Securities Enforcement Alert

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Securities Enforcement Alert: Fifth Circuit Reinstates Insider Trading Claims Against Mark Cuban

On September 21, 2010, the Fifth Circuit Court of Appeals reinstated insider trading charges brought by the Securities and Exchange Commission against Texas entrepreneur Mark Cuban.[1] The suit arose out of Cuban's sale of his entire stake in Canadian internet search company Mamma.com shortly after he had received non-public information about the company's planned PIPE stock offering. As we discussed in a prior securities enforcement alert last year,[2] the district court had dismissed the complaint, holding the SEC had failed to adequately plead Cuban was liable for insider trading on a misappropriation theory. While the complaint alleged that Cuban had agreed to keep certain information confidential, it did not allege Cuban had agreed not to trade on that non-public information.[3] In reversing, the Fifth Circuit held that reading the complaint in the light most favorable to the SEC, the SEC had provided "more than a plausible basis" to find that Cuban had agreed not to trade on the information, and that "[i]t is at least plausible that each of the parties understood, if only implicitly . . . that Cuban could not use the information for his own personal benefit." By grounding its ruling in a disagreement with the district court's reading of the complaint, the Fifth Circuit declined to reach the lower court's holdings relating to the extent of the misappropriation theory and the viability of SEC Rule 10b5-2 in the misappropriation context.

Factual Background

Cuban's interest in Mamma.com dated back to March 2004, when he purchased 600,000 shares, or a 6.3% stake, in the search engine company. Later that spring, the company decided to raise capital through a Private Investment in Public Equity (PIPE) offering, a potentially unpalatable move to existing shareholders due to the likelihood it would dilute their ownership stakes and depress the company's stock price. Prior to public disclosure of the PIPE offering, Mamma.com's CEO called Cuban, a large minority shareholder, to inform him of the offering and to invite his participation. Based on the complaint, the CEO told Cuban about the offering only after Cuban agreed to keep the information confidential. As alleged, Cuban was unhappy with the planned PIPE, and at the end of the call purportedly told the CEO, "Well, now I'm screwed. I can't sell."

A few hours after the call, the CEO emailed Cuban the contact information for the investment bank assisting in the offering. Cuban called a sales representative at the bank, from whom he received additional confidential information about the PIPE. One minute after ending that call, Cuban telephoned his broker and directed him to sell all of Cuban's shares in Mamma.com. According to the complaint, by selling his shares prior to the public announcement of the PIPE, Cuban avoided losses of over $750,000.

District Court's Decision Granting Cuban's Motion to Dismiss

The SEC sued Cuban under the "misappropriation theory" of insider trading, first recognized by the Supreme Court in *United States v. O'Hagan*, under which it is a violation of the federal securities laws to misappropriate "confidential information for securities trading purposes, in breach of a duty owed to the source of the information."[4] *O'Hagan* did not define all circumstances giving rise to a duty whose breach would be actionable under a misappropriation theory. In *O'Hagan*, as is often the case in the misappropriation context, the duty was supplied by a fiduciary relationship between the source of the confidential information and its recipient who traded on it.

Here, the SEC argued that Cuban was liable because his agreement to keep the PIPE offering information confidential allegedly gave rise to a duty to the company which he allegedly breached by selling his Mamma.com stock without disclosing to the company his intent to trade on that non-public information. The SEC bolstered its argument by reference to Rule 10b5-2, which the commission adopted after *O'Hagan* to provide clarity as to certain circumstances under which a misappropriation theory duty arises. Subsection (b)(1) of the rule provides that "a duty of trust or confidence exists [for purposes of the misappropriation theory] . . . [w]henever a person agrees to maintain information in confidence."

While agreeing with the SEC that the requisite duty of trust or confidence in this context can be created by operation of SEC rule and a contractual agreement between parties, as opposed to a common law fiduciary relationship, the district court nonetheless rejected the SEC's argument that a "simple confidentiality agreement" by itself was enough to create such a duty. The district court held that there could be no liability under a misappropriation theory when a non-fiduciary, like Cuban, had not also agreed to refrain from trading on or otherwise using the confidential information for his personal benefit. The court further held that the SEC could not rely on Rule 10b5-2(b)(1) to supply the requisite misappropriation theory duty, because the rule purports to impose insider trading liability solely on the basis of a confidentiality agreement.

Finding that the SEC had alleged at most that Cuban had agreed to keep the non-public PIPE offering information confidential, but that it had failed to allege an agreement not to trade on that information, the district court dismissed the complaint.

Fifth Circuit Reverses

Reviewing *de novo*, the Fifth Circuit reversed the district court's dismissal of the insider trading charges on the relatively narrow ground that it disagreed with the lower court's reading of the complaint. Viewing the complaint in the light most favorable to the SEC, the Fifth Circuit concluded "the allegations, taken in their entirety, provide more than a plausible basis to find that the understanding between the CEO and Cuban was that [Cuban] was not to trade, that it was more than a simple confidentiality agreement." The Fifth Circuit remanded the case to the district court for further proceedings without reaching the lower court's holdings relating to when a misappropriation theory duty arises and the viability of Rule 10b5-2 in that context.

Reasons for Caution

While the Fifth Circuit's reversal turned on its more expansive reading of the SEC's complaint, the opinion suggests a variety of cautionary notes to a trader evaluating potential insider trading issues:

- The Fifth Circuit noted that Cuban's own reading of the complaint could raise questions of liability on a tipper-tippee theory of insider trading. The court pointed out that "[u]nder Cuban's reading, he was allowed to trade on the information but prohibited from telling others—in effect, providing him an exclusive license to trade on the material nonpublic information." In a footnote, the court added:

  > Such an arrangement would raise serious tipper/tippee liability concerns were it explicit. If the CEO knowingly gave Cuban material nonpublic information and arranged so he could trade on it, it would not be difficult for a court to infer that the CEO must have done so for some personal benefit — e.g., goodwill from a wealthy investor and large minority stakeholder.

- In construing the complaint, the appeals court also adverted to whether a more complete record might demonstrate that "Cuban mislead the CEO regarding the timing of his sale in order to obtain a confidential look at the details of the PIPE." This raises the question whether in such a case a court could find liability by reason of Cuban's deception without recourse to *O'Hagan* and the misappropriation theory, as the Second Circuit did in *U.S. v. Dorozhko*.[5]

- The appeals court concluded its decision by saying —

  > Given the paucity of jurisprudence on the question of what constitutes a relationship of "trust and confidence" and the inherently fact-bound nature of determining whether such a duty exists, we decline to first determine or place our thumb on the scale in the district court's determination of its presence or to now draw the contours of any liability that it might bring, including the force of Rule 10b5-2(b)(1).

The court, thus, did not reach whether Rule 10b5-2(b)(1), and its equation of an agreement of confidentiality with the trust and confidence required for misappropriation under *O'Hagan*, might yet have vitality in the Fifth Circuit.

Conclusion

Given the many doors left open by the Fifth Circuit, and holdings by other courts that assume, without discussion, that an agreement to keep information confidential is a sufficient predicate for insider trading under the misappropriation theory, it would be prudent to continue to exercise caution in this area. It would seem advisable that, absent special circumstances, an agreement to maintain the confidentiality of material non-public information, whether taking the form of a written non-disclosure agreement, an oral communication or the acceptance of a placement document with a confidentiality legend, should be presumptively treated as an agreement not to trade while in possession of material non-public information. At the very least, the case signals to traders and practitioners that the SEC's position on agreements of confidentiality and insider trading, whose rejection found encouraging support in the *Cuban* district court decision, should continue to be seriously regarded.

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Endnotes

[1] *See SEC v. Cuban*, No. 09-10996, 2010 U.S. App. LEXIS 19563 (5th Cir. Sept. 21, 2010).

[2] *See Texas District Court Dismisses Insider Trading Charges Against Mark Cuban and Holds That Misappropriation Theory Requires Duty Not to Trade, Securities Enforcement Alert*, August 2009. http://www.kramerlevin.com/news/Detail.aspx?id=41a82d72-06f8-4ad4-8701-00f6ace2047b

[3] *See SEC v. Cuban*, 634 F. Supp. 2d 713 (N.D. Tex. 2009)

[4] 521 U.S. 642 (1997).

[5] 574 F.3d 42 (2d Cir. 2009). In *Dorozhko*, the Second Circuit held that a computer hacker who penetrated a financial news site and traded on information obtained from the site ahead of its release to the market could be found liable under Rule 10b-5 if he gained access to the site through deceptive means.

If you have any questions or need additional information, please feel free to contact any member of our Litigation or Corporate Department.

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