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KIRKLAND **M&A UPDATE**

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Recent District Court Ruling Addresses Third-Party Trading on Confidential Information

The decision calls into question whether a confidentiality agreement between a company and a shareholder that does not contain restrictions on the use of confidential information received by the shareholder can be the basis of an insider trading claim under the "misappropriation" theory.

Public companies often require non-insider shareholders and other third parties to enter into confidentiality agreements before the public companies disclose confidential information to such persons. In many cases, the confidentiality agreement only requires the recipient to keep the information confidential and does not specifically prohibit the recipient from trading on that information. Until now the SEC (and many commentators) believed that a specific "use" prohibition was unnecessary, as the duty to keep the information confidential was sufficient to impose liability on the recipient if he traded in securities of the company while in possession of the information. A recent federal court decision—*Securities and Exchange Commission v. Mark Cuban*—has called that reasoning into question.

Since the 1960s, the SEC has prosecuted persons trading on the basis of material nonpublic information under Section 10(b) of the Exchange Act and Rule 10b-5, which prohibit the use of "deceptive devices" in connection with the purchase and sale of securities. Prosecutions generally apply one of two theories. First, under the "classical" theory, a fiduciary of the company acts deceptively when he or she trades using material nonpublic information because the trade violates the fiduciary's duty to disclose the information to the counterparty prior to executing the trade. Second, under the more recently developed "misappropriation" theory, liability may attach to a trader who was entrusted with access to the confidential information, even though the trader may have no duty to the issuing company or its shareholders.

Cuban is a misappropriation theory case. According to the SEC's complaint, in spring 2004 Mamma.com, a Canadian company traded on the NASDAQ (now known as Copernic Inc.), decided to raise capital through a private (or PIPE) issuance of stock. Prior to making a public announcement, the Mamma.com CEO disclosed the PIPE offering to Cuban (its then-largest known shareholder) by telephone, but only after obtaining Cuban's agreement

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to keep confidential the information he was about to receive.

Despite stating at the end of the call, "Well, now I'm screwed. I can't sell," Cuban sold all of his shares shortly afterwards. By selling his shares prior to the public announcement of the PIPE offering, Cuban avoided losses of more than $750,000. The SEC filed suit against Cuban alleging insider trading.

The United States District Court for the Northern District of Texas dismissed the suit, distinguishing an agreement not to disclose confidential information from an agreement not to use the information. In its view, a duty to keep information confidential was compatible with a trade based on material nonpublic information, since the trade does not involve or result in the *disclosure* of the confidential information. Thus, while Cuban agreed to keep the information confidential, he never agreed to any restrictions on its use and was thus free to trade upon it. As a result, according to the Court, there had been no deceptive act, so the SEC could not prosecute. The Court also concluded that Rule 10b5-2(b)(1) exceeded the SEC's power to regulate deceptive practices because the mere agreement to keep information confidential did not establish the necessary duty of trust or confidence to render trading on that information illegal.

Though the decision in *Cuban* might lead to future revisions of SEC regulations to reflect *Cuban*'s emphasis on restricting use of confidential information, any party seeking to trade based upon confidential information should be wary of relying upon *Cuban* until such revisions occur, as there is little indication yet that the SEC will change its enforcement strategy in light of this opinion. However, companies concerned that stockholders and other persons receiving confidential information may seek to rely upon *Cuban* to trade on the information may consider requiring recipients to agree to both keep the information confidential and refrain from using it for trading (or other) purposes.

If you have any questions about the matters addressed in this *Kirkland M&A Update,* please contact the following Kirkland authors or your regular Kirkland contact.

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