

Federal Court Dismisses SEC Insider Trading Charges Against Mark Cuban

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In July of this year, the U.S. District Court in Dallas dismissed the Securities and Exchange Commission's insider trading suit against billionaire entrepreneur and Dallas Mavericks owner Mark Cuban. The case has surprising implications.

Background

Cuban owned 600,000 shares of a small public company, Mamma.com, Inc. After Mamma decided to engage in a so-called "PIPE" transaction, the company's CEO contacted Cuban to gauge his interest in participation. Before revealing the information to Cuban, the CEO asked Cuban, and Cuban agreed, to keep the information confidential. When he learned about the planned PIPE, Cuban allegedly became upset, fearing, not unreasonably, that a PIPE transaction would adversely affect the market price of the stock and dilute his interest in the company. Cuban ended the call by stating, "Well, now I'm screwed. I can't sell."

Shortly thereafter, without disclosing the PIPE transaction to anyone and without the knowledge and contrary to the expectations of the company, Cuban directed his broker to liquidate his position in Mamma, and his broker did so. The SEC claims that Cuban, by liquidating in advance of the public announcement of the PIPE deal, avoided losses of over \$750,000.

Misappropriation Theory

The law of insider trading has developed through judicial interpretation of Section 10(b) and Rule 10b-5 under the Securities Exchange Act of 1934. The SEC based its allegations against Cuban on the "misappropriation theory" of insider trading. Under that theory, a person commits fraud "in connection with" a securities transaction, and thus violates Section 10(b) and Rule 10b-5, when he misappropriates confidential information for securities trading purposes, in breach of a duty of loyalty owed to the source of the information. If the recipient of the information is in a relationship of trust and confidence with the provider of the information, e.g., is a fiduciary, and makes undisclosed, self-serving use of the principal's information in order to purchase or sell securities, that action defrauds the principal of the exclusive use of that information. The SEC argued, relying in part on its own Rule 10b5-2, that a confidentiality agreement, by itself alone, *establishes* the requisite relationship of trust and confidence to warrant application of the misappropriation theory. Cuban urged that under misappropriation theory, liability can arise only where there is a preexisting fiduciary relationship. He also argued that the SEC had exceeded its statutory authority when it promulgated Rule 10b5-2.

Case Dismissed

The Court first turned to Cuban's contention that only state law could supply the source of duty for liability under misappropriation theory. The Court agreed with Cuban that state law might be a source of a duty of disclosure, but it also held that other sources, such as SEC rules, can be valid sources of a duty that could give rise to potential insider trading liability.

The Court rejected Cuban's theory that liability under misappropriation theory requires a preexisting fiduciary or fiduciary-like relationship and held that breach of a legal duty arising from a contemporaneous agreement can constitute a basis for misappropriation theory liability. Where a fiduciary relationship exists, a duty arises by operation of law when the relationship is created; where there is no fiduciary relationship, but rather an agreement imposing a duty of trust and confidence, the duty arises by operation of the contemporaneous contractual commitment between the parties.

The Court then considered whether the exchange between Cuban and Mamma was sufficient to impose misappropriation theory liability. The Court held that a contemporaneous contractual agreement giving rise to such a liability must impose both a legal duty to keep the information confidential (non-disclosure) and a legal duty to refrain from trading on or using the information for personal gain (non-use). In a fiduciary relationship, both non-use and non-disclosure are wrapped into the duty that arises by operation of law. In the case of an agreement, for a duty to arise, a party must agree, implicitly or explicitly, to both non-disclosure and non-use. Because the SEC had alleged facts sufficient only to establish non-disclosure and did not allege any facts with regards to non-use, the SEC failed to state a claim of insider trading under misappropriation theory. The Court also determined that the SEC had exceeded its rule-making authority by extending the reach of Rule 10b5-2 beyond conduct that is manipulative and deceptive, because the rule allows liability to be based upon an agreement of confidentiality only.

The Implications

SEC v. Cuban is not over yet. The case was dismissed without prejudice, meaning that the SEC may refile its complaint against Cuban by pleading additional facts to meet the non-use standard. The Court noted Cuban's statement to the company, when he first learned of the PIPE transaction, "Well, now I'm screwed. I can't sell." However, the Court did not infer from this statement the existence of a contract not to use. The SEC is likely to allege that Cuban's statement meant precisely that, leaving the determination to a finder of fact. The SEC could also appeal the dismissal. This route may be more preferable to the SEC because the decision questions the scope of the SEC's authority in promulgating Rule 10b5-2. If the Court's decision remains controlling law, and especially if the decision is adopted by other circuits, it could have an adverse impact on the SEC's enforcement program.

There also may be important consequences for confidentiality agreements and their use by participants in securities markets. Many, perhaps most, non-disclosure agreements, including those designed to comply with Regulation FD – which

prohibits selective disclosure – specify only that a party agrees to keep information in confidence, and does not address any obligation of that party not to trade or make other advantageous use of that confidential information. Companies should make sure that both non-disclosure *and* non-use is clearly prohibited if the situation requires.