New York Law Journal
SERVING THE BENCH AND BAR SINCE 1888
WWW.NYLJ.COM
An ALM Publication
VOLUME 250—NO. 114
THURSDAY, DECEMBER 12, 2013

Outside Counsel

The 'Cuban' Case: Lessons For Insider Trading Law

By **George A. Borden**

And **John S. Williams**

Mark Cuban, the high-profile owner of the Dallas Mavericks, was the subject of a Securities and Exchange Commission insider trading case for almost five years. After many twists and turns, including an initial dismissal that was reversed by the U.S. Court of Appeals for the Fifth Circuit, the case finally went to trial in federal court in Dallas recently. On Oct. 16, a jury returned a defense verdict. The result in the case appears to have turned largely on the jury's view of the facts and witnesses. But the case also included much wrangling over a variety of unsettled legal issues that make for interesting contrasts with other similar cases, including a number in the Southern District of New York.

Mamma and the PIPE

The Cuban insider trading case arose from Cuban's role as a major shareholder of a company then called Mamma.com. In 2004, Mamma.com decided it wanted to do a PIPE (private investment in public equity) transaction, which would involve seeking investors to buy stock in the company in private transactions, at a discount to the market price. The announcement of such a transaction often causes the market price of the company's stock to drop.

As alleged by the SEC, Mamma.com's CEO had a telephone call with Cuban to invite him to participate in the PIPE. The SEC alleged that the CEO prefaced the conversation by informing Cuban that he had confidential information to convey, and Cuban agreed to keep the information confidential. The CEO then told Cuban about the PIPE.

Cuban allegedly became angry because he did not like PIPE transactions, and at the end of the call allegedly said, "Well, now I'm screwed. I can't sell." Cuban allegedly then learned additional information about the PIPE from Mamma.com's investment banker. One minute later, the SEC alleged, Cuban told his broker to sell his entire stake in Mamma.com. After the PIPE was announced, Mamma.com's stock price declined. The SEC alleged that Cuban avoided losses in excess of $750,000 by selling when he did.

The Cuban case is one of a series of cases in which prosecutors and the SEC have attempted to crack down on trading by people who get information about an upcoming PIPE transaction. A number of these cases have been brought in the Southern District of New York.

Duty and the Rule

Perhaps the most significant legal issue involved in the Cuban case was one that was not contested at trial, because it had been resolved at an earlier stage of the case. That issue is: What is required to create a duty to abstain from trading or to disclose the inside information the party has obtained. Wrapped up in that question is the validity of SEC Rule 10b5-2(b)(1). That rule, which was promulgated in 2000, purports to create a duty not to trade on inside information based solely on an agreement to keep the information confidential. (In pertinent part, the rule provides that "a duty of trust or confidence" exists "[w]henever a person agrees to maintain information in confidence"). The SEC promulgated the rule to flesh out an ambiguous part of the law under the so-called "misappropriation theory" of insider trading.

In contrast to the "classical theory" of insider trading, in which a corporate insider trades on (or tips) inside information, the misappropriation theory applies when a non-insider misappropriates information from someone to whom the misappropriator owes a duty. The Supreme Court first accepted this theory in

GEORGE A. BORDEN *is a partner in Williams & Connolly in Washington, D.C.* JOHN S. WILLIAMS *is an associate in the firm.*

1997 in *United States v. O'Hagan*,[1] a case in which a lawyer misappropriated information from his law firm, to which he owed a fiduciary duty.

Since *O'Hagan*, the question of exactly what kind of duty is necessary to make out a violation under the misappropriation theory has bedeviled courts. Is a simple agreement to treat the information confidential enough? Rule 10b5-2(b)(1) says yes, but Cuban argued that the rule goes beyond the SEC's authority as granted by Section 10(b) of the Securities Exchange Act because that statute requires deception. In *O'Hagan*, the Supreme Court found deception inherent in a fiduciary's failure to abide by his duty not to profit from inside information. When there is no fiduciary relationship, where is the deception?

The district court agreed with Cuban that Rule 10b5-2(b)(1) is invalid and dismissed the complaint against him. But it did not go so far as to hold that only a fiduciary duty can support an insider trading charge. According to the Cuban court, violation of an agreement—even if only implicit—is enough to establish a violation, but only if the agreement goes beyond confidentiality and includes an agreement not to trade.[2]

The Fifth Circuit subsequently reinstated the SEC's complaint, but not on the basis of Rule 10b5-2(b)(1).[3] Rather, the circuit court held that the SEC's complaint sufficiently alleged that Cuban had agreed not to trade as well as to keep the information about the PIPE confidential. It declined to reach the district court's invalidation of Rule 10b5-2(b)(1). Therefore, the invalidation of the rule remained the law of the case, and the SEC was required to prove that Cuban "expressly or implicitly agreed with Mamma.com to keep the material, nonpublic information confidential and not to trade on or otherwise use the information for his own benefit." Ultimately, the jury found there was no such agreement in the Cuban case.[4]

As the Cuban case illustrates, it is far from clear that an obligation to keep information secret carries with it an obligation not to trade.

Would the result have been different in the Southern District of New York? The U.S. Court of Appeals for the Second Circuit has not addressed the validity of Rule 10b5-2(b)(1), but at least one judge in the Southern District has upheld the rule. In *United States v. Corbin*,[5] Judge Victor Marrero rejected a challenge like the one made by Cuban, in part by referring to the pre-rule Second Circuit case *United States v. Chestman*. In that case, the Second Circuit suggested, at least in dictum, that "explicit acceptance" of an "express agreement of confidentiality" would suffice.[6]

Based on these decisions, one might conclude that Cuban's argument likely would not have been accepted if the case had been brought in the Southern District. In *Corbin* and *Chestman* (both of which involved personal relationships, not business relationships like that between Cuban and Mamma.com), however, the courts did not expressly consider the possible difference between an agreement of confidentiality and an agreement not to trade.[7]

Southern District cases involving PIPEs also do not provide a clear answer. In one such case, *SEC v. Lyon*, the SEC apparently did not assert Rule 10b5-2(b)(1) as the source of duty.[8] In two opinions in that case (denying the defendants' motion to dismiss and denying both sides' summary judgment motions),[9] Judge Sidney Stein appeared to accept that an agreement of confidentiality was sufficient, but again, the court did not specifically address the distinction between confidentiality and not trading.

In another PIPE case, Judge Robert Sweet held that "[i]t is antithetical to the concept of keeping information private or secret that the information be used by the person receiving the information for their own personal benefit without obtaining the express approval to so use it."[10] But that, too, was arguably dictum because the private placement memorandum that the defendant received stated that the recipient agreed to use the information "for the sole purpose of evaluating a possible investment."

Thus, it is unclear whether things would have been different in the Southern District. It remains to be seen whether the decision in *Cuban* may persuade courts in the Second Circuit to change their approach to the duty question or take a more skeptical view of Rule 10b5-2(b)(1). As the Cuban case illustrates, it is far from clear that an obligation to keep information secret carries with it an obligation not to trade.

Use Versus Possession

Another issue that seems not to have been contested at trial is what is required to prove that a defendant traded "based on" material nonpublic information. Like the question of duty, this is a point on which the SEC has promulgated a rule. It is Rule 10b5-1, and it provides (with a number of exceptions) that "a purchase or sale of a security of an issuer is 'on the basis of' material nonpublic information about that security or issuer if the person making the purchase or sale was aware of the mate-

rial nonpublic information when the person made the purchase or sale." Thus, under this rule, awareness of the information equals use.

The Cuban court, however, did not instruct the jury based on Rule 10b5-1. Instead, it instructed the jury that "the SEC must prove that Cuban used, or was motivated by, the material, nonpublic information…." It added that "[t]he SEC is not required to prove that Cuban sold his Mamma.com stock solely because of the material, nonpublic information."[11] The SEC apparently did not object to this instruction, perhaps because the Fifth Circuit has suggested that "'use' of or reliance on" inside information is required.[12] Ultimately, the jury found for Cuban on the question of whether he "traded on" the information about the PIPE.

Would things have been different in the Southern District of New York? In a pre-rule case, *United States v. Teicher*,[13] the Second Circuit suggested in dictum that it was inclined to take a position consistent with the rule—knowing possession of material nonpublic information is enough.[14] But despite *Teicher*, Cuban might have gotten a similar instruction even if his case had been tried in the Southern District. For example, in the recent trial of Doug Whitman, Judge Jed Rakoff instructed the jury that the inside information had to be "at least a factor" in the defendant's trading decisions,[15] and Judge Richard Sullivan gave a very similar instruction in *United States v. Contorinis*.[16] Of course, these were criminal cases, and it is possible that a different standard would apply in a civil case.[17]

Nonpublic Information

One issue that was hotly contested at the Cuban trial was what is "nonpublic information." In the past, this has not been a major battleground in insider trading cases, but the Cuban case may signal a shift in strategy. It was a key part of Cuban's defense that information about the PIPE was already public at the time he traded. He presented an expert witness to address that topic as well as to argue that the information about the PIPE was not material. The jury found that Cuban did not receive "material, nonpublic information" about the PIPE.

> In contrast to the 'classical theory' of insider trading, in which a corporate insider trades on (or tips) inside information, the misappropriation theory applies when a non-insider misappropriates information from someone to whom the misappropriator owes a duty.

Both sides in *Cuban* invoked the instructions on the nonpublic issue given by Judge Sullivan and affirmed by the Second Circuit in *Contorinis*,[18] and the Cuban court largely adopted those instructions. Thus, there is little reason to believe that the result would have been any different in the Southern District. Sullivan instructed the jury in *Contorinis* that "the fact that information has not appeared in a newspaper or other widely available public medium does not alone determine whether the information is nonpublic" and that more limited dissemination could render the information public. The Cuban court adopted that instruction but also added that information "known only by a few persons" is public if "their trading on it has caused the information to be fully incorporated into the price of the particular stock."[19] This latter point comes from the Second Circuit's decision in *United States v. Libera*.[20]

Looking Ahead

Given the frequency with which insider trading cases are brought in the Southern District, the issues aired in the Cuban case may soon arise in cases here. For those who litigate insider trading cases in this district, the case provides potential arguments and questions, but few clear answers.

1. 521 U.S. 642 (1997).
2. *SEC v. Cuban*, 634 F.Supp.2d 713 (N.D. Tex. 2009).
3. *SEC v. Cuban*, 620 F.3d 551 (5th Cir. 2010).
4. Because the verdict form did not separate the issues of confidentiality and non-trading, we cannot know if the jury thought there was an agreement as to one of the two issues, and thus we cannot know if the difference in legal tests made a difference to the Cuban result.
5. 729 F.Supp.2d 607 (S.D.N.Y. 2010).
6. 947 F.2d 551, 571 (2d Cir. 1991) (en banc).
7. There is a question whether Rule 10b5-2(b)(1) is even intended to apply to business relationships. In promulgating Rule 10b5-2, the SEC stated that it intended to address "when a breach of a family or other non-business relationship may give rise to liability under the misappropriation theory of insider trading." Securities Act Release No. 7881 (Aug. 15, 2000). Most of Rule 10b5-2 deals with family and other personal relationships, but Rule 10b5-2(b)(1) itself is not clearly limited to non-business situations.
8. *Lyon* makes for a particularly interesting comparison to *Cuban* because the defendant in that case, like Cuban, lives in Dallas, Texas, and some of the same lawyers who were involved on both sides of the *Lyon* case also were involved in the Cuban case. As in *Cuban*, the court in *Lyon* ruled that a trial was needed to decide the case. Lyon, however, ultimately chose to settle the case against him.
9. *SEC v. Lyon*, 605 F.Supp.2d 531 (S.D.N.Y. 2009); *SEC v. Lyon*, 529 F.Supp.2d 444 (S.D.N.Y. 2008).
10. *Compudyne v. Shane*, 453 F.Supp.2d 807, 819 (S.D.N.Y. 2006).
11. Court's Charge to the Jury at p.11 in *SEC v. Cuban*, No. 3:08-CV-2050-D (N.D. Tex.) (docket number 278).
12. See *United States v. Shelby*, 604 F.3d 881, 887 (5th Cir. 2010). The Shelby case did not mention Rule 10b5-1, possibly because the conduct at issue there took place before the rule's effective date.
13. 987 F.2d 112 (2d Cir. 1993).
14. Some other courts have disagreed. See, e.g., *United States v. Smith*, 155 F.3d 1051, 1067-70 (9th Cir. 1998) (rejecting the knowing possession standard and requiring "actual[] use[]" of the information). Since the promulgation of Rule 10b5-1, some have argued that it is invalid, see, e.g., Horwich, "The Origin, Application, Validity and Potential Misuse of Rule 10b5-1," 62 Bus. Lawyer 913 (2007); Swanson, "Insider Trading Madness: Rule 10b5-1 and the Death of Scienter," 52 U. Kan. L. Rev. 147 (2003), but no court has held it invalid.
15. The Court's Instructions of Law to the Jury in *United States v. Whitman*, No. 1:12-cr-00125-JSR, at p. 17 (S.D.N.Y.) (docket number 102). The jury found Whitman guilty. He appealed, and the case is now pending before the Second Circuit.
16. Trial Transcript at page 1,872 in *United States v. Contorinis*, No. 09-cr-1083-RJS (S.D.N.Y.).
17. Interestingly, in *SEC v. Patton*, No. 02-cv-02564 (E.D.N.Y.), the SEC did not press for knowing possession instruction but rather advocated an instruction based on *SEC v. Adler*, 137 F.3d 1325 (11th Cir. 1998), to the effect that if the jury found the defendant traded while in possession of material, nonpublic information, "then you must give the Commission the benefit of a strong inference that he also used the information in reaching his decision to buy."
18. 692 F.3d 136 (2d Cir. 2012).
19. Court's Charge to the Jury at p.10 in *SEC v. Cuban*, No. 3:08-CV-2050-D (N.D. Tex.) (docket number 278).
20. 989 F.2d 596 (2d Cir. 1993).