Cuban Insider Trading Decision Will Refine Use of Confidentiality Agreements

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SEC v. Cuban, Civil Action No. 3: 09-CV-2050 (N.D. Tex. Decision Filed July 17, 2009)

In the SEC's insider trading case against Mark Cuban, the District Court granted Cuban's motion to dismiss, finding that the SEC did not adequately allege that Cuban undertook a duty to refrain from trading. In an issue of first impression, the court concluded that, absent a fiduciary or similar relationship between the parties, a confidentiality agreement may form the basis for a misappropriation charge but only if the agreement explicitly or implicitly imposes *both* a duty not to disclose material, nonpublic information *and* a duty not to trade on or otherwise use that information. The court gave the SEC thirty days to file an amended complaint. If the decision survives appellate review or is followed by other courts, it will have important consequences for the law and practice surrounding the use of confidentiality agreements, which are frequently used in capital market transactions.

The SEC alleged that Cuban promised during a telephone call with Mamma.com's CEO to keep confidential material, nonpublic information about a planned PIPE offering of the company's stock. Later that day, Cuban sold his 6.3 percent stake in the company, avoiding losses when the stock price dropped after the PIPE was publicly announced.

The court rejected Cuban's contention that liability under the misappropriation theory depends on the existence of a pre-existing fiduciary or fiduciary-like relationship and found that breach of an agreement may be the basis of liability. The court then concluded that any such agreement must have two components–the recipient of the material, nonpublic information must undertake, expressly or implicitly, *both* to keep the information confidential *and* not to trade on or otherwise use the information. Although the SEC alleged that Cuban had entered into an agreement not to disclose the information, it did not allege that he had expressly or implicitly agreed not to use the information.

After deciding that the allegations in the SEC's complaint were insufficient to establish the necessary duty arising from an agreement, the court turned to whether the SEC could rely on Rule 10b5-2(b)(1) to impose a duty not to trade. Rule 10b5-2(b)(1) provides that a duty of trust and confidence for purposes of the misappropriation theory of insider trading law arises "whenever a person agrees to maintain information in confidence." The court found that because
Rule 10b5-2(b)(1) attempts to predicate misappropriation theory liability on a confidentiality agreement alone and not on such an agreement having a non-use component, the SEC could not rely on it to establish Cuban's liability. To permit liability based on such a rule "would exceed the SEC's § 10(b) authority to proscribe conduct that is deceptive."

If the decision survives appellate review or is followed by other courts, it will have important consequences for participants in securities markets and law enforcement authorities. Market participants commonly use confidentiality agreements to allow others to evaluate potential investment opportunities. They should consider reviewing all active agreements to distinguish between those that need to prevent trading and those that need only to prohibit disclosure of information. In some circumstances, the disclosing person might have an obligation to others to prevent both use and disclosure when communicating confidential information. Ultimately, the court's decision could facilitate capital markets transactions by eliminating any doubt that market participants have the flexibility to draw the distinction between no use and no disclosure in confidentiality agreements.

The decision is also likely to have consequences for the enforcement of the insider trading laws. In the short term, law enforcement authorities will have difficulties in cases based solely on a simple confidentiality agreement. In the longer term, the decision should be helpful to law enforcement authorities because the court confirmed that a contract with trading restrictions will support an insider trading violation. No pre-existing fiduciary relationship is needed.

The court's decision leaves several questions open. First, the court did not explain the sort of contractual provision that would create an implicit undertaking not to trade. A form of agreement often used in potential securities transactions is one that does not expressly prohibit trading but does oblige the recipient of the information to use it only for a narrowly defined purpose, such as solely for the purpose of evaluating an investment opportunity. A court might view this type of limited use agreement as an implicit promise not to trade.

Second, the court did not explain why a simple breach of contract should qualify as fraud. That is not typically the way the law characterizes a breach of contract. A contract entered into with no intention to perform and the failure to meet obligations in a fiduciary relationship created by a contract-like document (agency, trusteeship) could constitute fraud, but otherwise the law traditionally treats contracts and broken promises differently. A contract is a voluntary ordering of private affairs, and contracting parties are free to make economic decisions about whether to fulfill promises or run the risk of a private breach of contract action. A broken promise gives rise to certain private remedies, most usually money damages, but does not normally constitute a deception forming the basis of a governmental law enforcement action for fraud.

Third, it is unclear if the court's decision to narrowly construe Rule 10b5-2(b)(1) also means that the court would apply a similarly narrow construction to the other two subsections of Rule 10b5-2(b), which deal with family relationships and patterns or practices of sharing confidential information. The court's language suggests that it would apply the same construction and require an understanding not to trade or use the information for personal benefit, but the court did not resolve the question.

Fourth, the court did not consider whether its requirement for a non-use term in a confidentiality agreement also should apply to the type of confidentiality agreement that protects an issuer's disclosure from violating Regulation FD. Regulation FD contains a provision permitting issuers to disclose material, nonpublic information selectively "to a person who expressly agrees to maintain the disclosed information in confidence," but that provision does not require an agreement not to trade on the disclosed information. That might be because the Commission in the proposing release for Regulation FD said "a confidentiality agreement would also include an agreement not to trade on the nonpublic information." The court's reasoning and the purposes of Regulation FD suggest that a confidentiality agreement for the rule also must include an explicit or implicit prohibition on trading, but the court did not address this issue.