

Capital Markets | July 28, 2009

## The Cuban Missive Crisis – Texas District Court Dismisses Mark Cuban Insider Trading Case

Practical Implications for Premarketed Offerings, PIPEs Offerings and Regulation FD Compliance

In the latest celebrity insider trading case, a federal district court in Dallas, Texas dismissed the Securities and Exchange Commission's insider trading complaint against Mark Cuban, the owner of the NBA's Dallas Mavericks. The case, *Securities and Exchange Commission v. Mark Cuban, No. 3:08-CV-2050-D (N.D. Tex. July 17, 2009)*, is notable because the District Court found that an agreement to keep material non-public information confidential *without an implicit or explicit agreement to refrain from trading* is not sufficient to establish a duty not to trade under the "misappropriation theory" of insider trading. The case raises an interesting issue as to what type of communication – a formal written agreement, an e-mail exchange, some other form of missive or a simple telephone conversation – is enough when disclosing material non-public information to a corporate "outsider" to clearly establish the recipient's agreement to refrain from trading on the information.

### Background

The factual background of the *Cuban* case is quite straightforward. Mark Cuban owned 6.3% of Mamma.com, a NASDAQ-listed internet search company, and at the time was its largest shareholder. Mamma.com was in the process of raising equity through a private investment in public equity (PIPEs) offering, when at the suggestion of the company's investment bankers, the CEO called Mark Cuban to invite him to participate in the offering. The CEO prefaced the call with Cuban by saying that he had confidential information that he wanted to share with Cuban, and Cuban agreed to keep the information confidential.

Relying on Cuban's oral agreement to keep the information confidential, the CEO told Cuban that the company was undertaking a PIPEs offering. The information was not well-received by Cuban and at the end of the call, Cuban reportedly said, "Well, now I'm screwed. I can't sell."

In a subsequent e-mail to Cuban, the CEO suggested that Cuban get in touch with the company's investment bank to get more details about the offering. Cuban made that call and received additional details about the offering. Following that conversation, Cuban instructed his broker to sell all of his shares of Mamma.com the day before the PIPEs offering was publicly announced. The SEC alleged that Cuban avoided \$750,000 in trading losses after the

price of Mamma.com's stock dropped nearly 10% following the announcement of the offering.

## The Court's Decision

The SEC's insider trading case against Cuban was brought under the "misappropriation theory" of insider trading. Under this theory, a person violates Rule 10b-5 when he or she misappropriates confidential information for securities trading purposes, in breach of a duty owed to the source of the information. Put simply, the issue in the case was whether Cuban owed a duty not to trade on the material non-public information he received from Mamma.com's CEO based on his oral agreement to keep the information confidential. The Court said no. While an agreement between a corporate "outsider" and the source of the material non-public information can create a duty that when breached can give rise to insider trading liability, the Court said that the agreement must consist of more than an express or implied promise to keep information confidential – it must contain an implicit or explicit agreement not to trade on the information or to use it for personal gain.

In the Court's view, the obligation to keep the information confidential and the obligation not to trade on it are distinct obligations. Since deception is essential to a 10b-5 claim, the Court found that Cuban had not acted deceptively since he only agreed to keep the information confidential, but never agreed to refrain from using it for personal gain. The Court also rejected the notion that the CEO's "unilateral" expectation (apparently only expressed in an e-mail to the board of directors and not in an e-mail to Cuban) that Cuban would not trade on the information imposed a duty on Cuban to refrain from trading under Rule 10b-5 and created insider trading liability.

## So Where Does the *Cuban* Case Leave Us?

Is agreeing to keep information confidential the same as agreeing not to use that information for personal gain? Many would have thought so before the *Cuban* case. But the Court viewed these as entirely distinct obligations,

and because the SEC had not proved an express agreement on the trading component, the Court dismissed the claims against Cuban – game over, at least for now.

Although the SEC's complaint was dismissed, the Court gave the SEC thirty days to replead the case if it can provide sufficient evidence that there was in fact an agreement to refrain from trading. The SEC could also appeal the case to the Fifth Circuit Court of Appeals. While the Court's decision is the view of only one of many district courts, the celebrity nature of the litigant has resulted in a spotlight being placed on the core issue. So while we wait for the final buzzer, market participants are left wondering what best practices to put in place to minimize or eliminate the risk from this sort of situation.

## Practical Advice

Corporate officers, investment bankers, and other market participants regularly find themselves in situations involving material non-public information. The *Cuban* decision serves as a reminder that the disclosure of such information presents risks to both sender and recipient. The following are a few practical suggestions for addressing those risks.

## Get it in Writing: The Missive Rule

Recognizing the possibility that other courts may follow the lead of the *Cuban* Court and carefully scrutinize the exact nature and content of confidentiality agreements, it is advisable going forward to obtain the recipient's written agreement to keep material non-public information confidential *and* to refrain from trading on that information. Although oral confidentiality agreements are enforceable, the absence of a written record of the agreements' particulars could easily lead to "he says, she says" evidentiary disputes. Since e-mail is the functional equivalent of a formal writing, a confidentiality agreement does not need to be embodied in a formal written document – an e-mail will suffice. But to avoid

evidentiary disputes down the road, it may be best to obtain a two-way e-mail, in which one party sends an e-mail stating the requirement that there be no trading and the recipient acknowledges the agreement. In any event, external or internal counsel should be consulted early in a potential transaction to ensure that proper procedures are in place from the beginning to adequately protect material non-public information and ensure compliance with insider trading rules.

### Implications for PIPEs Transactions

Disclosure of material non-public information in PIPEs offerings presents some of the most common opportunities for the misuse of material non-public information. Generally in PIPEs offerings, potential investors are asked to sign written confidentiality agreements. Given the attention that the *Cuban* decision focuses on the specifics of confidentiality agreements, those agreements should be reviewed carefully to ensure that both obligations – to keep the information confidential and to refrain from trading – are spelled out clearly. At a minimum, it may be helpful to specify that the confidential information may not be used for any purpose other than to evaluate the potential transaction. Although the *Cuban* Court did not address this particular circumstance, such a prohibition would seem to satisfy the Courts' requirement that the parties explicitly or implicitly agree not to trade on the basis of the information.

### Implications for Premarketed Offerings

In premarketed public offerings (sometimes referred to as “wall-crossings”), the material non-public information is generally disclosed in a telephone conversation that is preceded by an agreement embodied in an e-mail to the potential investor or the investor's in-house counsel, to keep the information confidential. It may be best to ensure that the e-mail includes an agreement that the recipient will not trade on the information and, from an evidentiary perspective, it would be best if the e-mail was

a two-way exchange. It is interesting to note that in the *Cuban* case, the CEO did not send Mr. Cuban a follow-up e-mail confirming his understanding that Mr. Cuban would not trade on the information. The case may have come out differently if he had done so.

### Regulation FD

While not an issue in the *Cuban* case, Regulation FD prohibits public companies from making selective disclosure of material non-public information prior to making such information available to the public. The rule contains a specific exception for selective disclosures to persons who expressly agree to maintain the information in confidence. While oral confidentiality agreements satisfy Regulation FD, companies that intend to rely on confidentiality agreements as the basis for intentional selective disclosure would be well-advised to obtain a written agreement. Regulation FD confidentiality agreements should be reviewed to make sure that they include an explicit agreement not to trade.

### Considerations for Those Who Disclose

Those who disseminate material non-public information pursuant to confidentiality agreements should remain alert to their own potential exposure. Even if other courts agree that a person who receives material non-public information (the “tippee”) is immune from insider trading liability absent an agreement not to trade, those who disclose that information (the “tipper”) may nevertheless be at risk.

Tipsters often acquire their information through a fiduciary or quasi-fiduciary relationship and, therefore, themselves owe duties of care and loyalty to their source of information. The *Cuban* decision in no way relieves a tipper of those obligations. In certain circumstances, tipsters who provide material non-public information knowing that their tippee intends to trade on the information could be subject to claims of insider trading, breach of fiduciary duty, or other common law causes of action.

This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

If you wish to receive more information on the topics covered in this memorandum, you may contact your regular Shearman & Sterling contact person or any of the following:

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