NBA Insider: The Strange Case of Mark Cuban – The dangers of trading with material non-public information

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This is the silly season. One administration is packing their bags, while another waits in the wings. At the SEC, top officials are departing, even though they are not political appointees, anticipating that the new administration will have other people in mind for their jobs. The new people are likely to have other and different theories of regulation to advance.

Meanwhile, a credit crisis of Tyrannosaurus Rex proportions continues to wreak havoc in our economy. Armed with a popgun, the SEC is unlikely to take much action during this interregnum. The job of killing this beast is left with Treasury, the Fed and the next administration.

Fortunately, in these difficult times, Mark Cuban, owner of the Dallas Mavericks basketball franchise, and his attorneys, have provided us with some comic relief.

Cuban is accused by the SEC of trading on the basis of material non-public information. What makes this case more interesting than most is that Cuban has decided to discuss it on his blog, which is something of a pulpit for Cuban to trumpet his libertarian views. Cuban's case would probably be news anyway, due to his prominence as the owner of the Mavericks, but the blog has created a rich mine for news stories about the case. For purposes of this column, the blog provides us with a rare glimpse into the theory of the case currently held by Cuban and his defense counsel.

Thanks to the blog, the facts are not in dispute, except for one item pounced upon by Cuban's lawyers. Cuban owned about 600,000 shares of Mamma.com Inc., making him the holder of roughly 6.3% of its common stock. In June 2004, Mamma.com's CEO called to inform Cuban that the Company was planning to sell shares in a private placement with a commitment to register the shares as soon as practicable, which would permit purchasers in the private placement to sell their shares quickly. This type of transaction is commonly known as a PIPE (private investment in public equity). The CEO began the conversation by telling Cuban that what he was about to hear would be confidential. He then told Cuban that the Company was planning to do a PIPE and invited him to participate in the offering.

Cuban was not happy to hear about this because the offering would dilute his interest, and being a man of strong opinions, strongly objected to the Company's plans. The next day, Cuban sold all of his stock, thereby avoiding losses when the price of the stock fell following the public announcement of the PIPE a few days later.

So far, this would seem to be a typical case of trading on the basis of material non-public information in violation of Rule 10b-5. The SEC has prosecuted successfully several insider trading cases involving PIPES with very similar facts. But, Cuban and his lawyers have seized on one element of the SEC's complaint. The SEC alleges that Cuban agreed to keep the information about the PIPE confidential. Cuban hotly contends that he never agreed to any such thing.

Does Cuban's agreement, or lack thereof, make any difference? That is the question the courts will have to decide. Cuban has the money to finance the litigation; so, my guess is that he will try the case all the way to the Supreme Court. For what it's worth, I think his case is a loser.

The SEC has won many cases where someone – referred to in the cases as a "tippee" – receives material non-public information from an insider – a "tipper." I think it is unlikely the Supreme Court will rethink those cases, which is why I don't think Mr. Cuban ultimately will prevail. That said, in recent years, the Supreme Court pronounced two separate theories of insider trading, neither of which would appear to cover Mr. Cuban's case. This is the basis, I believe, for his hopes.

The first theory came up in a case involving Chiarella, an employee of a financial printer, and was later elaborated upon in the case of Dirks, an officer of a brokerage firm. In both cases, the Supreme Court found the defendants had not traded on the basis of material non-public information in violation of Rule 10b-5.

Mr. Chiarella handled some draft tender offer announcements, which had blank spaces or fictitious names to disguise the name of the target. The names would only be supplied on the evening before the public announcement of the transaction. However, by reading the documents, he was able to determine the identity of the targets. In five situations, he bought stock in the target, selling after the tender offers became public.

Mr. Dirks was an officer of a brokerage firm who received information from Secrist, a former officer of Equity Funding, that the assets of Equity Funding were overstated on its public financial statements as a result of fraud. Secrist urged Dirks to investigate the allegations and expose the fraud. Along the way, Dirks reported the results of his allegations to several investment firms, as well as to a reporter for the *Wall Street Journal*. The stock price fell, leading to an investigation by California insurance authorities, who uncovered evidence of the fraud and placed

Equity Funding in receivership. The SEC brought an action against Dirks for repeating Secrist's story to investors, who sold their stock in response.

In *Chiarella* and *Dirks*, the Court found that a person must have a fiduciary, trust or confidence relationship to the source of the information to be guilty of insider trading. On this theory, an officer or director would have such a relationship because of their relationship to the issuer. Similarly, a person who receives the information because of a fiduciary, trust or confidence relationship with an officer of the issuer – a derivative relationship -- would also be prohibited from trading on the basis of material non-public information received from the officer. But a person without any such relationship to the officer would have no duty and therefore would not be prohibited from trading. On the basis of this "relationship" theory, neither Chiarella nor Dirks were guilty of insider trading.

The second theory was delivered in the case of James O'Hagan, a partner in the law firm of Dorsey & Whitney, which represented Grand Metropolitan PLC. Mr. O'Hagan did not work for Grand Met, but learned from reading documents in the office that Grand Met was planning a tender offer for Pillsbury. Mr. O'Hagan purchased call options for Pillsbury stock and sold them when the tender offer was announced for a tidy profit of $4.3 million. Mr. O'Hagan's case bore a strong resemblance to *Chiarella*. Moreover, it was hard to argue that Mr. O'Hagan received his information as a result of a relationship with the source of the information because he did not work on the representation of Grand Met. Nonetheless, the Supreme Court found that O'Hagan had violated Rule 10b-5 because he had "misappropriated" the information.

Cuban's case would appear to fall between the cracks in these legal theories. Assuming Cuban is right that he did not agree to keep information about the PIPE confidential, it would be hard to argue that the CEO breached his duty to Mamma.com by telling Cuban about the PIPE. After all, the CEO was merely doing his job by calling Cuban in an attempt to raise money for the Company. Nor can it be argued that Cuban received the information dishonestly.

So, why do I think Cuban will lose?

Stepping back a bit, I don't think the Supreme Court is prepared to overturn the tipper-tippee line of cases. Very few of those cases turned on the existence of any sort of confidentiality agreement. When a corporate director or officer provides material non-public information to someone, whatever relationship the insider may have to the tippee, I believe the Supreme Court will find a theory under which the tippee is liable for trading on the basis of the information.

For what it's worth, I think the Supreme Court took a wrong turn with *Chiarella* and stubbornly refused to recognize the logical trap it had created in that case when it heard *Dirks*. The whole business of relationship to define unlawful behavior is a dead end theory in my view that will ultimately have to be distinguished out of existence.

Instead, the Court's focus should have been on scienter, a classic element of fraud. Scienter means that the persons committing fraud knows that they are intending to deceive their counterparties. In the case of material non-public information, the persons using it to trade should be convicted if it can be demonstrated that they knew the information was material and not available to the public. The right question is whether the persons involved knew or should have known that they were dealing with material non-public information. If so, they were committing fraud on their counterparties by trading on the basis of it. This means that Chiarella and O'Hagan were guilty, and Dirks was not. Dirks obtained information from sources available to anyone who cared to investigate.

I therefore don't believe much turns on whether Cuban entered into a confidentiality agreement with Mamma.com. It is sufficient that he knew the information was confidential.

On the practical side, I sometimes get a call from a client who has received material non-public information and would like to trade the stock. It is worthwhile to keep in mind that the legal duty of the person receiving material non-public information is to disclose the information to her counterparty. "Disclose or refrain from trading," is the rule. So, the first question to ask is whether there is a confidentiality agreement in place. If not, there's an easy solution: Call a press conference. On a serious note, the way to cleanse material non-public information is to make it public. This is usually done by putting it in a press release and sending it over the wire. You wait a reasonable amount of time so that the market can absorb the news. Then, you trade.

Had Cuban taken that road, the CEO of Mamma.com would have been irate and probably would never have spoken to Cuban again. Cuban would have made a bit less money on the trade. But, Cuban would not be facing the pain and suffering involved in defending an insider trading case brought by the SEC.

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