WHITE & CASE

Client Alert

Capital Markets | Mergers and Acquisitions

July 2009

United States District Court for the Northern District of Texas Clarifies Theory of Insider Trading in *Securities and Exchange Commission v. Mark Cuban*

In a widely-reported decision, on July 17, 2009 the United States District Court for the Northern District of Texas dismissed the insider trading complaint filed by the Securities and Exchange Commission (the "SEC") against Dallas Mavericks' owner, Mark Cuban.[1] The Court's reasoning provides useful guidance to companies disclosing material nonpublic information pursuant to confidentiality undertakings. Even though Mr. Cuban prevailed in the decision, the Court granted the SEC the right to file an amended complaint within 30 days and, whether or not an amended complaint is filed, the decision may be appealed. As a result, recipients of material nonpublic information should not, at this stage, draw firm conclusions from the decision.

Insider Trading

The prohibition against insider trading in the United States has developed incrementally over the years through SEC rule-making and judicial decisions interpreting the anti-fraud provisions contained in Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder. A person can be liable for insider trading under two theories:[2]

- The "classical theory" of insider trading holds that a corporate insider, such as a director, officer or controlling shareholder,[3] by virtue of his or her relationship with a corporation, owes a fiduciary duty to the corporation and the corporation's shareholders and must either disclose any material nonpublic information to a trading counterparty or abstain from trading while in possession of such information. Likewise, a corporation's consultants—including its bankers/underwriters, accountants and lawyers—who become privy to material nonpublic information with the understanding, implicit or explicit, that this information is to remain confidential and is being given solely for a corporate purpose, are also deemed to have a relationship of trust and confidence with the corporation and its shareholders akin to a fiduciary duty. They are under the same duty to disclose or abstain from trading.

1 *Sec. & Exch. Comm'n v. Mark Cuban*, No. 3:08-CV-2050-D (N.D. Tex. July 17, 2009), https://ecf.txnd.uscourts.gov/cgi-bin/show_public_doc?2008cv2050-33.

2 In addition, Rule 14e-3 under the Exchange Act provides a separate basis for liability, which does not require the existence of a duty, in the case of a person who trades in stock of a target company if "any person has taken a substantial step or steps to commence, or has commenced, a tender offer" and the person trading received material nonpublic information regarding the tender offer from the acquirer, the target or any director, officer, partner or person acting on behalf of either of them.

3 Controlling shareholders are recognized as quintessential insiders because of their ability to control the makeup of the board of a corporation. *See Dirks v. Sec. & Exch. Comm'n*, 463 US 646, 653 (1983) (citing *In re Cady, Roberts & Co.*, 40 S.E.C. 907, 911 (1961)) (listing officers, directors, and controlling shareholders as primary examples of insiders).

White & Case is a leading global law firm with lawyers in 35 offices across 24 countries.

If you have questions or comments about this alert, please contact one of the lawyers listed below:

William Currier
Partner, Washington, DC
Tel: + 1 202 626 3679
E-mail: wcurrier@whitecase.com

Colin Diamond
Partner, New York
Tel: + 1 212 819 8754
E-mail: cdiamond@whitecase.com

Mark Mandel
Partner, New York
Tel: + 1 212 819 8546
E-mail: mmandel@whitecase.com

John Reiss
Partner, New York
Tel: + 1 212 819 8247
E-mail: jreiss@whitecase.com

White & Case LLP
701 Thirteenth Street, NW
Washington, DC 20005
United States
+ 1 202 626 3600

White & Case LLP
1155 Avenue of the Americas
New York, NY 10036
United States
+ 1 212 819 8200

- The "misappropriation theory" of insider trading was affirmed by the US Supreme Court in 1997.[4] It expands the classical theory by extending liability to non-insiders of a corporation, namely those individuals who owe no fiduciary duty to the company or its shareholders. Under this theory of liability, an insider trading violation occurs when an individual misappropriates material nonpublic information in breach of a duty of trust and confidence owed to the *source* of the information. The theory was affirmed in connection with a partner in a law firm that was retained to represent an acquiror in a tender offer who purchased stock in the target company prior to commencement of the tender offer. In that situation, the partner owed no duty of trust or confidence to the target or its shareholders. Rather, such duty was owed solely to the acquiror. When the partner misappropriated the acquiror's confidential information (namely, its intention to make the tender offer) for securities trading purposes, the court found that a breach of that duty had occurred.

The Cuban Case and Decision

In June 2004, the CEO of Mamma.com Inc. informed Cuban, then the company's largest stockholder with a 6.3 percent stake, about an impending stock offering to see if he wished to participate. The CEO shared this information after receiving Cuban's oral agreement to keep it confidential. Within hours of obtaining this information, Cuban sold his entire position in the company. After the offering was announced publicly, Mamma.com's stock price fell and Cuban avoided losses in excess of US$750,000 by selling his stock. The SEC filed a complaint against Cuban, alleging that he had committed an insider trading violation.[5]

The Court's decision dismissing the SEC's complaint is instructive:

- First, Cuban contended that any agreement to maintain information confidential or not to trade must arise in the context of a preexisting fiduciary or fiduciary-like relationship. The Judge rejected this argument and determined that a simple contractual duty owed to the source of material nonpublic information is sufficient to establish liability under the misappropriation theory of insider trading. This appears to be the first time that a court has addressed in detail the nature of the agreement required to give rise to liability under the misappropriation theory.
- Second, the Judge determined that, even though Cuban had agreed not to *disclose* the material nonpublic information, that agreement was insufficient for liability under the misappropriation theory. In addition to an agreement not to disclose, there must be an agreement not to *use* the information. In reaching this determination, the Judge also found that the SEC exceeded its rulemaking authority in promulgating Rule 10b5-(2)(b)(1), the rule upon which the SEC based Cuban's liability. Rule 10b5-(2)(b)(1) defines a "duty of trust and confidence" for the purpose of the misappropriation theory as existing" whenever a person agrees to maintain information in confidence." The Judge found that the rule can only proscribe behavior that is "manipulative" or "deceptive," and that an agreement not to *use* confidential information was necessary in addition to an agreement not to *disclose* it.

Implications

Companies disclosing material nonpublic information should ensure that they obtain both an undertaking not to *disclose* and an undertaking not to *trade* from the third party recipient of that information. Ideally, that agreement should be in writing in order to avoid the risk of different interpretations that frequently arise from oral agreements. Companies should review their standard confidentiality agreements to ensure that they restrict both disclosure and trading. It should be noted that a mere warning that trading could result in a violation of the federal securities laws may not be sufficient since it does not amount to a contractual prohibition on trading.

It is too early for persons receiving material nonpublic information pursuant to a non-disclosure agreement to conclude that they are free to trade if they have merely agreed to keep the information confidential. First, whether there is an agreement not to trade involves a fact-specific analysis. Non-disclosure agreements generally do not include a provision stating that the agreement represents the entire agreement between the parties, called a "non-integration clause." Absent that clause, there is a heightened risk that a company may successfully claim that the overall arrangement included an undertaking not to trade. Furthermore, the Judge permitted the SEC to file within 30 days an amended

4 *See,* e.g., *United States v. O'Hagan*, 521 US 642 (1997).

5 Complaint, *Sec. & Exch. Comm'n v. Cuban*, No. 3:08-CV-2050-D (N.D. Tex. Nov. 17, 2008), *available at* http://www.sec.gov/litigation/complaints/2008/comp20810.pdf.

complaint alleging that Cuban "undertook a duty, expressly or *implicitly*, not to trade on or otherwise use material" (emphasis added). This reference to an implicit agreement leaves room for fact-specific interpretation in this and future cases. Second, the Cuban case is a District Court case of first instance that is not binding on other courts. Although the SEC will accept a portion of the decision, it will likely take issue with the Judge's ruling on Rule 10b5-2(b)(1). As a result, the case may be appealed to the Fifth Circuit of the Court of Appeals and, since it deals with novel issues, may reach the Supreme Court.

It is worth making particular mention of questions that arise in connection with preliminary acquisition discussions. For example, the CEO of a potential acquiror may make an informal inquiry of the CEO of a target. In the course of those discussions, the CEO of the acquiror may learn, for example, that target's board is unlikely even to consider a transaction for less than a certain price per share. At that point, the acquiror may wish to acquire shares in the market before entering into formal negotiations. The Cuban decision implies that absent an agreement not to disclose and not to trade, such acquisitions would be permitted. Nevertheless, for the reasons described above, we believe that reliance on the Cuban decision would be premature. As a general matter, if an acquiror wishes to acquire shares in a potential target, it is still preferable to acquire those shares prior to discussions with the target's management or board.

Conclusion

The reasoning in the Cuban decision is a positive step in starting to clarify the scope of liability under the misappropriation theory. However, further examination at the appeals level or through a revision to Rule 10b5-2(b)(1) would be helpful if recipients of material nonpublic information are to have certainty regarding their ability to trade. In the meantime, companies should obtain express agreements regarding confidentiality and trading when they disclose material nonpublic information. Recipients of material nonpublic information should continue to view the law in this area as being in a state of flux and await further clarification before drawing firm conclusions from the decision.

This Client Alert is provided for your convenience and does not constitute legal advice. It is prepared for the general information of our clients and other interested persons. This Client Alert should not be acted upon in any specific situation without appropriate legal advice and it may include links to websites other than the White & Case website.

White & Case has no responsibility for any websites other than its own and does not endorse the information, content, presentation or accuracy, or make any warranty, express or implied, regarding any other website.

This Client Alert is protected by copyright. Material appearing herein may be reproduced or translated with appropriate credit.

In this publication, White & Case means the international legal practice comprising White & Case LLP, a New York State registered limited liability partnership, White & Case LLP, a limited liability partnership incorporated under English law and all other affiliated partnerships, corporations and undertakings.
© 2009 White & Case LLP

NYC/0709_CM_A_04916_v1