Corporate Governance Feature: 10b5-1 Plans and M&A Transactions

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Companies are under increasing pressure to scrutinize 10b5-1 plans in the wake of several recent high profile insider trading enforcement actions, including the charges brought against Angelo Mozilo in connection with his adoption of 10b5-1 plans after he learned of problems in Countrywide’s operations during the developing mortgage crisis, and Joseph Nacchio, whose 10b5-1 plan accelerated its trading after he learned Qwest would fail to meet revenue targets. Six years ago, the Director of the SEC’s Enforcement Division acknowledged evidence that trades made pursuant to 10b5-1 plans do statistically better than other trading and promised closer scrutiny. More recently, after a series of Wall Street Journal reports on potential abuse of 10b5-1 plans, federal prosecutors in New York began criminal investigations of suspicious plan-based trading.

The plans are sometimes mischaracterized as providing safe harbors for insider trading activity, which is not the case. They merely provide affirmative defenses that can be rebutted. Trading that coincides with significant M&A transactions, when analyzed in hindsight, may suggest a basis for such rebuttals. Accordingly, companies need to be very wary of 10b5-1 plan activity that occurs when they are in the midst of deal talks.

Some companies should even consider adopting restrictions on such activities in advance. This article focuses on four specific issues that arise in the context of M&A transactions:

1. M&A Related Provisions of a Plan: How should 10b5-1 plans address potential M&A transactions at the time the plans are established?

2. Adoption in the Face of M&A Activity: Can an insider adopt a 10b5-1 plan in connection with securities of an issuer that regularly considers its strategic options or otherwise has M&A deals on the horizon that have not yet been publicly announced?

3. Changing the Plan in the Face of M&A Activity: Can an insider terminate or suspend a 10b5-1 plan in the face of a pending M&A transaction?

4. Timing the Announcement of M&A Activity: Can an insider influence the timing of the issuer’s announcement of a material M&A transaction if the timing will impact the price of shares bought or sold under a 10b5-1 plan relative to the post-announcement price?

Overview of 10b5-1 Plans

Many excellent articles have been written about the history and requirements of Rule 10b5-1 and the general issues associated with 10b5-1 plans. This article will not attempt to replicate all of the detail and nuance addressed in other publications. However, set forth below is a short summary of certain key aspects of 10b5-1 plans to set the stage for the ensuing discussion of the M&A-related issues associated with the plans.

Rule 10b-5 prohibits trading “on the basis of” material non-public information (“MNPI”). In ruling on insider trading cases brought under Rule 10b-5, federal courts historically split on the question of whether “on the basis of” implied mere possession of MNPI, or required actual use of MNPI. In 2000, the SEC promulgated Rule 10b5-1 to resolve the courts’ inconsistent interpretations and codify the SEC’s position that mere possession, not use, of MNPI is sufficient...
to establish liability in insider trading cases. This expanded potential liability by prohibiting trades made while someone is merely “aware” of MNPI, even if they are not “using” MNPI in their trade. However, Rule 10b5-1 also created an affirmative defense for trading based on a 10b5-1 plan.

Fundamentally, a 10b5-1 plan is a pre-set trading arrangement that allows corporate insiders to trade in the issuer’s shares even if the insiders later acquire knowledge of MNPI after the plan is established. These plans are often used by people presumed to have inside information, like directors and officers. However, the plans do not guarantee that insider trading charges will not be brought. In other words, 10b5-1 is not a “safe harbor,” it is an affirmative defense. Further, the defense is exclusive: It is only available if the plan meets all the requirements of Rule 10b5-1.

Rule 10b5-1 requires that a 10b5-1 plan be written down and designed in accordance with Rule 10b5-1(c). Specifically:

- the plan must be established in good faith and not as part of a plan or scheme to evade the prohibitions of Rule 10b5-1;
- the plan must be adopted at a time when the person trading was not “aware” of the MNPI;
- the terms of the plan must specify the amount, price and date of the trades to be made under the plan (or include a written formula, algorithm or computer program for determining the amount, price and date);
- the person trading under the plan must not exercise any subsequent influence over how, when or whether to make trades under the plan;
- trades must be made pursuant to the plan; and
- trades cannot be offset by hedging transactions.

In theory, 10b5-1 plans decrease the burden on in-house counsel and trading compliance officers of monitoring insiders’ trading activity and making subjective determinations about when trading under the plans is permissible. However, for most companies, trading under the plans is not exempt from the company’s internal insider trading policies and compliance departments still play an important role in assessing whether the plan design and activities conducted under the plan are consistent with Rule 10b5-1. For example, some companies have adopted “approved templates” for 10b5-1 plans. These templates may include features, such as waiting periods, restrictions on having multiple plans, requirements regarding plan duration and other alleged “best practices” that are not technically required by Rule 10b5-1. That compliance role continues even after a plan that complies with all applicable legal and internal requirements has been established. For example, Rule 10b5-1 permits plans to be cancelled or modified after their adoption. Accordingly, compliance departments are often now asked to make subjective judgments about the permissibility of cancelling or modifying existing plans, and some companies expressly require that all plan modifications be pre-cleared through their compliance department.

The rationale for continued compliance department monitoring of plan activities is that, when viewed in hindsight, there are many plan-related activities that could be construed as being problematic under the good-faith prong of Rule 10b5-1(c)—i.e., they could be viewed as part of a “plan or scheme to evade the prohibitions of ...Rule 10b5-1” or otherwise as evidence of the absence of “good faith” in entering into the plan. Such a determination could result in the plan failing to provide an affirmative defense to charges of insider trading, in turn resulting in potential criminal liability for the insider and, under the Insider Trading and Securities Fraud Enforcement Act of 1988, potential liability for the employer if it is found to have acted recklessly in failing to prevent an insider trading violation, such as the failure to maintain appropriate policies.

The types of activities that are particularly at risk of triggering scrutiny under the good-faith prong of Rule 10b5-1(c) include making changes to the plan, such as cancelling or suspending it, while appearing to be in possession of MNPI. The SEC once took the position that there could be no private right of action for insider trading without
an actual securities transaction, such that merely cancelling a plan without trading under the plan would not be actionable. More recently, however, the SEC modified its guidance to reflect recent developments in Supreme Court case law, stating that the cancellation of one 10b5-1 plan could call the good faith of other plans into doubt, and asserting its right to bring an enforcement action in connection with the cancellation of a plan (even though there may be no private right of action arising from the cancellation). Accordingly, insiders and issuers now need to be wary that cancellation or suspension of a plan can lead to appearance of manipulation of the plan or can otherwise jeopardize the “good faith” element of the plan. This in turn could call into question the availability of the affirmative defensive for all previous trades under the plan.

**10b5-1 Plans and M&A Activity:**

**Common Issues**

Any analysis of the existence of insider trading is extraordinarily fact-intensive. Rule 10b5-1 heightens the emphasis on facts through its “good faith” requirement, which eliminates the affirmative defense even for procedurally unobjectionable actions if undertaken for subjectively “bad” reasons. Accordingly, this is not an area of the law that is susceptible to the articulation of bright-line rules.

This fact-intensiveness is further accentuated by the SEC’s decision to tackle abuses in an ad hoc manner through enforcement actions rather than by amending the regulations or clarifying its guidance. According to former SEC Commissioner Joseph Grundfest, the “[w]eaknesses inherent in 10b5-1 plans were well known to the commission, to the commission’s staff, and to practitioners when the rule was first adopted.” For that reason, people at the time “thought that, with the accumulation of experience, the commission would proceed, over time, to refine the rule so that it would better protect investors without imposing unreasonable burdens on executives and insiders.” Alas, Grundfest lamented, the SEC “ha[s] accumulated the experience” without “refin[ing] the rule.”

Recently, the Council of Institutional Investors submitted a rulemaking petition to the SEC suggesting changes to Rule 10b5-1 or interpretive guidance that would impose more objectively-verifiable requirements for 10b5-1 plans. Many of their proposals would codify what are purportedly already “best practices.” The SEC has said that it is “looking into” the suggestions raised by the Council, noting that “10b5-1 plans are issues that [it] grapple[s] with regularly in insider trading cases.” However, as of yet, there does not appear to be widespread agreement on the desirability of the Council’s approach, and in any event the Council’s proposals do not address all of the unique situations that can arise, such as M&A deals. Set forth below this article poses four such recurring M&A-related questions for which neither the SEC nor the Council of Institutional Investors has articulated a specific guideline.

**M&A Related Provisions of a Plan**

*How should 10b5-1 plans address potential M&A transactions at the time they are established?*

Rule 10b5-1 does not impose any specific M&A-related requirements on 10b5-1 plans. However, several issuers impose their own requirements, examples of which include:

- automatic suspension of trading under the plan upon the issuer’s announcement (or notice from an issuer’s general counsel or compliance officer) of an M&A transaction;

- automatic suspension of trading under the plan to comply with Regulation M or during the pendency of an issuer tender offer;

- following a suspension of the type described in the foregoing two bullets, permission to resume trading under the plan only upon satisfaction of all the elements of establishing a new plan; and

- limits on cancellation, amendment or replacement of a plan upon notice from an issuer’s general counsel or compliance officer of an M&A transaction.
Imposing these features as mandatory elements of a plan template raises thorny issues about how to define the requisite materiality and certainty of the relevant M&A transaction, since these attributes can be difficult to assess at the early stages of a transaction. However, companies in consolidating industries or that are otherwise serial participants in M&A deals should consider whether these restrictions make sense for them or whether the very existence of these restrictions would call into question the good faith prong of Rule 10b5-1’s requirements. It is possible to limit the applicability of these features to those individuals who are actually “under the tent” for a particular M&A deal, although this approach would add an additional layer of complexity to the compliance monitoring function.

Adoption in the Face of M&A Activity

Can an insider adopt a 10b5-1 plan in connection with securities of an issuer that regularly considers its strategic options or otherwise has M&A deals on the horizon that have not yet been publicly announced?

An insider cannot adopt a 10b5-1 plan if he or she has MNPI at the time the plan is adopted. The assessment of whether information is actually MNPI, however, is always tricky and involves a degree of judgment and risk assessment that can make even a seasoned compliance officer uncomfortable. Fundamentally, this question is no different in the 10b5-1 plan context than it is in other situations in which compliance with Rule 10b-5 is required, but the personal stakes for senior executives may add to the pressure that compliance officers face in exercising their judgment. Further, many brokerage firms actually require confirmation that adoption of a plan was consistent with the issuer’s insider trading policy. Here are some examples of questions that may arise:

- For companies that regularly review their strategic alternatives and lists of potential counterparties but do not have a specific deal on the horizon, can their insiders adopt a plan?

- If information concerning a potential M&A deal is determined not to constitute MNPI at the time the plan is adopted, but later becomes MNPI when the deal becomes more certain, must trading under the plan be suspended?

- What sort of record, if any, should the company maintain to establish the company’s and the insider’s understanding of the status of a potential M&A transaction at the time the plan was adopted?

- If a plan terminates in the ordinary course in the midst of the company’s non-public discussions regarding an M&A transaction, can the insider adopt a new, mirror plan to replace it?

One of the Council of Institutional Investors’ rulemaking proposals could actually further complicate the landscape. The proposal would require disclosure of the adoption of 10b5-1 plans. Currently, plans need not be disclosed, although some issuers and insiders do disclose them in Form 4s and other Exchange Act filings. However, if disclosure were mandatory, the absence of disclosure in the face of a pending M&A transaction at a time when disclosure of plan adoptions would otherwise be expected for a particular issuer (such as, for certain issuers, in connection with the scheduled vesting of equity awards) could be a signal to the market of an impending material announcement and could hasten the inevitable deal rumors and potentially even cause the issuer to have to put out a leak statement.

Changing the Plan in the Face of M&A Activity

Can an insider terminate or suspend a 10b5-1 plan in the face of a pending M&A transaction?

There are many legitimate reasons why insiders may need to modify their 10b5-1 plans, such as when they face new or unexpected financial milestones (tuition payments, home purchases and other life changes triggering a need for different personal liquidity), the need for diversification of their portfolio as their aggregate wealth increases
and the need to adjust their retirement planning. Insiders sometimes also need the ability to react to public announcements by the issuer along with other shareholders.

As discussed above, insiders and issuers need to be wary that cancellation or suspension of a 10b5-1 plan can, when viewed in hindsight, lead to the appearance of manipulation of the plan or can otherwise jeopardize the “good faith” element of the plan. Whether the issuer should impose a bright-line rule that prohibits these actions in the face of M&A activity or otherwise, however, is a delicate question that can even, in some cases, affect an insider’s perception of the value of his or her equity compensation. Further, the issuer would have to decide whether this bright-line requirement would apply at all times that an insider could be deemed to have MNPI, or only in the face of specific types of MNPI-generating events (such as M&A transactions). For companies active in M&A, the former approach effectively could lock CEOs and CFOs into their plans once adopted, without regard to changes in their personal situations, because they will almost certainly be at risk of being thought to have had MNPI at all times. Less strict formulations, each of which may deter “bad” behavior, include disallowing modifications and terminations other than during open trading windows, imposing waiting periods following terminations or suspensions or requiring public disclosure of a termination or suspension.

### Timing the Announcement of M&A Activity

**Can an insider influence the timing of the issuer’s announcement of a material M&A transaction if the timing will impact the price paid for shares bought or sold under a 10b5-1 plan relative to the post-announcement price?**

Insiders often have a lot of influence over the timing of the announcement of M&A deals. For example, they can impact the timing of a signing merely by accelerating or delaying the speed with which they return phone calls from their counterpart. If the insider has scheduled trades under a 10b5-1 plan that would fall shortly before or after announcements of MNPI, the insider may be at risk of being alleged to have altered the announcement date of the MNPI to maximize the value of his or her trades under the plan. The SEC has announced that it intends to look at this issue more closely, as it may fall under the rubric of market manipulation as a “deceptive” act under Rule 10b-5. Such activity could also raise a “good faith” issue under Rule 10b5-1(c). The appearance of manipulating the timing of an announcement in a manner that appears to improve the return on a plan’s trade, by calling into question the “good faith” prong of Rule 10b5-1, could also call into question previous trades under the plan.

### Other 10b5-1 “Best Practices”

The Council of Institutional Investors and others have additional “best practices” for structuring 10b5-1 plans. These include, for example:

- mandatory waiting periods before commencing trading under a new plan;
- limiting each insider to conducting all trading under a single plan; and
- restricting communications with the administrator of the plan.

Although these “best practices” are not targeted to the M&A context, they could have an impact on the administration of 10b5-1 plans in connection with issuers undertaking M&A activity. For example, if the issuer engages in an M&A transaction that has a unique structure and it is unclear if the transaction triggers any rights or restrictions under the plan, a restriction on the insider’s ability to communicate with the plan administrator could leave the insider (and the administrator, for that matter) in the dark as to how the plan will operate in that context.

Some legal advisors also advise insiders to structure their plans and their activity conducted under the plans in a fashion designed to reduce the risk of the appearance of “bad facts” when trades are viewed in hindsight. These include, for example:
• making all trading practices more easily defensible, such as by spreading smaller trades over a longer period;
• establishing a consistent pattern of trading; and
• in cases where an insider has multiple plans, canceling and modifying all plans in a uniform manner.

These recommendations are “evidentiary” in nature and may not be appropriate in all circumstances or in relation to all issuers. This fact reinforces a consistent theme associated with 10b5-1 plans, which is that it is difficult to articulate bright-line rules that apply in all situations. That being said, it is important for issuers and insiders alike to be sensitive to the issues associated with these plans, particularly in the M&A context where scrutiny of insider trading activity may be heightened.

NOTES
7. 17 C.F.R. § 240.10b5-1(c).
9. See Horwich, supra note 4, at 928 n.73 (quoting then-current SEC guidance, which relied on Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975)).
12. Id.
13. Id.
15. Pulliam et al., supra note 3.
16. An electronic search of unamended Form 4s filed with the SEC in the past three years showed that approximately nine percent (51,102 of 577,796) of such forms disclosed that the trades they described were made pursuant to a 10b5-1 plan. Executives must also disclose whether a trade triggering the need to file a Form 144 was made under a 10b5-1 plan. Parris, supra note 4.
17. But see Horwich, supra note 4, at 952 (opining that timing disclosure to maximize profits under a plan is not a “deceptive” act within the meaning of Rule 10b-5” because “no one is ‘deceived’ by a delayed or accelerated corporate disclosure” when “there [i]s no independent duty to make earlier disclosure”).