Client Advisory

Katten
Katten Muchin Rosenman LLP

Financial Services

August 5, 2009

Effects of the Cuban Decision on the Misappropriation Theory of Insider Trading

On July 17, a federal district court in Dallas dismissed the complaint of the Securities Exchange Commission in *SEC v. Cuban*, 3:08-cv-02050-D, 2009 WL 2096166 (N.D.Tex July 17, 2009), a case in which the court addressed the misappropriation theory of insider trading liability. Under the misappropriation theory, a person commits fraud when he misappropriates confidential information for securities trading purposes in breach of a duty owed to the source of that information. In dismissing the SEC's complaint, the court held that although the SEC had alleged that Cuban had agreed with a corporate insider not to disclose material, nonpublic information, the SEC had failed to allege that Cuban had agreed—either expressly or implicitly—not to trade on such information. Accordingly, the court held that an agreement to keep the information confidential, alone, without the additional agreement not to trade on that information, was insufficient to establish fraud.

In our view, the Cuban decision sends a clear message to corporate executives that they cannot rely on generic confidentiality representations when they discuss material, nonpublic information with outsiders. Only an express agreement that the outsider will not trade or otherwise seek to profit from the information can prevent misuse of the information. In addition, recipients of material, nonpublic information should not view Cuban as the death knell of the misappropriation theory and a green light to trade. Whether this decision will be upheld if appealed or be followed by other district courts remains to be seen.

Factual Background

According to the SEC complaint, Mark Cuban, owner of the NBA's Dallas Mavericks, owned 600,000 shares of Mamma.com, representing a 6.3% ownership interest. In the spring of 2004, Mamma.com decided to conduct a so-called private investment in public equity ("PIPE") offering in an attempt to raise working capital. The CEO of Mamma.com telephoned Cuban, the largest known shareholder, to inform him of the PIPE offering. The CEO prefaced the call by telling Cuban that he had confidential information; Cuban orally agreed to keep whatever information the CEO shared with him confidential. Cuban reacted angrily when he heard the news about the PIPE offering and ended the call by saying, "Well, now I'm screwed. I can't sell." Following the call, and after gathering some additional facts, Cuban instructed his broker to sell all his 600,000 shares of Mamma.com. Cuban never informed Mamma.com that he intended to sell or had sold his shares. After Cuban had sold his shares, Mamma.com announced the PIPE offering and, predictably, the stock price dropped. Cuban avoided over $750,000 in losses by selling his stock early, based on nonpublic information.

For additional information, please contact one of the Katten Muchin Rosenman LLP attorneys listed below:

Robert W. Gottlieb
212.940.7090 / robert.gottlieb@kattenlaw.com

Scott A. Resnik
212.940.8543 / scott.resnik@kattenlaw.com

Bruce G. Vanyo
212.940.8787 / bruce@kattenlaw.com

Meryl E. Wiener
212.940.8542 / meryl.wiener@kattenlaw.com

The District Court's Decision

The court found that the SEC had failed to allege a claim for insider trading under the misappropriation theory. While the SEC was able to show that there was a fiduciary or fiduciary-like relationship between Cuban and Mamma.com (the CEO had told Cuban that the information was confidential, and Cuban agreed to keep the information confidential), the SEC failed to show that the trading was in breach of a duty not to misuse the information.

The court held that a mere confidential relationship was not enough to establish liability. Rather, the SEC needed to demonstrate that Cuban had agreed not to trade or otherwise profit from the information. The court stated, "with respect to confidential information, nondisclosure and non-use are logically distinct." The court explained that the deception occurs when a person secretly trades on confidential information in violation of the source's legitimate and justifiable expectation that the recipient will not do so. Further, the court held that this expectation of non-use is not unilateral, but rests on the recipient of the information's acceptance of a duty to refrain from using the information.

The SEC argued that SEC Rule 10b5-2(b)(1) allowed the SEC to allege a fiduciary or fiduciary-like relationship merely by alleging the existence of a confidential relationship. However, the court found that under the plain meaning of the Rule, misappropriation theory liability could not be based on a mere confidentiality agreement without an agreement not to use the information. The court found that because it did not include this non-use component, the SEC could not rely on the Rule to establish liability because that would exceed the SEC's §10(b) authority.

Since the SEC only alleged the existence of a confidential relationship and did not allege that the defendant had agreed not to use the confidential information, the court dismissed the complaint and gave the SEC 30 days to amend the complaint.

Conclusion

Notwithstanding that the claims against Cuban were dismissed, we believe both providers and recipients of material, nonpublic information should proceed with caution. Persons who are the recipients of material, nonpublic information should consult counsel before trading securities based on that information, even in the absence of an explicit representation that they will not trade in such information. Similarly, corporate executives who provide material, nonpublic information should obtain a representation that the recipient will not trade based on that information.

It should be noted that, while this case achieved significant notoriety, it is a U.S. district court decision in Texas, and courts in other jurisdictions are not bound by it; the case may be appealed and the SEC, pursuant to leave granted, may amend the complaint.

Katten

Katten Muchin Rosenman LLP

www.kattenlaw.com

CHARLOTTE CHICAGO IRVING LONDON LOS ANGELES NEW YORK PALO ALTO WASHINGTON, DC