ARTICLES

Nondisclosure Agreements and Insider Trading Risk

By Ronald G. White

Nondisclosure agreements (NDAs) are frequently used by corporations in connection with a host of different types of proposed transactions or relationships in order to safeguard their confidential information. But if a party to an NDA uses the information he or she obtains pursuant to the agreement to trade in the corporation's securities, has that party engaged in insider trading in violation of federal securities laws? The U.S. Court of Appeals for the Second Circuit addressed this question in a pair of recent cases and attempted to clarify this area of law. In *United States v. Kosinski*, 976 F.3d 135 (2d Cir. 2020), and *United States v. Chow*, 993 F.3d 125 (2d Cir. 2021), the court ruled that a party's trading in violation of an NDA requiring it to keep corporate information confidential—even if the NDA does not expressly prohibit such trading and even if the party is an outsider with an arm's-length relationship with the company—can constitute insider trading.

Insider Trading Law

Section 10(b) of the Securities Exchange Act of 1934 makes it unlawful to use a "manipulative or deceptive device or contrivance" in connection with the purchase or sale of securities in violation of Securities and Exchange Commission (SEC) rules. 15 U.S.C. § 78j(b). In turn, SEC Rule 10b-5(a) prohibits the use of a "device, scheme, or artifice to defraud" in connection with the purchase or sale of securities. 17 C.F.R. § 240.10b-5(a). In interpreting these broadly worded provisions, the Supreme Court has recognized two main forms of insider trading. Under the "classical" theory, a corporate insider violates the law if he or she trades on material, nonpublic information in violation of a fiduciary duty to the corporation's shareholders. *United States v. O'Hagan*, 521 U.S. 642, 651 (1997). Under the "misappropriation" theory, a person violates the law "when he misappropriates confidential information for securities trading purposes, in breach of a duty owed to the source of the information." *Id*. at 652. To establish the "duty" required under the misappropriation theory, the government must show that the defendant had a "fiduciary relationship" or a similar "relationship of trust and confidence" with the source of the information. *Id*. at 652, 662 (citation omitted).

The issue of whether an agreement by a party to keep corporate information confidential gives rise to the type of "relationship of trust and confidence" required under the misappropriation theory is not a new question. For example, well-known entrepreneur and Dallas Mavericks owner Mark Cuban initially succeeded in having the SEC's high-profile insider trading case against him dismissed on the ground that an agreement not to disclose confidential information could not create such a relationship. *SEC v. Cuban*, 634 F. Supp. 2d 713, 725–26 (N.D. Tex. 2009). On appeal, the Fifth Circuit reversed and ruled that the case could go forward, holding that the SEC's complaint could be read to plausibly allege that Cuban agreed not to *use* the information in addition to agreeing not to disclose it. As a result, the appeals court did not address the issue of whether an agreement not to disclose alone could create a relationship of trust and confidence. *SEC v. Cuban*, 620 F.3d 551, 556–58 (5th Cir. 2010). Because the trial jury ultimately returned a verdict in Cuban's favor, the legal issue remained open.

The Second Circuit's two recent decisions, *Kosinski* and *Chow*, addressed this same issue of whether an individual who had entered into an NDA had created a "fiduciary relationship" or "relationship of trust and confidence" with the corporation such that the individual was barred from trading in its securities based on the confidential corporate information disclosed to the individual.

United States v. Kosinski

In *Kosinski*, decided by the Second Circuit in September 2020, the defendant, Edward Kosinski, was a medical doctor who was a "principal investigator" in the clinical trial of a cardiac drug developed by Regado Biosciences, Inc., a publicly traded corporation. In that position, he recruited subjects for the trial, determined their suitability, monitored their reaction to the drug, and reported the results. 976 F.3d at 139. Kosinski and Regado entered into two agreements regarding his participation in the trial. The first prohibited both the disclosure *and use* of the confidential information Kosinski would receive from Regado as part of the trial. The second agreement, the Clinical Study and Research Agreement (CSRA), superseded the first and prohibited disclosure of Regado's confidential information but did *not* include an express prohibition on its use.

Specifically, the CSRA required Kosinski to (1) maintain in "strict confidence" all the information provided to him in connection with the assignment and (2) "promptly" disclose to Regado if the value of his Regado stock exceeded $50,000. The required disclosure provision was intended to allow Regado to identify any conflict of interest its investigators might have, which could, in turn, potentially jeopardize Food and Drug Administration (FDA) approval of the drug. *Id.* at 140, 147. The evidence at trial indicated that, at several points during the clinical trial, Kosinski was alerted to negative news regarding the drug and traded on this information before the information was made public. *Id.* at 141–42.

After being convicted of securities fraud in the U.S. District Court for the District of Connecticut, Kosinski appealed, arguing that the evidence was insufficient to establish that he had breached a duty to Regado. Kosinski maintained that the CSRA required only that he keep the information he received in confidence (which he claimed he did) and that trading on the basis of that information did not breach the terms of the agreement. *Id.* at 142–43. The Second Circuit rejected this argument. The court engaged in an extensive discussion of the various factors identified by prior case law as indicative of a fiduciary relationship, but the court ultimately ruled, as a factual matter, that the trial evidence was sufficient to show Kosinski's relationship with Regado was "fiduciary in nature" because it was a relationship based on "trust and confidence." *Id.* at 146.

The court first noted that Kosinski was a distinguished cardiologist, chosen by Regado for his "experience and skill," and entrusted to conduct a drug trial that was literally "a matter of life and death." It noted that Regado relied on the "integrity" of investigators like Kosinski to conduct the clinical trial and that any conduct undermining such integrity potentially jeopardized FDA approval of the drug. In addition, the court found that Kosinski's agreement in the CSRA to hold Regado's information in "strict confidence" gave the company the "trust and confidence" it required to disclose inside information to him and thus "clothed him with fiduciary status." *Id.* at 146–47. Similarly, the court ruled that Kosinski's "explicit acceptance of a duty of

confidentiality" was "itself sufficient to establish the necessary fiduciary duty of trust and confidence." *Id.* at 146 (citation omitted). The court ruled that, given the other facts regarding the relationship between Kosinski and Regado, "the absence of an express prohibition on trading [in the CSRA] is not fatal here." *Id.* at 147. The court also found that it did not need to address Kosinski's argument that the district court erroneously instructed the jury that "a person has a requisite duty of trust and confidence whenever a person agrees to maintain information in confidence." *Id.* at 152. The court ruled that, because the trial evidence "overwhelmingly established that Kosinski had a fiduciary or fiduciary-like duty to Regado," this instruction, even if erroneous, would have been harmless error. *Id*.

United States v. Chow

The *Chow* case, decided in April 2021, about six months after *Kosinski*, presented the question of whether an outsider with an arm's-length relationship with a corporation could be deemed to have a "relationship of trust and confidence" with the company simply by virtue of having entered into an NDA. As discussed above, in *Kosinski*, the defendant was a doctor engaged by a pharmaceutical company as a consultant to assist in a drug trial and thus fit more easily into the category of "temporary insiders" to which the misappropriation theory has traditionally been applied. In *Chow*, by contrast, the defendant was on the *other* side of a proposed transaction with the company—he signed an NDA in connection with negotiations he was leading on behalf of hedge funds to acquire the corporation.

In *Chow*, the defendant, Benjamin Chow, engaged in negotiations to purchase a public company, Lattice Semiconductor Corporation, on behalf of hedge funds that he managed. In the course of these negotiations, Chow executed two NDAs (one on behalf of each of the hedge fund firms he represented), which had identical confidentiality provisions. Each agreement provided that the parties would not "disclose, commercialize, or use any Proprietary Information of the other Party for any purpose, except" in connection with the potential business transaction between the parties. 993 F.3d at 129–31. The evidence at trial indicated that, while the NDAs were in effect, Chow provided material, nonpublic information regarding the negotiations and proposed transaction to a former work colleague, who traded in Lattice securities based on this information, earning profits of at least $5 million. *Id.* at 131–33. Chow was convicted of securities fraud at trial in federal district court in the Southern District of New York. *Id.* at 128.

On appeal, among other arguments, Chow contended that the government had failed to prove that he had a duty of "trust and confidence" to Lattice and challenged the district court's use of a jury instruction with respect to this element that was substantially similar to the one that the Second Circuit declined to rule on in *Kosinski*. Chow argued that it was erroneous for the court to instruct the jury that "as a matter of law . . . an express agreement to keep certain information confidential gives rise to a duty of trust and confidence between the parties to that agreement with respect to the information protected by the agreement." *Id.* at 134. The Second Circuit rejected Chow's argument as "meritless," citing prior Supreme Court and Second Circuit law, as well as SEC regulations. *Id*. at 139. The court noted that in *O'Hagan*, the Supreme Court had ruled that the misappropriation theory "premises liability on a fiduciary-turned-trader's deception of those who entrusted him with access to confidential information." *Id.* at 137 (quoting *O'Hagan*, 521 U.S. at 651–52). The Second Circuit also cited its own prior precedents, including *Kosinski*, upholding criminal convictions for insider trading where the defendant's duty of trust

and confidence arose, in part, from confidentiality agreements. Specifically, the court noted that, in *Kosinski*, it had ruled that the "explicit acceptance of a duty of confidentiality was itself sufficient to establish the fiduciary duty of trust and confidence" that subjected an individual to penalties for insider trading. *Id.* at 138 (internal quotation marks omitted).

With respect to Chow's argument that he did not have a fiduciary duty to the company because he had an "arm's-length relationship" with Lattice, the court noted that Kosinski also had an "arm's-length relationship" with Regado, which did not prevent the finding of a fiduciary duty in that case. The court apparently did not find significant the arguably more-attenuated posture that Chow was in with respect to Lattice as a potential acquirer on the opposite side of negotiations with the company, because it did not even address the potential distinction. Finally, the court noted that the SEC had promulgated a rule that specifically provided that, "for purposes of § 10b, a duty of trust or confidence exists, among other times, whenever a person agrees to maintain information in confidence." *Id.* (internal punctuation and quotation marks omitted) (quoting SEC Rule 10b5-2, 17 C.F.R. § 240.10b5-2(b)(1)).

Conclusion

In *Kosinski* and *Chow*, the Second Circuit appears to have established a bright-line rule that entering into an NDA or otherwise agreeing to keep a corporation's information confidential by itself gives rise to the fiduciary duty or duty of "trust and confidence" that can trigger insider trading liability. The potentially distinguishing factors cited in those cases—in Kosinski's case, that his NDA did not contain an express prohibition on his use of the confidential information, and in Chow's case, that his posture as potentially adverse to the company in negotiations was not one typically thought to give rise to a fiduciary relationship—were dismissed by the Second Circuit as distinctions without a difference. Because none of the other federal appellate courts appear to have addressed this issue directly, and given the Second Circuit's traditional prominence in the field of securities law, these decisions may have significant persuasive effect, even outside the Second Circuit.

Whether or not the Second Circuit's rulings on this issue are ultimately approved by the Supreme Court or adopted by other courts, they have attempted to set clear boundaries for market participants to follow (the need for which is a common theme of insider trading jurisprudence): an agreement to maintain the confidentiality of corporate information creates a duty of trust and confidence such that the use of the information to trade constitutes insider trading. This bright-line rule applies even in the absence of an agreement not to use the information, and it applies even to individuals who, in other contexts, would not be considered fiduciaries of the company.

Ronald G. White is a partner with Morrison & Foerster, LLP, in New York City, New York.