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Shareholder's Promise to Keep PIPE Offering Information Confidential

5th Circuit Reinstates SEC Insider Trading Case Against Mark Cuban

A federal appeals court recently handed the SEC a victory in its long-running battle against Mark Cuban, the well-known entrepreneur and owner of the Dallas Mavericks. The decision, *SEC v. Cuban*, reinstates an enforcement action that had been dismissed by a district court judge in Texas. It was one of numerous cases brought several years ago by the SEC against investors who sold stock (or sold short) after learning about imminent offerings for "private investment in public equity," or PIPEs. The SEC took the position that information about PIPEs, which is by definition non-public, is also material. Last year, the SEC suffered a serious setback when its insider-trading case against Cuban was thrown out on the ground that Cuban had not promised that he would not trade after learning about a PIPE offering. Three weeks ago, the SEC experienced another defeat when a judge (in another action) ruled that information relating to PIPEs may not be material in all cases. Now, with the Cuban case revived, the SEC's aggressive position on trading prior to the announcement of a PIPE offering looks more reasonable.

In light of the fact-and-circumstances standard announced in the Cuban decision, companies need to pay close attention to the promises they exact when sharing non-public information with investors. Likewise, investors are on notice that if they receive non-public information from an issuer about a PIPEs offering, they should not sell any of the issuer's stock until news of the PIPEs offering becomes public, whether or not they have promised to refrain from selling.

The PIPE Offering

As alleged in the SEC complaint, Cuban acquired a 6.3% stake in Mamma.com in March 2004.[1] Shortly thereafter, the CEO of Mamma.com asked Cuban if he would like to participate in a PIPE offering. The CEO informed Cuban at the beginning of that call that he had confidential information to convey to him, and Cuban agreed to keep confidential whatever information the CEO intended to share with him.

When he heard that the confidential information involved a PIPE offering, Cuban was unhappy because he predicted that a PIPE offering would dilute his investment. He said to the CEO: "Well, now I am screwed. I can't sell." Cuban then requested additional information on the PIPE offering, and later received an e-mail from the CEO with the

[1] *SEC v. Cuban*, 634 F. Supp. 2d 713 (N.D. Tex. 2009), *vacated*, No. 09-10996, 2010 U.S. App. LEXIS 19563 (5th Cir. Sept. 21, 2010).

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contact information for the investment bank handling the offering.[2] Cuban called the investment bank and acquired additional confidential information, including the fact that the PIPE would be sold at a discount to the market price.

Despite his statement to the CEO that the information of information regarding the PIPE prevented him from selling, following the call with the investment banker Cuban placed an order to sell all of his shares in Mamma.com.[3] The shares were sold during the next two days, before any public announcement concerning the PIPE offering. According to the SEC's complaint, Mamma.com's shares closed substantially lower after the disclosure, and Cuban avoided losses in excess of $750,000.

In a characteristically aggressive move, Cuban disclosed in the SEC filing concerning the sales that he had sold his stake in the company because of the PIPE offering. In November 2008, almost four years later, the SEC charged Cuban with insider trading, in violation of Section 17(a) of the Securities Act of 1933 and Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder.

SEC Loss in Lower Court

In an opinion widely hailed by the white-collar defense bar, a federal court in Texas ruled that the SEC had not stated a case against Cuban. The Court found that Cuban had not "misappropriated" any material non-public information because he had not violated a "legal duty to refrain from trading on or otherwise using it for personal benefit." Rejecting the SEC's argument that Cuban could not trade because he had agreed to keep the information confidential, the Court found that Cuban had not promised that he would refrain from any trading. Cuban's observation—"Well, now I am screwed. I can't sell"—did not amount to such an agreement. Because he had not promised to refrain from trading, there was no "deception," which is a required element for a fraud violation involving insider trading. The Court also found that an SEC rule supporting the SEC's position, Rule 10b5-2(b)(1), was invalid. The SEC had overstepped its rulemaking authority in promulgating the rule by proscribing conduct that involved no deception according to the Court.

SEC Victory on Appeal

A three-judge panel on the Fifth Circuit Court of Appeals ruled that a finder of fact could plausibly find that Cuban had promised that he would not sell his stock. Cuban's statement that "I can't sell" was not necessarily an agreement to refrain from selling, the appellate court ruled. But Cuban had requested more information, and in accommodating him, the CEO may plausibly have understood that Cuban would not sell before a public announcement of the PIPE offering.

However, the Fifth Circuit refrained from holding that the relationship between Cuban and Mamma.com's CEO and investor bankers must be one of "trust and confidence" because Cuban had agreed to keep the information confidential. Thus the Court implicitly called into question the validity of Rule 10b5-2(b)(1), which provides that a duty of trust or confidence exists "[w]henever a person agrees to maintain information in confidence."[4] While the Court did not follow the district court in rejecting the rule (as exceeding the SEC's rulemaking authority), the enforceability of the SEC rule—at least in the Fifth Circuit—is in doubt.

The Court was, however, clearly troubled by Cuban's argument that he had *carte blanche* to sell his stock after learning information from the CEO that he had agreed to keep confidential. If the CEO had "tipped" Cuban, with awareness he would sell his stock, both Cuban and the CEO would have engaged in classic insider trading, provided the CEO received a personal benefit from "tipping" Cuban.

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[2] *SEC v. Cuban*, No. 09-10996, 2010 U.S. App. LEXIS 19563 (5th Cir. Sept. 21, 2010).

[3] *SEC v. Cuban*, 634 F. Supp. 2d 713 (N.D. Tex. 2009).

[4] 17 C.F.R. § 240.10b5-2(b)(1).

Unresolved Issues

The Court issued a very narrow holding, noting the "paucity of jurisprudence" on what constitutes a relationship of trust and confidence. No circuit court has directly addressed whether an agreement to keep information confidential by itself acts as a bar on trading relevant securities. With this decision, the Fifth Circuit has not clarified the issue, but instead announced a facts-and-circumstances standard.

It is clear, however, that a promise to refrain from trading is enforceable, and any subsequent trades in the relevant security prior to public disclosure of the information will result in "deception." If there were ever any doubt, issuers should obtain promises to refrain from trading (as well promises to maintain confidentiality) prior to disclosing non-public information to persons outside the company, including shareholders.

The import of *SEC v. Cuban* is less clear for investors and others outside the company. Following the district court decision, outsiders in this position could have assumed—at least in the Fifth Circuit—that they could sell their stock after acquiring non-public information, as long as they did not promise to refrain from selling. Now, that approach is at best unwise. The better approach is to reject an offer of non-public information in order to preserve the ability to sell stock of the issuer. Without any bright-line standard, a court could find a relationship of trust and confidence, depending on the specific communications and other factors.

Although the Court reinstated the SEC's case, allowing it to proceed with discovery, the SEC did not achieve the result it had hoped for. There is a gaping hole in the definition of insider trading, as it has been refined by judicial precedent spanning 50 years. The loophole is that an investor provided non-public information by company management for a legitimate reason is not necessarily breaching any fiduciary duty or engaging in any deception when the investor buys or sells company stock while in possession of that information. No duty is breached, and no deception occurs, unless the investor has promised not to trade. The SEC tried to address this loophole by promulgating Rule 10b5-2(b)(1), which has now been called into question.

The SEC also faces an uphill battle in trying PIPEs cases, as illustrated by the decision in its case against hedge fund manager Robert Berlacher.[5] Following a non-jury trial, the judge ruled that the SEC had not met its burden in proving that information about a PIPE offering was material. The judge did not credit an SEC expert witness who opined that adding shares to the float would "most likely" have caused the share price to decline and therefore was "material."

Cuban has shown no inclination to settle. His well-funded defense includes a separate lawsuit against the SEC for improperly withholding documents he requested under the Freedom of Information Act. Two weeks ago, the day after the Texas lawsuit was reinstated, a judge in Washington, D.C. ruled against the SEC, ordering it to produce its case file "forthwith."[6] It remains to be seen whether Cuban—or the SEC—will throw in the towel.

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5 *SEC v. Berlacher*, No. 07-3800, 2010 U.S. Dist. LEXIS 95759 (E.D. Pa. Sept. 14, 2010).

6 *Cuban v. SEC*, No. 09-0996, 2010 U.S. Dist. LEXIS 99664 (D.D.C. Sept. 22, 2010).

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