Mark Cuban Defense Verdict Highlights Difficulty of Proving "Misappropriation" Theory of Insider Trading

Mamma.com Insider Trading Lawsuit

Mark Cuban, the well-known entrepreneur, purchased a 6.3 percent stake in the NASDAQ-listed company Mamma.com, a Canadian internet search engine company, in March 2004.[1] In spring 2004, Mamma.com's CEO told Cuban in a telephone call – allegedly subject to a confidentiality agreement – that the company was planning to raise capital through a private investment in public equity (PIPE) offering, which would dilute existing shareholders' stock. Cuban sold his Mamma.com stock before the company publicly announced the PIPE offering, thereby avoiding losses in excess of $750,000.

The SEC brought a civil action against Cuban in the US District Court for the Northern District of Texas in November 2008, claiming that Cuban engaged in insider trading in violation of section 17(a) of the Securities Act of 1933, section 10(b) of the Securities Exchange Act of 1934, and Rule 10b-5 thereunder, by "misappropriating" material, non-public information conveyed to him pursuant to a confidentiality agreement. After nearly five years of litigation and an eight-day jury trial, on October 16, 2013, the jury returned a verdict in Cuban's favor on all claims.

Misappropriation Theory of Insider Trading

The SEC's suit against Cuban is noteworthy for its reliance on the relatively unsettled "misappropriation" theory of insider trading under SEC Rule 10b5-2. Under the "classical" theory of insider trading, a corporate insider is liable under section 10(b) and Rule 10b-5 when he or she trades in the securities of his or her corporation on the basis of material, non-public information. Liability is premised on the notion that a corporate insider has a relationship of trust and confidence with the company's shareholders, giving rise to a duty to either disclose material, non-public information prior to trading or abstain from trading.

The US Supreme Court later expanded the scope of insider trading liability to reach company outsiders whose misappropriation of material, non-public information for securities trading purposes breaches a duty of loyalty or confidentiality owed to the source of the confidential information. In 2000, the SEC enacted Rule 10b5-2, identifying circumstances under which such a duty of loyalty or confidentiality arises, including where the outsider agrees to maintain the information in confidence. Because as a mere investor Cuban was a corporate outsider, the SEC claimed that his alleged confidentiality agreement with Mamma.com's CEO created a duty of confidentiality, which he breached by selling his stock in violation of Rule 10b5-2(b)(1).

Authorities have disagreed about exactly what circumstances give rise to liability under the misappropriation theory of insider trading. The district court in the Cuban lawsuit, for example, held that the recipient of information under a confidentiality agreement is not prohibited from trading in reliance on that information because he or she has not engaged in any deceptive act, the *sine qua non* of fraud. After all, the recipient only agreed to keep the information confidential – not to refrain from

[1] Mamma.com changed its name to Copernic Inc. in June 2007.

acting on it personally.[2] Thus, over the SEC's objection, the court instructed the jury that it could find Cuban liable only if it determined that Cuban agreed to keep the information confidential *and* that he agreed not to personally trade on that information.

Cuban Jury Verdict

The jury verdict – a complete victory for Cuban – ultimately did not turn on the existence of an agreement to keep information confidential and to refrain from trading on that information. Rather, the jury found that the SEC failed to prove even that Cuban received material, non-public information from Mamma.com about the company's impending PIPE transaction. However, the result may have been informed, in part, by the court's and the jury's skepticism concerning the legal and factual requirements necessary to establish a corporate outsider's duty of loyalty and honesty for purposes of insider trading liability.

Securities Analysts and Major Investors Should Remain Cautious

The Cuban verdict appears, at first glance, to be a substantial victory for securities analysts and major investors, whose businesses depend on regular communications with corporate insiders or others who possess material non-public information. It demonstrates the challenges the SEC faces under existing law in establishing a relationship of trust and confidence between the recipient of alleged material, non-public information and the source of that information for purposes of proving misappropriation liability. Nevertheless, the Cuban judgment did not ultimately turn on the existence of such a relationship, and the contours of misappropriation liability remain unsettled. Accordingly, securities analysts, investors and any other entity or individual who receives information pursuant to a confidentiality agreement should remain cautious and refrain from acting on material, non-public information regardless of the circumstances.

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[2] *SEC v. Cuban*, 634 F. Supp. 2d 713, 730-31 (N.D. Tex. 2009), *rev'd on other grounds*, 620 F.3d 551 (5th Cir. 2010).