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IN THE COURTS

Misappropriation: The *Mark Cuban* Decision and Its Potential Impact on Insider Trading Law

by Christopher G. Green and Julie H. Jones

Many attorneys may have been casually following the SEC's insider trading case against Mark Cuban, the colorful owner of the Dallas Mavericks, purely for its popular appeal. But the decision issued on July 17th by Chief Justice Fitzwater of the Northern District of Texas dismissing the SEC's case against Mark Cuban has interest and potential importance beyond sensational intrigue and water-cooler talk.[1] If the decision is affirmed on appeal or is followed by other courts—both important qualifiers—it may impact insider trading law and certain market practices in important respects. It may significantly alter the way in which companies, investors, and other market professionals share and receive material, non-public information. It also may change the dynamic of insider trading enforcement actions, in light of additional, and potentially dispositive arguments that litigators can marshal on behalf of clients alleged to have violated the insider trading laws In the end, it may prompt legislation or SEC rulemaking in order to reverse the decision and thereby clarify and broaden the circumstances giving rise to liability under the misappropriation theory of insider trading.

INSIGHTS published an article in February 2009, well before the issuance of the court's decision, highlighting certain notable issues presented in the Cuban matter, including whether the SEC's complaint adequately alleged that Cuban agreed to maintain confidential information "in trust or confidence," and whether knowledge of an imminent PIPE[2] transaction was "material."[3] Both potentially were dispositive issues, and both are critical issues for practitioners and market participants. But Chief Judge Fitzwater's decision turned on a different, and not readily anticipated, ground. Specifically, Chief Judge Fitzwater held that the SEC had not adequately alleged that Cuban "undertook a duty of non-use of information required to establish liability under the misappropriation theory of insider trading[.]" [4] Notable and potentially game-changing is

Christopher G. Green *is a partner in the Litigation Department and Securities Litigation Group of Ropes & Gray LLP.* **Julie H. Jones** *is a partner in the Corporate Department of Ropes & Gray LLP and head of the firm's Federal Securities and Public Companies practice.*

the fact that the Court held that the duty giving rise to liability under the misappropriation theory of insider trading requires not only a duty to maintain the information in "trust or confidence," but also a duty of "non-use," that is, an agreement by the recipient not to use the information as a basis to trade in the publicly traded securities of the issuer.

Previously, most securities practitioners had proceeded on the view that a duty to maintain confidential information "in trust or confidence" was alone sufficient to give rise to liability under the misappropriation theory of insider trading. In fact, Rule 10b5-2, promulgated by the SEC under the Securities Exchange Act of 1934, expressly notes that an agreement to maintain material non-public information in confidence is sufficient to establish a basis of insider trading liability. This decision alters that basic understanding of insider trading law, and potentially narrows the circumstances that give rise to liability under the misappropriation theory of insider trading. A flurry of client alerts and legal commentary immediately followed the issuance of the decision, noting the dismissal on novel grounds of a case that appeared too many to be legally solid against Cuban, particularly at the pleading stage.

The Facts

Many observers viewed the straightforward facts alleged in the Cuban matter as a slam dunk for the SEC. Cuban was the largest shareholder of Mamma.com (Mamma), owning 6.3 percent. In spring of 2004, Mamma decided to raise capital through a PIPE. Mamma informed Cuban of the PIPE and invited him to participate. In that regard, the CEO of Mamma, Guy Faure, spoke with Cuban by telephone. The SEC alleged the call unfolded as follows:

> The CEO prefaced the call by informing Cuban that he had confidential information to convey to him, and Cuban agreed that he would keep whatever information the CEO intended to share with him confidential. The CEO, in reliance on Cuban's agreement to keep the information confidential, proceeded to tell Cuban about the PIPE offering.

Cuban allegedly reacted angrily, stating he did not like PIPE offerings because they diluted existing shareholders. At the end of the call, Cuban said, "Well, now I'm screwed. I can't sell." Several hours later, Cuban contacted the investment bank conducting the offering who allegedly supplied Cuban with additional confidential details about the PIPE. One minute later, Cuban telephoned his broker and directed the broker to sell all 600,000 of his Mamma shares. Mamma announced the PIPE the next day, the stock dropped 10.2 percent, and Cuban avoided $750,000 of losses. Cuban filed the required disclosure statement with the SEC and publicly stated that he had sold his Mamma shares because the company was conducting a PIPE.

Two Principal Legal Issues

Chief Judge Fitzwater's ruling addresses two principal legal issues presented by the parties' briefing:

1. Whether breach of a legal duty arising by agreement can be the basis for misappropriation theory liability; and
2. If so, what are the essential components of the agreement.[5]

As to the first issue, supported by a group of law professors as *amici curiae*, Cuban argued that liability under the misappropriation theory of insider trading requires a fiduciary or fiduciary-like relationship with the provider of the information, and that an agreement alone cannot provide a basis for liability. In a lengthy analysis reciting much of the Supreme Court's decision in *U.S. v.O'Hagan*[6] and the cases applying it, the court rejected this view, holding that an agreement alone, even absent a fiduciary relationship, can be the basis of the predicate duty giving rise to misappropriation theory liability.[7]

As to the second issue (*i.e.*, what the essential components of the agreement must be), and again relying at length on recited language from the *O'Hagan* decision, the court held that:

> The agreement, however, must consist of more than an express or implied promise merely to keep the 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.[8]

The court continued:

> But although conceptually separate, both nondisclosure and non-use comprise part of the duty that arises by operation of law when a fiduciary relationship is created. Where misappropriation theory liability is predicated on an agreement, however, a person must undertake, either expressly or implicitly, both obligations. He must agree to maintain the confidentiality of the information *and* not to trade on or otherwise use it. Absent a duty not to use the information for personal benefit, there is no deception in doing so.[9]

Applying that formulation to the facts alleged, the court held that the SEC did not allege that Cuban agreed, implicitly or explicitly, to refrain from trading.[10] According to the court, Cuban's comment that he was "screwed" and could not sell merely expressed "his belief, at least at that time, that it would be illegal for him to sell," but the comment did not constitute an agreement not to trade.[11]

The court went on to rule that the SEC cannot rely on Rule 10b5-2(b)(1) to impose the required duty. Rule 10b5-2(b)(1) defines the circumstances that establish the predicate "duty of trust or confidence" to include, among others, "whenever a person agrees to maintain information in confidence."[12]

None of the enumerated circumstances also expressly requires a duty to refrain from trading. As a result, the Court held that the SEC cannot rely on the rule to establish Cuban's liability under a misappropriation theory. According to the court, to permit otherwise "would exceed the SEC's Section 10(b) authority to proscribe conduct that is deceptive."[13]

The Court thus granted Cuban's motion to dismiss and gave the SEC 30 days to amend its pleading.

Key Takeaways

The first question issuers and investors now confront is whether this decision should prompt a change in current policies concerning the sharing, receipt, and use of material, non-public information. A wait-and-see approach may be the most prudent. This is a single case in a federal district court, and unless and until it survives appellate review or is followed by other courts, most market participants likely will refrain from relying on it to adopt new or substantially revised policies and practices. Because the precise issue on which the case turned is arguably one of first impression or could be limited to its facts (a limited oral conversation), market participants likely will wait and see how the decision is treated by the appellate court and other courts.

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There, however, will be some immediate revisions to market practices and the terms that govern the sharing of confidential information. For issuers, the decision may raise questions about how to handle disclosures under Regulation FD. Regulation FD permits issuers to provide information selectively "to a person who expressly agrees to maintain the disclosed information in confidence." Mamma appears to have followed Regulation FD, as it obtained a confidentiality commitment from Cuban, and there is no hint that the SEC perceived there to be an FD issue with Mamma's actions. However, if left unresolved, the decision creates a gap between Regulation FD and insider trading laws that the SEC likely would seek to close. In its proposing release for Regulation FD, the SEC had indicated that a FD compliant confidentiality agreement must include an agreement not to trade on the nonpublic information.

The SEC dropped this language in the final release, presumably because the requirement was unnecessary in light of Rule 10b5-2, but it is an indication of a change that the SEC may quickly institute.

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With respect to confidentiality agreements, for issuers who frequently have business reasons to provide material, non-public information to certain investors, whether in the context of a PIPE as in the Cuban matter or in other circumstances, the decision counsels them to negotiate specifically for an express provision by which the recipient agrees not to trade on the information provided pursuant to the agreement. As a practical matter, of course, many issuers and other providers of material, non-public information already obtain "sole use" provisions (e.g., "recipient agrees to use the information solely for the purpose of considering this specific investment"). And while the court in the Cuban matter was not presented with the issue, investors reasonably could infer from the court's reasoning that the court would have found such a sole use provision to constitute an agreement not to trade in publicly traded securities. In order to avoid tipper liability, or even the allegation or suggestion of tipper liability, many issuers and other providers of material, non-public information will undertake a review of their confidentiality agreements to determine whether a duty of "non-use" undertaken by the recipient is sufficiently explicit.

Issuers also may require the same explicit agreement at the outset of oral conversations with investors and market participants. The scripts used by investor relations personnel and senior executives at the outset of investor teleconferences or one-on-one discussions would remove any ambiguity by including language seeking to elicit an express agreement undertaken by the recipient not only to maintain the confidentiality of the information but also to refrain from trading or otherwise using the information.

For investors and other recipients of material non-public information, the decision likely will have less immediate impact. Whether or not the SEC chooses to replead the case or prevails on appeal, the SEC may continue to take enforcement action on reasonably analogous facts where an investor is under a duty to maintain information "in confidence" but nonetheless trades on the information. Depending on the circumstances, few investors are likely to seize on this decision as justification to trade not withstanding such an agreement.

These and other tweaks in market practices may limit the practical impact of the decision. It may have direct bearing only in the limited circumstance in which there is utter silence about any use restriction. The Mamma CEO did not instruct Cuban not to trade, and Cuban neither asked whether he could trade nor agreed not to trade. The issue of use was simply not raised. In most circumstances, however, the issue of use is raised in a confidentiality agreement or at the outset of a call. And in the event the recipient wants to establish perfect clarity on this point and says at the outset of the call, "Tell me whatever you want, but I might trade on it," the provider (if counseled on the issue) will invariably refrain from providing the information absent the recipient's oral agreement not to trade.

However, if the decision is affirmed on appeal and is subsequently followed by other courts, it would represent a sufficiently significant change to market practice and the current general understanding of misappropriation law that Congress might be prompted to clarify through legislation the everelusive scope of insider trading liability.

Notes

1. *SEC v. Mark Cuban*, Civ. No. 3:08-CV-2050-D (N.D. Tex July 17, 2009).

2. A “PIPE” is a private investment in public equity wherein selected accredited or institutional investors enter into a purchase agreement with an issuer of publicly traded securities committing to purchase a specific number of securities at a specified price, and the issuer agrees to register the resale of the securities by the investors.
3. Stephen E. Older and Seth T. Goldsamt, “The *SEC v. Mark Cuban* Insider Trading Case: Does It Pay to Be a Maverick When Trading Securities?,” *Insights*, February, 2009, Vol. 23; No. 2.
4. *SEC v. Mark Cuban*, Civ. No. 3:08-CV-2050-D (N.D. Tex July 17, 2009), at 1.
5. *Cuban* at 15.
6. *U.S. v. O’Hagan*, 521 U.S. 642 (1997).
7. *Cuban* at 20.
8. *Id.* at 21.
9. *Id*.
10. *Id.* at 27.
11. *Id*.
12. *Id.* at 31.
13. *Id.* at 34.

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