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Public Company Update: Recent Cases and SEC Guidance on Rule 10b5-1 Trading Plans

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Recent insider trading allegations by the Securities & Exchange Commission against the former CEO of Countrywide Financial, filed June 4 in Los Angeles federal court, illustrate the SEC's continuing concern about potential abuses of so-called "Rule 10b5-1" trading plans. In addition, the SEC's Division of Corporation Finance recently updated its Compliance and Disclosure Interpretations (CDIs) regarding Rule 10b5-1 plans.[2] In light of these developments, corporate executives and directors should pay renewed attention to the timing and substance of their trading plan activities. Particular care should be taken to avoid adopting or amending trading plans when in possession of material nonpublic information. Structured properly, however, Rule 10b5-1 plans remain useful tools to mitigate corporate insiders' litigation risk.

Recent Litigation Focusing on 10b5-1 Plans

As a safe harbor from insider trading liability under the SEC's Rule 10b-5, Rule 10b5-1(c) provides that a purchase or sale of securities will not be deemed to be on the basis of material nonpublic information if it is pursuant to a contract, instruction or plan that (i) was entered into before the person became aware of the information, (ii) specifies the amounts, prices and dates for transactions under the plans (or includes a formula for determining them), and (iii) does not subsequently permit the person to influence how, when or whether purchases or sales will occur. The affirmative defense is applicable only "when the contract, instruction, or plan to purchase or sell securities was given or entered into in good faith and not as part of a plan or scheme to evade" the federal insider trading prohibitions.

[1] The assistance of David Furbush, co-leader of the Firm's Securities Litigation Team, and Kamal Patel, a Summer Associate in the Firm's San Francisco office, is gratefully acknowledged.

[2] The CDIs are available at: http://www.sec.gov/divisions/corpfin/guidance/exchangeactrules-interps.htm

Although Rule 10b5-1 plans have been commonplace since the rule's adoption in 2000, alleged abuses of these plans have taken center stage in a number of recent lawsuits instituted by the SEC and aggrieved investors:

- On June 4, 2009, the SEC filed a civil complaint in Los Angeles federal court against the former CEO of Countrywide Financial, Angelo Mozilo, and other former Countrywide executives, alleging (among other things) that they used Rule 10b5-1 plans to trade illegally on inside information. According to the complaint, Mr. Mozilo (and trusts and charities that he controlled) sold nearly $140 million in Countrywide stock from November 2006 to August 2007, when he allegedly knew that Countrywide's underwriting policies and deteriorating mortgage portfolio were exposing the company to significant undisclosed risks. Although all of these trades were made through Rule 10b5-1 plans, the SEC alleges that Mr. Mozilo had material nonpublic information when he instituted the plans. The complaint also emphasizes that Mr. Mozilo implemented no fewer than four separate 10b5-1 plans during a three-month period, under which sales occurred quickly. One plan was approved on September 25, 2006, with the potential for sales to begin on November 1, and another was established on December 12, 2006, with sales to occur on specific days after January 5, 2007. The SEC noted that the first plan was approved just one day before Mr. Mozilo sent an internal email stating that the company was "flying blind" regarding its loans' performance in an increasingly difficult environment, and the second was instituted five days after he circulated an internal memorandum analyzing the company's subprime mortgage situation. (The two other plans resulted in essentially immediate sales on behalf of a family trust and a Mozilo-controlled charitable organization.) *SEC v. Mozilo*, No. 09CV03994 (C.D.Cal. filed June 4, 2009).

  The SEC's complaint also emphasizes that Mr. Mozilo amended the December 2006 plan in February 2007, essentially doubling the number of shares at a time when Countrywide's stock price was at a historic high – but retaining the same time schedule for sales. This amendment was also found particularly noteworthy by the federal judge in an earlier lawsuit by private investors. In refusing to dismiss the case against Mr. Mozilo, the judge stated that he "actively amended and modified his 10b5-1 plans…. Mozilo's actions appear to defeat the very purpose of 10b5-1 plans, which were created to allow corporate insiders to 'passively' sell their stock based on triggers, such as specified dates and prices, without direct involvement." *In Re Countrywide Financial Corp.*, 554 F. Supp. 2d 1044, 1068-69 (C.D.Cal. 2008).

- In March 2009, the SEC filed a complaint in federal court in North Carolina, alleging that former officers of Krispy Kreme Doughnuts created 10b5-1 plans to sell stock shortly after issuing misleading statements to securities analysts. The complaint emphasized that the trading plans called for "limit order" prices which, given the stock's then-current trading price, "essentially guaranteed that their Rule 10b5-1 plans would be executed immediately, and all stock identified within their plans promptly sold." *SEC v. Livengood*, No. 09CV00159 (M.D.N.C. filed Mar. 4, 2009).

- In addition to the well-publicized Countrywide case, other aggrieved investors have seized on perceived abuses of Rule 10b5-1 plans, in pursuing insider trading claims. For example, in April 2009, a California federal court refused to dismiss an insider trading case against a technology company's officers, based partly on allegations that they amended trading plans to increase their sales of stock before the market learned that a major customer would no longer purchase an important product. The judge stated that allegations of amending 10b5-1 plans to add shares based on inside information supports an inference of "scienter," the state of mind required in a private Rule 10b-5 insider trading lawsuit. The judge also commented that the pattern of the executives' sales "does not square with a typical 10b5-1 plan triggering stock sales on certain dates and at certain prices, as Defendants unloaded varying amounts of stock just before July 20, 2007 [when rumors of the lost business became public] on varying dates (i.e. not on

the first of every month) and failed to sell in the months after July 2007 when [the company's] stock hit similar prices." *Backe v. Novatel Wireless, Inc.*, 607 F. Supp. 2d 1145 (S.D.Cal. 2009).

New SEC Staff Guidance

The SEC Staff recently included new advice about Rule 10b5-1 plans in its Compliance and Disclosure Interpretations (CDIs) regarding the rules under the Securities Exchange Act of 1934. These new interpretations provide additional insight into how the rule may be interpreted by SEC enforcement staff. Key points include:

- **Delaying Commencement of Sales until Release of Material Nonpublic Information Known at the Time of Plan Adoption May Not Legitimize the Plan.** The Staff's new guidance interprets Rule 10b5-1(c) to preclude reliance on the rule's affirmative defense when a person institutes a trading plan while aware of material nonpublic information, even if the plan is structured to delay all plan transactions until after the information becomes public. (CDI 120.20).

  This interpretation is difficult to reconcile with the rule's purpose and language. If no sales under the plan occur until *after* full release of any material nonpublic information known when the plan was adopted, then the insider has not obtained any improper benefit or advantage from the information. Rule 10b5-1 states that "a purchase or sale of a security of an issuer is 'on the basis of' material nonpublic information about that security or issuer if the person making the purchase or sale was aware of *the* material nonpublic information when the person made the purchase or sale" (emphasis added). The rule's use of the word "the" rather than "any" is consistent with the common-sense interpretation that the only information relevant for insider trading purposes is information that is material and nonpublic *both* at the time of the sales decision (in this case, the adoption of the plan) and at the time of the purchase or sale. If the Staff's interpretation were to prevail, then whenever it could be argued that an insider was aware of *any* material nonpublic information upon adoption of a plan, the entire plan would be ineffective to protect subsequent transactions while in possession of unrelated, subsequently acquired material nonpublic information – even where the insider could clearly demonstrate that he or she was unaware of that information when adopting the plan. Given the uncertainty that is inherent in determining what constitutes material nonpublic information, such an interpretation would significantly weaken the protections of the rule.

- **Replacing a Trading Plan.** Rule 10b5-1's affirmative defense is available only when the plan was entered into "in good faith and not as part of a plan or scheme to evade" the federal insider trading laws. The Staff's recent interpretations elaborate on this "good faith" requirement in the context of terminating one plan, and instituting a new one. The new guidance states that all of the surrounding facts and circumstances will be evaluated, including the time period between the cancellation of the old plan and the establishment of the new one. This reinforces the advisability of observing a "cooling off" period before entering into a new Rule 10b5-1 plan, after terminating one. It further suggests that an insider should think long and hard about the potential circumstances that could cause him or her to want to stop selling, and build those contingencies into the plan so that sales can cease automatically, rather than requiring the insider to terminate the plan, upon the occurrence of those events. Corporate insiders should also keep in mind that, according to the SEC's Staff, cancelling one or more plan transactions will be considered an "alteration or deviation" that automatically terminates the plan. (CDI 120.19).

- **Transfers to New Broker.** In guidance that is particularly timely given the continued turmoil on Wall Street, the Staff has confirmed that if, after a trading plan has been in effect for several months, the broker that has been executing plan sales goes out of business, a corporate insider may transfer his or

her 10b5-1 plan to a new broker without the plan being deemed cancelled, so long as (i) the transfer is timed to avoid any cancellation of transactions under the plan, and (ii) the new broker effects trades in accordance with the plan's original terms. The transfer may occur even at a time when the insider has material nonpublic information. However, corporate insiders should note that the requirement to avoid cancelling transactions under the plan may require prompt action, depending on the timing of the broker's failure. In addition, this new interpretation is limited, on its face, to cases in which the original broker goes out of business. (CDI 220.01).

- **Company Stock Repurchases.** The benefits of Rule 10b5-1 are available to companies that repurchase their own securities. In the recently released interpretations, the SEC's staff has clarified that a company *may not* automatically reduce the number of shares authorized for repurchase under its 10b5-1 plan by the number of shares that it repurchases in privately negotiated block trades, because this gives the issuer "the potential to effectively modify the plan by doing the block trades while aware of material nonpublic information." The Staff distinguished this situation from delegating discretion to a broker to reduce the number of shares to be sold under a trading plan to comply with the volume limitations of Rule 144(e), since the latter reflects "limitations imposed by law rather than an exercise of discretion by the seller." (CDI 220.02).

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