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Memorandum

Combatting Securities Fraud Allegations With 10b5-1 Trading Plans

July 24, 2017

A recent decision issued by the United States District Court for the District of Massachusetts, *Harrington v. Tetraphase Pharmaceuticals, Inc.*, highlights the value of established trading plans in defending against securities fraud allegations.[1] These trading plans, which are established pursuant to Rule 10b5-1 under the Securities Exchange Act of 1934, are not absolute defenses, but do offer corporate directors and officers ("insiders") a greater level of protection in the event they purchase or sell company shares during the putative class period of a subsequent securities litigation. There are, however, several factors to consider in deciding whether a 10b5-1 trading plan is appropriate for a particular insider at a particular time and, if so, in determining how to structure such a plan. In addition to discussing *Tetraphase Pharmaceuticals* and other case law regarding the role of 10b5-1 plans in refuting securities fraud allegations, this memo briefly outlines the requirements of 10b5-1 plans and provides practical reminders to corporations and their counsel on crafting plans that will likely be most successful in shielding corporate executives from liability.

I. 10b5-1 Plans and Regulatory Requirements

Recognizing that insiders often want to diversify or liquidate their holdings for legitimate reasons, the Securities and Exchange Commission ("SEC") promulgated Rule 10b5-1 to permit insiders to sell company stock while protecting them from liability in subsequent litigation and SEC actions under certain circumstances. The rule generally allows insiders to enter into a prearranged contract, instruction or plan for future stock trades at a time when they are not aware of material nonpublic information. 10b5-1 trading plans may provide an executive with an affirmative defense to insider trading charges brought by the SEC and may be used in securities fraud litigation to rebut any inference of scienter resulting from trading by insiders.

[1] No. 16-10133-LTS, 2017 WL 1946305 (D. Mass. May 9, 2017).

The benefits of a 10b5-1 trading plan are available only if the insider can demonstrate that material nonpublic information was not a factor in the trading decision. Rule 10b5-1 provides that an insider's sale of stock is deemed not to be made on the basis of material nonpublic information if the insider can demonstrate that, *before* becoming aware of any material nonpublic information, the insider had:

1. Entered into a binding contract to sell the stock;
2. Instructed another person to sell the stock for the insider's account; or
3. Adopted a written plan for trading securities.

In addition, this preexisting contract, instruction or written plan must:

1. Specify the amounts, prices, and dates for such stock to be sold;
2. Include a written formula for determining such parameters; or
3. Delegate all trading discretion and decisions to a person who does not possess material nonpublic information.

Finally, the insider must not exercise subsequent influence over trades made pursuant to the 10b5-1 contract, instruction or plan.

II. *Harrington v. Tetraphase Pharmaceuticals Inc.*

In January 2016, investors in Tetraphase Pharmaceuticals Inc. filed a complaint, naming the corporation and three individual officers as defendants in a securities fraud suit. The complaint stemmed from events surrounding the company's development and clinical testing of the new drug Eravacycline. Initially, the company announced favorable results for the first phase of trials and issued a press release to that effect. Tetraphase's quarterly and annual reports also indicated the company's intention to move forward with testing and its belief that the drug would ultimately be profitable. As the company continued to announce encouraging results, the stock price climbed, increasing by 30% after the first press release and another 18.5% when Tetraphase publicized the start of the second phase of trials for the drug.

Following the second phase of testing, however, the company reported in a press release that Eravacycline had failed to meet a crucial milestone and that the drug was not nearly as promising as originally predicted. Following this disclosure, Tetraphase Pharmaceuticals' stock price fell approximately 80%, representing a $1.3 billion loss for the corporation.

The plaintiffs alleged that the company's President and CEO, its former COO and its former CFO and Senior Vice President possessed information indicating that the drug they were testing was going to fail, misrepresented the drug's prospects to shareholders via SEC filings, press releases and statements made to analysts and engaged in insider trading. The defendants thereafter filed a motion to dismiss.

To survive the motion to dismiss and establish their securities fraud claim, the plaintiffs were required to show that the defendants possessed scienter, or the requisite state of mind.[2] In this regard, the investors offered evidence of the officers' stock trades throughout the class period. In response, Tetraphase Pharmaceuticals countered that all of these trades were made pursuant to 10b5-1 trading plans, as reflected in the officers' Form 4 filings. Though not dispositive, 10b5-1 trading plans, the court explained, "rebut[ ] an inference of scienter and support[ ] the reasonable inference that stock sales were prescheduled and not suspicious."[3] The court ultimately found that the trades made pursuant to these plans were insufficient to provide evidence of scienter. Accordingly, the defendants' motion was granted, and the suit was dismissed.

III. The Role of 10b5-1 Trading Plans in Refuting Securities Fraud Claims

A. Rebutting Inferences of Scienter from Insiders' Securities Sales

Tetraphase is reminiscent of many private securities fraud cases, in which courts consider a number of factors in deciding whether an inference of scienter can be drawn, including the amount of stock sold by insiders and the context surrounding those sales.[4] In these cases, plaintiffs routinely point to insider sales to support their allegations of scienter, theorizing that "trading at a particular time is circumstantial evidence that the insider knew the best time to trade because he or she had inside information not shared [with] the public" and "kept the information from the public in order to trade on the unfair advantage."[5]

The mere fact that insider stock sales occurred, however, is not sufficient to establish scienter in a private securities fraud case. Courts have held that, to demonstrate scienter, plaintiffs must plead that the stock sales were "unusual" or "suspicious."[6] Generally, no single circumstance is determinative of the court's decision in this regard; courts typically consider several factors, with the weight attached to each dependent on the particular circumstances involved.[7]

One of the principal factors courts have considered in assessing whether an insider stock sale establishes scienter is the timing of the sale and/or whether the insider entered into a legitimate 10b5-1 trading plan. As

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[2] *See Dura Pharm., Inc. v. Broudo*, 544 U.S. 336, 341-42 (2005).

[3] *Harrington*, 2017 WL 1946305, at *7.

[4] To establish a claim for securities fraud, a plaintiff must plead: "(1) a material misrepresentation or omission; **(2) scienter**; (3) a connection with the purchase or sale of a security; (4) reliance; (5) economic loss; and (6) loss causation." *Dura Pharm., Inc.*, , 544 U.S. at 341-42 (emphasis added).

[5] *Florida State Bd. of Admin. v. Green Tree Fin. Corp.*, 270 F.3d 645, 656 (8th Cir. 2001).

[6] *See, e.g., Zucco Partners, LLC v. Digimarc Corp.*, 552 F.3d 981, 1005 (9th Cir. 2009), as amended (Feb. 10, 2009).

[7] Some of the key factors courts have considered in assessing whether an insider stock sale supports an inference of scienter are: (i) the amount of overall stock holdings sold by the insider; (ii) consistency of the sale with the insider's prior trading practices; (iii) whether other insiders sold stock during the same period; and (iv) whether the selling insider made any of the alleged misstatements.

seen in *Tetraphase Pharmaceuticals*, sales made under 10b5-1 trading plans can substantially assist a company in getting such a claim dismissed by helping to rebut the inference of scienter that normally results when plaintiffs present evidence of insider stock sales during the class period.[8] As discussed, under Rule 1ob5-1, an insider is deemed to be unaware of material nonpublic information when trades are made pursuant to legitimate 10b5-1 trading plans. Like *Tetraphase Pharmaceuticals*, many courts have adopted the reasoning of Rule 10b5-1 and have held, particularly at the motion to dismiss stage, that no inference of scienter should be drawn from insider sales of stock made pursuant to legitimate 10b5-1 trading plans entered into prior to the alleged class period.

B. Proving the Plan's Authenticity in Litigation

Because Rule 10b5-1 allows insiders to rebut an inference of scienter in private securities fraud claims, the defendant has the burden of establishing the trading plan's legitimacy.[9] This includes demonstrating that the plan was entered into before the insider became aware of any material nonpublic information and that the plan was entered into in good faith and not as part of a plan or scheme to evade securities laws.

Recently, courts have shown an increased willingness to thoroughly examine the legitimacy of 10b5-1 trading plans. For example, in *Employees' Retirement System of Government of the Virgin Islands v. Blanford*, the Second Circuit Court of Appeals reversed the district court's dismissal of a private securities fraud action, finding that insider sales supported a strong inference of scienter even though the sales were made pursuant to a 10b5-1 trading plan.[10] The court rejected the defendants' 10b5-1 rebuttal argument because the defendants were allegedly involved in a fraudulent scheme to deceive investors prior to entering into the trading plans. The court explained that trading plans do not provide a cognizable defense to scienter allegations when "the purpose of the plan was to take advantage of an inflated stock price" and the plan was instituted after the beginning of the class period.[11]

Though courts have been demonstrating a greater proclivity to scrutinize 10b5-1 trading plans, these plans remain an effective method of protecting executives and preventing and defending securities fraud claims. For instance, in *Jasin v. Vivus, Inc.*, the court rejected the plaintiffs' argument that insider sales supported

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[8] *See, e.g.*, *Elam v. Neidorff*, 544 F. 3d 921, 928 (8th Cir. 2008) ("Stock sales pursuant to Rule 10b-5 trading plans . . . [are] not suspicious."); *Glaser v. The9, Ltd.*, 772 F. Supp. 2d 573, 592 (S.D.N.Y. 2011) ("[I]t is well established that trades under [a] 10b-5-1 plan do not raise a strong inference of scienter.") (internal quotations omitted).

[9] *See, e.g.*, *Freudenberg v. E*Trade Fin. Corp.*, 712 F. Supp. 2d 171, 201 (S.D.N.Y 2010) ("[T]he existence of a Rule 10b5-1 Trading Plan is an affirmative defense that must be pled and proved.") (citing *Malin v. XL Cap. Ltd.*, 499 F.Supp.2d 117, 156 (D. Conn. 2007)).

[10] 794 F. 3d 297, 308 (2d Cir. 2015).

[11] *See also Yates v. Mun. Mortg. & Equity, LLC*, 744 F.3d 874, 891 (4th Cir. 2014) (noting the defendant's 10b5-1 trading plan did not rebut an inference of scienter because it was entered into during the class period).

an inference of scienter. In doing so, the court relied entirely on the defendants' 10b5-1 trading plans.[12] Likewise, in *Yates v. Municipal Mortgage & Equity, LLC*, though the court rejected one defendant's 10b5-1 trading plan defense because the plan was devised during the class period, the court accepted his co-insiders' defenses, as they asserted that they had entered into the plans prior to any events alleged in the plaintiffs' claims.[13] When corporate defendants can demonstrate that they had proper motives in entering into the plans and that they had no knowledge of material nonpublic information at that time, courts are more apt to view the plan as mitigating any inference of scienter.

IV. Recommended Best Practices for 10b5-1 Trading Plans

Tetraphase Pharmaceuticals illustrates that 10b5-1 trading plans continue to provide a defense to insider trading allegations in securities fraud suits. Because some courts have begun to examine these plans more closely, however, there are a number of "best practices" to consider to help ensure the maximum effectiveness of Rule 10b5-1 trading plans.

A. Adopting and Amending the Plan

Executives should be encouraged to create and develop a consistent trading pattern for trades of company stock, and 10b5-1 trading plans are one method by which this can be accomplished. As noted earlier, a plan will be deemed valid only if the insider was not aware of any material nonpublic information at the time the plan was adopted. Indeed, one of the most common reasons courts cite to support denying a defendant's motion to dismiss is that the defendant entered into the trading plan after the start of the alleged class period.[14] Accordingly, insiders should only adopt (and amend or terminate) a 10b5-1 trading plan during an open trading window and when they are not otherwise aware of any material nonpublic information.[15] In addition, to the extent practicable, it is preferable for executives to enter into 10b5-1 trading plans shortly after the company's trading window opens as opposed to later in the open window period. Finally, the cancellation of existing 10b5-1 trading plans is also viewed skeptically and should only be permitted in unusual circumstances and ideally only during an open window period. Trading activity that occurs shortly after such cancellations may appear particularly suspicious.

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[12] 2016 WL 1570164, *20 (N.D. Cal. Apr. 19, 2016).

[13] 744 F. 3d 874, 891 (4th Cir. 2014).

[14] *See, e.g.*, *Levy v. Gutierrez*, No. 14-CV-443-JL, 2017 WL 219592, at *14 (D.N.H. May 4, 2017); *Van Noppen v. InnerWorkings, Inc.*, 136 F. Supp. 3d 922, 944 (N.D. Ill. 2015); In re *Intuitive Surgical S'holder Derivative Litig.*, 164 F. Supp. 3d 1106, 1120 (N.D. Cal. 2015); In re *Mun. Mortg. & Equity, LLC, Sec. & Derivative Litig.*, 876 F. Supp. 2d 616, n.34 (D. Md. 2012) (ultimately concluding that plaintiffs failed to provide sufficient evidence to support an inference of scienter, but declining to consider defendants' 10b5-1 plans as a defense).

[15] *See Freudenberg*, 712 F. Supp. 2d at 200 ("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.") (internal quotations omitted).

B. Waiting Period

Although Rule 10b5-1 does not impose a waiting period from the time of the trading plan's adoption to the time of the first trade executed under the plan, it is recommended that insiders wait 30 to 90 days before selling stock under the trading plan for the first time. A cooling-off period prior to the first trade under a Rule 10b5-1 plan minimizes the appearance of market timing and strengthens the affirmative defense.

C. Multiple/Overlapping Plans

Rule 10b5-1 does not prohibit the use of multiple, overlapping trading plans. That said, the adoption of multiple, overlapping 10b5-1 trading plans has drawn the skepticism of the SEC and courts. Multiple plans that contain overlapping and inconsistent terms may undermine the notion that the insider entered into the 10b5-1 trading plan in good faith and while not in possession of material nonpublic information. As a general rule, then, executives should avoid adopting multiple, overlapping 10b5-1 trading plans.

D. Sales Outside the Plan

Insiders who have 10b5-1 trading plans should generally only trade the company's stock pursuant to that plan. In addition, Rule 10b5-1 expressly provides that its protections are not available when the insider has entered into a "corresponding or hedging transaction or position" with respect to the stock covered by the plan.

E. Duration of the Plan

10b5-1 trading plans with short durations may be viewed with skepticism. In order to avoid the appearance of impropriety, 10b5-1 trading plans should generally have a duration of six to 12 months. Extending the length of the plan mitigates the concern that such plans are merely cover for short-term trading decisions.

F. Size of Sale Under the Plan

Rule 10b5-1 does not impose any limitations on the volume of the stock an insider may sell under a trading plan. Therefore, in theory, insiders may safely sell more than 25% of their holdings if those sales are made under legitimate 10b5-1 trading plans. In private securities fraud cases, however, because the applicable class period and the legitimacy of the 10b5-1 trading plan can only be determined in hindsight, the percentage of stock sold remains an important factor. Courts have stated that "the percentages of holdings sold," in conjunction with "whether sales were made pursuant to trading plans," are weighed in assessing whether plaintiffs have satisfied their burden of showing scienter.[16] Therefore, as a precautionary measure,

[16] *Glaser v. The9, Ltd.*, 772 F. Supp. 2d 573, 587 (S.D.N.Y. 2011).

companies may want to consider discouraging their executives from selling more than 25% of their overall company stock holding in any given transaction.

G. Public Disclosure

Disclosure practices regarding 10b5-1 trading plans vary. It is generally best, however, at least to disclose executives' sales made pursuant to 10b5-1 trading plans in Form 4 filings. Though not strictly necessary, executives should also consider whether it would be appropriate to make disclosures in the company's periodic reports or in Form 8-K filings.

If you have any questions or would like additional information, please do not hesitate to contact **Yafit Cohn** at +1-212-455-3815 or yafit.cohn@stblaw.com, or any other member of the Firm's Public Company Advisory Practice.

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