The Fifth Circuit Reinstates the SEC's Insider Trading Case Against Mark Cuban

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March 29, 2011

On Sept. 21, 2010, a federal court of appeals reversed the July 2009 decision of a lower court and reinstated an insider trading case brought by the Securities Exchange Commission (SEC) against Mark Cuban, the internet billionaire and owner of the Dallas Mavericks. The lower court's decision was significant because it appeared to conflict with the traditional interpretation of U.S. insider trading laws. Although the case appears far from over, the appeals court's decision reaffirms the need for public companies, their agents and other market participants to follow certain guidelines when communicating and receiving material, non-public information regarding proposed financings and other significant transactions.

Background of *SEC v. Cuban*

According to the SEC's complaint, in March 2004, Cuban purchased 600,000 shares of common stock in Mamma.com Inc., a publicly-traded search engine company. The purchase gave Cuban a 6.3 percent position in the company and made him the company's largest shareholder. Subsequently, Mamma.com sought to raise financing through a transaction commonly referred to as a "PIPE" – a private investment in public equity. Because the securities sold in a PIPE transaction are deemed "restricted" under applicable securities laws, they are typically sold at a discount to the issuer's recent trading price, which often causes the issuer's stock price to drop once the PIPE transaction is publicly announced. On June 28, 2004, as the PIPE progressed toward closing, the company's CEO contacted Cuban to invite him to participate as an investor in the financing. According to the SEC, the CEO began his discussion by noting that he had confidential information about Mamma.com to convey to Cuban, and Cuban agreed that he would keep the information confidential. The CEO proceeded to tell Cuban about the PIPE. Cuban apparently responded angrily and informed the CEO at the end of the call: "Well, now I'm screwed. I can't sell."

Immediately following the call, Cuban contacted Mamma.com's placement agent for the offering to obtain additional confidential information about the PIPE. Following the call, Cuban instructed his broker to sell all of his Mamma.com shares. By the next day, Cuban had sold all 600,000 shares at an average price per share of $13.29. Mamma.com publicly announced the PIPE offering that same day after the markets closed. The day after the announcement, Mamma.com's stock opened at $11.89, down $1.215 per share from the previous day's closing price, and it continued to decline over the following week. The SEC alleged that by selling his 600,000 shares prior to the public announcement of the PIPE, Cuban avoided more than $750,000 in losses.

On Nov. 17, 2008, the SEC filed a complaint against Cuban in the United States District Court for the Northern District of Texas alleging that Cuban violated Section 10(b) of the Securities Exchange Act of 1934, Rule 10b-5 thereunder and Section 17(a) of the Securities Act of 1933. Specifically, the SEC alleged that in selling his shares of Mamma.com, Cuban committed unlawful insider trading under the misappropriation theory of liability.

Law of Insider Trading

Section 10(b) of the Exchange Act prohibits the use of any deceptive device in connection with the purchase or sale of securities. Rule 10b-5 under the Exchange Act prohibits both affirmative misrepresentations and nondisclosure of material information in connection with the purchase or sale of any security. Although neither Section 10(b) nor Rule 10b-5 expressly prohibits insider trading (and neither Congress nor the SEC has expressly defined insider trading in a statute or rule), together these rules form the basis of insider trading laws in the United States. They have been developed over the past 50 years through a number of SEC interpretations and judicial decisions. During this time, the U.S. Supreme Court has developed two complementary theories of insider trading: the "traditional" theory (also known as the "classical" theory) and the "misappropriation" theory.

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Traditional/Classical Theory

Under the "classical theory" of insider trading, "§10(b) and Rule 10b-5 are violated when a corporate insider trades in the securities of his corporation on the basis of material, nonpublic information." (United States v. O'Hagan 521 U.S. 642 (1997).) Corporate insiders generally include a company's officers and directors, as well as its attorneys, accountants, consultants and others who temporarily become fiduciaries of the corporation. As *O'Hagan* outlines, this type of trading qualifies as a "deceptive device" under Section 10(b) because insiders with access to the company's confidential information have a relationship of trust and confidence with the company's shareholders. (521 U.S. at 652 (quoting *Chiarella v. United States*, 445 U.S. 222, 229 (1980)).) This relationship imposes a duty on the insider to either disclose the information to the counterparty to a trade or abstain from trading in the company's securities (often referred to as the disclose or abstain rule). In most cases, disclosure would constitute a breach of the insider's fiduciary duties and confidentiality obligations to the issuer. Therefore, it is rarely an option.

Misappropriation Theory and Rule 10b5-2

Under the "misappropriation theory" of insider trading, a corporate *outsider* violates Section 10(b) and Rule 10b-5 when he "misappropriates confidential information for securities trading purposes, in breach of a duty owed to the source of the information." Under this theory, a corporate outsider's use of a "principal's information to purchase and sell securities, in breach of a duty of loyalty and confidentiality, defrauds the principal of the exclusive use of that information," which is akin to embezzlement. *O'Hagan*, 521 U.S. at 652 and 654. Whereas the classical theory targets an insider's breach of duty to shareholders, the misappropriation theory prohibits trading on the basis of nonpublic information by a corporate "outsider" in breach of a duty "of some fiduciary, contractual, or similar obligation" to the person who shared the confidential information with the trader. *O'Hagan*, 521 U.S. at 652. Under the misappropriation theory, the source of the confidential information is not required to be the issuer of the securities that are the subject of the insider trading.

In 2000, following the *O'Hagan* decision, the SEC promulgated Rule 10b5-2 under the Securities Exchange Act of 1934 to provide a non-exclusive definition of circumstances in which a person has a duty of trust or confidence for purposes of the misappropriation theory of insider trading. Rule 10b5-2(b)(1) provides that "'a duty of trust or confidence' exists ….[w]henever a person agrees to maintain information in confidence." According to the SEC, under Rule 10b5-2(b)(1), a party's agreement to maintain information in confidence includes an agreement not to trade. The SEC alleged that Cuban was liable under the misappropriation theory of insider trading, in accordance with Rule 10b5-2, based on his oral agreement to keep confidential the information he was provided about Mamma.com's PIPE transaction.

The District Court's Ruling

The District Court ruled that the SEC failed to allege that Cuban committed each of the actions necessary to establish insider trading under the misappropriation theory. Specifically, the Court held that in order to establish insider trading under the misappropriation theory, Cuban must have both (i) agreed to maintain the confidentiality of the information regarding the proposed PIPE, and (ii) either agreed or had a duty to refrain from trading on or otherwise using the information about the PIPE for his personal gain. According to the Court, when the trader and the issuer are in a fiduciary relationship (i.e., the classical theory), the duty to refrain from trading or using the information arises by operation of law. However, Cuban was not deemed to be in a fiduciary relationship with Mamma.com. As a result, although Cuban agreed to keep the information about the PIPE confidential, because he did not expressly agree to refrain from trading or using the information regarding the PIPE, the Court determined that the SEC had failed to allege facts that would establish insider trading liability under the misappropriation theory. According to the Court, the CEO's expectation that Cuban would not sell was a "mere unilateral expectation on the part of the information source… [which] cannot create the predicate duty for misappropriation theory liability." In short, the Court found that a non-disclosure agreement and a non-use agreement were distinct. Therefore, Cuban's oral agreement to maintain confidentiality of the information, without an undertaking not to trade on it, was insufficient to establish a misappropriation claim.

The Court then attacked the SEC's attempt to use Rule 10b5-2 to impose a non-use obligation on Cuban. In particular, it noted that Section 10(b) only prohibits conduct that is "deceptive" and that, under *O'Hagan*, conduct is deceptive *only* if it involves breach of both an agreement to maintain information in confidence *and* an agreement not to use the information. The Court announced that under the misappropriation theory of liability it is the undisclosed

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use of confidential information for personal benefit, in breach of a duty not to do so, that constitutes the deception. Therefore, it concluded that permitting liability based on Rule 10b5-2(b)(1) would exceed the SEC's authority under Section 10(b) to prohibit conduct that is deceptive.

The Circuit Court's Decision

The SEC appealed the District Court's decision to the Fifth Circuit Court of Appeals. The Circuit Court reversed the District Court's decision and, in so doing, determined that the SEC's complaint alleged sufficient facts to infer that Cuban had agreed not to trade on Mamma.com's shares. However, the Court did not rule on the SEC's claim that a confidentiality agreement, without more, is sufficient to impose insider trading liability on a non-fiduciary under the misappropriation theory of insider trading. The Circuit Court remanded the case to the District Court for further proceedings, including discovery.

Recommendations

Cuban and the SEC appear prepared to fight this case all the way up to the U.S. Supreme Court. Pending its final resolution, the following are a few suggestions for investors, issuers and agents:

> *1. Investors Should Proceed Cautiously.* The District Court's decision took a number of securities practitioners and market participants by surprise because it contradicted the long-standing view that an agreement to maintain information in confidence gives rise to a duty not to trade on the information – a view that the SEC continues to hold. In light of the Fifth Circuit's decision, investors are cautioned not to engage in transactions in an issuer's securities any time they are in possession of material, non-public information about the issuer. This guidance applies even without the receiving party's agreement, expressly or otherwise, not to trade in the issuer's securities. Information that an issuer is contemplating a financing transaction may, by itself, be deemed material.
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> *2. Express Confidentiality, Standstill and Use Agreements.* In addition to obtaining a non-disclosure agreement with respect to material, non-public information (which is also critical for purposes of satisfying SEC Regulation FD), issuers and their agents should consider requiring an agreement from investors not to *trade* in the issuer's securities for a defined period of time after receiving the information – typically until the information is publicly disclosed by the issuer. Issuers and agents should take steps to obtain these agreements prior to providing the information to third parties. They also may consider seeking an agreement from third parties not to use the material, non-public information for any purpose other than evaluating the pending transaction (commonly known as a "sole use" agreement). Issuers and their agents should exercise caution in providing material, non-public information to any third party who objects to a signing a sole use agreement.
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> *3. Written Documentation.* The Cuban case highlights some of the perils in relying solely on oral communications to substantiate and later verify the obligations of parties receiving material, non-public information. A written agreement is recommended in order to avoid the potential "he said/she said" issues raised by alleged oral agreements. Where a formal written agreement is impractical, an email or other written communication in which the party to be provided the material, non-public information acknowledges and agrees to the non-disclosure and use requirements is recommended.

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