring in the denial of rehearing en banc, joined by Pooler, J.); see also *id.* at 89 (embracing the circuit’s “longstanding tradition” of deference to panels).

⁷³ Martin Flumenbaum & Brad S. Karp, *The Rarity of En Banc Review in the Second Circuit*, *N.Y. L.J.*, Aug. 24, 2016, at 3, 7.

⁷⁴ Sloan, *supra* note 68, at 725; see also *id.* at 727.

⁷⁵ See *id.* at 728 fig.1.

⁷⁶ *Id.* at 753–58.