First 10b5-1 Insider Trading Case Raises Compliance Issues

By **Kenneth Breen, Phara Guberman and Elizabeth Gorman** (April 17, 2024)

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Before last year, the U.S. Department of Justice had never brought insider trading charges against an executive based primarily on the filing of 10b5-1 plans. But, last month, U.S. v. Peizer — the first case of this kind — survived the defendant's motion to dismiss the indictment.

The case, alleging securities fraud and insider trading against former chairman and CEO of Ontrak Inc., Terren Peizer, continues on.

In public remarks following the indictment last year, Assistant Attorney General Kenneth Polite credited the work of DOJ analysts who searched 10b5-1 filings to identify "company insiders who greatly outperformed the market when trading pursuant to 10b5-1 plans," and noted that Peizer "allegedly tried to use the cloak of a 10b5-1 plan as cover for his criminal conduct."[1]

Polite dubbed the case "groundbreaking" and promised that the DOJ "will not allow corrupt executives to misuse 10b5-1 plans as a shield for insider trading."[2]

There is a parallel action by the U.S. Securities and Exchange Commission.[3]

Here, we will review the background issues of this case and why, even at this stage, there are important practice takeaways for attorneys and their clients.

10b5-1 Plans and Insider Trading

At issue in this case are 10b5-1 plans, which are generally understood to allow executives to buy and sell their company's stock without violating insider trading laws. A 10b5-1 plan is a written agreement between an executive — e.g., a corporate insider — and a broker that establishes predetermined trading instructions for company stock.

10b5-1 plans are established during an open trading window before the executive — the insider — holds any material nonpublic information, setting forth trading details like the number of company shares to be sold or purchased, when the trading will take place, and the prices to buy or sell shares.

Typically, company stock trades are triggered once the plan is in place and a cooling-off period — where there are no purchases or sales — has expired.

The premise is that 10b5-1 trades are executed according to a predetermined plan, rather than by the insider directly, which typically offer executives a defense to any possible insider trading charges. The allegations in this case are that there were illicit stock sales made by Peizer in prearranged 10b5-1 trades.
The DOJ has taken the position that a 10b5-1 plan cannot protect an executive if the trading

plan was not entered into in good faith or was entered into a part of a scheme to evade 10b5-1 prohibitions. And a 10b5-1 plan cannot be used as a defense if the executive is in possession of MNPI.

Factual Background

Ontrak is a publicly traded telehealth company that contracts with health insurance providers to provide behavioral health services. Peizer held insider roles as Ontrak's CEO and later also its chairman. As alleged in the indictment, on May 10 and Aug. 13, 2021, Peizer falsely certified two 10b5-1 trading plans to sell 600,000 shares of Ontrak stock, based on MNPI related to Ontrak's relationship with its biggest customer, Cigna Group.

As alleged, when Peizer established the first Rule 10b5-1 plan at issue, he had learned that Ontrak's relationship with Cigna, purportedly representing more than half of Ontrak's revenue, was tenuous; more specifically, that Cigna had slowed referrals to Ontrak, informed the company that it would need to renegotiate its contract, and had scheduled an imminent meeting to discuss the business relationship.[4]

Further, as alleged, when Peizer established the second Rule 10b5-1 plan at issue, Peizer had allegedly learned that the Cigna relationship was on the verge of being terminated entirely.

On Aug. 19, 2021, just days after Peizer had executed his second 10b5-1 plan, Ontrak publicly disclosed that Cigna had ended its relationship with the company, and Ontrak's stock price dropped by more than 44%.[5] In all, Peizer had sold approximately $20 million in stock and avoided approximately $12.5 million in losses pursuant to the trade plans.[6]

As is required with 10b5-1 plans, Peizer certified that the trades were not based on his possession of MNPI.

The case therefore hinges on whether the information at issue is, in fact, MNPI — both material and nonpublic.

Recent Developments

Earlier this year, Peizer moved to dismiss the indictment, arguing in part that certain public disclosures made before he implemented his trade plans undercut the government's factual basis for alleging that he possessed and acted on MNPI.

Peizer argued that he did not trade on material nonpublic information because, in his view, Ontrak had publicly disclosed the material information about the company's relationship with Cigna prior to Peizer's execution of his 10b5-1 plans.

For example, days before Peizer executed his May 10 trading plan, Ontrak disclosed in a May 6, 2021, 10-Q filing that its "business currently depends upon four large customers" — with the largest being Cigna — and "the loss of any one [of] such customers would have a material adverse effect on" the company.[7]

Additionally, the company disclosed that its key customers "may not achieve the savings [Ontrak] expect[s]" and "may decrease their enrollment levels."[8] Peizer also pointed out that Ontrak adjusted its revenue guidance downward in May 2021, reflecting its "current expectations with [its] existing health plan customers."[9]

Similarly, Peizer observed that in 10-Q and 8-K filings from Aug. 5, 2021 — eight days before Peizer executed the second trade — the company disclosed downward revenue projections "reflecting current expectations with [its] existing health plan customers,"[10] as well as the adverse "impact of continued development and enhancement of [its] customer relationships, [its] product solutions and new lines of business, and related pricing structures."[11]

The filings reiterated that "[a] substantial percentage of" the company's revenues "are attributable to four large customers, any or all of which may terminate [Ontrak's] services at any time."[12]

In Peizer's view, the company's May and August disclosures "cover[ed]" all of the MNPI the government alleged that he had traded on, except for an alleged nonpublic statement made by Cigna in May 2021 that it intended to terminate its contract with Ontrak — a statement that Peizer claims Cigna later withdrew — the purported and subjective belief of Ontrak's lead negotiator that Cigna would terminate its contract, and the plans for an Aug. 18 meeting between Cigna and Ontrak representatives that would cover Cigna's potential termination.[13] Peizer argued that such information was "speculative" and "uncertain," and "therefore immaterial."[14]

In response, the government argued that the language in Ontrak's May and August 2021 disclosures constituted "boilerplate risk language" that was insufficient to constitute a public disclosure of the material information that served as the basis of Peizer's trade plans.[15] Specifically, the government observed that the May and August disclosures did not "reference any specific customer," were "framed as hypothetical risks," and, "more importantly," had been "included in every annual and quarterly filing dating back to at least 2019."[16]

On March 7, 2024, U.S. District Judge Dale S. Fischer of the U.S. District Court for the Central District of California denied Peizer's motion to dismiss in a four-page order, holding that the government had alleged facts sufficient to give rise to a charge of insider trading based on Peizer's 10b5-1 trading plans. The court's denial did not address the parties' specific contentions on the materiality of the information at issue.[17]

Takeaways

As referenced above, both the materiality and public nature of the information will be heavily litigated in this case.

As to materiality, the assessment will turn on whether there is a substantial likelihood that a reasonable investor would find the information important in its investment decision, and the impact such information had on the other information available at this time. The government applies a backward-looking test in these circumstances and will likely look at the impact on the Ontrak stock when announcements were made about the company's relationship with Cigna.

As to the public or nonpublic nature of the information, a question in Peizer will be whether the general revenue guidance disclosures in Ontrak's Form 10-Q and 8-K and public statements, which predicted downward revenue figures and referenced decreased enrollment levels by significant customers, are enough to render public the more particularized information that Peizer allegedly possessed.

To be clear, Ontrak is not charged in the indictment. However, these charges underscore

the importance for companies to regularly review policies and internal controls related to the possession of MNPI. As any attorney who has written or advised on such a policy knows, it is not possible for companies to define all categories of material information in their policies.

As a practice, policies should inform directors and employees that information will be regarded as material if there is a reasonable likelihood that it would be considered important to an investor in making an investment decision regarding the purchase or sale of that company's securities. Of course, either positive or negative information may be material.

Companies can and should advise directors and employees in their policies of various categories of information that are particularly sensitive and, as a general rule, should be considered material. This will vary based on industry.

Examples may include: (1) financial results; (2) projections of future earnings or losses; (3) knowledge of a pending or proposed merger or acquisition; (4) knowledge of a planned disposition of a subsidiary; (5) financial liquidity issues; (6) significant pricing changes; (7) new product announcements of a significant nature; (8) significant product defects or modifications; (9) significant litigation exposure with threatened litigation; or (10) planned major changes in management.

This list would usually also — and should — include "gain or loss of a substantial customer or supplier" as a category of material information. Peizer, though, raises questions about what stage negotiations should be in with significant customers or suppliers to give rise to an MNPI categorization. Counsel may want to advise companies to be specific in this regard.

As to 10b5-1 plans more generally, recent public statements from the DOJ and SEC make clear that they will be subject to increasing scrutiny. Counsel should recommend reviewing these plans with protocols to document an executive's good faith before the plan is entered.

Counsel should advise on an appropriate and mandatory cooling-off period for 10b5-1 plans that can vary based on an insider's role at his or her respective company. In this case, the indictment focuses on Peizer's alleged rejection of such a period as suggestive of his intent to commit insider trading. Counsel should recommend that 10b5-1 plans not be entered prior to any cooling-off period.

If an employee terminates or suspends the 10b5-1 plan, counsel should consider whether to advise on a 30-day trading lock-up period restricting the insider's ability to sell company stock. Similar to a cooling-off period, this restriction can aid a future good faith defense if one is needed.

While it remains to be seen how this case will be resolved, counsel should consider these proactive steps in advising companies and their executives.

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should not be taken as legal advice.

[1] Press Release, Assistant Attorney General Kenneth A. Polite, Jr. Delivers Keynote at the ABA's 38th Annual National Institute on White Collar Crime, U.S. Dep't of Justice (Mar. 3, 2023), https://www.justice.gov/opa/speech/assistant-attorney-general-kenneth-polite-jr-delivers-keynote-aba-s-38th-annual-national.

[2] Press Release, CEO of Publicly Traded Health Care Company Charged for Insider Trading Scheme, U.S. Dep't of Justice (Mar. 1, 2023), https://www.justice.gov/opa/pr/ceo-publicly-traded-health-care-company-charged-insider-trading-scheme.

[3] Press Release, SEC Charges Ontrak Chairman Terren Peizer With Insider Trading, U.S. Securities and Exchange Commission (Mar. 1, 2023), https://www.sec.gov/news/press-release/2023-42.

[4] First Superseding Indictment, United States v. Peizer, No. 23-00089, ECF Doc. No. 105, at ¶ 9(a)(i)-(ii), (g) (Jan. 31, 2024).

[5] Id. at ¶ 11(r).

[6] Id. at ¶ 11(a), (q).

[7] Ontrak Inc. Form 10-Q, at 33 (May 6, 2021).

[8] Id. at 33, 36; Def.'s Mot. to Dismiss, United States v. Peizer, No. 23-00089, ECF Doc. No. 113, at 9 (Feb. 9, 2024).

[9] Ontrak Inc. Form 8-K, at 2 (May 6, 2021); Mot. to Dismiss at 9.

[10] Ontrak Inc. Form 8-K, at 2 (Aug. 5, 2021).

[11] Ontrak Inc. Form 10-Q, at 30 (Aug. 5, 2021).

[12] Id. at 38.

[13] Mot. to Dismiss at 13-14.

[14] Id. at 13.

[15] Gov.'s Opp'n, United States v. Peizer, No. 23-00089, ECF Doc. No. 115, at 7 (Feb. 16, 2024).

[16] Id. at 8.

[17] Order, United States v. Peizer, No. 23-00089, ECF Doc. No. 126, at 2 (Mar. 7, 2024).