

Client Alert

A report
for clients
and friends
of the Firm July 2009

Securities and Exchange Commission vs. Mark Cuban

The following is a brief description of the decision of the United States Court for the Northern District of Texas with respect to the SEC's case against Mark Cuban and what it means for issuers, placement agents and investors in PIPE and similar confidential securities offerings.

On July 17, 2009, the United States District Court for the Northern District of Texas dismissed the Securities and Exchange Commission's insider trading case against Mark Cuban. The court stated that: "The dispositive question presented by Mark Cuban's ... motion to dismiss was whether the plaintiff Securities and Exchange Commission ... has adequately alleged that Cuban undertook a duty of non-use of information required to establish liability under the misappropriation theory of insider trading. Concluding that it has not, the court grants Cuban's motion to dismiss, but it also allows the SEC to replead."

The facts of the case appear straightforward. The SEC alleged that, "after Cuban agreed to maintain the confidentiality of material, nonpublic information concerning a planned private investment in public equity ("PIPE") offering by Mamma.com Inc. ("Mamma.com"), he sold his stock in the company without first disclosing to Mamma.com that he intended to trade on this information, thereby avoiding substantial losses when the stock price declined after the PIPE was publicly announced." The SEC asserted that Cuban violated Section 17(a) of the Securities Act of 1933 (the "Securities Act"), Section 10(b) of the Securities Exchange Act of 1934 (the "Exchange Act") and Rule 10b-5 under the Exchange Act.

In the spring of 2004, Mamma.com proposed to engage in a PIPE offering and the company's CEO decided to telephone Cuban, the company's largest stockholder, to inform him of the offering and invite him to participate. According to the SEC: "The CEO prefaced the call by informing Cuban that he had confidential information to convey to him, and Cuban agreed that he would keep whatever information the CEO intended to share with him confidential. The CEO, in reliance upon Cuban's agreement to keep the information confidential, proceeded to tell Cuban about the PIPE offering." Cuban was unhappy with the PIPE offering and at the end of the offering stated: "Well, now I'm screwed. I can't sell." Several hours after the phone call, the CEO sent Cuban a follow-up e-mail in which he provided contact information for the investment bank conducting the offering. Cuban then contacted a sales representative who supplied him with additional confidential information regarding the offering. One minute later, Cuban directed his broker to sell all of his 600,000 shares of Mamma.com, thereby avoiding losses of \$750,000.

In its analysis, the court cited *United States v. O'Hagan*, 521 U.S. 642 (1997), in which the Supreme Court recognized the "misappropriation theory" of insider trading, which "holds that a person commits fraud in connection with a securities transaction, and thereby violates Section 10(b) and Rule 10b-5, when he misappropriates confidential information for securities trading purposes, in a breach of duty owed to the source of the information." The court stated that "[t]he nature of the duty required to support misappropriation theory liability is at the heart of the present case..." and determined that Cuban did not have a fiduciary duty to Mamma.com to not use the confidential information he received for his personal benefit.

The court stated that "trading on the basis of material, nonpublic information cannot be deceptive [because Cuban did not disclose to the source of his information

that he intended to trade on it] unless he is “under a legal duty to refrain from trading on or otherwise using it for personal benefit.” Absent a fiduciary duty, that legal duty needed to arise from Cuban’s oral agreement with the company. However, Cuban’s agreement with the CEO did not impose a “legal duty to refrain from trading on or otherwise using the information for personal gain.” The court stated that “[w]here misappropriation theory liability is predicated on an agreement, ... a person must undertake, either expressly or implicitly, both ... [the obligation] to maintain the confidentiality of the information and not to trade on or otherwise use it. Absent a duty not to use the information for personal benefit, there is no deception in doing so” and, therefore, no liability under the misappropriation theory. “Because the SEC has failed to allege that Cuban undertook a duty to refrain from trading on information about the impending PIPE offering, ... Cuban cannot be held liable under the misappropriation theory of insider trading liability...” The court therefore granted Cuban’s motion to dismiss.

What does this decision mean for issuers and placement agents in PIPEs and other confidential offerings?

Issuers that are going to engage in a PIPE or other confidential offering need to make sure that investors, in addition to agreeing to keep the transaction confidential, specifically agree not to trade on the information. Placement agents in such offerings should make sure that their policies and procedures are consistent with this premise. During the process of bringing an investor “over the wall,” the investor should agree both to (1) keep the information about the offering confidential and (2) not use it for any other purpose than to evaluate the offering; *i.e.*, not trade in the company’s securities until the confidential information about the offering is publicly disclosed. This second part should be explicit.

What does this mean for investors in PIPEs and other confidential offerings?

There is a good chance that the SEC will appeal this decision or replead its case in order to address the Court’s concerns. Accordingly, any investor who is in possession of material, non-public information regarding a company should not trade in such company’s securities, nor should the investor transmit or otherwise communicate such information. This is a complex area of the law and other courts may take a different view of these facts. Therefore, before an investor who has material, non-public information trades or communicates such information to others, he or she should consult a counsel expert in this area.

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