

District Court Dismisses Insider Trading Complaint Against Mark Cuban

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The S.E.C. v. Cuban insider trading case is discussed in this article. According to the authors, the case is significant because it reaches important conclusions — at odds with positions taken by the Securities Exchange Commission (“SEC”) — about the nature of the duty the SEC must establish in a misappropriation case.

On July 17, 2009, Chief Judge Sidney A. Fitzwater of the United States District Court for the Northern District of Texas issued an order dismissing without prejudice an insider trading case brought by the Securities Exchange Commission (“SEC”) against Mark Cuban, the Texas businessman.¹ The SEC alleged that Cuban violated Section 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934 pursuant to the misappropriation theory of insider trading, which imposes insider trading liability for undisclosed use of material, nonpublic information by someone who trades, or tips others, in breach of a duty owed to the source of the information whether or not that source is the issuer of the securities traded. The *Cuban* decision is significant because it reaches important conclusions — at odds with positions taken by the SEC — about the nature of the duty the SEC must establish in a misappropriation case.

FACTUAL BACKGROUND AND THE SEC COMPLAINT

The SEC contended that Cuban engaged in insider trading when, after agreeing to maintain the confi-

dentiality of material, nonpublic information about a planned private investment in public equity (“PIPE”) offering by Mamma.com, Cuban sold his stock in the company without first disclosing that he intended to trade on the information. According to the SEC, Cuban held 600,000 shares — a 6.3 percent stake — in Mamma.com, making him its then largest-known shareholder. During the course of the PIPE offering, Mamma.com decided to inform Cuban and invite him to participate. According to the complaint, Mamma.com’s CEO called Cuban, prefacing his remarks by telling Cuban that he had confidential information to convey, and asking Cuban to maintain the confidentiality of the information. Cuban agreed, and the CEO proceeded to tell Cuban about the offering.

Cuban reacted negatively to the news, stating that he did not like PIPE offerings because they diluted existing shareholders. At the close of the call, Cuban remarked that he now would not be able to sell his shares. Later that day, Cuban contacted the investment bankers conducting the offering to obtain additional confidential information. After that call he instructed his broker to sell all 600,000 of his Mamma.com shares. Cuban did not inform Mamma.com of his intent to sell.

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CUBAN'S MOTION TO DISMISS AND THE COURT'S DECISION

Cuban moved to dismiss the SEC's complaint, arguing that the SEC failed to plead a violation of Section 10(b) and Rule 10b-5 under the misappropriation theory. Under the misappropriation theory, "a person commits fraud 'in connection with' a securities transaction, and thereby 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."²

Cuban first argued that liability under the misappropriation theory can only lie where state law imposes fiduciary-like duties on a trader. The court rejected this argument, noting that under state law, an agreement could be the source of the duty. The court then analyzed the "essential components" of an agreement that would form the basis for liability under the misappropriation theory, and reasoned that for the misappropriation theory to apply, there must be some element of deception on the part of the trader — "[i]n simple terms, the misappropriator acts deceptively, not merely because he uses the source's material, nonpublic information for personal gain, in breach of a duty not to do so, but because he does not disclose to the source that he intends to trade on or otherwise use the information."

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Thus, the court reasoned, the relevant duty owed to the source of the information is not simply a duty of confidentiality; *O'Hagan* involved a relationship with a fiduciary character.³ Such a relationship includes not only a duty of confidentiality but also a duty of loyalty, and where a fiduciary "deceives the principal by acting the part of the faithful agent in

other respects while secretly appropriating the principal's confidential information for his own use," the fiduciary engages in deceptive conduct under the misappropriation theory of liability.

Although Cuban argued that the *O'Hagan* analysis applied only to fiduciaries, the court disagreed, noting that there is no reason that such an obligation cannot be formed by agreement. However, the agreement "must consist of more than an express or implied promise merely to keep information confidential. It must also impose on the party who receives the information the legal duty to refrain from trading on or otherwise using the information for personal gain." The court reasoned that "[a] person who receives material, nonpublic information may in fact preserve the confidentiality of that information while simultaneously using it for his own gain." The misappropriation theory therefore only applies where the trader agrees "to maintain the confidentiality of the information *and* not to trade on or otherwise use it."

Based on this standard, the court determined that the SEC failed to allege an agreement sufficient to impose misappropriation liability. While Cuban agreed to maintain the confidentiality of the information, he did not undertake not to use the information about the PIPE transaction. Although the complaint alleged that Cuban told the CEO that he "[could not] sell," this unilateral statement at the end of Cuban's call with the CEO could not be understood as an agreement not to use the information. The CEO's expectation in light of this comment, that Cuban would not sell, was a "mere unilateral expectation on the part of the information source...[that] cannot create the predicate duty for misappropriation theory liability."

Finally, the court rejected the SEC's argument that Rule 10b5-2(b)(1) imposed a duty not to trade. Rule 10b5-2(b)(1) provides:

- (b) For purposes of this section, a "duty of trust or confidence" exists in the following circumstances....
 - (1) Whenever a person agrees to maintain information in confidence.

By its terms, the Rule "attempts to base misappropriation theory liability on an agreement that lacks an obligation not to trade or otherwise use confidential

information.” However, Section 10(b) only enjoins conduct that is “deceptive,” and under *O’Hagan*, conduct is deceptive only if it involves breach not only of an agreement to maintain information in confidence, but also an agreement not to use the information.

The *Cuban* decision is significant in several respects. First, it represents a departure from prior case law on misappropriation theory liability in the context of a confidentiality agreement. Several other courts have recognized that misappropriation theory liability may be premised on breach of a confidentiality agreement, without more. For instance, in *United States v. Falcone*,⁴ the court upheld imposition of misappropriation theory liability against a broker who obtained pre-release copies of a *Business Week* column from an employee of the magazine’s distributor, where the distributor had agreed to maintain the confidentiality of the magazine. The court held that that “a fiduciary relationship, or its functional equivalent, exists only where there is explicit acceptance of a duty of confidentiality or where such acceptance may be implied from a similar relationship of trust and confidence between the parties.”⁵

Second, the SEC continues to take the position that trading in breach of a confidentiality agreement, without more, is sufficient basis for misappropriation theory liability. It is unlikely that a single district court decision will alter the SEC’s position on this issue. Nor is the SEC likely to easily accept the *Cuban* decision’s limits on Rule 10b5-2.

Finally, the decision suggests that companies considering sharing confidential, nonpublic information with third parties should consider not only seeking an agreement to maintain the confidentiality of that information, but also an agreement not to use the information. And, persons who receive material nonpublic information from a public company without giving an express undertaking either to keep the information confidential or not to trade on the basis of the information should keep in mind that public company representatives who communicate such in-

formation may well have a different recollection of what was undertaken if questions are raised by the SEC.

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NOTES

¹ *S.E.C. v. Cuban*, 2009 WL 2096166 (N.D. Tex. July 17, 2009).

² *United States v. O’Hagan*, 521 U.S. 642, 652 (1997).

³ *O’Hagan*, 521 U.S. at 652.

⁴ *United States v. Falcone*, 257 F.3d 226 (2d Cir. 2001) (Sotomayor, J.).

⁵ *Id.* at 234; see also *S.E.C. v. Yun*, 327 F.3d 1263, 1273 (11th Cir. 2003) (“Of course, a breach of an agreement to maintain business confidences would also suffice” to yield insider trading liability); *United States v. Chestman*, 947 F.2d 551, 571 (2d Cir. 1991) (noting that ‘fiduciary status’ may be established by “a pre-existing fiduciary relation or an express agreement of confidentiality”); *SEC v. Lyon*, 529 F.Supp. 2d 444, 452-53 (S.D.N.Y. 2008) (holding that SEC adequately alleged existence of predicate duty for misappropriation theory liability where it alleged that purchase agreement and other materials related to PIPE offering contained confidentiality conditions and provisions, including requirements that defendants use information for sole purpose of evaluating possible investment in the offering).