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CRIMINAL INDICTMENT OF EXECUTIVE CHAIRMAN AND PARALLEL CIVIL CHARGES SHOW FEDS' WILLINGNESS TO CHALLENGE RULE 10B5-1 TRADING PLANS

DOJ INCLUDES FRAUD CLAIM BASED ON “CLEAN HANDS” REPRESENTATION IN TRADING PLANS FILED AS 13D EXHIBITS

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WHAT HAPPENED

The Justice Department recently indicted the Executive Chairman of Ontrak, Inc. alleging that he failed the “clean hands” requirement because he had been aware of material nonpublic information relating to the potential loss of the company’s largest customer when establishing two 10b5-1 trading plans. Shortly after, the SEC announced the filing of a complaint making parallel allegations.

TAKEAWAYS

According to the DOJ announcement, the indictment represents the first criminal prosecution challenging a Rule 10b5-1 trading plan – likely reflecting the confidence of the DOJ that it can prove the allegations beyond a reasonable doubt. The chronology in the indictment raises serious issues about the timing of the trading plans, in particular, the insider’s access to material nonpublic information regarding the deterioration of the company’s relationship with its largest customer.

DOJ stated that “[t]he investigation is part of a data-driven initiative led by the Fraud Section to identify executive abuses of 10b5-1 trading plans,” indicating that such plans may represent a continuing focus of the department.

The indictment doesn’t try to establish new law but focuses instead on the need for “clean hands” – the requirement that the insider not be in possession of material nonpublic information at the time of entry into a 10b5-1 trading plan. This requirement has been fundamental since inception of the rule. Virtually every brokerage trading plan requires a customary “clean hands” representation.

The case illustrates that the DOJ and the SEC are willing to challenge Rule 10b5-1 trading plans as well as the value of cooling-off periods and pre-clearance policies. As discussed in our February 21 post, effective Monday, February 27, cooling-off periods are now required under recently amended Rule 10b5-1.

It also provides a reminder that representations contained in agreements included as exhibits in SEC filings can be considered disclosures to investors that can create liability. In this case, the trading plans were filed as exhibits to the insider's Schedule 13Ds and included "clean hands" representations that the DOJ believes were false and provide a basis for fraud-on-the market liability.

Companies can use this case as a teaching moment for insiders and the importance of complying with Rule 10b5-1 and maintaining strong pre-clearance policies and following the advice of law departments.

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The facts alleged in the indictment and the complaint can provide a useful roadmap for companies to train insiders in the future.

Ontrak is a virtualized behavioral health company that contracts with health plans to identify members whose chronic disease will improve with behavior change, and then provides those members with additional healthcare solutions. It earns revenue through fees it charged to its health plan customers based on the number of the customers' own members that were enrolled in the company's program. Its ability to fund ongoing operations was dependent on increasing the number of members that enroll in its program.

On March 1, 2021, the company announced the loss of its then largest customer (customer B), triggering a 46% drop in stock price and resulting in a loss of over $265 million in value of Peizer's shares. Following that loss, the next largest customer (customer A) rose to represent over 50% of total annualized revenue. At a March 1 healthcare conference and subsequent earnings call, management stated they hoped to make up for the loss of the customer B by expanding the contract with customer A and enrolling more customer A members.

By late March through April, shortly before and after retiring as CEO and becoming Executive Chairman of the company, Peizer began receiving reports of a severely deteriorating relationship with customer A. The customer had substantially reduced utilization of the company, had insisted on renegotiating its contract on less favorable terms for the company, and had halted discussion about any possibility of expanding its relationship. The CEO sent proposed fee and other concessions to try to salvage the relationship. During this period, Peizer sent at least three text messages about the need to "save" customer A.

In early May, Peizer contacted Broker A to establish a 10b5-1 plan to sell approximately $19 million shares of stock. After learning that Broker A required a cooling-off period, he contacted another firm, Broker B. That firm did not require a cooling-off period but warned that immediate trades might "create an appearance of impropriety and call into question whether a plan adopter had MNPI at the time of plan adoption." Peizer rejected the suggestion and insisted on immediate sales.

On May 10, 2021, Peizer, through his personal holding company, entered into the trading plan, which included a customary "clean hands" representation. According to the complaint, at that time, customer A represented over two-thirds of the company's business. This was Peizer's first 10b5-1 plan. After exercising warrants on a cashless basis, he began selling 11,000 shares per day, or approximately $19 million through July 20, 2021. These were his first stock sales since 2011.

On May 18, 2021, customer A notified the company of its intent to terminate the contract by the end of the year. Throughout the spring and summer, the company reached out with proposals and more fee concessions in an effort to preserve the relationship. Customer A did not respond substantively and declined requests to discuss the proposals. The company continued to receive indications of the impending termination by the customer, but did not make public disclosure.

In July, Peizer received a text message that utilization by the customer had continued to significantly decline and, on August 18, he called the company's lead negotiator to find out the status of retaining the customer and learned that the individual believed formal termination was likely. Immediately after hearing the latter statement, Peizer established a second 10b5-1 plan, which included a customary "clean hands" representation and did not include a cooling-off period. The company publicly announced the customer's termination of its contract on August 19, by which point Peizer had sold another $900,000 of shares. Following the announcement, the stock price fell approximately 44%. Altogether, according to the court filings, Peizer avoided approximately $12.5 million in losses.

The indictment (but not the complaint) does allege that Peizer pre-cleared the trades with the company's CFO pursuant to the company's insider trading policy by falsely certifying that the proposed trade "was not a result of access to, or receipt of Material Nonpublic Information." However, it does not discuss the CFO's knowledge or if others at the company, such as legal counsel, had considered the issue of the company's deteriorating relationship with its largest customer at the time the trades were pre-cleared.

Further, the indictment (but not the complaint) alleges that Peizer made false and misleading representations to shareholders and the public about his possession of material nonpublic information about the company's relationship with its largest customer, by virtue of including the trading plans as attachments to his Schedule 13D filings. Although not further explained, this charge may be treating the "clean hands" representations in those plans as constituting representations on which the trading public can rely – akin to the SEC's position in the Titan Section 21(a)(1) Report (March 1, 2005) that representations and warranties in merger agreements filed as 1934 Act exhibits can be viewed as disclosures to investors.

If convicted, Peizer faces a maximum penalty of 25 years in prison on the securities fraud scheme charge and 20 years in prison on each of the two insider trading charges.

The SEC complaint charges Peizer and his company with violating antifraud provisions of the federal securities laws and seeks permanent injunctive relief, disgorgement of ill-gotten gains with prejudgment interest, civil penalties, and an officer and director bar for Peizer.

MEET THE TEAM

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