CORPORATE COUNSEL
An ALM Web site

What To Do When Your Company's Stock is Targeted by Internet Short Sellers

From the Experts

By Christopher A. Lilly All Articles

Corporate Counsel

January 28, 2013

Christopher A. Lilly

Using the newfound credibility of mainstream blogging, Internet short sellers have found a way to make money that pushes the envelope on securities fraud—but that in many cases is legal.

Suppose a business journalist were just putting the finishing touches on a scathing article about a public company, created from publicly available information such as the company's own Securities and Exchange Commission filings. Suppose also that there is almost no doubt that the company’s stock will plunge once the article is printed, because the company has been carefully chosen based on its small capitalization and timed for a period of slow or no news about the company.

Would it be legal for the journalist to take a short position in the company before the article is published? Similarly, would it be legal for the journalist to tip off the owners of the paper or magazine as to the content of the article before publishing?

Provided that it is done with the appropriate disclaimer, the answer in both cases, surprisingly, is “yes.” And the bloggers, taking on the mantel of business journalists, have taken full advantage—and have done so with increasing sophistication over the past few years.

The trick is for Internet short sellers to cast themselves as crusaders for the truth, shining a light on behalf of the investing public on corporate waste and fraud. This is often done with an official-looking website and detailed biographies of the "journalists," which give an air of credibility and credence to the website.

Once the Internet short sellers publish one or two accurate articles, they can develop a following among the brokerage and investing communities, particularly if they focus on a niche in the market. As that point, the short sellers have the power to move the market and make money on their short positions.

What is the catch, and what can companies targeted by these Internet short sellers do? The catch is that, over time, the courts have deemed that it’s securities fraud for the authors to fail to disclose in the article itself that they have taken a short position.

It is a violation of Rule 10b-5 (promulgated under Section 10(b) of the Securities Exchange Act of 1934 to regulate securities fraud) to, in connection with the purchase or sale of securities, and acting with intent, make a material misrepresentation or omit to disclose material information that the aggrieved party relied on to their detriment.

The bloggers protested that: (1) their failure to disclose their short position is not material; (2) they have no duty to the investing public to make such a disclosure; and (3) a general disclaimer that they “may” have a short position in the company shields them from liability. The bloggers have lost all three arguments.

As far back as the late 1970s, the court in *Zweig v. Hearst Corp.*, 594 F.2d 1261 (1979) addressed the materiality issue in the context of print media. There, the journalist published a puff piece on a publicly traded company, but first purchased the stock at a low price.

The court reasoned that given the story’s “style and tone, with its glowing praise of [the company] and conclusion that the firm was a worthy investment despite the risks, the effect of the [journalist’s] stock ownership on his objectivity would be important to his readers. We conclude, therefore, that the omitted facts alleged as violations were material.” *Id.* at 1266. That is, the failure to disclose the short position is a lie by omission.

Next, the bloggers have argued that the U.S. Supreme Court’s decision in *Chiarella v. United States*, 445 U.S. 222 (1980) (a case where a printer obtained and traded on information about upcoming transactions) means they may only be liable for securities fraud if they have a duty to disclose, and as “outsiders” they have no such duty. But the courts have dispensed with that argument too. As the court in *In re Credit Suisse First Boston Corp. Securities Litigation*, 1998 U.S. Dist. Lexis 16560 (S.D.N.Y. 1998) held, “Rule 10b-5 creates a statutory duty to speak the full truth when a defendant undertakes to say anything.” *Id.* at 16. A defendant may not deal in “half-truths.” *Id.*

Finally, the bloggers argued that a general disclaimer of their possible positions in the company's stock, disclaimers that are often placed at the bottom of the article, shields them from liability. It does not. As the court in *In re Credit Suisse* also held, where the party is aware of “actual danger or cause for concern, the party may not rely on a generic disclaimer in order to avoid liability . . .." *Id.* at 21. The court held that a "blanket disclaimer [that the journalist] 'may from time to time have long or short positions' was not enough to protect the defendants from liability as a matter of law." *Id.* at 22.

In view of this backdrop, what should a company that has been targeted by Internet short sellers do? The primary and achievable goal is to have the article retracted. Have the article taken down from the authors' website, and have the authors assist the company in getting it taken down from other websites that may have picked up the article.

The first place to look is whether the website has made a detailed disclosure of any short position taken by any of the authors or contributors to the article. The failure to have made an adequate disclosure may be securities fraud. While the party who would have standing to bring a securities fraud case would be shareholders or the SEC, if the website has run afoul of this disclosure requirement, an appropriately worded lawyer’s letter (lawyers may not threaten criminal prosecution at this stage) may achieve the desired result of a retraction.

Next, the company may want to consider having its lawyers prepare and send to the authors of the article a draft complaint for business defamation (i.e., trade libel and libel per se), along with an appropriately worded letter about filing a lawsuit if the article is not retracted. These lawsuits, while unusual, have been filed by companies targeted by Internet short sellers. When relying on these grounds, the company plainly has standing to bring the lawsuit. But the challenge comes in identifying and articulating the material inaccuracies in the article as to the substance of what is written, as opposed to simply relying on the fact that the authors failed to disclose their short position.

This is a case-by-case analysis, but often the more outrageous the claims of corporate misconduct, the greater is the likelihood that the authors got basic facts wrong, and thus the conclusions they drew were erroneous. In many cases, the authors simply do not understand the SEC filings they rely on to make their conclusions.

When faced with a detailed and well-crafted draft complaint that confronts the authors with a list of material inaccuracies in the article, the authors may elect to recall that discretion is the better part of valor and simply retract the article.

Third, the company may, depending on the size of the drop in the price of the company's stock, want to consider retaining a crisis manager to shape the message that the company provides to the public, and specifically whether the company should issue a press release that counters the article.

The key is that the company needs to act quickly. Getting the article taken down swiftly sends a powerful message to the market that the article lacked merit and places the company in a good position for the stock to return to its pre-publication price.

Christopher A. Lilly is an attorney with TroyGould in Los Angeles. He has broad trial, arbitration, and appellate experience, with a focus in employment, securities, and entertainment litigation. Mr. Lilly is also chair of the firm's recruiting committee.

Reprinted with permission from the January 28, 2013 edition of Corporate Counsel © 2013 ALM Media Properties, LLC. All rights reserved. Further duplication without permission is prohibited. For information, contact 877-257-3382 or reprints@alm.com or visit www.almeprints.com.