

## SEC Scrutiny of Stock Plans Could Spell Trouble for General Counsel

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In January 2004, Mark Webbink, then-general counsel for software maker Red Hat Inc., entered into a plan designed to put his stock trades on autopilot.

Broadcom Corp.'s general counsel, David Dull, made a similar move the following year -- as have executives at more than 35 percent of S&P 500 companies, according to a 2006 study by Equilar compensation consultants.

And like other executives, it appears both of these in-house lawyers benefited from their plans.

A popular vehicle for insider executives at public companies to sell their stock, 10b5-1 plans were devised by securities regulators as a defense against insider trading allegations -- as long as executives create them at a time when they don't possess any material, nonpublic information.

But now these kinds of arrangements have come under fresh scrutiny. A recent Stanford University study showed that executives who use the plans tend to do better than colleagues who don't. The study also found plan users tend to make sales in advance of negative news.

The Stanford study "raises the possibility that plans are being abused in various ways to facilitate trading based on inside information," Securities and Exchange Commission enforcement chief Linda Chatman Thomsen said in a March speech. "We're looking at this -- hard. We want to make sure that people are not doing here what they were doing with stock options."

If the SEC goes after companies with fraudulent 10b5-1 plans, general counsel could find themselves in the crosshairs -- not only for their own trading behavior, but for the same reason they've been targets in the backdating scandal: They're the corporate gatekeepers. Securities attorneys say GCs almost always sign off on their executives' 10b5-1 plans.

"The GC has the responsibility of getting it together," said Jay Brown, a law professor at the University of Denver, adding that it's likely GCs get an outside attorney to look it over, given the high stakes. Sarbanes-Oxley rules also require general counsel to take action if they notice possibly fraudulent trading occurring under the plans.

### **TROUBLE BREWING?**

Corporate insiders typically have a vast store of information about a company's prospects, including nonpublic information that, once disclosed, can affect share prices. Many in the business world say 10b5-1 plans are useful in allowing executives to increase or decrease their ownership stake over time without worrying that a particular trade can subject them to a charge of insider trading. For example, the plans often allow executives to execute pre-planned trades during traditional blackout periods, such as when their employer reports quarterly earnings.

But the Stanford study, and recent stories in *BusinessWeek* magazine, raise the possibility that participants are setting up plans knowing bad news is coming, or are somehow manipulating the plans.

*BusinessWeek* noted that after shares of Red Hat tripled in 2005, CEO Matthew Szulik sold \$52 million in stock under a 10b5-1 plan, only to see the share price fall to about a half of its peak. There are any number of innocent explanations for well-timed sales, of course. It could be that he filed a plan calling for the sale of some shares when the price reached a certain threshold. It's hard to know, though, because plan details aren't public -- plan holders aren't even required to disclose the existence of a plan, though they often do.

SEC filings indicate that some executives' trades are a mix of planned and unplanned sales, which lawyers say can lessen the defense the plan was meant to provide.

Consider Webbink, the former Red Hat GC. He set up his plan in January 2004, as the stock neared the \$20 strike price for options he held. Over the next five months, the shares steadily rose, and he disclosed 10 plan sales between April and June 1 of that year, netting \$1.3 million. But he also sold shares three times between January and April without designating them as planned sales. The stock reached a three-year high of \$28.73 on June 1, and around then Webbink voluntarily gave up his GC title and became a deputy general counsel. His stock trades after that aren't known, because they no longer had to be publicly disclosed.

On July 13, the Raleigh, N.C.-based company announced it had changed its revenue-accounting procedures and would need to restate three years' worth of earnings. The stock plunged nearly \$5 that day, and would eventually bottom out at \$10.46 in March of the following year.

Neither Red Hat nor Webbink, who is still employed there, returned telephone calls or e-mail messages asking about his 10b5-1 trades. The SEC has made no allegation of wrongdoing against Webbink, and there's no evidence he knew of the company's revenue recognition problem when he set up his plan.

Though there are innocuous reasons -- such as a family emergency or some other unexpected personal expenditure -- for someone to sell stock outside a plan, Brown and other experts say doing so can weaken the defense the plans are meant to provide. When people repeatedly deviate from their plans, "what it looks like is that you're staying on the plan when it's useful but maybe getting off the plan when it's not," Brown said. "That makes it look like when you went on and off the plan you had inside information."

## **POPULAR PLANS**

In the last few years the popularity of 10b5-1 plans has leaped. Among the 35 percent of S&P 500 companies that use them, about 40 percent are tech firms, according to the 2006 Equilar study.

Securities attorneys say executives are most often the recipients of the plans, because their trades are the most often scrutinized. Plan users can design them to cover any length of time, and can peg their future stock trades to whatever factor they choose, whether it's a date, a stock price, or even a complex economic algorithm, attorneys say.

"It's just a way of using some common sense notions to minimize exposure," said Morrison & Foerster partner Jordan Eth, who does white-collar defense work.

"I've been able to make the argument in a number of cases that my client's trades were at regular intervals and therefore didn't suggest any improper motive or activity," said William Freeman, head of Cooley Godward Kronish's securities litigation practice. "It's very strong evidence to counter a claim of fraud."

Since the plans were created, media reports have raised questions about a handful of executives using 10b5-1 plans, at such Silicon Valley companies as Netflix and Openwave Systems. Suspicious deviating from a 10b5-1 came into play in the recent trial of former Qwest chief executive Joe Nacchio, who was found guilty on 19 of 42 insider trading counts last month.

The government had alleged that Nacchio abused his plan by abandoning it and then selling off shares faster than the plan would have allowed, according to the *Wall Street Journal*, though he was acquitted on those counts. Prosecutors alleged he sold his stock in such a hurry because he knew Qwest was going down the tubes.

Other abuses are possible as well, said plaintiffs attorney Mark Molumphy, a principal with Cotchett, Pitre & McCarthy who litigates securities fraud suits.

For instance, if, at a company "everyone knows under the plan when trades are going to be made, there's a built-in incentive" to adjust public announcement times to suit the trades.

Broadcom is another company held up by *BusinessWeek* as a source of peculiar 10b5-1 sales. The magazine noted that CEO Scott McGregor ramped up his sales, disposing of \$19 million worth of stock before the price began a sharp descent last year.

Dull, the general counsel at the Irvine, Calif.-based company, set up a 10b5-1 plan in 2005, around the same time as McGregor. Over the next year, as the price rose to a peak of \$65 and his options continued to vest, Dull also ramped up his sales, making dozens of trades under his plan that netted \$7.1 million. Ten days after his last trade, on May 1, Broadcom stock fell below \$40, and bottomed out in July at \$22, after the company restated its financials to account for \$750 million in backdated stock options.

Dull and other Broadcom executives were sued in civil court and accused of insider trading based on their alleged knowledge of the company's backdating problems. A federal judge tossed out one of the insider trading claims against Dull earlier this month.

Dull's lawyer, O'Melveny & Myers partner Seth Aronson, said his client did nothing wrong, and said his 10b5-1 plan called for sales based on dates and share prices.

"The plan was optimistic in that it tied the frequency and volume of sales to increases in the stock price, which is a very typical pattern of trading for both executives and ordinary shareholders," Aronson said.

SEC officials declined to explain their thinking about 10b5-1 plans beyond Thomsen's speech. But if the SEC's closer scrutiny of 10b5-1 plans falls on general counsel -- either for their own shenanigans or for those of other executives -- finding fault may be more difficult than in the stock option backdating probes, Brown said.

That's because with backdating, prosecutors were able to find actual option documents that had been altered, and were not trying to discern how much a person knew, and when. If the SEC wants to hold a GC responsible for, say, a chief executive who abuses a 10b5-1, the agency will have to show the GC knew the CEO was going to commit wrongdoing.

"I think this is one where the in-house counsel can say I wrote the plan, but it wasn't my job to know whether the CEO had inside information" or was going to go off the plan, Brown said.

If GCs suspect that executives are committing fraud with 10b5-1 plans, they have an obligation to notify the board under Sarbanes-Oxley, Brown said.

Experts say they aren't yet aware of any SEC prosecution solely for abuse of a 10b5-1 plan.

"If they thought someone was abusing 10b5-1s, I have no doubt they would go after them," said securities attorney Stephen Quinlivan, a shareholder with Leonard, Street and Deinard in Minneapolis. "I think anybody who thinks they can get away with it is basically nuts."