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Capital Markets and Securities

Rule 10b5-1 Can Be an Effective Part of a Year-end Strategy to Lock in Capital Gains at the 2010 Rate

For most individuals, the top federal income tax rate on capital gains is scheduled to increase by a third, from 15% to 20%, starting on January 1, 2011. Under the recently enacted health care legislation, a 3.8% Medicare surtax will be imposed, beginning in 2013, on investment income (including capital gains, interest and dividends) of single taxpayers earning more than $200,000 per year and couples earning more than $250,000 per year. Taken together, these actions represent a nearly 60% increase in federal income taxes on the capital gains of high earners as compared to prevailing 2010 rates.

In light of these expected tax increases, anyone sitting on significant unrealized capital gains may want to consider realizing such gains before the end of this year.

Ordinarily, trading by insiders at year end could give rise to insider trading liability. However, Rule 10b5-1 under the Securities Exchange Act of 1934 provides an affirmative defense to insider trading liability for purchases and sales made through trading plans adopted in accordance with the rule. When properly drafted and entered into, these plans can facilitate trades even during "blackout" periods or when an insider is otherwise in possession of material nonpublic information.

The Basics. To fall within the protections of the rule, an insider's trades must be made pursuant to a binding contract, instruction, or written plan that:

- is entered into or given at a time when the insider is not in possession of material nonpublic information;
- specifies the amount, price, and date of the purchase or sale transaction (or sets out a formula for determining the same) or does not permit the insider to exercise any subsequent influence over how, when, or whether to effect purchases or sales; and
- is entered into or given in good faith and not as part of a plan or scheme to evade liability.

The Benefits. A properly designed and executed trading program under Rule 10b5-1 can protect an insider from civil and criminal penalties for insider trading. Recognizing that insiders are often in possession of material nonpublic information, the SEC intended that the rule would enable insiders to diversify or liquidate their holdings at such times without fear of insider trading liability, so long as the trading program satisfied the conditions of the rule. The rule has been effective in achieving this goal, with more than $8.5 billion in trades under Rule 10b5-1 plans estimated in 2006, the most recent year for which data is publicly available.[1]

> Insiders at calendar year companies seeking to effect sales before the end of 2010 should consider putting a Rule 10b5-1 plan in place following the release of second quarter results

In addition to protecting insiders, well-constructed and disclosed plans can also serve as an important part of a public company's securities litigation loss prevention program. In securities litigation, plaintiffs typically seek to show the requisite fraudulent intent (or "scienter") by detailing insider trading patterns in the complaint. Courts have held that a

properly designed Rule 10b5-1 trading plan can negate an inference of scienter arising from insider trading, and lead to an early dismissal of litigation.[2] Although courts typically consider only the plaintiff's pleadings at the motion to dismiss phase, courts may take judicial notice of a publicly disclosed Rule 10b5-1 plan in determining whether to dismiss an action.[3]

The Traps. Compliance with the rule's requirements would seem simple enough. However, some practices in designing and executing Rule 10b5-1 plans can provide the SEC and private litigants with a basis for challenging the validity of a trading plan. In the last few years, several articles and academic studies have suggested that trades made in reliance on Rule 10b5-1 have significantly outperformed non-10b5-1 trades.[4] The authors of one study suggested that insiders trading through Rule 10b5-1 plans may outperform the market because they possess material nonpublic information at the time of entering into the plan, terminate sales under a plan prior to announcement of positive news, or defer the announcement of negative news until a sales plan has been substantially completed.[5] The SEC and the plaintiff's bar have taken note.[6]

In perhaps the highest profile litigation involving Rule 10b5-1 plans, the federal district court in the Central District of California noted that flaws in the structure and timing of several Rule 10b5-1 trading plans adopted by Angelo Mozilo, the former CEO of Countrywide Financial, were probative of scienter and declined to dismiss the action.[7] The court noted that Mozilo had four separate Rule 10b5-1 plans in place as well as the timing of entering into the plans, the concurrent company stock repurchase program, and the nature and timing of amendments to the plans. For example, the court noted that Mozilo "actively amended and modified his 10b5-1 plans" and commenced transactions shortly after implementing certain of his plans. The court determined that his actions "appear to defeat the very purpose of 10b5-1 plans" and do not support the contention that his trades were prescheduled.[8] The SEC has brought a separate civil action against Mozilo and certain other former Countrywide officers based on insider trading claims.[9]

The Safe Way Forward. Despite increased regulatory scrutiny, these plans can still provide valuable protections to insiders if properly structured and implemented. In structuring a Rule 10b5-1 trading plan, insiders should consider the following:

- ***Cooling-off Period***. First trades under a trading plan should be deferred until a "cooling-off" period is satisfied, typically 30 days and/or until publication of the next quarterly earnings release. A cooling-off period can avoid the appearance that a Rule 10b5-1 trading plan is being used as a veneer to mask insider trading. Insiders at calendar year companies seeking to effect sales before the end of 2010 should consider putting a Rule 10b5-1 plan in place following release of second quarter results.

- ***Don't "Front Load" Plans***. Loading up sales in the initial stages of a plan can create an appearance that the insider is trying to effect transactions before an expected material development or before circumstances become public.

- ***One Plan at a Time***. Insiders should put in place only one Rule 10b5-1 plan at a time. Multiple plans can raise the appearance of an insider continuing to manage the trading, rather than the pre-programmed approach contemplated by the SEC when it adopted Rule 10b5-1.

- ***Be Careful with Concurrent Company Stock Buybacks***. Rule 10b5-1 sales plans entered into at a time when the company is executing a stock buyback program can raise a question—"why is it a good deal for stockholders that their company buys back stock when insiders think it's a good time to sell?" Companies conducting a buyback program at a time when insiders may be entering into or selling under Rule 10b5-1 plans should insulate the selling insiders from influencing the company's buyback decisions. This can limit the appearance of the selling

insider manipulating the buyback program (for example, to raise the market price of the stock to boost proceeds to the insider, or to drive price-sensitive triggers under the insider's sales plan). If both the company and insider are buying, care should be taken that the aggregation of company and "affiliated purchaser" purchases do not exceed the Rule 10b-18 volume limits.

- ***Limit Plan Terminations***. It is not illegal to abstain from trading based on inside information.[10] However, terminating a plan may call into question whether the plan was entered into in good faith at the outset, possibly jeopardizing the insider's ability to rely on the safe harbor for earlier trades under that plan. Similarly, terminations can call into question the validity of a subsequent plan unless the subsequent plan is entered into after a considerable cooling-off period. Terminations should be effected only after careful consideration of all the circumstances with the company and its counsel.

- ***Avoid Plan Modifications***. Similar to terminations, plan modifications (amendments or voluntary suspensions) can create an appearance that the trading is being managed by the insider, and can call into question whether the plan was originally adopted in good faith. Any modifications must be made at a time when the insider is not in possession of material nonpublic information, and then only after consulting with the company and its counsel.

- ***No Hedging or Transactions Outside a Plan***. Rule 10b5-1 expressly provides that its protections are not available where the insider has entered into a "corresponding or hedging transaction or position" with respect to the securities covered by the plan. Even "same-way" trades can give rise to an appearance of managing trades under a plan, and should only be undertaken after consultation with the company and its counsel.

- ***Pre-Approval by Company***. Rule 10b5-1 plans should not be entered into absent consultation with the company to ensure the insider is not in possession of material nonpublic information, the plan is not being entered into during a "blackout" period and that the plan otherwise complies with the company's insider trading policy. Most companies' insider trading policies require pre-approval of the terms of any trading plan under Rule 10b5-1.

- ***Disclosure of New Plans, Modifications and Terminations***. Although not required by the rule, companies should consider disclosing the entry into Rule 10b5-1 plans by insiders. Doing so will enable the company to put such plans in context, more freely address the significance of insider trades with market participants in a Regulation FD-compliant manner, and can also provide tactical litigation advantages as discussed above. The SEC's staff has also indicated that it is taking a critical look at disclosures surrounding Rule 10b5-1 plans, including "asymmetrical" disclosures where the company discloses the entry into the plan, but not terminations or modifications of the plan.

- ***Other Compliance Matters***. Insiders looking to lock in gains on their company's stock at the 2010 tax rate should also be mindful to comply with their company's stock ownership guidelines, Rule 144, Section 13(d) beneficial ownership reporting and Section 16 short swing profits rules.

Please direct any questions regarding Rule 10b5-1 plans and other aspects of federal securities law compliance to any member of the Capital Markets Group listed below.

[1] *See* Linda Chatman Thomsen, SEC Director, Division of Enforcement, Opening Remarks Before the 15th Annual NASPP Conference, October 10, 2007, *available at www.sec.gov/news/speech/2007/spch101007lct.htm*, citing Gidon Caine et al., *United States: Rule 10b5-1 Plans Under Scrutiny: The Next Executive Stock-Timing Story*, Mondaq Business Briefing, June 1, 2007.

[2] *See*, *e.g.*, Fishbaum v. Liz Claiborne, Inc., No. 98-9396, 1999 WL 568023, at *4 (2d Cir. 1999) (insider trades not unusual because, among other reasons, two defendants' stock sales were made pursuant to periodic divestment plans); In re IAC/InterActiveCorp Sec. Litig., 478 F. Supp. 2d 574, 604 (S.D.N.Y. 2007) (trades under 10b5-1 plan "do not raise a strong inference of scienter"); *see also* Elam v. Neidorff, 544 F.3d 921, 928 (8th Cir. 2008) ("Stock sales pursuant to Rule 10b-5 trading plans can raise an inference that the sales were prescheduled and not suspicious"); *but see* In re Countrywide Financial Corp. Derivative Litigation, 554 F. Supp. 2d 1044, 1068 (C.D. Cal. 2008) (where the court declined to dismiss a securities fraud claim in part due to insider trades under questionable Rule 10b5-1 plans being probative of scienter).

[3] *See generally* Henderson, M. Todd, Jagolinzer, Alan D. and Muller, Karl A., Strategic Disclosure of 10b5-1 Trading Plans (September 14, 2009). U of Chicago Law & Economics, Olin Working Paper No. 411; CLEA 2008 Meetings Paper; Rock Center for Corporate Governance at Stanford University Working Paper No. 7., *available at http://ssrn.com/abstract=1137928* citing Friedman v. Rayovac Corp., 291 F. Supp. 2d 845 (W.D. Wis. 2003), In re Netflix, Inc. Sec. Litig., 2005 WL 1562858 (N.D. Cal. June 28, 2005) and Wietschner v. Monterey Pasta Company, 2003 WL 22889372 (N.D. Cal. Nov. 4, 2003).

[4] *See, e.g.,* "Do Insiders Trade Strategically Within the SEC Rule 10b5-1 Safe Harbor?" Professor Alan D. Jagolinzer, Stanford University Graduate School of Business, December 2006.

[5] *Id*.

[6] *See* Linda Chatman Thomsen, SEC Director, Division of Enforcement, Opening Remarks Before the 15th Annual NASPP Conference, October 10, 2007, *available at www.sec.gov/news/speech/2007/spch101007lct.htm*; *see also* Backe v. Novatel Wireless, Inc., 642 F. Supp. 2d 1169, 1183 (S.D. Cal. 2009) (plaintiff alleged that defendants adopted or amended their Rule 10b5-1 trading plans to allow them to sell more shares of stock near the highest stock prices during the class period); In re Countrywide Financial Corp. Derivative Litigation, 554 F. Supp. 2d at 1055, 1068 (plaintiff cited frequent revisions to Rule 10b5-1 sales plans as evidence of insider trading and the court held that the timing of amendments and modifications to such plans were probative of scienter) and In re Immucor Inc. Securities Litigation, 2006 WL 3000133 (N.D. Ga.) at *18 (the court acknowledged "the possibility that a clever insider might 'maximize' their gain from knowledge of an impending price drop over an extended amount of time, and seek to disguise their conduct with a Rule 10b5-1 plan").

[7] In re Countrywide Financial Corp. Derivative Litigation, 554 F. Supp. 2d at 1068-69; *see also* In re Countrywide Financial Corp. Securities Litigation, 588 F. Supp. 2d 1132 (C.D. Cal. 2008).

[8] In re Countrywide Financial Corp. Derivative Litigation, 554 F. Supp. 2d at 1068-69.

[9] *See* SEC v. Angelo Mozilo, David Sambol, and Eric Sieracki, Litigation Rel. No. 21068A, AAER No. 3023 (June 4, 2009).

[10] *See* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975).

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