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July Madness: In Maverick Case, the SEC Tosses an Air Ball

On July 17, 2009, sports enthusiast Mark Cuban won a significant victory when a federal trial court in Dallas dismissed the SEC's insider trading charges against him.

The SEC's charges were based on a 2004 telephone conversation between Cuban and the CEO of internet search company Mamma.com, a publicly-traded company. At the time, Cuban was the largest shareholder, holding 6.3% of the shares. According to the SEC's allegations, during the call the CEO told Cuban he had confidential information to discuss, and Cuban agreed to keep the information confidential. The CEO then informed Cuban that the company intended to pursue a private investment in public equity (PIPE) offering and invited Cuban to participate. Upset, Cuban objected to the PIPE offering because of its dilutive effects on existing shareholders. He expressed further displeasure to the CEO saying, "Well, now I'm screwed. I can't sell."

After the phone call, Cuban contacted the company's investment banker for additional non-public information regarding the proposed PIPE transaction. Then, prior to any public announcement of the PIPE offering, Cuban sold 600,000 shares, his entire position, in Mamma.com's stock.

According to the SEC's complaint, Cuban's sale violated the duty of confidentiality he assumed in his conversation with the CEO, and that accordingly Cuban engaged in unlawful insider trading in violation of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b5-2 thereunder. The SEC alleged that Cuban avoided losses of $750,000 that he would have incurred when the company's stock price dropped after it announced the PIPE deal.

Despite the SEC's arguments, the trial court granted Cuban's motion to dismiss (a motion supported by an amicus brief filed by a Dream Team of law professors). The court ruled that an agreement to maintain confidentiality is not a sufficient predicate for insider-trading liability under the misappropriation theory. In an issue of first impression, the court concluded that, absent a fiduciary or similar relationship between the parties, a confidentiality agreement may form the basis for a misappropriation charge but only if the agreement explicitly or implicitly imposes a duty not to disclose material, nonpublic information *as well as* a duty not to trade on that information. Since the SEC did not allege that Cuban had agreed not to trade, the case was dismissed. The court did not view Cuban's admission at the end of his conversation with the CEO that "I can't sell" as evidence of an actual agreement not to sell.

The trial court's decision, however, was not a slam dunk for Cuban. Rather, the court gave the SEC thirty days to file an amended complaint if it can allege Cuban undertook a duty not to trade. Also, whether or not the SEC files an amended complaint, it is unclear if the decision will survive appellate review or will be followed by other courts. In the meantime, the case has important consequences for the law and practice surrounding the use of confidentiality agreements, which are frequently relied upon in capital market transactions.

- Securities and corporate lawyers should ensure their form confidentiality agreements cover both transmitting the information and trading on the information. Note, however, that under Regulation FD, an issuer is permitted to share material information with a significant stockholder if that stockholder agrees to keep the information confidential. Because Mamma.com's management followed this course, they were not charged by the SEC. In light of the *Cuban* case, the question arises whether Regulation FD will have to be amended since its purpose is to prevent selective disclosure to people who could trade on selectively disclosed information.

- While accepted in this case, until other courts agree, clients who trade after signing a Confidentiality Agreement that does not contain a prohibition on trading, risk SEC action that they traded while in possession of non-public information. Given the uncertainty, sometimes a four-corners stalling tactic is better than a fast break into a strong defense.

- The *Cuban* case illustrates the dangers of relying solely on oral communications. In the event of an investigation down the road, there may likely be disputes about what words were spoken. Putting such agreements in writing gives each side the opportunity to confirm their understanding.

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