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Corporate Governance Group

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FEDERAL COURT – DISMISSING SEC SUIT AGAINST MARK CUBAN – EXPANDS SCOPE OF MISAPPROPRIATION THEORY OF INSIDER TRADING

The U.S. District Court for the Northern District of Texas recently dealt a high-profile blow to the Securities and Exchange Commission when it dismissed an insider trading action brought against Mark Cuban, the colorful Internet entrepreneur and owner of the National Basketball Association's Dallas Mavericks.[1] The Commission alleged that Cuban violated SEC Rule 10b-5 by trading on material inside information obtained from a Canadian Internet search engine company, Mamma.com Inc. (the "Company"), that he had agreed to keep confidential.

In so ruling, the Court acknowledged that breach of a contract provision establishing "a duty of non-use of information" may serve as a basis for liability under the misappropriation theory developed under Rule 10b-5, even when the recipient of the information has no fiduciary relationship with its provider. However, because Cuban had agreed with the Company only to keep the information provided to him confidential, but not to refrain from trading on or otherwise using the information for his personal benefit, the Court found that Cuban had not engaged in misappropriation for purposes of Rule 10b-5. The Court also concluded that Rule 10b5-2(b)(1), insofar as it "attempts to base misappropriation theory liability on an agreement that lacks an obligation *not to trade on or otherwise use confidential information* ... would exceed the SEC's §10(b) authority to proscribe conduct that is deceptive." [emphasis added]

The Court did grant the Commission 30 days to amend its complaint if it could produce sufficient facts to support an allegation that Cuban undertook a duty to the Company to actually refrain from trading on the confidential information. The Commission has declined that offer and is instead considering whether to appeal the decision.

[1] *Securities and Exchange Commission v. Mark Cuban*, C.A. No. 3:08-CV-2050-D (U.S. District Court Jul. 17, 2009).

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Background

In March 2004, Cuban purchased 600,000 shares of Company stock, becoming the largest known shareholder with a 6.3% equity stake. Shortly thereafter, the Company decided to raise additional capital through a private investment in public equity transaction, commonly known as a "PIPE".

As preparations for the PIPE were progressing, but before any public announcement, the Company's CEO telephoned Cuban to inform him of the forthcoming offering and invite him to participate. At the outset of the conversation, the CEO received an assurance from Cuban that he "would keep whatever information the CEO intended to share with him confidential." On this basis, the CEO proceeded to describe the proposed PIPE transaction to Cuban. Because the offering would be conducted at a discount to the prevailing market price, Cuban "reacted angrily" to the potential dilution of his ownership position. Undeterred, the Company provided Cuban with contact information for the investment bank conducting the PIPE so that he could obtain additional information. That same day, Cuban contacted the bank's sales representative and was supplied with additional information about the proposed offering. Just "[o]ne minute" after ending his call with the sales representative, Cuban instructed his broker to sell all of his shares of Company stock.

The Company's stock price declined when the PIPE offering was announced the next day, and continued to decline in the ensuing days. By selling before the Company's announcement, Cuban was able to avoid in excess of $750,000 in losses. Cuban subsequently filed the required public disclosure of his sales within the time period required by the Commission's rules. His disclosure stated that he sold his shares "because the company was conducting a PIPE."

Subsequently, the Commission filed suit against Cuban, charging him with insider trading in violation of Rule 10b-5 on the basis that he misappropriated material, non-public information from the Company to avoid a loss on the sale of his shares, despite having agreed to maintain the confidentiality of such information. Cuban, "supported by five law professors as *amici curiae*," responded with a motion to dismiss, arguing that his confidentiality agreement did not create a relationship with the Company akin to a traditional fiduciary as required by the misappropriation theory of liability. Cuban also argued that the Commission was exceeding its authority in relying on Rule 10b5-2(b)(1) to establish liability under the misappropriation theory on the basis of Cuban's alleged breach of his confidentiality agreement with the Company. While not agreeing with all of Cuban's positions, the Court granted his motion to dismiss the SEC's claims.

The Court's Analysis

The Court began its analysis by pointing out that the law of insider trading is based not on federal statute, but rather on SEC and judicial interpretations of the prohibition on "deceptive" conduct "in connection with the purchase or sale of any security" contained in Section 10(b) of the Securities Exchange Act of 1934. Next, the Court explained that two theories of liability have been developed under Rule 10b-5:

- The *traditional* or *classical theory*, which is premised on the breach of the "relationship of trust and confidence between the shareholders of a corporation and those insiders who have obtained confidential information by virtue of their position with that corporation." Under this theory, Rule 10b-5 is violated "when a corporate insider trades in the securities of his corporation on the basis of material, nonpublic information."

- The *misappropriation theory*, which expands the scope of insider trading liability to one who "misappropriates confidential information for securities trading purposes, in breach of a duty owed to the source of the information." In other words, "[i]n lieu of premising liability on a fiduciary relationship between company insider and purchaser or seller of the company's stock, the misappropriation theory premises liability on a fiduciary-turned-trader's deception of those who entrusted him with access to confidential information."[2]

In 2000, the SEC adopted Rule 10b5-2, "which delineates certain circumstances that will give rise to a 'duty of trust or confidence' for purposes of the misappropriation theory." Among other circumstances, this Rule provides that a "duty of trust or confidence" exists "[w]henever a person agrees to maintain information in confidence."

Because Cuban was not a Company insider, the Commission relied on the misappropriation theory, premised on Cuban's alleged breach of his agreement to keep the information provided to him about the PIPE offering confidential. The Court rejected Cuban's argument that the existence of a "preexisting fiduciary or fiduciary-like relationship," or the creation of a relationship "that bears all the hallmarks of a traditional fiduciary relationship," was necessary to hold Cuban liable. Instead, the Court found that a duty to refrain from trading on inside information may be found outside a traditional fiduciary relationship, such as through a contractual arrangement. "The SEC can promulgate a rule that imposes such a duty," the Court observed, "provided the rule conforms with the SEC's rulemaking powers." Ultimately, the Court concluded that the "state law of contracts" may supply the "requisite duty" under Rule 10b-5 to refrain from using a source's "material, non-public information for personal benefit," even in the absence of a traditional fiduciary relationship.

Next, the Court considered whether Cuban's confidentiality undertaking to the Company could serve as the basis for liability under this expanded construction of the misappropriation theory. In this connection, the Court noted that a contractual arrangement supporting a claim of insider trading "must consist of more than an express or implied promise merely to keep information confidential. It must also impose … the legal duty to refrain from trading on or otherwise using the information for personal gain." Because Cuban undertook only a duty not to disclose, rather than a duty not to make use of, the confidential PIPE information, the Court found the essential element of "deception" to be missing from the SEC's complaint. In other words, a confidentiality agreement lacking an express or implied prohibition on using the confidential information for personal benefit "cannot create the predicate duty for misappropriation theory liability," even though the individual subject to the confidentiality agreement trades securities on the basis of such information.

Finally, the Court addressed the issue whether the Commission could rely on Rule 10b5-2(b)(1) to "impose the required duty" to establish misappropriation liability, despite the fact that Cuban's confidentiality undertaking did not also prohibit him from trading on the information entrusted to him by the Company. At the outset of this discussion, the Court noted that "the SEC's rulemaking authority under §10(b) [of the Exchange Act] is bounded by the statute's proscription of conduct that is manipulative or deceptive," and that the Commission "cannot by rule make unlawful conduct that does not fall into one of these categories." The Court then observed that Rule 10b5-2(b)(1), by its "plain meaning," "attempts to predicate misappropriation theory

[2] Under the misappropriation theory, the *source* of the confidential information need not be the *issuer* of the securities that are the subject of the insider trading. *See* our Client Alert entitled "Ninth Circuit Applies Misappropriation Theory of Insider Trading to "Corporate Outsider" Despite Absence of Fiduciary Relationship with the Issuer of the Securities" (July 16, 2008).

liability on a mere confidentiality agreement lacking a non-use component." As such, "the SEC cannot rely on … [the Rule] to establish Cuban's liability under the misappropriation theory." To do so, according to the Court, "would exceed the SEC's §10(b) authority to proscribe conduct that is deceptive."

Conclusion

The *Cuban* decision reminds us that trading securities on the basis of material inside information, absent a duty to refrain from trading, cannot give rise to liability under SEC Rule 10b-5. However, the *Cuban* Court determined that a traditional fiduciary or fiduciary-like relationship is not the only source for supplying the requisite legal duty to establish insider trading liability under the misappropriation theory. Rather, the Court concluded that contractual obligations can create the requisite legal duty, provided that the contract itself includes a non-use component. A mere agreement to keep information confidential, by contrast, will not be sufficient for this purpose.

Confidentiality agreements customarily used in M&A transactions generally contain both non-disclosure *and* non-use obligations on the part of the recipient of confidential information. In light of the *Cuban* decision, however, companies preparing to engage in M&A activity, and their advisors, would be well advised to ensure that the non-use restriction necessary to establish a legal duty for misappropriation theory liability, in the absence of a traditional fiduciary or fiduciary-like relationship, is expressly included in their confidentiality agreements. And, obviously, preservation of the confidentiality of M&A discussions remains of paramount importance.

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