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Law on Insider Trading **Misappropriation Theory** Remains Unsettled

Recent cases address the “duty of trust or confidence.”

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The government has characterized insider trading as a significant threat to the integrity of U.S. securities markets.¹ But determining what constitutes insider trading can prove to be a challenging exercise. One area of particular difficulty involves the misappropriation theory of insider trading, where it is frequently unclear what types of relationships among the individuals involved give rise to liability.

This article will explore recent insider trading cases and highlight the legal contours that are still being developed in this area of law. In particular, it will focus specifically on two recent cases applying the misappropriation theory, comparing the facts and nuances of each case to better understand which scenarios might give rise to a “duty of trust or confidence” whose breach can trigger insider trading liability under §10(b) of the Securities Exchange Act of 1934.

Legal Framework

There are two main types of insider trading: (1) the classical form, where a corporate insider trades in the securities



of a corporation on the basis of material, non-public information;² and (2) the misappropriation form, where a corporate outsider “misappropriates confidential information for securities trading purposes, in breach of a duty owed to the source of the information.”³

Classical insider trading liability is premised on the need to prevent a corporate insider from taking unfair advantage of uninformed stockholders.⁴ It stems from the “relationship of trust and confidence ... between the shareholders of a corporation and those insiders who have obtained confidential information by reason of their posi-

tion with that corporation.”⁵ The classical theory applies also to attorneys, accountants, consultants, and others who temporarily become fiduciaries of a corporation.⁶

There are two important carve-outs to classical insider trading liability. First, it does not attach where a defendant lacks any specific relationship with the company’s shareholders, such as a printer employed at a print shop that handled documents with the names of companies targeted in takeover bids.⁷ Under those circumstances, the U.S. Supreme Court reversed a trial court conviction because there is no “general duty between all par-

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ticipants in market transactions to forgo actions based on material, non-public information."⁸ Rather, the duty to abstain from trading only "arises from a specific relationship between two parties."⁹

Second, the Supreme Court has recognized that no insider trader liability can attach where a source legally discloses material, non-public information to a recipient and does not expect the recipient to keep the material, non-public information confidential.¹⁰ Against this backdrop, in 1997 the Supreme Court ratified the misappropriation theory in the seminal case *United States v. O'Hagan*.¹¹

The misappropriation insider trading theory extends liability to a corporate outsider who misappropriates confidential information for securities trading purposes in breach of a duty owed to the source of the information.¹² It is rooted in the notion that a "misappropriator who trades on the basis of material, non-public information ... gains his advantageous market position through deception; he deceives the source of the information and simultaneously harms members of the investing public."¹³ It is that deception that triggers liability under §10(b).

This extension of insider trading liability to corporate outsiders aims to capture non-fiduciary relationships that were unaddressed by the classical theory. Thus, under the misappropriation theory as formulated in *O'Hagan*, liability can arise from trading on information obtained in violation of a "relationship of trust and confidence."¹⁴ But *O'Hagan* left open the determination of precisely which non-fiduciary relationships contain the requisite "trust and confidence" sufficient to give rise to liability.

In 2000, the SEC promulgated Rule 10b5-2 to clarify and enhance the misappropriation theory after *O'Hagan*.¹⁵ Under Rule 10b5-2(b), a duty of trust or confidence exists: (1) "Whenever a person agrees to maintain information in confidence;" or (2) "Whenever the person communicating the material non-public information and the person to whom it is communicated have a history, pattern, or practice of sharing confidences, such that the recipient of the information knows or reasonably should know that the person communicating the material non-public information expects that the recipient will

maintain its confidentiality."¹⁶

But notwithstanding the promulgation of Rule 10b5-2(b), lower courts still struggle to articulate which non-fiduciary relationships actually give rise to liability, at times reaching conflicting outcomes,¹⁷ and the number of misappropriation theory insider trading cases reaching the Circuit Courts of Appeal is relatively few. *McGee*¹⁸ and *Cuban*¹⁹ provide recent examples of the circuit courts attempting to provide guidance in this often muddled area of law. Interestingly, these two cases reached opposite results. McGee's conviction was recently affirmed by the Third Circuit. Cuban prevailed on a motion to dismiss, but after that dismissal was reversed by the Fifth Circuit, he was absolved entirely at trial. Nuances in the legal and factual issues of each case shed light on how the different results were reached.

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'McGee'

In 2008, Timothy McGee obtained material, non-public information about the impending sale of Philadelphia Consolidated Holding Corporation (PHLY), a publicly traded company, from Christopher Maguire, a PHLY insider. McGee had met Maguire years earlier through Alcoholics Anonymous (AA), where McGee became Maguire's informal mentor. Because AA members are encouraged to seek support from other members in their efforts to stay sober, McGee assured Maguire that their conversations would remain private.²⁰

In 2008, Maguire was involved in non-public negotiations to sell PHLY. During this time, he experienced sporadic alcohol relapses, and once again saw McGee at an AA meeting. Maguire mentioned the pressure he was under because of PHLY's impending sale, believing that McGee would keep this information confidential.

After this conversation, McGee borrowed over \$200,000 to purchase more

than 10,000 PHLY shares. Shortly after the public announcement of PHLY's sale, McGee sold his shares and realized a profit of nearly \$300,000.

McGee was charged criminally with, inter alia, securities fraud under the misappropriation theory. McGee argued that his relationship with Maguire was not sufficiently fiduciary-like to serve as a foundation for misappropriation liability. In 2012, a jury found McGee guilty of insider trading, determining that McGee's trades "violated a relationship of trust or confidence with Maguire based on their history, pattern, or practice of sharing confidences pursuant to Rule 10b5-2(b)(2)."²¹

The Third Circuit affirmed the verdict, finding sufficient evidence of a pattern of sharing confidences between McGee and Maguire based on the parties' mutual understanding that information discussed would not be disclosed or used by either party. For nearly a decade, McGee informally mentored Maguire, who entrusted extremely personal information to McGee to alleviate stress associated with alcohol relapses. That, the court concluded, was more than adequate to trigger liability under Rule 10b5-2(b)(2).

'Cuban'

In 2004, Mark Cuban acquired 600,000 shares of Mamma.com and became its largest shareholder. A few months later, the CEO invited Cuban to participate in a round of capital raising through a PIPE (Private Investment in Public Equity) offering, prefacing the conversation with an alleged request to keep the information confidential. The parties disputed the exact language of the request and whether Cuban agreed only to keep the conversation confidential or whether he also agreed to refrain from trading the stock.²²

After speaking with Mamma.com's investment banker about the terms of the PIPE offering, Cuban disagreed strategically with the company's decision to proceed with the PIPE offering and sold his entire stake in the company. The next day, Mamma.com announced the PIPE offering and its shares declined in price by 40 percent over the next week. By selling his shares when he did, Cuban avoided over \$750,000 in losses. Cuban notified the SEC that he sold his stake in the company and publicly stated that he sold his shares because the com-

pany “was conducting a PIPE, which issued shares at a discount to the prevailing market price and also would have caused his ownership position to be diluted.”²³

The SEC charged Cuban with insider trading under the misappropriation theory. It alleged that Cuban deceived Mamma.com by agreeing to maintain the confidentiality of the material, non-public information concerning the PIPE offering, agreeing not to trade on the information, and then failing to live up to those agreements.

In 2009, the district court granted Cuban’s motion to dismiss the complaint, determining that the complaint alleged an agreement to keep the information confidential but not an agreement not to trade. In 2010, the Fifth Circuit reversed the dismissal of the complaint. The court held that the SEC adequately pleaded that Cuban reached an agreement with the CEO not to trade, and reasoned that if such an agreement could be proven at trial, it would give rise to liability under 10b5-2(b)(1).²⁴ In its opinion, the Fifth Circuit acknowledged the paucity of jurisprudence on the question of what constitutes a relationship of trust and confidence. It further recognized the inherently fact-bound nature of the inquiry, and thus remanded the case to the district court.

In March 2013, the district court denied Cuban’s motion for summary judgment, reasoning that the SEC was allowed to demonstrate at trial that a relationship of trust and confidence existed between Cuban and the CEO; furthermore, that it could do so based on an agreement implied from the parties’ conduct and the surrounding circumstances to maintain the confidentiality of Mamma.com’s material, non-public information and to refrain from trading its stock.

In October 2013, after an eight-day jury trial, a jury returned a verdict in favor of Cuban, explicitly rejecting the SEC’s argument that Cuban had agreed to not to trade.²⁵

Significance of ‘McGee’ and ‘Cuban’

The main issue in both cases, albeit stemming from two different subsections of Rule 10b5-2, was what type of relationship could give rise to an insider trading violation. *Cuban* focused on subsection (b)(1), which addresses a relationship based on an alleged agreement not to trade. *McGee* focused on subsection (b)(2), which addresses a relationship based on sharing

prior confidences. In both instances, the SEC pushed for an aggressive application of the rules, seeking to establish each relationship as one of trust and confidence.

In a sense, both cases represent victories for the SEC. *McGee* validates the SEC’s broad view of confidential relationships. And in *Cuban*, despite the SEC’s loss at the trial level, the Fifth Circuit nonetheless validated the SEC enforcement division’s expansive view of what constitutes an agreement to maintain confidentiality and refrain from trading. It is unlikely that the SEC will be deterred by the verdict in *Cuban*. The SEC’s official response was that “[w]hile the verdict in this particular case is not the one we sought, it will not deter us from bringing and trying cases where we believe defendants have violated the federal securities laws.”²⁶

The implications of *McGee* could be even more far-reaching. *McGee* could set the stage for expansive judicial interpretations of the fluid language in Rule 10b5-2(b)(2). After *McGee*, courts might be less receptive to counsel’s argument that the sharing of the non-public information in question exceeded the scope of the confidential relationship. Even if the non-public information was not the type of content usually discussed within the confidential relationship, courts may interpret *McGee* to conclude that any non-public information discussed by parties privy to a confidential relationship relates sufficiently to that relationship.

Indeed, the rule’s broad language of a “history, pattern, or practice of sharing confidences,” coupled with broad judicial rulings, has, rather than provide guidance, only served to raise more questions. What if the history of sharing confidences has been dormant for several years, or ended long ago? How many instances are needed to establish a practice? These difficult questions are likely to be grappled with on a fact-specific basis in the trial courts without clear guidance from the appellate courts for some time.

Similarly, the term “agreement” in subsection (b)(1) could conceivably be used against not only those with explicit agreements to keep information confidential, but also perhaps to allege an implicit understanding to keep information confidential and to refrain from trading. It is thus possible that even casual conversations with an insider who conveys confidential information could give rise to liability under an “implicit agreement” construct.

On the other hand, *Cuban* should empower defense counsel to argue that the government must demonstrate both an agreement to keep information confidential and an agreement not to trade. Indeed, the jury instructions in *Cuban* required the SEC to prove both.

Conclusion

The promulgation of Rule 10b5-2 and the cases decided thereunder have not ended the debate over the nature of relationships that give rise to liability under the misappropriation theory of insider trading. The mixed results in both civil and criminal cases indicate that this area of the law remains unsettled and will continue to be shaped by the facts and circumstances of new cases as they make their way through the courts.

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1. See Thomas Newkirk, Assoc. Dir., Div. of Enforcement, SEC & Melissa Robertson, Senior Counsel, Div. of Enforcement, SEC, Insider Trading—A U.S. Perspective, Remarks at 16th International Symposium on Economic Crime (Sept. 19, 1998), available at <http://www.sec.gov/news/speech/speecharchive/1998/spch221.htm>.

2. *United States v. O’Hagan*, 521 U.S. 642, 651-52 (1997).

3. *Id.* at 652.

4. *Id.*

5. *Id.* (quoting *Chiarella v. United States*, 445 U.S. 222, 228 (1980)) (internal quotation marks omitted).

6. *Id.* (citing *Dirks v. SEC*, 463 U.S. 646, 655 n.14 (1983)).

7. See *Chiarella v. United States*, 445 U.S. 222, 224 (1980).

8. *Id.* at 233.

9. *Id.*

10. See *Dirks v. SEC*, 463 U.S. 646, 665 (1983).

11. 521 U.S. 642 (1997).

12. *Id.* at 652.

13. *Id.* at 656.

14. *Id.* at 652 (citation and internal quotation marks omitted).

15. *SEC v. Cuban*, 620 F.3d 551, 555 (5th Cir. 2010) (“*O’Hagan* did not set the contours of a relationship of ‘trust and confidence’ giving rise to the duty to disclose or abstain and misappropriation liability ...”).

16. 17 C.F.R. §240.10b5-2(b) (2014).

17. See, e.g., *SEC v. Yun*, 327 F.3d 1263, 1271 (11th Cir. 2003) (“[I]t is unsettled whether non-business relationships, such as husband and wife, provide the duty of loyalty and confidentiality necessary to satisfy the misappropriation theory.”); *United States v. Kim*, 184 F. Supp. 2d 1006, 1012-13 (N.D. Cal. 2002) (no duty of confidentiality between members of a social group, despite club rules emphasizing confidentiality); *SEC v. Kirch*, 263 F. Supp. 2d 1144, 1149-50 (N.D. Ill. 2003) (duty of confidentiality existed among group members because the need was understood).

18. *United States v. McGee*, 763 F.3d 304 (3d Cir. 2014).

19. *SEC v. Cuban*, 620 F.3d 551 (5th Cir. 2010).

20. *McGee*, 763 F.3d at 308-09.

21. *Id.* at 310 (quoting 17 C.F.R. §240.10b5-2(b)(2)) (internal quotation marks omitted).

22. See *Cuban*, 620 F.3d at 552-53.

23. *Id.* at 556 (citation and internal quotation marks omitted).

24. See *id.* at 557-58.

25. See Court’s Charge to Jury at 13. *SEC v. Cuban*, Civil Action No. 3:08-CV-02050-D, Dkt. No. 278 (N.D. Tex. Oct. 16, 2013) (special verdict form).

26. Ben Protess & Lauren D’Avolio, “Jury Rules for Cuban in Setback for S.E.C.,” N.Y. Times, Oct. 17, 2013, (Dealbook), at B1 (internal quotation marks omitted).