Clients&FriendsMemo

Government's Decision Not to Charge Phil Mickelson Illustrates Difficulties in Proving Insider Trading Cases Against Tippees

May 24, 2016

On May 19, 2016, the United States Attorney's Office for the Southern District of New York and the Securities and Exchange Commission ("SEC") announced insider trading charges against Las Vegas sports bettor William ("Billy") Walters and former Dean Foods chairman Thomas Davis for allegedly trading on nonpublic company information.[1] Tellingly, no charges were brought against professional golfer Phil Mickelson, who was named as a relief defendant and agreed to repay close to $1 million in trading profits made as part of the alleged scheme. The government's decision not to charge Mickelson as an outsider "tippee" is a likely result of the Second Circuit's 2014 decision in *United States v. Newman*, which required a heightened showing to prove insider trading cases against individuals many steps removed from corporate insiders.[2] However, future tippees may not be as fortunate as Mickelson, depending on whether the Supreme Court this term adopts the *Newman* standard or opts for the seemingly lower burden accepted last year by the Ninth Circuit in *United States v. Salman*.[3]

I. The Government's Case against Walters and Davis

According to the charging documents, over the course of five years Davis provided Walters with nonpublic information about Dean Foods, including business plans and earnings forecasts, as well as confidential information about Darden Restaurants of which Davis was a potential investor. The information was passed along in part using a prepaid cellular phone and cryptic code words used to disguise its content. Walters allegedly benefited by $40 million in profits and avoided losses from trading on this information. In exchange, Davis purportedly received various forms of financial assistance from Walters, including investment capital and approximately $1 million in forgiven loans.

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1 Indictment, *United States v. Walters*, No. 16-338 (S.D.N.Y. May 19, 2016), https://www.justice.gov/usao-sdny/file/852356/download; Criminal Information, *United States v. Davis*, No. 16-338 (S.D.N.Y. May 16, 2016), https://www.justice.gov/usao-sdny/file/852361/download; Complaint, *SEC v. Walters*, 1:16-cv-03722 (S.D.N.Y. May 19, 2016), https://www.sec.gov/litigation/complaints/2016/comp-pr2016-92.pdf.

2 773 F.3d 438 (2d Cir. 2014), *cert. denied*, 84 U.S.L.W. 3170 (U.S. Oct. 5, 2015) (No. 15-137).

3 792 F.3d 1087, 1089 (9th Cir. 2015), *cert. granted*, 84 U.S.L.W. 3405 (U.S. Jan. 19, 2016) (No. 15-628).

For his part, Mickelson is alleged to have accepted a tip from Walters to buy Dean Foods stock approximately one week before plans were publicly announced to spin off a profitable business segment. According to the SEC, Walters called Mickelson the day after he learned about the spin-off plans from Davis, and the two exchanged text messages later that day and again over the weekend. After the markets opened, Mickelson, who had never before traded in Dean Foods stock, purchased approximately 240,000 shares using three brokerage accounts. Mickelson then sold all of his Dean Food shares the day after the spin-off announcement for a profit of approximately $931,000. Mickelson allegedly repaid a gambling debt owed to Walters a month later, in part with the trading profits.

II. Difficulty Proving Outsider Tipping Cases in the Second Circuit

In December 2014, the Second Circuit in *Newman* reversed the insider trading convictions of former hedge fund traders Todd Newman and Anthony Chiasson, dealing a significant blow to the government's ability to prosecute insider trading cases involving tipping.[4]

Not only insiders are forbidden from trading on material, nonpublic information. An outsider can be held liable under Section 10(b) of the Securities and Exchange Act of 1934, and Rule 10b-5 thereunder, when trading on information that was obtained in violation of a duty of trust and confidence owed to another party.[5] Newman and Chiasson were alleged to have traded on inside information received through a group of analysts, who themselves received the information through a chain of other sources. The government presented no evidence that either was aware of the personal benefit provided to the insiders, or even of the insiders' identities. Rather, the government argued that it was sufficient that Newman and Chiasson knew that insiders breached their duties of confidentiality by disclosing the information. After receiving jury instructions in line with the government's theory, a jury convicted Newman and Chiasson of insider trading

The Court of Appeals for the Second Circuit reversed, criticizing the government for bringing prosecutions which are "increasingly targeted at remote tippees many levels removed from corporate insiders." The court rejected the government's positions, as well as its alternative argument that the specificity, timing, and frequency of the updates were so "overwhelmingly suspicious" that Newman and Chiasson must have known that the information originated with insiders and that those insiders disclosed the information in exchange for a personal benefit. As a result, the government must prove that "the tippee knew that an insider disclosed confidential information *and* that he did so in exchange for a personal benefit."

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[4] *See* Jodi L. Avergun and Douglas H. Fischer, *Friends With Benefits: Second Circuit Overturns Newman and Chiasson Convictions and Raises the Government's Burden in Insider Trading Cases Against Tippees*, BLOOMBERG CORPORATE LAW AND ACCOUNTABILITY REPORT, Dec. 12, 2014, http://www.bna.com/friends-benefits-second-n17179918853/#!.

[5] *See*, *e.g.*, *Dirks v. SEC*, 463 U.S. 646, 649 (1983).

III. Ninth Circuit Takes a Narrow Reading of Newman

Following the *Newman* decision, Bassam Yacoub Salman, who was convicted for trading on inside information he obtained through a chain of tips originating with his brother-in-law, urged the Ninth Circuit to adopt *Newman* and overturn his conviction. He argued that the evidence presented at trial was insufficient under *Newman* to find that his brother-in-law disclosed the information in exchange for a personal benefit, or, if he did, that Salman knew of such benefit.

The Ninth Circuit panel affirmed the conviction, finding that Salman's reading of *Newman* was too narrow. The court did not, however, address *Newman's* holding that the tippee must have some knowledge of the personal benefit, because the jury in *Salman* was instructed to find that Salman "knew that Maher Kara personally benefitted in some way, directly or indirectly, from the disclosure."

On January 19, 2016, the Supreme Court agreed to hear Salman's appeal.[6]

IV. Conclusion

The government's case against Walters and Davis appears to include both direct and circumstantial evidence that Walters knew Davis breached his duty as a director to Dean Foods not to reveal confidential company information. As a successful businessman, Walters was likely to be well-versed in the legal obligations owed by insiders and prohibitions against insider trading. Walters' actions, including the purchase of a prepaid cellular phone for Davis and the use of code words, also suggest he knew Davis owed a duty of trust and confidence to Dean Foods. Walters' knowledge of the personal benefit to Davis is even more obvious—he provided Davis capital for joint business ventures and two loans of nearly $1 million.

However, the government does not appear to have evidence that Mickelson knew that Davis breached his duty to the Dean Foods, knew that Davis disclosed the information to Walters in exchange for a personal benefit, or knew the identity of Walter's source. Rather the government appears to rely on the timing of Mickelson's conversations with Walters and his trading activity. And even though the alleged events may be described as "suspicious," the Second Circuit rejected similar arguments in *Newman*. Under the circumstances, the decision not to bring charges against Mickelson was likely a wise one. Until the Supreme Court hands down a decision in *Salman*, the government may choose to reserve insider trading cases against outsider tippees to those situations where knowledge is more apparent.

In the meantime, we should consider this valuable lesson: taking a stock tip from your bookie can result in one expensive mulligan.

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[6] *See* Jodi L. Avergun, Martin L. Seidel, Douglas H. Fischer and Kendra Wharton, *Getting By With a Little Help From Friends: United States Supreme Court to Clarify Insider Trading Liability in Tipping Cases*, THE NATIONAL LAW REVIEW, Jan. 27, 2016, https://www.cadwalader.com/resources/clients-friends-memos/getting-by-with-a-little-help-from-friends-united-states-supreme-court-to-clarify-insider-trading-liability-in-tipping-cases.

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