WILLKIE FARR & GALLAGHER LLP

CLIENT MEMORANDUM

FEDERAL DISTRICT COURT IN *MARK CUBAN* CASE ISSUES DECISION ON MISAPPROPRIATION THEORY OF INSIDER TRADING

On July 17, a federal district court in Dallas, Texas issued an important decision, *S.E.C. v. Cuban*, 2009 WL 2096166 (N.D. Tex. July 17, 2009), addressing the scope of liability under the "misappropriation" theory of insider trading. That theory, recognized over a decade ago by the Supreme Court of the United States, permits insider trading liability to attach under the federal securities laws when there is an 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. The *Cuban* decision is noteworthy because it clarifies the rights, obligations, and potential liabilities of corporate outsiders who receive material, nonpublic information regarding a company and subsequently trade in securities based upon that information — particularly at a time when the SEC is actively enforcing the nation's insider trading laws through civil enforcement activities.

The district court's decision in *S.E.C. v. Cuban*:

- holds that third parties who accept material, nonpublic information from an issuer on a confidential basis are not precluded from trading on that information absent a specific agreement with the issuer not to trade;
- rejects the notion that liability under the misappropriation theory requires the existence of a pre-existing fiduciary or fiduciary-like relationship between the issuer and the trader; and
- provides that the duty necessary to support liability based upon misappropriation may be established by way of a private agreement, and that the SEC has not impermissibly created federal common law by promulgating rules governing when a duty of "trust or confidence" arises.

Factual Background and the SEC's Claims

In November 2008, the SEC brought a civil enforcement action against Mark Cuban, the owner of the NBA's Dallas Mavericks franchise. The action arose from Cuban's June 2004 sale of his entire 6.3% ownership interest (600,000 shares) in Mamma.com Inc. (now Copernic, Inc.), a Canadian internet search company.

According to the SEC's complaint, during the spring of 2004, Mamma.com's executives decided to initiate a so-called private investment in public equity ("PIPE") offering to raise additional capital. Given the tendency of such offerings to dilute the value of existing shares, the company expected Cuban, its largest known shareholder at the time, to be unhappy with the news. The company's CEO telephoned Cuban and informed him of the PIPE offering. Cuban orally agreed to keep the information regarding the PIPE offering confidential, but allegedly reacted negatively upon hearing the news, saying: "Well, now I'm screwed. I can't sell." Despite his reaction, following the telephone conversation with the CEO and another discussion with the investment

bank conducting the PIPE offering, Cuban instructed his broker to sell his entire stake in Mamma.com. The next day, the company publicly announced the PIPE offering, an announcement which resulted in a decline in the price of Mamma.com stock. By selling on the nonpublic information, Cuban avoided over $750,000 in losses.

The SEC alleged that by selling his shares, Cuban misappropriated information belonging to the company regarding the offering in violation of Section 17(a) of the Securities Act of 1933 and Section 10(b) of the Securities Exchange Act of 1934. The SEC argued that Cuban's agreement to keep the information concerning the offering confidential gave rise to the predicate duty necessary for misappropriation liability, and that he could not trade once he agreed to keep the information confidential. In so arguing, the SEC drew upon Rule 10b5-2, a regulation that creates "a duty of trust of confidence" whenever "a person agrees to maintain information in confidence."

Supported by five law professors appearing as *amici curiae*, Cuban moved for dismissal of the SEC's claims, principally arguing that despite his oral agreement to keep news of the offering confidential, he could not be held liable under the misappropriation theory because, as a minority shareholder in Mamma.com, he did not stand in a fiduciary relationship with the company under Texas law. Cuban further argued that to the extent Rule 10b5-2 purported to create liability in the absence of a preexisting fiduciary or fiduciary-like relationship, the SEC impermissibly broadened the scope of insider trading liability.

The District Court's Decision

The district court noted that at the heart of the case was "[t]he nature of the duty required to support misappropriation theory liability." Although the court dismissed the SEC's claims, it rejected Cuban's primary argument that "liability under the misappropriation theory depends upon the existence of a preexisting fiduciary or fiduciary-like relationship." Discussing the Supreme Court's ruling in *United States v. O'Hagan*, 521 U.S. 642 (1997) – the landmark decision recognizing the misappropriation theory – the district court reiterated 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."

The court determined that "a duty sufficient to support liability under the misappropriation theory can arise by agreement absent a preexisting fiduciary or fiduciary-like relationship." The court noted that "[t]he goal of protecting the integrity of the securities markets and promoting investor confidence would be achieved just as effectively by enforcing duties of nondisclosure and non-use that arise by agreement as by enforcing duties that flow from the nature of the relationship between the information source and the misappropriator." Rejecting Cuban's argument that such a rule would constitute an impermissible extension of insider trading liability, the court held that "although the source of a duty adequate to support insider trading liability *can* be found in state law . . . it may be located elsewhere without violating the general rule against creating federal common law."

Nonetheless, in dismissing the complaint, the court found that to establish the duty necessary to support liability under the misappropriation theory, the agreement must have the "proper components." The agreement "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." According to the SEC's allegations, Cuban merely agreed to keep the information regarding the offering confidential; not to refrain from trading. Thus, his agreement with Mamma.com did not give rise to the duty necessary to support insider trading liability predicated upon misappropriation.

The SEC has been given the opportunity to amend its complaint, but it is unclear at this stage whether it will do so.

Conclusion

Although the claims against Cuban were dismissed, the decision does confirm that, as a general rule, courts broadly interpret the scope of the misappropriation theory. While each case will obviously turn on its facts and circumstances, persons in possession of material, nonpublic information should exercise great caution before they engage in securities trading, even in the absence of an explicit agreement to keep the information confidential or other restrictions concerning use of the information. Furthermore, corporate insiders and related parties who provide confidential information to outsiders should also exercise great care because providing such information without proper and necessary safeguards may create additional civil exposure. While the *Cuban* decision has generated much publicity, it is a district court decision from Texas and, therefore, it is possible that another court in another jurisdiction might have ruled differently on the SEC's claims.

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If you have any questions concerning the *Cuban* decision, or would like additional information, please contact Tariq Mundiya (212-728-8565, tmundiya@willkie.com), Todd G. Cosenza (212-728-8677, tcosenza@willkie.com), or the Willkie Farr & Gallagher attorney with whom you regularly work.

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