Dismissal of Mark Cuban Insider Trading Case Centers on Confidentiality Agreement

Misappropriation of Confidential Information

The United States District Court for the Northern District of Texas on July 17, 2009 dismissed a complaint brought by the Securities and Exchange Commission (“SEC”) against Mark Cuban, a well-known entrepreneur and owner of the Dallas Mavericks basketball team. The complaint, initially brought under the misappropriation theory of insider trading, centered on Cuban’s sale of stock of a company in which he was the largest investor. In its holding, the court determined that the SEC had not alleged adequately that Cuban undertook a duty of non-use of information necessary to establish liability under the misappropriation theory. Under the misappropriation theory, a person commits fraud in connection with a securities transaction, and thereby violates Section 10(b) of the Securities Exchange Act of 1934, as amended, and Rule 10b-5 thereunder, when he or she misappropriates confidential information for securities trading purposes, in breach of a duty owed to the source of the information.

Background of Case

According to the SEC’s complaint, in March 2004, Cuban purchased a 6.3% stake in Mamma.com Inc., a public company (“Mamma”). Shortly thereafter, Mamma decided to raise additional capital through a private investment in public equity, or PIPE, offering. The SEC alleged that as the PIPE offering progressed toward closing, the chief executive officer of Mamma spoke by telephone with Cuban, its then-largest known shareholder. The CEO prefaced his conversation by informing Cuban that he had confidential information to convey to Cuban. Cuban agreed that he would maintain the confidentiality of the information, at which point the CEO informed Cuban of the proposed PIPE offering.

Cuban allegedly reacted angrily and indicated that he objected to the proposed PIPE offering because it would dilute the interests of existing shareholders. He ended the call by saying, “[N]ow I can’t sell.” Notwithstanding this reaction, in a subsequent e-mail, the CEO suggested that Cuban get in touch with Mamma’s investment bank to get more details about the proposed offering. The SEC contended that by stating that he could not sell, Cuban recognized that it would be illegal to sell his shares until Mamma announced the PIPE offering.

Nevertheless, after the initial call, Cuban sold his entire stake in Mamma without first disclosing to the company that he intended to trade on the information he received. In so doing, Cuban avoided losses in excess of $750,000 as the stock price declined significantly after the PIPE was announced publicly. The SEC alleged that Cuban’s sales violated the duty of confidentiality that he agreed to assume while speaking with the CEO and that he therefore engaged in unlawful insider trading.
Outcomes of Case

Cuban moved to dismiss the SEC’s complaint, and the court ultimately granted his motion. In its decision, the court considered whether the breach of a legal duty arising by agreement could be the basis for liability under the misappropriation theory and, if so, what the essential components of such an agreement would be. The court determined that, where liability is predicated on the existence of an agreement, the agreement must consist of more than an express or implied promise to keep information confidential. Rather, the agreement must also impose on the party receiving the information a legal duty to refrain from trading on or otherwise using the information for personal gain.

The court held that the SEC did not allege adequately that Cuban agreed not to use the information for personal gain and that such agreement is necessary to create a duty sufficient to establish liability. Although the SEC alleged in its complaint that Cuban entered into an agreement with Mamma not to disclose material, non-public information about the PIPE offering, the SEC did not allege that Cuban had also agreed not to trade on or otherwise use that information. Accordingly, the court dismissed the case.

The court noted that Cuban’s statement in his conversation with Mamma’s CEO that he could not sell his shares did not amount to an agreement to refrain from trading based on the information. In granting Cuban’s motion to dismiss, the court allowed the SEC to re-plead if it could allege that Cuban undertook a duty not to trade.

Practical Application

The SEC has not yet indicated whether it will amend the complaint, and it remains to be seen whether this decision is affirmed on appeal or is followed by other courts. We also note that, in broad strokes, the “I’m about to give you confidential information” conversation described in the SEC complaint occurs frequently in many contexts in the financial markets. Under the ruling of the Cuban court, conversations of that character would not suffice, without more, to restrict a recipient’s ability to trade on such information—a view that may have far-reaching consequences. In light of these considerations, we draw the following lessons from the court’s decision:

- Issuer representatives conveying material non-public information, including disclosure about a proposed securities offering, to third parties should seek an express agreement or acknowledgement, in writing, by the recipient (1) to maintain the confidentiality of such information, and (2) not to use the information for the recipient’s personal benefit, including not trading in the issuer’s securities after receiving such information. Some investors will resist a forthright acknowledgement of a trading bar for fiduciary reasons. If an express agreement not to trade cannot be obtained, an issuer’s representatives could discuss the need for a bar on trading and suggest that the potential investor acknowledge, in writing, the restrictions imposed by federal and state securities laws on a person possessing material non-public information. It should be noted that such an agreement would be less helpful to the issuer than an explicit agreement not to trade, but may be sufficient as a basis to proceed with the disclosure, depending on the circumstances. The rationale for obtaining such an agreement stems from both potential insider trading liability as well as the issuer’s obligations to avoid selective disclosure of material non-public information under Regulation FD of the Securities Act.

- For the avoidance of doubt, even if a particular confidentiality agreement does not explicitly set forth an agreement not to trade, we would advise third parties who receive such information to refrain from trading activity while in possession of material non-public information, as potential liability for insider trading under the federal securities laws can apply to both tippers and tippees.

- Issuers should also be cautious about allowing placement agents to circulate “teaser documents” describing a proposed private placement that may tacitly identify the issuer before an offering is announced. In those circumstances, the issuer and placement agent should obtain a prior non-disclosure agreement from the prospective investors that they will keep confidential the existence and terms of the offering and will not engage in any trades in the issuer’s securities until the offering is announced.
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