McDermott Will & Emery

The *SEC v. Mark Cuban* Insider Trading Case

January 5, 2009

Does it Pay to be a Maverick When Trading Securities?

On November 17, 2008, the U.S. Securities and Exchange Commission (SEC) filed a civil complaint against entrepreneur and Dallas Mavericks' owner Mark Cuban alleging that he engaged in insider trading in 2004. The complaint, which was filed in the U.S. District Court for the Northern District of Texas, alleges that he sold 600,000 shares of the company Mamma.com, Inc. based on material, nonpublic information concerning an upcoming PIPE (private investment in public equity) offering of Mamma.com stock. The key issue in the case relates to whether Mr. Cuban had a duty to maintain trust and confidence to the source of such information that he breached.

The Facts

According to the SEC complaint, the key facts to the case are as follows. In March 2004, Mark Cuban purchased 600,000 shares of Mamma.com, which represented a 6.3 percent stake in the company. On June 28, 2004, Mark Cuban and the CEO of Mamma.com, Guy Faure, had a conversation during which Mr. Faure told Mr. Cuban about a PIPE[1] offering of Mamma.com stock that would be announced the next day, June 29, 2004. Mr. Faure told Mr. Cuban that the stock would be offered at a discount to the then market price and offered him an opportunity to participate in the PIPE. Mr. Cuban allegedly became upset because the offering would dilute his ownership stake in Mamma.com. Following this conversation, Mr. Cuban contacted his broker and instructed his broker to sell his entire position in Mamma.com. Mr. Cuban's broker sold 10,000 shares in after-hours trading on June 28, 2004, at an average price of $13.4990 per share and then during regular trading hours on June 29, 2004, sold the remaining 590,000 shares at an average price of $13.2937 per share.

Mamma.com publicly announced the PIPE offering at 6:00 pm ET on June 29, 2004, after the markets closed. The next day, Mamma.com shares opened trading at $11.89 per share and closed that day at $11.99 per share. The stock price continued to decline over the next week and a half, closing at $8.00 per share on July 8, 2004. The SEC claims that Mr. Cuban avoided more than $750,000 in losses by trading on this nonpublic information and Mr. Cuban could face up to $2.3 million in civil fines.

The SEC has alleged in its complaint that the Mamma.com CEO made it clear to Mr. Cuban that the information they discussed in their June 28 conversation was nonpublic information and was to be kept confidential. The SEC also alleges that Mr. Cuban acknowledged Mr. Faure's statement of confidentiality, agreed to keep the information confidential, and knew that the PIPE offering would be made at a discount to the prevailing market price.

Mr. Cuban responded to the SEC complaint with a post on his personal website, www.blogmaverick.com, stating that no agreement existed to keep information from the June 28, 2004, conversation confidential. He claims that his lawyers interviewed Guy Faure and recorded that interview. The transcription follows:

> Christopher Clark, Mr. Cuban's lawyer: "We spoke earlier about [how] you were telling Mr. Cuban in words or in substance: 'I have confidential information for you.'"
>
> Mr. Faure: "Right."
>
> Mr. Clark: "Do you recall anything Mr. Cuban said in response or reply to that statement by you?"
>
> Mr. Faure: "No, I do not."

The primary point of dispute between the SEC and Mr. Cuban appears to be that Mr. Cuban denies an agreement existed to keep information about the PIPE offering confidential. Since the conversation took place on the telephone, it is likely that neither side will be able to definitively prove what occurred during the June 28, 2004, conversation.

[1] A "PIPE" is a private placement of shares or convertible securities by a publicly traded issuer to selected accredited or institutional investors wherein the investors enter into a purchase agreement committing to purchase a specified number of securities at a specified price, and the issuer agrees to register the resale of the securities by the investors.

Relevant Law

Insider trading under U.S. law has developed through a case-by-case interpretation of Section 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934 in the federal courts. There are three basic elements to an insider trading claim. The elements include purchasing or selling a security after receiving information that is material, nonpublic, and obtained or used in breach of a fiduciary or similar duty.

There are two major theories of insider trading under federal law flowing from two different types of duties: the "classical" theory and the "misappropriation" theory. Under the classical theory of insider trading, the agents of an issuer of securities may be corporate insiders (*e.g.*, directors, officers, employees or controlling shareholders) or they may be "temporary" insiders by virtue of a professional relationship giving the agent access to nonpublic information about the issuer. A temporary insider is typically a lawyer, banker, accountant or consultant. If someone falls into either category and receives material, nonpublic information, then that person must either disclose such information to his counterparty before trading or abstain from trading. Under the misappropriation theory, a person will be held liable if he or she traded on material, nonpublic information and owed a duty to maintain trust and confidence to the source of that information.

MATERIALITY ELEMENT OF INSIDER TRADING

As discussed above, the information conveyed to the alleged insider must be material. Information is material if there is a substantial likelihood that a reasonable investor would consider the information important in deciding whether, and at what price, to buy, sell or hold securities.[2] Courts use a facts and circumstances inquiry in deciding whether the nonpublic information would alter the "total mix" of information for a reasonable investor.[3]

Several courts have held that information is immaterial as a matter of law when the public disclosure of such information has a negligible effect on the stock price.[4] On the other hand, information that does have an effect on the stock price when it becomes public may be evidence of materiality. The court in *In re Lucent Technologies Inc. Securities Litigation* stated that, "when a stock is traded in an efficient market, the materiality of disclosed information may be measured post hoc by looking to the movement, in the period immediately following the disclosure, of the price of the firm's stock."[5] Thus, a stock's price change becomes a factor for the court, when looking at the situation as a whole, in deciding whether nonpublic information altered the "total mix" of information available to a reasonable investor.

A question arises in the context of a PIPE transaction as to whether knowledge of the offering and its terms, in and of itself, is material, nonpublic information. A court recently held in *SEC v. Mangan* that knowledge of information about an upcoming PIPE was immaterial as a matter of law when the stock price changed negligibly after the PIPE was publicly announced. In *Mangan*, because the stock price closed at $14.25 per share, after public announcement of the PIPE, and the defendant entered into his transaction at $14.16 per share (which occurred before the public announcement of the PIPE), the court deemed the information regarding the PIPE to be immaterial.[6] In future cases, courts will continue to consider whether a reasonable investor would have found information regarding the PIPE offering important in making an investment decision and will look to the movement in stock price as possible evidence of materiality. It should be noted that an investor cannot determine in advance how

---

[2] See *SEC v. Texas Gulf Sulphur,* 401F.2d 833, 850 (2d Cir. 1968), cert. denied, sub nom., *Coates v. SEC*, 394 U.S. 976 (1969).
[3] See *TSC Industries v. Northway*, 426 U.S. 438, 96 S. Ct. 2126, 2132-33 (1976); *Greenhouse v. MCG Capital Corp.*, 392 F.3d 650, 656 (4th Cir. 2004).
[4] *SEC v. Mangan*, Fed. Sec. L. Rep. (CCH) P94,813, 2008 U.S. Dist. LEXIS 64814, *11 (W.D.N.C. 2008); see *Oran v. Stafford*, 226 F.3d 275, 283 (3d Cir. 2000) (dismissing the plaintiffs' claims where the public disclosure of information by the company "had no appreciable negative effect on the company's stock price"); *Burlington Coat Factory Sec. Litig.*, 114 F.3d 1410, 1425 (3d Cir. 1997) (where the release of sales information had no appreciable effect on the stock price, the information was immaterial as a matter of law); *In re Allied Capital Corp. Sec. Litig.*, 2003 U.S. Dist. LEXIS 6962, 2003 WL 1964184, *6 (S.D.N.Y. April 25, 2003) (10 percent decline in value of stock was immaterial when viewing stock's price movements as a whole).
[5] *In re Lucent Techs. Inc. Sec. Litig.,* 217 F. Supp. 2d 529, 543 (D.N.J. 2002).
[6] The court held that materiality should be measured by reference to the stock price at the time of the actual trade by the alleged insider against the movement of the stock price after the information regarding the PIPE offering becomes public. In *Mangan*, the defendant traded shares in the issuer on the open market at a price of $14.16 per share. At the time of his trade, information regarding the PIPE offering had not been made public. About two hours later, at 11:45 am ET news of the PIPE was made public. The issuer's share price closed that day at $14.25 per share. The court concluded that on that factual record, the stock price was determinative of materiality. Since there was no negative movement in the share price after the announcement of the PIPE offering, the court granted summary judgment for the defendant because the information was not material. See generally *SEC v. Mangan*.

the stock price will change after a PIPE is publicly announced. Therefore, an investor cannot rely upon any kind of assessment of the future stock price as to whether or not nonpublic information about an upcoming PIPE offering is material.

NONPUBLIC INFORMATION ELEMENT OF INSIDER TRADING

Information becomes public when it is broadly disseminated to the investing public, but without favoring any particular person or group.[7] Examples of information that is public are company press releases, SEC informational filings, and conference calls or meetings to which the public is invited.

BREACH OF DUTY ELEMENT OF INSIDER TRADING

Under the misappropriation theory of insider trading, corporate outsiders who do not owe a fiduciary duty because of their relationship to the issuer may nevertheless have a duty to disclose or abstain from trading if they are entrusted with material, nonpublic information by someone else to whom they owe a duty.[8] A duty to the source of the nonpublic information will arise when the information is given in trust and confidence.[9]

According to Rule 10b5-2 under Section 10(b) of the Securities Exchange Act of 1934, there are three non-exclusive situations that will give rise to a duty of trust or confidence. The most relevant situation enumerated by the rule is Rule 10b5-2(b)(1), which states, "a person has a duty of trust or confidence for purposes of the misappropriation theory of insider trading…(1) whenever a person agrees to maintain information in confidence."[10] The case law is unclear about what will constitute an "agreement to maintain information in confidence"[11] and courts will undergo a facts and circumstances based inquiry to determine whether an agreement existed. In *SEC v. Kornman*, the court found that Rule 10b5-2 supported the conclusion that a duty of trust and confidence existed when a tax advisor used information he obtained through his business relationship with a potential client.[12] In that case, the defendant traded in securities of the potential client on information obtained after telling the potential client, in writing, that the information disclosed would be kept confidential. Specifically, the court held that the SEC's allegations based on memos with nonpublic information marked "PERSONAL & CONFIDENTIAL" constituted an agreement to keep the information confidential and fell within Rule 10b5-2(b)(1). The SEC Proposing Release to Rule 10b5-2 makes it clear that a written confidentiality agreement is not required and it "recognizes the fact that in everyday personal interactions, individuals frequently rely on reasonable, implicit understandings of confidentiality."[13]

A court also could find that a duty of trust and confidence exists based on Rule 10b5-2(b)(2). The rule states that a duty will exist "whenever the person communicating the material nonpublic information and the person to whom it is communicated have a history, pattern, or practice of sharing confidences, such that the recipient of the information knows or reasonably should know that the person communicating the material nonpublic information expects that the recipient will maintain its confidentiality."[14] To date, however, courts have provided little guidance as to when this duty may arise.

Industry Practice

In a typical PIPE transaction, the placement agent will contact an investment fund's compliance officer or in-house counsel and disclose limited information about the PIPE issuer. The compliance officer then runs this information against the fund's restricted list, which is a list of investments in which the fund currently has a position. This is done to ensure that the fund will be able to freely trade investments it has already made. If the compliance officer finds the issuer's name on the fund's restricted list, he

---

[7] Regulation FD.
[8] *U.S. v. O'Hagan*, 521 U.S. 642, 665-66 (1997).
[9] The Supreme Court has declared, "In lieu of premising liability on a fiduciary relationship between company insider and purchaser or seller of the company's stock, the misappropriation theory premises liability on the fiduciary-turned-trader's deception of those who entrusted him with access to confidential information." *Id.* at 652.
[10] Rule 10b5-2(b) under Section 10(b) of the Securities Exchange Act of 1934 (*17 C.F.R. Section 240.10b5-2* (2002)).
[11] *Id.*
[12] *SEC v. Kornman,* 391 F.Supp.2d 477, 489-98 (N.D. Tex. 2005).
[13] Sec. Act Release No. 7787 (Dec. 20, 1999), 1999 WL 1217849, Pt. III.B.2.
[14] Rule 10b5-2(b) under Section 10(b) of the Securities Exchange Act of 1934.

generally will decline to learn anything further about the offering. If the issuer's name is not on a restricted list and the potential investor is interested in participating in the PIPE transaction, currently, best practices call for the placement agent either to have such investor sign a confidentiality agreement or a securities purchase agreement that includes a confidentiality provision, or to read a detailed script regarding confidentiality and have the investor consent in the presence of witnesses. This procedure is meant to prevent the circumstances now being litigated between the SEC and Mr. Cuban.

The Mark Cuban Case

MATERIALITY ELEMENT

The court will need to determine whether the information Mr. Faure told Mr. Cuban regarding the upcoming PIPE offering of Mamma.com stock was material. In doing so, the court must decide whether the news of the PIPE offering would have been important to a reasonable investor in deciding whether and at what price to buy or sell Mamma.com stock.

The SEC likely will argue that the information concerning the Mamma.com PIPE offering, especially that it was going to be offered at a discount, was material because a reasonable investor would have considered it important in deciding whether and at what price to purchase or sell Mamma.com stock. The SEC stated in its complaint that Mr. Cuban sold the vast majority of his shares at an average price of $13.2937 per share on June 29, 2004. The PIPE was announced publicly after the markets closed on June 29, and the stock closed at the end of trading on June 30 at $11.99 per share, representing a 10.2 percent decline in share price. The SEC will probably present the 10.2 percent decrease in price as evidence that an investor would have considered such information important and therefore that it was material.

Conversely, Mr. Cuban may cite *Mangan* and argue that mere knowledge of the PIPE offering was not material because it did not alter the "total mix" of information available to a reasonable investor. He may argue further that a 10.2 percent change in the stock price, when viewing Mamma.com's stock price fluctuations as a whole, given the high volatility of its stock price generally, is not enough evidence for a court to conclude as a matter of law that a reasonable investor would have found the information important. Mr. Cuban's argument will be supported by the *In re Allied Capital Corp. Securities Litigation* case, in which a 10 percent decline in value of stock was held to be immaterial when viewing the stock's price movements as a whole.[15]

NONPUBLIC INFORMATION ELEMENT

This element is met because a public announcement of the PIPE offering was not made until the day after the conversation between Mr. Cuban and Mr. Faure took place.

BREACH OF DUTY ELEMENT

It is unlikely that the SEC will pursue Mr. Cuban under the classical theory of insider trading, but the SEC could argue that Mr. Cuban was either a corporate or a constructive insider because he owned 6.3 percent of Mamma.com's stock and, by virtue of this ownership, he qualified as a controlling shareholder.

Mr. Cuban's case likely will be litigated under the misappropriation theory. Under this theory, Mr. Cuban will be found to have engaged in insider trading if the SEC can prove he traded on material, nonpublic information and that he owed a duty to maintain trust and confidence to the source of the information.

A court could find, based on the interpretation of Rule 10b-5(b)(1) in *SEC v. Kornman*, that an agreement existed between Mr. Cuban and Mr. Faure to keep information about the PIPE offering confidential. After hearing testimony and reviewing the evidence, a court could determine that Mr. Faure made an offer to furnish information about the PIPE offering which was predicated upon a condition that Mr. Cuban keep the information confidential. Relying on guidance from the Rule 10b5-2 Proposing Release, the court could find that an implicit understanding of confidentiality existed during Mr. Faure and Mr. Cuban's conversation. Because this will be a situation in which the court will probably have to weigh one party's testimony against the other's, the likely outcome is unclear.

[15] *In re Allied Capital Corp. Sec. Litig*., 2003 U.S. Dist. LEXIS 6962, 2003 WL 1964184, *6 (S.D.N.Y. April 25, 2003).

Alternatively, even though Mr. Cuban contends that during his call with Mr. Faure he did not agree to keep the information confidential, the court could find, according to Rule 10b5-2(b)(2), that Mr. Cuban and Mr. Faure had a history, pattern or practice of sharing confidences such that Mr. Cuban should reasonably have known that Mr. Faure expected him to keep the information confidential. For example, if the SEC could demonstrate that Mr. Faure told Mr. Cuban private company information on previous occasions, in similar situations as the one involving the PIPE offering, and that Mr. Cuban had on prior occasions understood that such information was to be kept confidential, then the court could find that Mr. Cuban should reasonably have known that information regarding the PIPE offering was confidential.

Practical Implications

Even if Mr. Cuban prevails in his case against the SEC, it provides a good example of what an investor – especially a significant shareholder – should not do when given nonpublic information about an upcoming PIPE or other securities offering. Notwithstanding a court's finding either that the PIPE offering information was not material, or that Mr. Cuban and Mr. Faure did not have an agreement or understanding to keep that information confidential, Mr. Cuban's decision to trade based on that information invited an investigation and allegations from the SEC. In addition to legal consequences, this investigation and lawsuit likely will be intrusive, costly, distracting and damaging to Mr. Cuban's reputation. It is recommended that when an investor receives information about an upcoming PIPE transaction from an issuer or any of its agents, the investor should either not trade based on that information or explicitly agree that he is not treating the information as confidential. The prudent course of action is to make sure the investor does not receive material, nonpublic information, or if he does, the investor should abstain from trading until the PIPE offering is announced to the market.

For more information, please contact your regular McDermott lawyer, or:

Stephen E. Older: +1 212 547 5649 solder@mwe.com

Seth T. Goldsamt: +1 212 547 5511 sgoldsamt@mwe.com

For more information about McDermott Will & Emery visit www.mwe.com.

The material in this publication may not be reproduced, in whole or part without acknowledgement of its source and copyright. "The *SEC v. Mark Cuban* Insider Trading Case" is intended to provide information of general interest in a summary manner and should not be construed as individual legal advice. Readers should consult with their McDermott Will & Emery lawyer or other professional counsel before acting on the information contained in this publication.

© 2009 McDermott Will & Emery. The following legal entities are collectively referred to as "McDermott Will & Emery," "McDermott" or "the Firm": McDermott Will & Emery LLP, McDermott Will & Emery/Stanbrook LLP, McDermott Will & Emery Rechtsanwälte Steuerberater LLP, MWE Steuerberatungsgesellschaft mbH, McDermott Will & Emery Studio Legale Associato and McDermott Will & Emery UK LLP. McDermott Will & Emery has a strategic alliance with MWE China Law Offices, a separate law firm. These entities coordinate their activities through service agreements. This communication may be considered attorney advertising. Previous results are not a guarantee of future outcome.