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Dismissal of SEC's Insider Trading Case Against Mark Cuban Makes New Law

On Friday, July 17, 2009, the District Court for the Northern District of Texas dismissed the SEC's insider trading complaint against Mark Cuban, based on an interesting and novel analysis of the duty required to support insider-trading liability under the so-called "misappropriation theory." *SEC v. Cuban*, No. 08-CV-2050 (N.D. Tex. July 17, 2009). In dismissing this much-watched case, the court held that, under the misappropriation theory, it is insufficient for the SEC to allege that a defendant traded stock based on information that he had agreed to maintain in confidence. To state its case, the SEC must also allege that the defendant breached an agreement not to trade.

This distinction – between a duty not to disclose and a duty not to trade – is one that no court before has drawn so explicitly. It led the court in the *Cuban* case to reject the SEC's contention that a confidentiality agreement alone can always give rise to liability, and also to reject Cuban's contention that an agreement between arm's length parties can never give rise to liability. Given the ubiquity of confidentiality agreements in complex private transactions, and the SEC enforcement staff's continued focus on insider trading cases, the analysis in the *Cuban* decision bears particular note.

Background

The SEC alleged that Cuban violated the securities laws when he traded on the basis of material nonpublic information that he had orally agreed to keep confidential. In June 2004, the CEO of internet search company Mamma.com told Cuban – the owner of NBA's Dallas Mavericks and, at the time, Mamma.com's largest shareholder – that the company would be raising capital through a private investment in public equity ("PIPE") offering. Cuban agreed to keep the information confidential. Although Cuban wanted to sell his shares (because he thought that the PIPE offering would dilute his investment), he apparently believed, at least initially, that his receipt of the material nonpublic information made such a sale impossible. According to the SEC, he told Mamma.com's CEO, "Well, now I'm screwed. I can't sell."

Nonetheless, after receiving additional confidential information from the investment bank conducting the PIPE offering, Cuban directed his broker to sell all of his Mamma.com shares. The SEC alleged that Cuban avoided more than $750,000 in losses by selling his stock before the company publicly announced the PIPE offering. The SEC asserted that

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Cuban's stock sales constituted insider trading in violation of Section 10(b) of the Exchange Act, Rule 10b-5, and Section 17(a) of the Securities Act.

The "Misappropriation" Theory

The SEC's complaint against Cuban relied on the "misappropriation" theory of insider trading, which extends insider-trading liability to corporate "outsiders." Unlike the "classical" insider-trading theory, which applies to corporate "insiders" with fiduciary duties to the companies and shareholders whose stock they have traded, the misappropriation theory applies to corporate outsiders with no such duties. The question in misappropriation cases is whether an outsider owed a duty to the source of the material nonpublic information upon which the outsider traded.

The *Cuban* Decision

The *Cuban* case turned on the nature of that outsiders' duty and how it is created. After reviewing numerous misappropriation cases, the court concluded that "the essence of the misappropriation theory is the trader's undisclosed use of material, nonpublic information that is the property of the source, in breach of a duty owed to the source to keep the information confidential and not to use it for personal benefit." In other words, the key issue is whether the trader is "under a legal duty to refrain from trading on or otherwise using [confidential information] for personal benefit."

This fundamental distinction – between the duty to maintain information in confidence and the duty to refrain from using confidential information for personal benefit – was not argued by either of the parties or articulated in any of the earlier misappropriation cases, but it nonetheless drove the court's analysis of the SEC's complaint.

First, the court rejected Cuban's argument that misappropriation liability requires a fiduciary or fiduciary-like relationship between the parties. While the court noted that such a relationship would, by operation of law, give rise to a duty not to use confidential information for the fiduciary's personal benefit, it also observed that this duty of "non-use" could arise by agreement. In fact, the court noted that an agreement, even between arm's length parties, could "capture[] the person's obligation with greater acuity than does a duty that flows more generally from the nature of the parties' relationship."

The court then analyzed the nature of an agreement that would give rise to the requisite duty and, in turn, misappropriation liability. Here, the court found it was breaking new ground: "no court appears to have analyzed the precise question that this court examines . . . the nature of an agreement that can give rise to misappropriation theory liability." The court then observed that while a fiduciary relationship and its attendant duty of loyalty would give rise to both of the requisite duties of nondisclosure and non-use, those two duties are analytically distinct in a misappropriation case – like the *Cuban* case – based on an agreement. After all, the court observed, a person who trades on the basis of

confidential information often has every incentive to agree to nondisclosure (because disclosing the information would eliminate the advantage he has over other market participants), but no incentive to agree to non-use. Thus, the court held that in cases where misappropriation liability is based on an agreement, "[the defendant] 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."

Next, the court rejected the SEC's reliance on Rule 10b5-2(b)(1), a Commission rule promulgated in 2000 that purports to define the circumstances in which a person has the requisite duty to establish misappropriation liability. By providing that such a duty arises where a person "agrees to maintain information in confidence," this rule would allow a misappropriation case to proceed on the basis of a confidentiality agreement alone. However, on the basis of the well-established doctrine that Section 10(b) requires some "deceptive" conduct, and the deception in a misappropriation case being "the undisclosed use of confidential information for personal benefit, in breach of a duty not to do so," the court concluded that Rule 10b5-2(b)(1) exceeded the SEC's authority under Section 10(b) and could not be relied upon because simply trading on confidential information is not deceptive.

Finally, turning to the allegations of the complaint, the court found that the SEC merely alleged that Cuban had agreed to maintain the confidentiality of the information about the PIPE offering. It did not allege that Cuban agreed to refrain from trading on the basis of the confidential information. On this basis, the court dismissed the complaint and gave the SEC 30 days to amend its pleading. It remains to be seen whether the SEC has any basis to allege that Cuban had agreed not to trade on the basis of the confidential information, or whether it will appeal the District Court's decision.

Lessons Learned

The *Cuban* case provides some interesting take-aways:

- *Absent a fiduciary (or fiduciary-like) relationship, liability under the misappropriation theory requires both an agreement not to disclose and an agreement not to trade.* Although the court did not cite any case articulating the distinction between the duty not to trade and the duty not to disclose, it reasoned that the distinction is inherent in the misappropriation theory because trading on confidential information does not deceive the source of the information unless the trader has expressly agreed to forego such trading.

- *A non-use or nondisclosure agreement may be oral or written.* The court did not give any weight to the fact that there was no written agreement between Cuban and Mamma.com's CEO.

- *An information source's unilateral "subjective" expectation will not suffice to create a duty not to trade.* The trader must expressly agree not to use the confidential information for his or her personal benefit.

- *The duty not to use confidential information for personal benefit is implied by law in a fiduciary relationship.* Thus, it does not matter whether a fiduciary enters into an agreement not to use confidential information – the fiduciary always owes such a duty.

- *Corporate "insiders" always owe a duty to their companies and shareholders not to trade on the basis of material nonpublic information.* The *Cuban* case only examined the misappropriation theory of insider trading.

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For further information about the *Cuban* decision, other insider trading cases, or any other enforcement developments, please contact any of your regular contacts at the firm or any of our partners and counsel listed under "Securities Enforcement and White-Collar Defense" in the "Practices" section of our website (http://www.clearygottlieb.com).

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