Revival of SEC’s Mark Cuban suit portends expansion of insider-trading ‘misappropriation’ theory

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Recently, the 5th U.S. Circuit Court of Appeals vacated the earlier dismissal by the U.S. District Court for the Northern District of Texas of an insider-trading action that the Securities and Exchange Commission brought against Mark Cuban, the colorful Internet entrepreneur and owner of the National Basketball Association’s Dallas Mavericks.¹

The commission alleged that Cuban violated Rule 10b-5 promulgated under the Securities Exchange Act of 1934 by trading on material inside information obtained from a Canadian Internet search engine company Mamma.com Inc., despite his agreement to keep the information confidential.

This suit has engendered an unusual level of acrimony between Cuban and the commission.

The District Court in 2009 granted Cuban’s motion to dismiss,² dealing a high-profile blow to the commission at a time when it was under significant political pressure to step up its enforcement activities. However, the 5th Circuit has breathed new life into the commission’s suit.

In essence, the appellate court was not prepared to accept, at least on the record before it, the District Court’s conclusion that Cuban’s undertaking of confidentiality was not sufficient to support a claim that he misappropriated confidential information from Mamma.com in violation of insider-trading laws.

Accordingly, the 5th Circuit vacated the lower court’s decision and remanded the case “for further proceedings including discovery, consideration of summary judgment and trial, if reached.”

BACKGROUND

In March 2004 Cuban purchased 600,000 shares of Mamma.com stock, becoming the largest known shareholder with a 6.3 percent equity stake. Later that spring, Mamma.com decided to raise additional capital through a “private investment in public equity” transaction, commonly known as a “PIPE.”

Prior to public announcement of the PIPE, Mamma.com’s CEO telephoned Cuban to inform him of the forthcoming offering and invite his participation.

At the outset of the conversation, the CEO received an assurance from Cuban that he would maintain the confidentiality of the information about to be shared with him. The CEO then proceeded to describe the proposed PIPE to Cuban.

Because the offering would be conducted at a discount to the prevailing market price, Cuban “reacted angrily” to the imminent dilution of his ownership position. He then requested additional information, and the CEO provided him with contact information for Mamma.com’s investment bank.

Later that day, Cuban contacted the bank’s sales representative, who supplied him with additional confidential information about the proposed offering.

Just “one minute” after ending his call with the sales representative, Cuban instructed his broker to sell all his shares.

As Cuban foresaw, Mamma.com’s stock price declined significantly when the PIPE was announced the next day and continued to decline in the ensuing days. By selling his shares before Mamma.com’s announcement, Cuban was able to avoid losses in excess of $750,000.

He then filed the required public disclosure of his sales as required by SEC rules. His filing disclosed that he had sold his shares “because Mamma.com was conducting a PIPE.”

The commission subsequently filed suit against Cuban, charging him with insider trading in violation of Rule 10b-5.

The complaint alleged that Cuban had misappropriated material, non-public information about the PIPE from Mamma.com to avoid a loss on the sale of his shares, despite having agreed to maintain the confidentiality of such information.

The misappropriation theory expands the scope of insider-trading liability beyond traditional insiders to one who “misappropriates confidential information for securities-trading purposes, in breach of a duty owed to the source of the information.”³

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In bringing its suit against Cuban, the commission relied specifically on Rule 10b5-2, "which delineates certain circumstances that will give rise to a duty of trust or confidence for purposes of the misappropriation theory,"⁴ including “[w]henever a person agrees to maintain information in confidence.”⁵

Cuban, supported by five law professors as amici curiae, responded with a motion to dismiss, arguing that his confidentiality undertaking did not create a fiduciary relationship with Mamma.com sufficient to serve as a basis for liability under Rule 10b-5. Cuban also argued that the commission was exceeding its authority in relying on Rule 10b5-2(b)(1).

THE DISTRICT COURT’S ANALYSIS

The District Court began its analysis by rejecting Cuban’s argument that the existence of a “pre-existing fiduciary or fiduciary-like relationship,” or the creation of a relationship “that bears all the hallmarks of a traditional fiduciary relationship,” is necessary to proceed with an insider-trading claim against Cuban under the misappropriation theory.

Instead, the District Court agreed with the commission’s expansive view that a duty to refrain from trading on inside information under Rule 10b-5 may be found outside a traditional fiduciary relationship, such as

References:

¹ Cuban v. SEC, 5th Cir. (2009).
⁴ Cuban v. SEC, 5th Cir. (2009).
⁵ Cuban v. SEC, 5th Cir. (2009).
⁶ Cuban v. SEC, 5th Cir. (2009).
As Cuban foresaw, Mamma.com’s stock price declined significantly when the PIPE was announced the next day.

through the “state law of contracts,” which may supply the “requisite duty” under Rule 10b-5 to refrain from using a source’s “material, nonpublic information for personal benefit.”

However, the District Court also concluded that Cuban’s confidentiality undertaking could not serve as a basis for liability under the misappropriation theory due to the absence of the essential element of “deception.”

From the District Court’s point of view, a contractual arrangement supporting a claim of insider trading “must consist of more than an express or implied promise merely to keep information confidential. It must also impose ... the legal duty to refrain from trading on or otherwise using the information for personal gain.”

In other words, a confidentiality agreement lacking an express or implied prohibition on using the confidential information for personal benefit “cannot create the predicate duty for misappropriation theory liability,” even when the individual subject to the confidentiality agreement profits from trading in the securities on the basis of such information.

The District Court also ruled that Rule 10b5-2(b)[1], insofar as it “attempts to base misappropriation theory liability on an agreement that lacks an obligation not to trade on or otherwise use confidential information ... would exceed the SEC’s Section 10(b) authority to proscribe conduct that is deceptive” (emphasis added).

The District Court further concluded that Rule 10b5-2(b)[1] cannot be used to “predicate misappropriation-theory liability on a mere confidentiality agreement lacking a non-use component.”

**THE APPEALS COURT’S ANALYSIS**

The 5th Circuit did not question the District Court’s finding that a contractual undertaking may be sufficient to supply the requisite duty to support misappropriation-theory liability. However, it did not agree with the District Court’s conclusion that Mamma.com and Cuban had not reached an understanding that Cuban would not sell his shares before public announcement of the PIPE.

Instead, the appellate court noted several key factors making it “at least plausibly that each of the parties understood, if only implicitly, that Mamma.com would only provide the terms and conditions of the offering to Cuban for the purpose of evaluating whether he would participate in the offering, and that Cuban could not use the information for his own personal benefit.”

In particular, the court emphasized that after being informed of the PIPE by Mamma.com’s CEO, Cuban volunteered: “Well, now I’m screwed. I can’t sell.”

The court also found it compelling that after Cuban made this statement, he asked for additional details, and the CEO, in a follow-up e-mail, provided him with access to the bankers for the transaction.

**CONCLUSION**

The appeals court’s decision in Cuban affirms the commission’s position that a traditional fiduciary or fiduciary-like relationship is not the only source for supplying the requisite legal duty to establish insider-trading liability under the misappropriation theory. Rather, at least in the 5th Circuit, it is clear that a contractual obligation also can create the requisite legal duty.

Moreover, the decision to overturn the District Court’s dismissal of the case against Cuban strongly suggests that factual circumstances surrounding a confidentiality undertaking may also give rise to a duty not to make personal use of the information in question, and that a violation of this duty can serve as a basis for liability under the misappropriation theory. It will be interesting to see how the suit proceeds in the District Court in light of the statements made by the 5th Circuit.

In the meantime, companies preparing to engage in M&A activity, and their advisers, are still well-advised to ensure that an explicit non-use restriction is included in confidentiality agreements with potential bidders and others. Furthermore, it continues to go without saying that, in light of both Cuban decisions, preservation of the confidentiality of M&A discussions remains of paramount importance for a number of reasons.

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A confidentiality undertaking may give rise to a duty not to make personal use of the information in question.
**NOTES**

1. SEC v. Cuban, 2010 WL 3633059 (5th Cir. Sept. 21, 2010).
5. SEC Rule 10b5-2(b)(1), 17 C.F.R. 240.10b5-2(b)(1).

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**SUBPRIME**

**Suit: Quick growth, risky loans caused fiscal services firm’s fall**

Investors in PrivateBancorp Inc. were blindsided when the financial services firm revealed a $91.3 million loss for 2008 after its officers grew the company too quickly by loading up on high-risk loans, according to a Chicago federal court securities fraud suit.

**City of New Orleans Employees Retirement System v. PrivateBancorp Inc. et al., No. 10-6826, complaint filed (N.D. Ill. Oct. 22, 2010).**

A New Orleans municipal pension fund says PrivateBancorp officers and directors violated federal securities laws by keeping shareholders in the dark about a growth plan that expanded the business too quickly with too many subprime, delinquent loans.


Investors were damaged when PrivateBancorp’s stock suddenly dropped by 22 percent after its officials revealed a loss of $91.3 million for 2008, the suit says.

However, three days after the suit was filed, PrivateBancorp announced a $4.5 million profit for the third quarter of 2010.

No one was immediately available at the Chicago-based company to comment on the lawsuit.

The pension fund claims PrivateBancorp, which is chartered in Delaware, specialized in providing commercial and private banking to middle-tier companies and high-end families when it embarked on an aggressive growth plan in 2007.

That plan “placed the achievement of financial targets above responsible banking” and resulted in the accumulation of “high-risk, low-quality loans,” the complaint alleges.

The suit claims PrivateBancorp’s top officers reviewed and signed off on numerous false and misleading statements about the company’s worth and fiscal future.

The defendant officers and directors knew their statements to investors and regulatory agencies were false when they were made, the complaint says.

**Attorney:**

**Plaintiffs:** Avi Josefson, Bernstein Litowitz Berger & Grossman, Chicago

**Related Court Document:**

Complaint: 2010 WL 4259166