Legal Backgrounder

Washington Legal Foundation
Advocate for freedom and justice®
2009 Massachusetts Avenue, NW
Washington, DC 20036
202.588.0302

Vol. 21 No. 7 February 24, 2006

PLAINTIFFS, LAWYERS, AND SHORT-SELLERS: THE LEGAL STATUS OF "DUMP & SUE"

By

Professor Moin A. Yahya

Short-selling is the practice of selling borrowed stock (usually borrowed from the short-seller's broker) with the hope that its price falls. If the price falls, the short-seller purchases the stock at the cheaper price and returns it to the lender, thereby profiting from the drop in price. While this practice is lawful, the murky alliance between short-sellers and the plaintiffs' bar raises troubling questions.

Examples of this alliance have been documented in the *The Wall Street Journal*, *The San Francisco Chronicle*, and other publications,[1] and the basic scenario is as follows. A plaintiff and the lawyer identify a firm that will be targeted for a lawsuit, and this information is passed on to a short-seller who then short-sells the targeted company's stock. Once the suit is filed or announced, the price of the target company's stock falls, thereby rewarding the short-sellers. The drop in price also causes the target company financial distress which usually induces a settlement with the lawyers. The prevalence of this practice is unknown, perhaps because its legal status is presently uncertain. The impact of the announcement of a lawsuit on a company's stock, however, is far from ambiguous.

When a lawsuit is filed against a publicly traded company, the market lowers the value of the company by the expected cost of the lawsuit, which includes the potential payout and legal fees. No matter how improbable the merits of the suit, given the high defense costs, the mere filing of a suit will negatively impact the stock's price. Numerous studies have demonstrated this. *See*, *e.g.*, Sanjai Bhagat, John Bizjak, & Jeffery L. Coles, *The Shareholder Wealth Implications of Corporate Lawsuits*, 27 FIN. MGMT. 5 (1998) (finding that the defendant's stock price drops an average of 1% across all types of lawsuits, and finding that some lawsuit announcements could lower the stock price by as much 3%).

This LEGAL BACKGROUNDER will argue that short-selling by plaintiffs, their lawyers, or anyone they tip about the impending suit, such as a short-selling hedge fund, should be considered unlawful under existing securities laws. The analysis focuses on the short-selling plaintiff, but that analysis is the same for

[1]David Armstrong & Ann Zimmerman, *Sowing Doubts: Battering Penney, A Lawsuit Served Short-Sellers Well*, WALL ST. J., Jan. 1, 2003, at A1; *In re Terayon Communications Systems, Inc.*, 2004 WL 413277 (N.D. Cal. 2004); Reynolds Holding, *Double-Whammy in Stock Fraud Case: Short-sellers Trash, then Sue, Santa Clara Tech Firm*, SAN FRAN. CHRONICLE, Nov. 9, 2003 at A1; Jathon Sapsford & Paul Beckett , *Informer's Odyssey: The Complex Goals and Unseen Costs of Whistle-Blowing*, WALL ST. J., Nov. 25, 2002 at A1.

Moin A. Yahya is an assistant Professor of Law at the University of Alberta. He has written a more extensive article on this subject, which is forthcoming in 39 SUFFOLK U.L. REV. (2006).

any short-sales executed by plaintiffs, their lawyers, or others who receive a tip concerning the impending lawsuit.

The Basics of Securities Law. The Securities Exchange Act of 1934 (SEA) established the Securities and Exchange Commission (SEC), and authorized it to combat illegal securities practices. 15 U.S.C § 78j. Section 10(b) of the SEA, 15 U.S.C § 78j(b), prohibits the use of "manipulative or deceptive device[s] or contrivance[s] in contravention of such rules and regulations as the [SEC] may prescribe" when such deception is used "in connection with the purchase or sale of any security." The SEC has enacted a powerful catchall regulation known as Rule 10b-5, which prohibits the employment of "any device, scheme, or artifice to defraud," or the making of "any untrue statement of a material fact or … omit[ing] to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or [engaging] in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security." 17 C.F.R. § 240.10b-5. Under this general regulation, the SEC combats two broad categories of fraud: (1) insider trading and (2) general market manipulation.

Insider Trading. Insider trading is not well-defined, but is generally considered to be the sale or purchase of corporate stock by "insiders" taking advantage of their knowledge of non-public information usually acquired through a confidential relationship. STEPHEN M. BAINBRIDGE, SECURITIES LAW: INSIDER TRADING 7-48 (1999). Traditionally, insiders (and hence those prohibited from trading on non-public material information) were officers, directors, and controlling shareholders of the corporation. They are known as classical insiders. *Id.*

Over the years, however, the SEC, with the approval of the courts, has added a new category of insiders who are also prohibited from trading using non-public information. This new category of insiders is organized under a theory known as "misappropriation." The simplest example of this is when a non-insider learns of material, non-public information from a classical insider. If the CEO of a company, for example, leaves a confidential document regarding an impending merger and his butler reads it, the butler is prohibited from buying stock of the CEO's company. But the misappropriation theory is broader, and encompasses any breach of a confidential relationship regardless of whether the relationship is with a classical insider or not. For example, in *United States v. O'Hagan*, Mr. O'Hagan was convicted of insider trading even though he was neither an insider nor did he learn of the information from an insider. 521 U.S. 642 (1997). Rather, he was a lawyer whose firm represented an acquiring company, Grand Met, which was tendering an offer to a target corporation, Pillsbury. O'Hagan purchased stock options and the Pillsbury stock and then profitably sold them when the offer was publicly announced. The Court held that Mr. O'Hagan owed Grand Met, the client of his law firm, a duty of confidentiality, so when he purchased Pillsbury stock, he committed fraud on the source of the information, his law firm's client Grand Met. In other words, he stole the information from his law firm's client and was guilty of insider trading even though he owed Pillsbury no fiduciary duty.

The short-selling plaintiff is not a classical insider, but the *O'Hagan* case provides some guidance for analyzing the situation of lawyers who tip short-sellers before they sue. If the lawyer does not receive permission from the client to disclose the information to the short-seller, then clearly the attorney has misappropriated the information; therefore, anyone who also receives the information (such as the short-seller) is guilty of misappropriation. The problem with *O'Hagan* is its suggestion that if the attorney actually informs the client (and the client consents) about the tip to the short-seller, then no unlawful insider trading has taken place. Furthermore, if the client is the source of the information to the short-seller (whether via the lawyer or not), there is no misappropriation under *O'Hagan*. This means that in the real-life examples of collusion between the plaintiffs' bar and short-sellers, *O'Hagan* is inapplicable since in those cases, the client was either the source of the tip regarding the impending lawsuit or consented to the tip

Copyright © 2006 Washington Legal Foundation

ISBN 1056 3059

being given to the short-sellers. The rules of insider trading, therefore, are inapplicable for analyzing the current alliance between plaintiffs, their lawyers, and the short-sellers.

General Market Manipulation. There are numerous fraudulent schemes that plague the securities market; among them are the "pump and dump" and the "cyber-smear" schemes. The "pump and dump" schemes involve the spreading of false or misleading *positive* information about a company to generate an interest in the company's stock, and a subsequent increase in its price, thereby allowing the profitable sale of the stock owned by those spreading the information. The "cyber-smear" (or "smear and dump") scheme is the reverse of the "pump and dump," where a short-seller spreads false or misleading *negative* information about a company driving down its stock price, allowing the profitable covering of the short-position by those spreading the information. Both of these illegal schemes are typically executed today on Internet message boards.

The short-selling plaintiffs and the cyber-smearers are analogous in that they both involve short-sales and some activity that drives down the stock price. The analogy between these schemes and the short-selling plaintiffs, however, is not exactly on point. The perpetrators of the cyber-smear scheme profit after spreading false and misleading information; the short-selling plaintiff, on the other hand, is not spreading any negative information at all. Rather, the plaintiff is intending to sue in the future, but remains silent about the timing of filing this future suit. Furthermore, the information that the cyber-smearer spreads is false, while the plaintiff truly intends to sue.

Is 'Dumping and Suing' Fraudulent Conduct Nonetheless? Given that dumping and suing is neither insider trading nor market manipulation (under the usual categories of "pump and dump" or "cyber-smear"), one must look to first principles to analyze the short-selling plaintiff. Regulation 10b-5 prohibits "omit[ing] to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or [engaging] in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security." 17 C.F.R. § 240.10b-5. Since short-sellers *sell* borrowed stock hoping that the price falls, the question is whether their failure to disclose to the public the fact that they imminently intend to sue (or that they know of an imminent lawsuit if the lawyer or the plaintiff is not the one actually doing the short-selling) constitutes an omission to disclose a material fact, and whether this omission operates as a fraud or deceit upon the purchaser.

The failure of the short-seller to disclose the impending suit, regardless of whether the short-seller is the potential plaintiff, lawyer, or any short-seller who received a tip from the lawyer, is arguably a material omission and constitutes fraud. The announcement of a lawsuit, as noted, has a substantial impact on the price; thus, no rational investor would ever consent to purchasing stock from someone who was about to sue the company whose stock was being transacted. While each party in any transaction involving a security risks that the stock may not perform according to expectations, the transaction becomes purely one-sided when one party causes the stock to fall.

Modern tort and contract law recognize that in some instances non-disclosure can be fraudulent. Section 551(1) of the Restatement (Second) of Torts states that the failure by one party to disclose a fact that may induce the other party to refrain from undertaking a transaction with the non-disclosing party may subject the party who did not disclose to liability. In the law of contracts, a similar principle applies whereby a party who enters into a contract and fails to disclose a material fact to the other party may be liable for rescission and restitution.

The case law also affirms this principle. For example, in *Caldwell v. Pop's Homes, Inc.*, a purchaser of a mobile home sued the seller who neglected to disclose the fact that the park where the mobile home was

Copyright © 2006 Washington Legal Foundation

ISBN 1056 3059

located was to be sold and all mobile homes located there would have to move. 634 P.2d 471 (Ore. App. 1981). The court held that silence in this case was fraudulent, because the purchaser had indicated that he wanted to live in the park and the seller knew that the park was being sold. It should be noted here that the silence was with respect to a proposed action by a third party; therefore, even if the short-seller simply received a tip from the lawyer about the suit, the short-seller can be liable for non-disclosure. And, when the plaintiff or the lawyer is the short-seller, the rationale for holding them liable for failure to disclose is even stronger.

Other Policy Reasons for Prohibiting Dumping & Suing. Having established the non-disclosure of the suit by the short-selling plaintiff arguably constitutes fraud under the law of torts and contracts, it should follow that such non-disclosure is also fraudulent under Regulation 10b-5. There are other reasons also for proscribing the practice of dumping and suing.

A plaintiff who short-sells and then sues is doubly enriched. The first instance occurs when the short-sale is followed by the announcement of the suit, causing the price of the stock to fall and the short-seller to profit. The second instance is when the plaintiff and lawyer settle with the defendant or collects a judgment following victory in court. Given that the plaintiff should only be entitled to the proceeds of the lawsuit, the proceeds of the short-sale are a form of unjust enrichment.

The fact that the plaintiff and lawyer can now profit by simply announcing a lawsuit means that more frivolous lawsuits can be filed than if the practice were prohibited. In the extreme, a lawyer can simply announce a suit, profit from the drop in price, and ultimately withdraw the suit. In many jurisdictions, for the purposes of sanctions, the standards for what constitutes a frivolous suit are fairly low. Hence, even though lawyers may bring frivolous lawsuits to induce a drop in the stock price, they will escape sanction due to the lax standards.

What Next? Allowing this practice to continue is an invitation for more lawsuits against our publicly traded companies and a license for the destruction of shareholders' wealth. The Washington Legal Foundation was the first to advance the theory in 2003 that plaintiffs' attorneys and short-sellers may be guilty of misappropriation/insider trading, and filed several complaints with the SEC calling for the investigation of these questionable practices. At the very least, the SEC should monitor this problem so that members of the investing public are aware of how rampant this practice is. This is not a tough proposition for the SEC to undertake. Companies already report major lawsuits to the Commission; they could also report on when they are the subjects of a major short-sale attack. It would be easy to match up the timing of short-sales with the announcements of the lawsuits.

If indeed this practice is as rampant as suspected, then narrowly tailored rules requiring short-sellers to disclose their contacts with the plaintiffs or their lawyers are in order. Plaintiffs and their lawyers should be deemed constructive insiders until they announce their intent to sue. By extension, all who receive tips from them will also be prohibited from short-selling the target company's stock. Whether this rule is promulgated by the SEC or developed by the courts through litigation against the short-sellers is immaterial. The issue needs immediate study and action.

Copyright © 2006 Washington Legal Foundation

ISBN 1056 3059