

The First, First Circuit Court to Opine on a Newman Challenge

May 18, 2015

And the Insider Trading Charges Stick

On May 12, 2015, in *United States v. Douglas Parigian*, U.S. District Court Judge Denise Casper became the first judge in the First Circuit to opine on a challenge to insider trading charges premised upon the Second Circuit's controversial ruling in *United States v. Newman*, 773 F.3d 438 (2d Cir. 2014). And the decision denied Parigian's motion to dismiss and held that under the facts of that case, *Newman* did not warrant dismissal despite that (1) there was no allegation that the "insider-tippee" received any benefit in exchange for the transmittal of the inside information, and (2) the alleged personal benefit to the "tippee" who subsequently tipped several rounds of inside information to Parigian was a steak dinner that the tippee would purportedly receive in the future.

The Parigian Case

The facts of the *Parigian* case at first blush appear to be classic insider trading. There are a group of golfing buddies. One of them is Douglas Parigian and another one is Eric McPhail. There is an insider – "Person A" – a senior executive at American Superconductor Corporation ("AMSC"), a company that produced wire, hardware and software for the wind power industry. According to the Superseding Indictment, beginning in July 2009, Person A disclosed material, nonpublic information about AMSC to McPhail, McPhail passed the information to Parigian and other golfing buddies, and they all traded on the information and made money. As luck would have it for the government, there are a series of emails chronicling the information flow, such as the following:

- On July 9, McPhail sent an email "Try this one ... AMSC ... watch it on July 30th." (Superseding Indictment ¶ 14). Between July 9 and July 24, Parigian bought 1200 shares of AMSC stock. (*Id.* ¶ 19). On July 30, AMSC announced positive earnings and its share price shot up. Between July 30 and 31, Parigian sold 1000 AMSC shares and made about \$9,000. (*Id.*) On July 30, McPhail emailed: "Nice profitable day for the boys. So when should I report in on which restaurant and massage parlor I want to be treated to?" (*Id.* ¶ 20).
- On September 29, McPhail sent an email: "Well boys ... went to the Sox game with a friend of mine tonight. He seems to think that AMSC has a \$100 Million deal with China that should be signed very shortly ... This announcement should spike them close to 10%. Furthermore, circle October 29th for the next big day ... it could/should be as good as the last one ... I like Pinot Noir and love steak ... looking forward to getting paid back." (*Id.* ¶ 21). Parigian replied "I will take you for a nice dinner at Grill 23." (*Id.* ¶ 22). On the morning of September 29, Parigian bought a total of 1100 AMSC shares. (*Id.* ¶ 23). After the markets closed that day, AMSC issued a press release announcing a \$100 million contract with Sinovel Wind Group Co., Ltd., a Chinese company involved in wind turbines, and the next day AMSC's stock shot up. (*Id.* ¶ 24). On September 30, Parigian sold 800 AMSC shares at a profit. (*Id.* ¶ 25).
- On September 29, McPhail sent an email about an AMSC quarterly earnings report to be released on October 29: "Hopefully there are no terrorist attacks between now and the 29th ... could be another bomber of a day. Similar to the end of July." (*Id.* ¶ 26). Parigian replied "I will be taking most my gains and putting it ALL on Options before Oct. 29. I just wish I knew what an Option was." (*Id.* ¶ 27). On October 22, McPhail emailed "Certainly looks like today may be a good buying opportunity for AMSC, T minus one week." (*Id.* ¶ 30). Between September 29 and October 28, Parigian purchased approximately 1180 AMSC shares and 60 AMSC call options. (*Id.* ¶ 32). On October 29, McPhail emailed "Please keep your arms and feet inside ... enjoy the ride," and AMSC announced high revenues accompanied by a share price increase. (*Id.* ¶ 31). Between October 29 and 30, Parigian sold 1480 AMSC shares and 60 AMSC call options and netted about \$5,952.36. (*Id.* ¶ 33).

The Newman Challenge

Parigian moved to dismiss the Superseding Indictment on the basis that the government failed to allege that the insider – Person A – breached a fiduciary duty to AMSC by receiving a personal benefit in exchange for providing the inside information to McPhail.

Specifically, Parigian relied upon the following language in *Newman*: “The test for determining whether the corporate insider has breached his fiduciary duty ‘is whether the insider personally will benefit, directly or indirectly, from his disclosure. Absent some personal gain, *there has been no breach of duty...*” 773 F.3d at 446 (quoting *Dirks v. SEC*, 463 U.S. 646, 662 (1983)(emphasis added in original). Moreover, Parigian argued that he, as a tippee, must have knowledge of the foregoing quid pro quo, according to *Newman*. “For purposes of insider trading liability, the insider’s disclosure of confidential information, standing alone, is not a breach. Thus, without establishing that the tippee knows of the personal benefit received by the insider in exchange for the disclosure, the Government cannot meet its burden of showing that the tippee knew of a breach.” *Id.* at 448. The Superseding Indictment charging Parigian failed to allege any of these facts.

The District Court’s Decision

The District Court declined to adopt the analysis espoused by Parigian. Rather, the Court found – consistent with the government’s argument – that the *Newman* test did not apply because the case involved McPhail “misappropriating” the inside information from Person A and therefore the misappropriation theory – versus the classical theory – of insider trading applied. “[U]nder a misappropriation theory ‘a fiduciary’s undisclosed, self-serving use of a principal’s information to purchase or sell securities, in breach of a duty of loyalty and confidentiality, defrauds the principal of the exclusive use of that information.’” *United States v. Parigian*, 2015 U.S. Dist LEXIS 62096 at *6 (quoting *United States v. O’Hagan*, 521 U.S. 642, 651-52 (1997)).

Thus, the Court found McPhail similar to the defendant in *O’Hagan*, a law firm attorney who was an “outsider” to a bidding company, who placed trades premised upon inside information about a proposed tender offer that was held by his law firm in confidence. Specifically, “the source of the material, nonpublic information (there, the law firm client; here, Person A) is an unknowing source and participant in the chain of information to the tipster (there, the law firm attorney; here, McPhail). Under this theory, a personal benefit need not be alleged to inure to the benefit of the unknowing participant, the source of the inside information.” *Id.* at *9.

The Court also found that the relationship between Person A and McPhail was a “fiduciary-like” relationship, similar to the close relationship between two members of Alcoholics Anonymous that was found sufficient for misappropriation liability in *United States v. McGee*, 763 F.3d 304, 316 (3d Cir. 2014). *Id.* at *9-10. “Given the nature of their close relationship and history, pattern and practice of sharing confidences, it is alleged that McPhail owed Person A a duty of trust and confidence and that he reasonably should have known that Person A’s communications about AMSC should be kept in confidence.” *Id.* at *10.

Finally, the Court found that “[t]o the extent that the Defendants are alternatively arguing that the indictment must allege that the tipster (McPhail) must receive a personal benefit and/or that the tippee (Parigian) knew that McPhail would receive, or expected to receive such benefit, the indictment here alleges both,” citing to the allegations relating to the future steak dinner. *Id.* at *9.

The Conditional Guilty Plea

On May 12, 2015, Parigian entered a conditional plea of guilty to a Superseding Information charging him with conspiracy to engage in securities fraud and securities fraud pursuant to a plea agreement under Federal Rule of Criminal Procedure 11(a)(2). Specifically, Parigian pled guilty but preserved his right to appeal the denial of his Motion to Dismiss, and should he prevail on appeal, Parigian preserved the right to withdraw his guilty plea.

Issues on Appeal

While it is hard to predict where the First Circuit will go on this case and future insider trading cases post-*Newman*, there are some issues that are fair game under the facts of *Parigian* and the backdrop of *Newman*:

- Whether the government must allege and prove a “personal benefit” to a tipper when alleging liability under the misappropriation theory of insider trading. Significantly, the Second Circuit came to the opposite conclusion in *Newman* and held that “the elements of tipping liability are the same, regardless of whether the tipper’s duty arises under the ‘classical’ or the ‘misappropriation’ theory,” 773 F.3d at 446, and at least one court in that circuit dismissed insider trading charges on that basis, see *United States v. Conratt*, 2015 U.S. Dist. LEXIS 16263 (S.D.N.Y. Jan. 22, 2015).
- Whether the government’s allegations with respect to the relationship between Person A and McPhail was sufficient to establish a fiduciary relationship sufficient to establish that McPhail “misappropriated” the AMSC inside information from Person A, similar to the *O’Hagan* law firm attorney misappropriating tender offer information from a client.
- Whether the government’s allegations with respect to McPhail anticipating receipt of a steak dinner at some point in the future

after providing rounds of AMSC inside information to Parigian (and others) is sufficient to satisfy the personal benefit requirement. See, e.g., *Newman*, 773 F.3d at 450 (quoting *Dirks v. SEC*, 463 U.S. 646, 664 (1983)) (“[A] breach of the duty of confidentiality is not fraudulent unless the tipper acts for personal benefit, that is to say, there is no breach unless the tipper ‘is in effect selling the information to its recipient for cash, reciprocal information, or other things of value for himself...’”).

RELATED INDUSTRIES

- [Investment Advisers & Private Funds](#)
- [Professional Services](#)

RELATED PRACTICES

- [White Collar Crime & Government Investigations](#)
- [Litigation](#)
- [Business Counseling](#)

This communication is intended for general information purposes and as a service to clients and friends of Foley Hoag LLP. This communication should not be construed as legal advice or a legal opinion on any specific facts or circumstances, and does not create an attorney-client relationship.

United States Treasury Regulations require us to disclose the following: Any tax advice included in this document was not intended or written to be used, and it cannot be used, for the purpose of avoiding penalties under the Internal Revenue Code.

Attorney advertising. Prior results do not guarantee a similar outcome. © 2017 Foley Hoag LLP. All rights reserved.