

## E-ALERT | White Collar

September 23, 2010

### THE FIFTH CIRCUIT'S DECISION IN SEC V. CUBAN: LESSONS FOR COMPANIES AND TRADERS

On September 21, 2010, the U.S. Court of Appeals for the Fifth Circuit, as expected, reinstated the SEC's insider trading case against Mark Cuban. Although the [decision](#) is written narrowly, it contains important lessons for both companies and traders: Companies who provide nonpublic information to third parties, such as potential investors, business partners, advisers, consultants, or vendors, should ensure that their confidentiality agreements expressly prohibit recipients of the information from trading on it. And traders should consult legal counsel and carefully assess all the relevant facts before trading with knowledge of nonpublic information, no matter how and from whom it was obtained.

The SEC's complaint alleges a colorful set of facts: Mr. Cuban, the owner of the Dallas Mavericks basketball team, also held a significant stake in a company called Mamma.com. In June 2004, Mamma.com's CEO called Mr. Cuban, elicited an oral agreement to keep what he was going to say confidential, and told him that the company was planning to raise capital through a private placement of its equity (PIPE offering). Because the offering would dilute his position, Mr. Cuban reacted angrily and said, "Well, now I'm screwed. I can't sell." Mr. Cuban later obtained additional confidential details about the PIPE, including that it would be sold at a discount to the market price, from the company's investment bank. Mr. Cuban immediately dumped his shares and saved himself over \$750,000 in losses, as the stock price plummeted after the PIPE was announced the next day.

Last year, Mr. Cuban, backed by an amicus brief from five prominent law professors, moved to dismiss the SEC's complaint. The district court granted his motion, holding that a mere agreement to keep information confidential—which does not explicitly bar trading on the information—is insufficient to establish liability under the misappropriation theory of insider trading. The district court also invalidated SEC Rule 10b5-2(b)(1), which says just the opposite. Regarding Mr. Cuban's alleged statement to the CEO that he "can't sell," the judge found that it reflected only Mr. Cuban's erroneous understanding of the law of insider trading.

In its recent ruling, the Fifth Circuit took issue with that conclusion and held that, based on the SEC's allegations, it was at least equally plausible to infer that Mr. Cuban had in fact agreed not to trade, and that his understanding with the CEO was "more than a simple confidentiality agreement." The appellate court also noted wryly that Mr. Cuban's position—that he could trade on the information but was prohibited from telling others about it—would in effect give him "an exclusive license to trade on the material nonpublic information." Nonetheless, the Fifth Circuit did not decide whether a mere confidentiality agreement

would be enough to prove insider trading, or whether an explicit trading ban is required. Nor did it rule on the validity of Rule 10b5-2(b)(1). Instead, it sent the case back to the district court for discovery and further proceedings.

Thus, it remains an open question whether a third party can trade with impunity on information provided under a confidentiality agreement that does not expressly prohibit trading. Companies should therefore make sure that their confidentiality agreements contain such a provision. And Mr. Cuban's plight in this case (even if he ultimately prevails) is a sober reminder that any trading on the basis of nonpublic information, regardless of the source of the information, risks incurring the cost and distraction of a lengthy SEC investigation, litigation, and potentially severe penalties and other sanctions. If you are contemplating such a trade, or if the SEC contacts you, please call us.

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If you have any questions concerning the material discussed in this client alert, please contact the following members of our white collar practice group:

|                         |              |  |
|-------------------------|--------------|--|
| <b>Bruce Baird</b>      | 202.662.5122 | <a href="mailto:bbaird@cov.com">bbaird@cov.com</a>           |
| <b>David Bayless</b>    | 415.591.7005 | <a href="mailto:dbayless@cov.com">dbayless@cov.com</a>       |
| <b>Haywood Gilliam</b>  | 415.591.7030 | <a href="mailto:hgilliam@cov.com">hgilliam@cov.com</a>       |
| <b>Nancy Kestenbaum</b> | 212.841.1125 | <a href="mailto:nkestenbaum@cov.com">nkestenbaum@cov.com</a> |
| <b>David Kornblau</b>   | 212.841.1084 | <a href="mailto:dkornblau@cov.com">dkornblau@cov.com</a>     |
| <b>Alan Vinegrad</b>    | 212.841.1022 | <a href="mailto:avinegrad@cov.com">avinegrad@cov.com</a>     |

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