

Insider Trading

The Best-Laid Plans: Preventing Rule 10b5-1 Plans from Going Awry (Part One of Two)

By Daniel Laguardia, K. Mallory Brennan and Ross Kamhi, *Shearman & Sterling*

The increased focus of regulators, media and private litigants on insider trading has recently expanded to a new target: Rule 10b5-1 trading plans (10b5-1 plans), which are intended to invoke the affirmative defense against insider trading claims provided by Exchange Act Rule 10b5-1 for trades executed pursuant to a written plan that meets specific requirements.^[1]

10b5-1 plans are best known as devices to allow company insiders to buy or sell securities pursuant to a pre-arranged instruction without facing automatic liability for insider trading. When properly implemented, the rule enables both investors and issuers to execute trades, even when they know material nonpublic information, so long as the trades are made pursuant to a plan established when the investor or issuer did not have inside information. These protections can extend beyond the diversification needs of individual company executives. For example, trades made by hedge funds pursuant to stop-loss and trailing-stop orders may be protected from insider trading liability if the orders are designed and implemented in accordance with Rule 10b5-1's parameters. And the protections of Rule 10b5-1 are not limited to publicly-traded stocks. Private equity funds and other distressed debt investors and investment managers can also benefit from Rule 10b5-1, such as by using a 10b5-1 plan to make future acquisitions of company debt without running afoul of insider trading restrictions. The protection of the affirmative defense is not absolute, however, and those trading under the auspices of even a properly adopted 10b5-1 plan have to be careful not to undermine their protection.

Rule 10b5-1 provides that an individual or entity with access to inside information can legally trade company securities when, prior to becoming aware of material nonpublic information, that person or entity entered into a binding contract to purchase or sell a security, instructed another person to purchase or sell the security, or adopted a written plan for trading the securities. The contract or plan must also meet specific requirements regarding the terms of the trade, such as amount, price, and date of the purchase or sale, and cannot permit the insider to exert influence over future trades.

When it was first introduced, Rule 10b5-1 was criticized as both too onerous and too generous.^[2] Some commenters suggested that the rule needed a "catch-all" defense to allow an investor to prove that inside information was not used in executing a trade,^[3] while others posited that the carve-outs of Rule 10b5-1(c) were ripe for abuse due to a lack of disclosure requirements.^[4] Criticism continued after the regulation was implemented in 2000, including in a 2006 study that concluded that trades made pursuant to 10b5-1 plans outperformed the market.^[5] In late 2012 and early 2013, a series of articles in *The Wall Street Journal* turned the spotlight on 10b5-1 plans and, after analyzing thousands of company executives' 10b5-1-plan trades, reported that insiders frequently achieved above-market returns.^[6] Just recently, a *New York Times* article questioned whether a company was manipulating its public disclosures to increase the profitability of its chief executive's 10b5-1 plan.^[7]

Some of these articles drew the attention of federal prosecutors and securities regulators, who began focusing investigations on 10b5-1-plan trading.^[8] The interest in potential abuses of 10b5-1 plans has also expanded to private litigants and players in bankruptcies. For example, following the Chapter 11 bankruptcy filing of Cengage Learning GP I LLC (with affiliates, “Cengage”), debt acquisitions by Apax Partners L.P. (with affiliates, “Apax”) and Cengage pursuant to 10b5-1 plans became the focus of an inquiry into possible insider trading.^[9] The inquiry ultimately determined that the trading had not violated insider trading restrictions, and the proposed restructuring (which enables Apax to maintain its equity interest in Cengage obtained through the debt-trading) recently cleared a major hurdle with the bankruptcy court.^[10]

The recent attention to 10b5-1-plan trading – and Apax’s experience in the Cengage bankruptcy – bring to mind Robert Burns’ warning that even the best-laid plans may go awry. The protections of Rule 10b5-1 are not a safe harbor but an affirmative defense, which means that the investor bears the legal burden of establishing that trades pursuant to a 10b5-1 plan are protected.^[11] Ensuring that such trades are defensible in the face of a subsequent lawsuit or investigation commenced with the benefit of 20/20 hindsight is no easy task. Likewise, managing 10b5-1 plans to promote defensibility without defeating the purpose of the plan – facilitating liquidity – requires a delicate balance. This article examines the lessons that can be learned from Cengage and Apax and recommends practices that may enhance the defensibility of a 10b5-1 plan.

The Best-Laid (10b5-1) Plan

The SEC adopted Rule 10b5-1^[12] in 2000 to resolve disagreement about the meaning of trading “on the basis

of”^[13] inside information. Historically, courts diverged as to whether an investor who traded while in “knowing possession” of material nonpublic information violated the securities laws even if the investor did not use the information to trade. Rule 10b5-1 clarified that a trade is made “on the basis of” inside information if the trader “was aware of the material nonpublic information when the person made the purchase or sale.”^[14]

Recognizing that the “absolute standard” of knowing possession “could be overbroad in some respects,”^[15] the SEC also established “carefully enumerated affirmative defenses” to balance the “knowing possession” standard.^[16] According to the SEC, the purpose of these defenses is “to permit persons to trade in certain circumstances where it is clear that the information was not a factor in the decision to trade.”^[17]

Specifically, Rule 10b5-1 permits investors to enter into a “binding contract to purchase or sell the security,” instruct “another person to purchase or sell the security” on behalf of the investor, or establish a “written plan for trading securities” – before the investor “becom[es] aware of the [inside] information.”^[18] To qualify under Rule 10b5-1, a plan, contract or instruction must be written and must contain three parameters: (1) the amount of securities to be sold, (2) the price(s) for purchase or sale of the securities, and (3) the date(s) for purchase or sale of securities.^[19] The instrument must either set forth this information expressly or establish a mechanism (such as formula or algorithm) by which the information is to be determined.^[20]

One of the first hurdles to a viable plan is, of course, timing: the plan must be established when the investor does not possess inside information.^[21] Additionally, the plan must

be implemented “in good faith and not as part of a plan or scheme to evade” insider trading restrictions.^[22] After a plan is set, an investor may not “exercise any subsequent influence over how, when, or whether to effect purchases or sales” of securities pursuant to the plan.^[23] To benefit from the affirmative defenses offered by the rule, a trade must be pursuant to the plan.^[24] If the investor has altered or deviated from a plan, or has entered into a corresponding or hedging transaction with respect to the relevant securities, then the trade is not made pursuant to the plan.^[25]

The defensibility of a trade diminishes “where a 10b5-1 plan is entered into – or strategically amended – to take advantage of an inflated stock price or insider information,”^[26] or if the trade was outside of a set plan. Similarly, frequent amendments to 10b5-1 plans, the existence of multiple plans for a single investor, or changes that seem out of line with prior practice may arouse suspicion.^[27] In extreme cases, such circumstances may have the opposite of the desired effect for 10b5-1 plans and be treated as evidence of scienter.^[28]

Cengage and Apax: An Example of a Best-Laid Plan?

The Cengage investigation provides a window into two separate issues that many investors may find of interest. First, it raises the question of how a bankruptcy filing may trigger insider trading concerns in connection with debt purchases. Second, the investigation undertaken by Willkie Farr & Gallagher LLP (Willkie) was forced to consider whether or not the 10b5-1 plan was properly adopted and executed.

The Cengage investigation arose out of Cengage’s 2013 bankruptcy proceedings,^[29] during which debtors asked Cengage independent director Richard Feintuch to evaluate

the propriety of an acquisition by Apax and Cengage of certain of Cengage’s outstanding debt obligations prior to Cengage’s filing.^[30] Feintuch engaged Willkie to assist in the investigation, and Willkie issued a detailed report on the investigation and their conclusions (the Willkie Report) that, among other things, the 10b5-1 plans implemented by Cengage and Apax in connection with the debt acquisitions provided an affirmative defense to any potential allegations of insider trading.^[31]

Background on Implementation of the 10b5-1 Plans

After disappointing results from the first quarter of its 2013 fiscal year,^[32] Cengage and its advisors realized that Cengage would face liquidity challenges if it was not able to extend the maturity of its existing debt.^[33] Cengage’s board of directors, in consultation with Apax, which held a 97% equity stake in Cengage,^[34] concluded that Cengage would be better-positioned if Apax and Cengage repurchased certain of Cengage’s outstanding debt obligations.^[35] Both Apax and Cengage recognized the potential insider trading risk in the planned purchases and took steps to protect against that risk, including the implementation of 10b5-1 plans.

First, Cengage and Apax waited to begin purchasing Cengage debt until completion of a November 9, 2012 earnings call with investors.^[36] Apax had concluded, in consultation with counsel, that information known to Apax about Cengage’s first-quarter earnings and a potential transaction with McGraw Hill was material nonpublic information that would be disclosed during the earnings call.^[37] That information was disclosed on the call, as was the prospect that both Cengage and Apax would in the future acquire Cengage’s debt in the open market.^[38]

After the call, but before their initial purchases, Apax and Cengage engaged in both an internal analysis and consulted with outside counsel to confirm that Apax and Cengage no longer possessed inside information after the disclosures made on the earnings call.^[39]

Apax and Cengage next engaged a third-party broker, J.P. Morgan, to execute their repurchases on the open market.^[40] In connection with that engagement, and with respect to debt acquisitions that preceded implementation of the 10b5-1 plans, Apax and Cengage each represented to J.P. Morgan that (1) the debt acquisitions were being made at a time when neither possessed inside information, and (2) if either entity acquired inside information, it would so inform J.P. Morgan immediately.^[41]

After engaging J.P. Morgan, and within one week of the November 9 earnings call, Apax and Cengage began consulting with outside counsel and J.P. Morgan to devise the 10b5-1 plan because Apax and Cengage were concerned that, as time passed after the earnings call, they would eventually come into possession of inside information.^[42] The plans were developed over the course of the next two weeks and executed on November 30, 2012.^[43]

Terms of the Plans

In addition to meeting the specific requirements of Rule 10b5-1, each of Cengage and Apax's 10b5-1 plans were developed and implemented using processes and terms that enhanced the defensibility of the plans under the rule.

- Cengage and Apax consulted with outside counsel and an outside advisor (J.P. Morgan) on the development of the plans.^[44]

- Cengage and Apax affirmatively represented in the plans that (1) they did not possess material nonpublic information at the time the plans were executed, (2) the plans were executed in good faith, (3) the plans were intended to comply with the requirements of Rule 10b5-1(c), and (4) Cengage and Apax agreed not to alter or deviate from the plans or to enter into corresponding transactions that would have such an effect.^[45]
- The plans each set forth specific parameters for acquisition of certain tranches of Cengage's debt and otherwise vested complete discretion^[46] in J.P. Morgan.^[47] With respect to trades made pursuant to 10b5-1 plans, J.P. Morgan has a policy that it will have no "substantive communications with principals during the time in which a 10b5-1 plan is in effect."^[48]
- After implementation, the plans "were on 'auto-pilot' and operated without interference," and communications between Apax and J.P. Morgan, and between Cengage and J.P. Morgan, during the time that the plans were in place "were limited to non-substantive communications."^[49]
- All of the trades entered into after the 10b5-1 plans became effective were made pursuant to the plans.^[50]
- The plans specified the period of time during which they were in force (through disclosure of Cengage's second-quarter results) and limited Apax's and Cengage's right to terminate the plans before the established termination date.^[51]

The Willkie Report also noted certain aspects of the implementation of the 10b5-1 plans that, while not fatal to the credibility of the plans, bespeak caution to would-be users of similar arrangements.

- For an approximately three-week period after the November 2012 earnings call, which Apax and Cengage determined had cleansed them of inside information, Apax traded in Cengage's debt without having implemented a 10b5-1 plan. The Willkie Report noted that "it would have perhaps been more prudent . . . to have implemented their respective [] plans earlier in November 2012."^[52]
- Both plans "were executed shortly before purchases were made."^[53] Under the circumstances, however, the Willkie Report concluded that this did not undermine the validity of the plans and noted that the securities laws do not require a waiting period between execution and the commencement of trading.^[54]

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^[1] 17 CFR 240.10b5-1 (2000).

^[2] Selective Disclosure and Insider Trading, Exchange Act Release No. 34-43154, 73 SEC Docket 3-1 (Aug. 15, 2000).

^[3] *Id.*

^[4] See, e.g., Marc J. Lane, *SEC Insider Trading Rule Doesn't Instill Confidence*, Crain's Chicago Business, Dec. 3, 2001.

^[5] See Alan D. Jagolinzer, *Do insiders trade strategically within the SEC Rule 10b5-1 safe harbor?*, Stanford Univ. Graduate Sch. of Bus., Working Paper, Dec. 2006.

^[6] Susan Pulliam and Rob Barry, *Executives' Good Luck in Trading Own Stock*, Wall St. J., Nov. 27, 2012.

^[7] Jesse Eisinger, *Repeated Good Fortune in Timing of C.E.O.'s Stock Sale*, N.Y. Times, Feb. 19, 2014.

^[8] Susan Pulliam, Jean Eaglesham, and Rob Barry, *Insider-Trading Probe Widens: U.S. Launches Criminal Investigation into Stock Sales by Company Executives*, Wall St. J., Dec. 10, 2012.

^[9] See generally Report of Richard D. Feintuch, Independent Director of Cengage Learning GP I LLC, *prepared by counsel*, Sept. 13, 2013.

^[10] See Order (I) Approving the Debtors' and Committee's Entry into a Plan Support Agreement; (II) Approving the Disclosure Statement Supplement; (III) Authorizing Expedited Supplemental Solicitation Procedures and the Modification of Deadlines Related Thereto; and (IV) Approving the Forms of the New Solicitation Materials, *In re Cengage Learning, Inc., et al.*, Case Nos. 13-44105, 13-44106, 13-44107, 13-44108 (ESS), Dkt. No. 1094 (Feb. 12, 2014).

^[11] By contrast, Exchange Act Rule 10b-18 provides a safe harbor from Rule 10b-5 liability for issuer-repurchases of common stock in accordance with certain manner, timing, price, and volume conditions. See 17 CFR 240.10b-18 (2005). To come within the safe harbor, "an issuer's repurchases must satisfy (on a daily basis) each of the section's four conditions": (1) the purchases must be effected from or through only one broker or dealer on any single day (with certain exceptions and additional requirements); (2) the issuer cannot effect the opening purchase reported on the consolidated system, and cannot effect purchases during the last 30 minutes of trading (or, in some cases, the last 10 minutes of trading); (3) the purchases must be effected at a purchase price that does not exceed the highest independent bid or the last independent transaction price, whichever is

higher, quoted or reported in the consolidated system at the time of the purchase; and (4) the total volume of the purchases effected by or for the issuer on any single day must not exceed 25 percent of the average daily trading volume for that security (although a once-weekly “block purchase” is permitted if certain other conditions are met). *Id.*

^[12] 17 CFR 240.10b5-1 (2000).

^[13] See *United States v. O'Hagan*, 521 U.S. 642, 651-52 (1997).

^[14] 17 CFR 240.10b5-1(b). The rule does not distinguish between traditional insiders, such as officers and directors, and investors who trade while in knowing possession of inside information gained through misappropriation.

^[15] Selective Disclosure and Insider Trading, Exchange Act Release No. 34-43154, 73 SEC Docket 3-1 (Aug. 15, 2000).

^[16] 17 CFR 240.10b5-1(c)(1)(A).

^[17] Selective Disclosure and Insider Trading, *supra* note 15.

^[18] 17 CFR 240.10b5-1(c)(1)(A)(1)-(3). Rule 10b5-1 also spells out an affirmative defense specifically for entity investors, so long as the individual making the decision to trade was not aware of inside information and the company has implemented appropriate policies to ensure compliance with securities laws, including effective information walls. 17 CFR 240.10b5-1(c)(2). Although this article does not focus on the protections offered by Rule 10b5-1(c)(2), this aspect of the rule should not be overlooked by entity investors in devising policies and procedures to manage their investments.

^[19] As used in Rule 10b5-1, amount “means either a specified number of shares or a specified dollar value of securities.” “Price” is either “the market price on a particular date or a limit price, or a particular dollar price.” The definition of “date” depends upon whether the contract, instruction, or plan gives a “market order” or a “limit order.” For market

orders, the date means “the specific day of the year on which the order is to be executed (or as soon thereafter as is practicable under ordinary principles of best execution).” For limit orders, the date means “a day of the year on which the limit order is in force.” 17 CFR 240.10b5-1(c)(1)(C)(iii)(A)-(C).

^[20] 17 CFR 240.10b5-1(c)(1)(B)(1)-(2).

^[21] As previously discussed in the context of distressed debt trading, assessing whether and when an insider is “aware of insider information,” and whether that information is material, is no easy task. See Daniel H.R. Laguardia and K. Mallory (Tosch) Brennan, “Navigating the Insider Trading Risks in Distressed Debt Trading,” *The Hedge Fund Law Report*, Vol. 5, No. 20 (May 17, 2012).

^[22] 17 CFR 240.10b5-1(c)(1)(C)(ii).

^[23] 17 CFR 240.10b5-1(c)(1)(B)(3).

^[24] 17 CFR 240.10b5-1(c)(1)(C).

^[25] *Id.*

^[26] See *George v. China Auto. Sys., Inc.*, No. 11 Civ. 7533 (KBF), 2012 WL 3205062, at *9 (S.D.N.Y. Aug. 8, 2012); see also *Freudenberg v. E*Trade Fin. Corp.*, 712 F. Supp. 2d 171, 200-01 (S.D.N.Y. 2010).

^[27] See *SEC v. Mozilo*, No. 09-cv-3994, 2010 WL 3656068, at **1, 20 (C.D. Cal. Sept. 16, 2010).

^[28] One court refused to dismiss a complaint where plaintiffs alleged that defendants were aware of “the Company’s mortgage exposure time bombs” when certain of these defendants adopted their trading plans. *Freudenberg*, 712 F. Supp. 2d at 200. In doing so, the court cautioned that a “Rule 10b5-1 trading plan may give rise to an inference of scienter because 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 10b5-1 plan.’” *Id.* at 200-01 (internal citations omitted).

^[29] See *In re Cengage Learning, Inc.*, Case No. 13-bk-44106-ESS (Bankr. E.D.N.Y.).

^[30] Report of Richard D. Feintuch, Independent Director of Cengage Learning GP I LLC, *prepared by counsel*, Sept. 13, 2013, at 7. Cengage recently reached a settlement that may help it emerge from bankruptcy. In addition to providing substantial recovery to junior creditors, the settlement agreement releases Apax from any potential liability in connection with its acquisition of Cengage debt and preserves Apax's equity interest in the company. On February 12, 2014, Judge Elizabeth Stong approved of Cengage moving forward with the settlement when she allowed Cengage to poll junior creditors affected by the deal. See Order (I) Approving the Debtors' and Committee's Entry into a Plan Support Agreement; (II) Approving the Disclosure Statement Supplement; (III) Authorizing Expedited Supplemental Solicitation Procedures and the Modification of Deadlines Related Thereto; and (IV) Approving the Forms of the New Solicitation Materials, *In re Cengage Learning, Inc., et al.*, Case Nos. 13-44105, 13-44106, 13-44107, 13-44108 (ESS), Dkt. No. 1094 (Feb. 12, 2014).

^[31] Report of Richard D. Feintuch, Independent Director of Cengage Learning GP I LLC, *prepared by counsel*, Sept. 13, 2013, at 4-5.

^[32] Cengage's fiscal year ran from July of the preceding calendar year through June of the next calendar year. See *id.* at n.40.

^[33] *Id.* at 20-21.

^[34] Apax owns 97% of Cengage Learning Holdings I LP, a limited partner and majority equity holder of CL Holdings II LP. CL Holdings II LP's remaining equity holder and general partner is Cengage Learning GP I LLC, which is a limited liability company organized under the laws of the State of Delaware. See *id.* at 1, 10, 12.

^[35] Cengage and Apax anticipated that by acquiring a portion of Cengage's debt, Apax could induce an extension of short-term maturities, thereby allowing Cengage more time to implement a sales recovery while enabling Apax to preserve the value of the equity it held in Cengage. Cengage also determined that it could repurchase certain of its own outstanding obligations, which were trading at discounted rates during that time period. *Id.* at 22-25.

^[36] *Id.* at 25-26, 31.

^[37] *Id.* at 25-26.

^[38] *Id.* at 29.

^[39] *Id.* at 31, 33.

^[40] *Id.* at 32, 33-34.

^[41] *Id.* at 32, 33-34.

^[42] *Id.* at 34-35.

^[43] *Id.* at 35.

^[44] *Id.* at 34-35.

^[45] *Id.* at 35-36.

^[46] Rule 10b5-1 does not permit an insider to have any influence over how, when, or whether trades made pursuant to a contract or plan are effected. A proper Rule 10b5-1 plan must transfer to a third party the discretion for executing trades on behalf of an insider. When a plan instructs an investment adviser to execute purchases or sales of a given security, the insider must not be able to exert influence over the trades the adviser executes.

^[47] *Id.* at 70-71.

^[48] *Id.* at 38.

^[49] *Id.* at 70-71.

^[50] *Id.* at 70-71.

^[51] *Id.* at 37-38.

^[52] *Id.* at 64, 70.

^[53] *Id.* at 71.

^[54] *Id.* at 71.

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This is the second article in a two-part series explaining the mechanics of 10b5-1 plans and their application to the private funds industry; examining the lessons that can be learned from an inquiry into possible insider trading by a major private equity fund manager that purchased debt of a portfolio company pursuant to a 10b5-1 plan (the inquiry ultimately determined that the trading had not violated insider trading restrictions); and recommending practices that may enhance the defensibility of a 10b5-1 plan. The authors of the series are Daniel Laguardia, a partner in Shearman & Sterling's Litigation Group, and K. Mallory Brennan and Ross Kamhi, both associates in that group. See also "The Best-Laid Plans: Preventing Rule 10b5-1 Plans from Going Awry (Part One of Two)," *The Hedge Fund Law Report*, Vol. 7, No. 22 (Jun. 6, 2014).

Issues Raised by the Cengage/Apax 10b5-1 Plans

Cengage's use of a 10b5-1 plan underscores issues of particular interest to many issuers and investors. First, there is the question of the significance and nature of insider trading concerns in the context of debt trading near the zone of insolvency. Second, there is the demonstration of the potential of a 10b5-1 plan to enable necessary trading in a context other than individual insider sales and purchases.

Why Do Debt Purchases Raise Insider Trading Concerns?

Although there are arguments to limit insider trading allegations to equity securities (in brief, because debt securities outside the zone of insolvency do not carry fiduciary duties to holders),^[1] commentators and at least some courts have suggested that the prohibitions against insider trading apply with equal force to the acquisition of debt as to more traditional securities trading. The safer course, particularly in today's environment of aggressive enforcement by the SEC and DOJ, is to assume debt securities should be treated like equities. The circumstances that may give rise to insider trading liability in the context of distressed debt investing, however, can be complicated and the risks difficult to readily identify.^[2]

For example, distressed debt investors who take active roles in bankruptcy proceedings, such as by joining a creditors' committee or forming an *ad hoc* or unofficial committee, may find themselves in possession of material nonpublic information concerning the debtor's financial position or its restructuring plans. As a committee member, the investor represents the interests of the committee's constituents, and though the law is by no means settled on the matter, at least some (including the U.S. Securities and Exchange Commission) have argued that this representation is sufficient to create a duty not to trade while in possession of material nonpublic information.^[3]

Similarly, at least one U.S. bankruptcy court has suggested that distressed debt investors who participate in settlement negotiations with a debtor may come into possession of inside information through those negotiations that would render the investors “temporary insiders” such that they were precluded from buying or selling even during “clear” periods designated for trading in the applicable confidentiality agreements.^[4]

Indeed, mediation orders in bankruptcy negotiations, such as the recently entered stipulation order in the General Motors bankruptcy, underscore that insider trading risks continue to be front-of-mind for distressed debt traders.^[5] In the General Motors order, as in most similar orders, the parties included a number of provisions that specifically address the treatment of confidential information in the context of compliance with securities laws. Though these provisions are generally thought of as standard in bankruptcy-related negotiations, they reinforce the insider trading risks that can be presented in negotiations in connection with the resolution of bankruptcy disputes and even adversary proceedings.^[6]

Use of a 10b5-1 Plan for Necessary Trading

As Cengage’s use of 10b5-1 plans demonstrates, the utility of Rule 10b5-1 is not limited to individual investors. Indeed, a 10b5-1 plan can be a very useful tool for companies to execute needed trades for a specific purpose (such as managing liquidity in anticipation of pending debt maturities) or to implement strategic business planning without running afoul of insider trading restrictions. The 10b5-1 plan can thus be particularly useful during times of market turbulence, but it is paramount that any plan

be vetted carefully and adopted when the investor is not in possession of material nonpublic information for at least two reasons: *first*, when markets are volatile it can be difficult to determine what information is material and when information is nonpublic, and *second*, post-hoc scrutiny of trading (especially by potential insiders) can be heightened during periods of market turbulence.

Apax and Cengage consulted with advisors before implementing their respective plans, perhaps in anticipation of potential turbulence for Apax, engaging legal counsel to vet the proposed plans^[7] and engaging J.P. Morgan to execute the actual trades. These added layers of protection enhanced the defensibility of trades subsequently executed pursuant to the plans. However, the plans were not formally adopted for several weeks following the earnings call identified as a “cleansing” event.^[8]

The Willkie Report concluded that earlier implementation of the 10b5-1 plans would have been preferable,^[9] as this would have strengthened the companies’ position that the plans were implemented at a time when they were not in possession of material nonpublic information. Indeed, the Willkie Report concluded that representatives of Cengage and Apax had received confidential information about Cengage’s business after the earnings call and before their respective 10b5-1 plans were implemented, although the report concluded that the information was not material to investors.^[10] This conclusion underscores the risks posed by fluidity in available information and the importance of thorough vetting and prompt implementation, particularly during periods of market turbulence.

Lessons Learned: Using 10b5-1 Plans and Reducing the Risk That They Go Awry

As the experience of Cengage and Apax confirms, the defensibility of trades made pursuant to a plan is highly fact-sensitive. While courts generally recognize that trades made pursuant to a 10b5-1 plan “do not raise a strong inference of scienter,”^[11] the investor bears the burden of proving that the trade(s) in question were made pursuant to a valid 10b5-1 plan.

Carrying this burden is made particularly difficult because even the best-laid plans are susceptible to scrutiny in hindsight. Set forth below are recommendations that distressed debt or equity investors may wish to consider in managing 10b5-1 plans. None of these practices is required under the securities laws, and none offers absolute protection from insider trading risk. However, taking one or more of these steps may enhance the defensibility of trades made pursuant to 10b5-1 trading plans.

Establish a Systematic Approach to Review and Approve of Plans

Consider establishing a protocol for review and approval by the firm of proposed plans or proposed amendments to existing plans. In addition to consulting with compliance personnel and in-house or outside counsel, as Apax and Cengage did, involving company personnel knowledgeable about the associated company’s current business activities – such as executives who sit on the board of directors or strategists working with the company – may afford greater insight into whether significant corporate events may be forthcoming (thus protecting against the appearance of carefully timed implementation of a plan). Any protocol would need to account for existing information walls and related considerations to avoid inadvertent violations of other policies.

Make Use of Individual Company Policies

Depending upon the practices of a particular company, non-officer directors may regularly receive information about the company outside of formal board meetings. An information flow of this kind can make it difficult to discern whether an affiliated director is in possession of material nonpublic information at any given time. This presents a challenge for an investment fund to properly implement, amend or terminate a 10b5-1 plan without inadvertently running afoul of regulations. Many public companies have trading policies that define “open window” periods during which insiders may trade, and these periods may be an optimal time to implement or modify a 10b5-1 trading plan. Private equity or hedge funds, and their investment managers, might consider establishing a comparable policy, particularly for investments in companies that do not have their own open-window policies, to establish a track record of acting only when the firm is not in possession of material nonpublic information.

Delegate Trading Authority

To the extent feasible, delegation of trading authority to a walled-off group of traders or to a third party (as Apax and Cengage did with J.P. Morgan) as a component of a 10b5-1 plan may enhance the defensibility of trades made pursuant to the plan. First, delegating authority to a third party is one way to bring a trading plan within the protections of Rule 10b5-1(c), and coupling delegation with other specified parameters such as an algorithm or price range may make a plan more defensible. Second, third parties may have internal policies to protect against inadvertently executing insider trades that may provide an additional layer of protection to the investing firm or fund. For example, the Willkie Report cited the affirmations made by Apax and

Cengage in accordance with J.P. Morgan's anti-insider trading policies as evidence supporting the validity of the trades executed pursuant to the plans.

Centralize Monitoring

Because an investment firm may have 10b5-1 plans in place with respect to multiple companies, it is important that management of those plans be coordinated, such as through the investment manager for a private equity fund. Centralized management and monitoring of the terms of 10b5-1 plans, timing of implementation of or revisions to the plans, and trades executed under those plans will reduce the risk of inadvertent violation of insider trading restrictions and enhance defenses against allegations of wrongdoing. An effective central management plan may require a multi-faceted approach involving personnel who oversee compliance, in-house counsel, traders and analysts, and the individuals who serve on the boards of the companies for which 10b5-1 plans are in place. In addition to controlling plans specific to the firm or fund's investments, companies should also be mindful of plans in place for individuals who wish to trade on their own account.

Consider a "Cooling-Off" Period

A longer delay between when a plan is implemented or changed and when trades may be executed pursuant to that plan may add an additional layer of protection against claims of insider trading. Although (as the Willkie Report noted) Rule 10b5-1 does not require a delay between the execution of a plan and the date on which trading commences, including a cooling-off period as part of the plan may enhance defensibility by ameliorating an inference that the plan was intended to capitalize upon near-term market-moving events.

Draft Plans With Defensibility in Mind

As the Willkie Report suggests, incorporating provisions into a plan that specifically address the requirements of Rule 10b5-1 may moderately enhance protection for trades executed thereunder. Consider including, for example, provisions that affirmatively state that (1) the plan has been entered into at a time when the investor is not in possession of inside information, and (2) the plan is entered into in good faith and without intent to manipulate or deceive. Where possible, designing the plan to require a series of transactions, as opposed to a one-off transaction, or to remain in place over a longer period of time, tends to undercut any suggestion that a plan was implemented to take advantage of a single, market-moving event. Additionally, capping the total percentage interest in a company that may be sold under a plan so as to avoid a substantial reduction in ownership if the stock price moves significantly may diminish the strength of an assertion that a plan was used surreptitiously to divest a large interest.

Know the Plans You Have

There may be instances where timing or other requirements necessitate having more than one plan in place for investment in a particular company; the need for multiple plans may also arise where both the firm and an individual employed by the firm, such as an executive, both hold stock in the same company. Although the securities laws do not preclude the use of multiple plans by a single investor or affiliated investors, the existence of multiple plans could arouse suspicion and may give the appearance of hedging or attempting to alter one plan by using a second plan. Maintaining clear records of the timing of execution and effective dates for plans, and being cognizant of how plans overlap, are administrative steps that may reduce these risks. Restricting the number of plans that can be in place

for trading with respect to a particular company, limiting the frequency of amendments to plans, and controlling the timing of any amendments may also streamline the management of multiple plans.

Beware of Trading Outside a Plan

The securities laws do not prohibit investors who have 10b5-1 plans in place from trading outside those plans. Even though an outside-plan trade may be entirely legal and appropriate, such trades may in hindsight give the appearance of impropriety. Some broker-dealers who execute on 10b5-1 plans even include contractual clauses that preclude outside-plan trading to protect against this risk. Such clauses are not required under law and may unnecessarily restrict the firm's ability to manage its investments; however, outside-plan trades should be approached cautiously. In addition to consulting firm records regarding the terms of the 10b5-1 plans in place, consider whether to pre-clear outside-plan trades with in-house or outside counsel, the company in which the trade will be made, and/or any broker-dealers administering the relevant plan(s).

Promote Transparency

Consider whether it is appropriate to implement a policy of formally disclosing newly implemented plans, amendments to or termination of existing plans, and trades executed pursuant to a 10b5-1 plan for both firm-executed trades and individual trades. Although Rule 10b5-1 does not require disclosure of the existence of 10b5-1 plans, and such a policy would need to take into account the particular practices of the companies for which 10b5-1 plans are in place, such disclosures would promote transparency and may support the defensibility of Rule 10b5-1 trades.

Consider the Timing of Public Disclosures

Stock sales made pursuant to a 10b5-1 plan may raise eyebrows when they regularly coincide with a company's public disclosures, even if they are executed in accordance with a properly adopted plan. A recent article has highlighted how one company's chief executive has benefited from the fortunate timing of his company's public disclosures, which on a consistent basis have immediately preceded his pre-arranged stock sales.^[12] Consider adopting a plan that accounts for the timing of the company's public disclosures in order to avoid any appearance of impropriety or disclosure manipulation.

Be Mindful About Cancelling Plans

Cancelling a 10b5-1 plan such that future trades contemplated by that plan do not take place is not prohibited by securities regulations and generally will not constitute insider trading in violation of Rule 10b-5 because no trading has taken place. While investors are free to cancel plans at any time, firms and funds should be mindful of the frequency and timing of cancellations. For example, investors may wish to avoid habitually cancelling plans before their expiration period and, when contemplating a cancellation, may wish to take into account whether the cancellation might coincide with earnings announcements or other public disclosures. This may militate in favor of using plans of moderate duration (such as six or eight months) rather than longer-term arrangements, depending upon the purpose of the plan. A mindful approach to planning that takes into account these purposes may avoid inadvertently creating the appearance of manipulative behavior through well-timed cancellation of plans.

Be Consistent

Employing any of the above-described mechanisms inconsistently, or departing from otherwise routine processes, might inadvertently suggest that a 10b5-1 plan is improper.

Conclusion

The growing popularity of 10b5-1 plans, coupled with increased scrutiny of the plans by the media, government regulators, and other investors, have increased the risk that trades executed pursuant to 10b5-1 plans will be subjected to second-guessing. The plans nevertheless remain an important tool for investment funds and individual investors and, as demonstrated in the case of Cengage and Apax, can be used effectively in both the private and public investment context. Though the regulations impose relatively few requirements to establish a 10b5-1 plan and offer little direction as to best practices, the risk of a 10b5-1 plan going awry can be minimized by establishing and following best practices for the development, structure and use of the plan.

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[1] By comparison, allegations of insider trading in connection with trading activities have arisen in the context of more traditional “special relationships,” such as the fiduciary relationship between a corporate insider and company

shareholders (i.e., the “classical” theory of insider trading) or the relationship of trust and confidence between a non-insider who receives material nonpublic information from another (i.e., the “misappropriation” theory of insider trading).

[2] For a more comprehensive discussion of the risks of insider trading in the context of distressed debt investments, see Daniel H.R. Laguardia and K. Mallory (Tosch) Brennan, “Navigating the Insider Trading Risks in Distressed Debt Trading,” *The Hedge Fund Law Report*, Vol. 5, No. 20 (May 17, 2012).

[3] See *SEC v. Barclays Bank PLC*, 07-cv-4427 (S.D.N.Y. May 30, 2007).

[4] See *In re Washington Mutual, Inc.*, 461 B.R. 200 (Bankr. D. Del. 2011).

[5] See Stipulation and Agreed Order Appointing Mediator, *In re Motors Liquidation Co., et al., f/k/a General Motors Corp., et al.*, Adv. Proc. Case No. 12-09802, Dkt. No. 241 (June 27, 2013).

[6] See generally *id.*

[7] Report of Richard D. Feintuch, Independent Director of Cengage Learning GP I LLC, *prepared by counsel*, Sept. 13, 2013, at 34.

[8] *Id.* at 25-26, 31.

[9] *Id.* at 70.

[10] *Id.* at 64.

[11] *Glaser v. The9, Ltd.*, 772 F. Supp. 2d 573, 592 (S.D.N.Y. 2011) (internal citations omitted); *In re Gildan Activewear, Inc. Sec. Litig.*, 636 F. Supp. 2d 261, 272 (S.D.N.Y. 2009) (trades pursuant to 10b5-1 trading plan “undermine[] any allegation that the timing or amounts of the trades [were] unusual or suspicious”); *Elam v. Neidorff*, 544 F.3d 921, 928 (8th Cir. 2008) (sales pursuant to Rule 10b5-1 plans “can raise an inference that the sales were prescheduled and not suspicious”) (internal quotations omitted).

[12] Jesse Eisinger, *Repeated Good Fortune in Timing of C.E.O.'s Stock Sale*, N.Y. Times, Feb. 19, 2014.