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Another SEC Setback On PIPES, Insider Trading

Law360, New York (July 31, 2009) -- The U.S. District Court for the Northern District of Texas has granted defendant Mark Cuban's motion to dismiss the U.S. Securities and Exchange Commission's complaint.

The court held that the SEC failed to allege adequately that Cuban undertook a duty of non-use of information required to establish liability under the misappropriation theory of insider trading.

This article addresses the circumstances under which this motion was granted and its broader implications for the capital markets.

The Facts

According to the allegations in the SEC's complaint, in 2004 the CEO of public issuer Mamma.com Inc. (Mamma) called Cuban, then its largest known shareholder, to see if he was interested in participating in a PIPE (private investment in public equity) financing.

The CEO prefaced the call in the traditional manner before taking a potential investor "over the wall," stating that he had confidential information to convey and sought Cuban's agreement to keep that information confidential. Cuban allegedly agreed to do so, at which point the CEO informed Cuban about the PIPE offering.

Cuban reacted angrily, going so far as to say, "Well, now I'm screwed. I can't sell." From two internal company e-mails following that conversation and quoted in the complaint, it arguably could be inferred that the CEO may have expected that Cuban would not sell his shares until after the PIPE offering was publicly announced.

Shortly after ending a subsequent call with Mamma's investment banker regarding the PIPE offering and after receiving additional information concerning the PIPE, Cuban telephoned his broker and directed him to sell all 600,000 of his Mamma shares.

In its following enforcement action, the SEC alleged that Cuban avoided losses of \$750,000 and that his trading violated, among other matters, Section 10(b) of the Exchange Act of 1934, as amended, and Rule 10b-5 thereunder.

Theory of Attacking the Complaint; What the Court Ultimately Relied On

Cuban's counsel went down a conventional, well-grounded but uneventful path, contending that the SEC had alleged merely that Cuban entered into a confidentiality agreement with Mamma; and, that this in itself was insufficient to establish liability under the misappropriation theory for insider trading because the agreement did not arise in the context of a pre-existing fiduciary or fiduciary-like relationship, or create a relationship that bears all the hallmarks of a traditional fiduciary relationship.

Cuban's counsel argued that while the SEC alleged in its complaint that he entered into a confidentiality agreement, the mere entry into a confidentiality agreement is not by itself adequate to establish liability under the misappropriation theory of insider trading.

The court largely rejected Cuban's counsel's arguments and the case precedents cited by them in support of this position. Instead, the court focused on *U.S. v. O'Hagan*, a U.S. Supreme Court decision in which the court expanded the scope of insider trading liability by recognizing the misappropriation theory.

For Chief Judge Sidney A. Fitzwater, it was the nature of the duty required to support liability for insider trading under the misappropriation theory that was at the very heart of the case and Cuban's motion to dismiss.

The court rejected Cuban's arguments that liability for insider trading under the misappropriation theory depended upon the existence of a pre-existing fiduciary-like relationship.

Instead, and in a great departure from the SEC's perspective of what constitutes insider trading, the court itself raised and considered the narrow issue of whether a breach of a legal duty arising by agreement can be the basis for the misappropriation theory of liability; and, if so, what were the essential components of the agreement that might give rise to liability for insider trading under the misappropriation theory.

Judge Fitzwater first reviewed the Supreme Court's decision in *O'Hagan*, which built upon the decision in *Chiarella v. U.S.* He then took the next logical leap by finding that in the context of the misappropriation theory, trading on the basis of material, nonpublic information cannot be deceptive unless the trader is under a legal duty to refrain from trading on or otherwise using it for personal benefit.

When the trader and the information source are in a fiduciary relationship, this obligation arises by operation of law. But Judge Fitzwater reasoned that, while under *O'Hagan* the deception that animates the misappropriation theory involves at its core the undisclosed

breach of a duty not to use another's information for personal benefit, there is no apparent reason why that duty cannot arise by agreement.

Based on this line of reasoning, Judge Fitzwater concluded that a duty sufficient to support liability under the misappropriation theory can arise by agreement even absent a pre-existing fiduciary or fiduciary-like relationship.

Indeed, Judge Fitzwater found that the duty that arises by agreement can be seen as conferring a stronger footing for imposing liability for deceptive conduct than does the existence, without more, of a fiduciary or similar relationship of trust and confidence.

SEC Failed to Allege Adequately Insider Trading

The court then examined whether the SEC had adequately alleged that Cuban had entered into an agreement sufficient to create the duty necessary to establish liability for insider trading under the misappropriation theory.

Judge Fitzwater clarified that the agreement must consist of more than an express or implied promise merely to keep the information confidential. When liability under the misappropriation theory is predicated on an agreement, a person must have undertaken, either expressly or implicitly, both obligations.

Specifically, the party receiving the information must agree to maintain the confidentiality of the information and not to trade on or otherwise use it for personal gain.

And, except for a fiduciary or fiduciary-like relationship, that expectation is not one that can be created unilaterally, arising merely from the information source's subjective belief that the recipient will not trade on the information. Rather, it rests on the recipient's specific undertaking of both obligations.

To state a viable claim of liability for insider trading under the misappropriation theory, Judge Fitzwater held that it was incumbent on the SEC to have alleged, with the requisite specificity, that Cuban had entered into an express or implied agreement with Mamma not to disclose material, nonpublic information about the PIPE offering and not to trade on or otherwise use the information for his own benefit.

The court found that while the SEC adequately pleaded that Cuban entered into a confidentiality agreement, the SEC did not allege that Cuban undertook, expressly or implicitly, to refrain from trading on or otherwise using for his own benefit the information about the pending PIPE offering the CEO was about to share. Thus, Judge Fitzwater concluded that the SEC's complaint was deficient.

Not Reliable Law Just Yet

Since the motion to dismiss was granted without prejudice, the SEC still has another shot at stating a legally viable claim. The court allowed the SEC 30 days within which to file an amended complaint — but only if the SEC can and does allege in good faith that Cuban undertook a duty, expressly or implicitly, not to trade on or otherwise use material, nonpublic information about the PIPE offering.

Bottom line: When liability for insider trading under the misappropriation theory is predicated on an agreement, a person must have undertaken, either expressly or implicitly, two separate obligations:

- 1) that person must agree to maintain the confidentiality of the information; and, even more critically,
- 2) that person must agree not to trade on or otherwise use that information for their own personal gain.

Moreover, the expectation of not trading or not using that information cannot be a subjective or unilateral expectation on behalf of the issuer or the issuer's placement agent. Rather, it rests on the market participant's specific undertaking described above.

What Does This Mean for the PIPEs Market, Hedge Fund Industry and More Generally?

If this decision withstands the scrutiny of appeal or is not appealed, it is likely that it will alter the approach taken by companies and other market participants to various types of transactions.

In a PIPEs offering, the PIPE issuer or its placement agent, will have the burden to either craft an appropriately worded confidentiality AND nontrading agreement and to make sure that it is signed by the potential PIPE investor before any confidential information is provided; or to read a script that is explicit as to both issues and to obtain an unqualified agreement as to both issues, particularly the latter.

Similar issues will be faced by companies in other transactional settings, likely resulting in the need to take greater care and create more formal documentation before the dissemination of material nonpublic information.

--By Perrie Michael Weiner (pictured) and Sanjay M. Shirodkar, DLA Piper LLP

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