New York Law Journal

SERVING THE BENCH AND BAR SINCE 1888

WWW.NYLJ.COM

An incisivemedia publication

VOLUME 242—NO. 31 THURSDAY, AUGUST 13, 2009

DIRECTORS' AND OFFICERS' LIABILITY

Developments In the Ongoing Insider Trading Debate

Corporate Update

By
Joseph M. McLaughlin

The debate over the proper reach of Section 10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5 as tools to combat insider trading was rekindled last month following two decisions in enforcement actions by the U.S. Securities and Exchange Commission against non-insiders who traded on material, nonpublic information. In *SEC v. Cuban*,[1] a Texas federal district court dismissed the SEC's enforcement action against Dallas Mavericks owner Mark Cuban for insider trading, holding that an express agreement to maintain nonpublic information in confidence is by itself insufficient to create the duty of trust and confidence which must underlie insider trading liability under a misappropriation theory. *Cuban* thus concluded that Rule 10b5-2(b)(1), which provides that a "duty of trust or confidence" sufficient to give rise to insider trading liability exists "[w]henever a person agrees to maintain information in confidence" exceeds the SEC's rulemaking authority to proscribe conduct that is deceptive.

In a significant ruling addressing what may constitute a "deceptive device" under §10(b), the U.S. Court of Appeals for the Second Circuit in *SEC v. Dorozhko*[2] held that a computer hacker who illegally accesses material, nonpublic information and then trades on it can be liable for securities fraud even if he did not violate any fiduciary duty in obtaining the information. *Dorozhko* held that U.S. Supreme Court case law requiring the existence of a fiduciary duty to disclose the intention to trade or abstain in order to find a "deceptive device" prohibited by Section 10(b) applies only to insider trading cases based on an omission. The court enunciated a theory of liability for alleged fraud cases involving an affirmative misrepresentation, under which misrepresenting one's identity in order to gain access to secure information may constitute an actionable misrepresentation, and that such a misrepresentation can be a "deceptive device" within the meaning of §10(b).

Theories of Liability

Section 10(b) creates fraud liability for conduct involving a "deceptive device or contrivance" used "in connection with" the purchase or sale of securities. The Supreme Court has rejected a general duty to disclose before trading on material, nonpublic information because a duty to disclose under §10(b) does not arise from mere possession of nonpublic information. Such a duty arises from the existence of a fiduciary relationship between the trader and the company or other traders in the market. In addition, for insider trading to come within the ambit of 10b-5 there must also be some kind of "manipulation or deception." Thus the "traditional" or "classical" theory of insider trading liability holds that §10(b) is violated when a corporate insider trades in the securities of his corporation on the basis of material, nonpublic information, in breach of a duty to disclose the information or abstain from trading.

JOSEPH M. MCLAUGHLIN *is a partner at Simpson Thacher & Bartlett.*

The duty underpinning the classical theory arises from the relationship of trust and confidence between the shareholders of a company and insiders who have obtained confidential information by reason of their position at the company. Insiders include corporate officers, directors, or controlling stockholders, all of whom have a fiduciary relationship with their company.

In *United States v. O'Hagan*,[3] the Supreme Court expanded the scope of insider trading liability by recognizing a second basis for § 10(b) liability, the "misappropriation theory" (first recognized in the Second Circuit). Under that theory, "a fiduciary's undisclosed, self-serving use of a principal's information to purchase or sell securities, in breach of a duty of loyalty and confidentiality, defrauds the principal of the exclusive use of that information." The misappropriation theory thus outlaws trading on the basis of nonpublic information by a corporate "outsider" in breach of a duty owed not to a purchaser or seller of the stock, but to the source of the information.

In *O'Hagan*, the Court upheld the conviction of an attorney charged with misappropriating confidential information in breach of a duty of confidence and trust to his law firm and the client that entrusted the information to the firm, identifying both the firm and the firm's client as the information's "source." Under *O'Hagan*, the "deception" requirement of §10(b) is met by the misappropriator's "feigning fidelity to the source of [the confidential] information." The misappropriation theory "is thus designed to protec[t] the integrity of the securities markets against abuses by 'outsiders' to a corporation who have access to confidential information that will affect th[e] corporation's security price when revealed, but who owe no fiduciary or other duty to that corporation's shareholders."[4]

After the *O'Hagan* decision, the SEC in 2000 promulgated Rule 10b5-2, which provides a non-exclusive list of three circumstances in which a person is deemed to have a "duty of trust or confidence" for purposes of applying the misappropriation theory. These are: (1) Whenever a person agrees to maintain information in confidence; (2) Whenever the person communicating the confidential information and the person to whom it is communicated have a history of sharing confidences, such that the recipient should know that there is an expectation that confidentiality will be maintained; and (3) Whenever a person receives material nonpublic information from designated close relatives, unless the recipient demonstrates that no duty of trust or confidence existed with respect to the information by showing that he or she had no reason to know that the source of the information expected that the information would be held confidential.

Thus, the classical theory of insider trading liability is predicated on fraud by a corporate insider on other traders, while the misappropriation theory is predicated on fraud by a corporate outsider not on a trading party, but on the person who entrusted the information to the fiduciary-turned-trader.

'Cuban'

The existence of a duty of confidentiality—sometimes referred to as a "fiduciary duty" or similar relationship of "trust and confidence"—is the cornerstone of a misappropriation liability case. Whether such a duty had been assumed by Mr. Cuban was the pivotal question in *Cuban*. The SEC alleged that the CEO of Mamma.com Inc. placed a phone call to Mark Cuban, the company's largest shareholder, to determine if he wanted to participate in a private offering. At the CEO's request during the call, Mr. Cuban agreed to keep all information about the offering confidential.

As alleged in the SEC's complaint, at the end of the call Mr. Cuban said: "Well, now I'm screwed. I can't sell," and two company e-mails indicated that the CEO may have understood that Mr. Cuban would not sell his shares until after the offering was announced. In reliance on Mr. Cuban's agreement to maintain confidentiality, the company provided Mr. Cuban with material, nonpublic offering information.

Unhappy that Mamma.com was conducting the offering he believed would be dilutive, Mr. Cuban promptly sold his entire 600,000-share Mamma.com position before the offering was publicly announced, thereby avoiding $750,000 in losses when Mamma.com's stock price declined after the public announcement.

The SEC sued Mr. Cuban for insider trading in federal court in the Northern District of Texas, invoking the misappropriation theory based on an alleged duty created by his agreement to keep confidential the information that Mamma.com's CEO provided him. Mr. Cuban moved to dismiss, arguing that in the context of an arm's-length business relationship, a confidentiality agreement alone is insufficient to create a fiduciary or similar relationship of trust and confidence between the parties. Rather, he contended, a confidentiality agreement creates only a contractual obligation to maintain the secrecy of the information, not a fiduciary or fiduciary-like duty to act loyally to the source of the information.

The court agreed, concluding that an agreement containing only a promise to maintain confidentiality does not establish the requisite relationship of trust and confidence needed for liability. Under the misappropriation theory, the court noted, trading on the basis of material, nonpublic information "cannot be deceptive unless the trader is under a legal duty to refrain from trading on or otherwise using it for personal benefit."

The court agreed with the SEC that a fiduciary duty of "loyalty and confidentiality" can be created by agreement and does not require (as Mr. Cuban argued) a pre-existing fiduciary or fiduciary-like relationship, but ruled that the agreement "must consist of more than an express or implied promise merely to keep information confidential. It must also impose on the party who receives the information the legal duty to refrain from trading on or otherwise using the information for personal gain." That is, the recipient must agree to maintain the confidentiality of the information and also agree not to trade on or otherwise use it. "Absent a duty not to use the information for personal benefit, there is no deception in doing so" and therefore no insider trading liability.

The court also held that Rule 10b5-2's provision that a duty exists "[w]henever a person agrees to maintain information in confidence" exceeds the SEC's authority under Section 10(b) to proscribe conduct that is deceptive to the extent the Rule "attempts to predicate misappropriation theory liability on a mere confidentiality agreement lacking a non-use component." The court did grant the SEC 30 days to file an amended complaint seeking to allege that Mr. Cuban did undertake a duty, expressly or implicitly, not to trade on or otherwise use material, nonpublic information about the offering.

It is unclear whether the SEC will amend the complaint or seek to appeal the ruling to the U.S. Court of Appeals for the Fifth Circuit. Regardless of next steps in the Cuban case, the SEC is unlikely to regard the decision as the final word on its use of the misappropriation theory and the decision obviously is not binding on other courts. Prudence dictates that recipients of material nonpublic information pursuant to a confidentiality agreement continue not to trade on the basis of such information. On the other side of the table, public companies frequently share nonpublic information with potential business partners, investors and acquirers. *Cuban's* emphasis on the distinction between obligations under an agreement to maintain information in confidence and obligations under an agreement also not to trade, i.e., a standstill agreement, counsels public companies to include language in confidentiality agreements imposing an express duty not to trade on the basis of confidential information.

The Second Circuit's expansive interpretation of the term 'deceptive device' in 'Dorozhko' to include hacking into a secure computer system to obtain confidential information then used to trade securities may trigger an increase in enforcement activity predicated on allegations of 'affirmative misrepresentation.'

'Dorozhko'

The conduct at issue in *Dorozhko* is difficult to frame as insider trading under any prevailing theory. The SEC therefore sued Oleksandr Dorozhko under §10(b), alleging that he hacked into a financial information service company's computer network and obtained nonpublic information concerning IMS Health Inc., which 35 minutes later he used to purchase 90 percent of all put options for IMS common stock for the six weeks before an IMS analyst call, expecting that the company's stock price would decline quickly. The day after his purchase IMS issued a negative earnings announcement and the company's stock fell, upon which Mr. Dorozhko immediately sold all of his put options and realized profits in excess of $286,000.

The district court denied the SEC's request for a preliminary injunction freezing the sale proceeds because the SEC failed to establish a likelihood of success on the merits of its claim. Noting that "no federal court has ever held that the theft of material non-public information by a corporate outsider and subsequent trading on that information violates §10(b)," the court reasoned that while hacking may be illegal under several laws (including the Computer Fraud and Abuse Act and the mail and wire fraud statutes), it is not a "deceptive device" under §10(b) because, whether the SEC is relying on the traditional or misappropriation theories of insider trading, hacking does not involve a breach of a fiduciary duty to disclose nonpublic information or refrain from trading.

In a pathbreaking decision approving a theory the SEC has used in several other enforcement actions which were resolved prior to adjudication, the Second Circuit reversed, holding that a violation of fiduciary duty is not a required element in a securities fraud enforcement action alleging an affirmative misrepresentation. Writing for a unanimous panel, Judge Jose A. Cabranes acknowledged that the SEC's theory that computer hacking was a "deceptive device" actionable under §10(b) was not based on either of the two generally accepted theories of insider trading, both of which require a breach of a fiduciary duty to disclose or abstain that coincides with a securities transaction. Those generally accepted theories were developed where the theory of fraud was silence or nondisclosure, not affirmative misrepresentation.

Reviewing Supreme Court case law on insider trading, the Second Circuit read the cases to hold that remaining silent was actionable only where there was a duty to speak, arising from a fiduciary relationship. But "an affirmative misrepresentation is a distinct species of fraud," the court reasoned, under which even a person with no fiduciary duty to disclose or abstain from trading "nonetheless has an affirmative obligation in commercial dealings not to mislead." The court acknowledged that computer-hacking is not a monolithic activity—the circumstances under which electronic information was stolen will determine whether a particular theft was "deceptive"—and remanded the case to the district court for a determination of whether the method of computer hacking used by Mr. Dorozhko was "deceptive."

If Mr. Dorozhko misrepresented his identity in order to gain access to secure information, the court stated, that "plainly" would be "deceptive" within the ordinary meaning of the word. It was unclear, however, "that exploiting a weakness in an electronic code to gain unauthorized access is 'deceptive,' rather than being mere theft." Accordingly, depending on how the hacker gained access, the court held it is "entirely possible that computer hacking could be, by definition, a 'deceptive device or contrivance' that is prohibited by Section 10(b) and Rule 10b-5."

The securities fraud in insider trading cases ordinarily consists in buying or selling stock based on material, nonpublic information in breach of a duty to disclose the intention to trade or refrain from trading, not (as in *Dorozhko*) in how the defendant obtained nonpublic information.

The Second Circuit's expansive interpretation of the term "deceptive device" to include hacking into a secure computer system to obtain confidential information then used to trade securities may trigger an increase in enforcement activity predicated on allegations of "affirmative misrepresentation," including that a person traded on the basis of nonpublic information obtained through deceptive means. Under the Second Circuit's approach, no breach of fiduciary duty is required when the defendant engages in affirmatively deceptive conduct, which can be argued to encompass a multitude of misconduct, such as lying, acting deceptively, or perhaps even telling half-truths.

1. 2009 WL 2096166 (N.D.Tex. July 17, 2009).
2. 2009 WL 2169201 (2d Cir. July 22, 2009).
3. 521 U.S. 642 (1997).
4. Id. at 653.