SECURITIES LAW360

Portfolio Media, Inc. | 648 Broadway, Suite 600 | New York, NY 10012
Phone: +1 212 537 6331 | Fax: +1 212 537 6371 | customerservice@portfoliomedia.com

Dumping And Suing: Legal, But Questionable

Friday, March 03, 2006 --- Plaintiffs and their attorneys are often accused of scouring the legal underbelly in search of greater potential payouts, but the growing practice of the plaintiffs' bar teaming up with short-sellers signals a new low, critics charge.

Dumping and suing, which involves plaintiffs short-selling a company's stock before announcing the suit, has become the subject of a growing debate on whether plaintiffs' attorneys or hedge funds tipped off by plaintiffs who engage in these practices are guilty of traditional insider trading.

Current securities law says no, but because lawsuits against companies can cause substantial plunges in market value, some practitioners say the strategy should cause concern.

Moin Yahya, Assistant Professor of Law at the University of Alberta and an outspoken critic of the practice, points to a recent spate of cases in which the plaintiffs' bar and short-sellers "just so happened" to be present at the same time to show that the practice is on the rise.

In one case involving J.C. Penney, a pharmacist with the company's subsidiary, Eckerd Drug Stores, voiced concerns to the authorities regarding Eckerd's billing practices. An analyst with a short-selling hedge fund started contacting the pharmacist regarding those concerns. When a lawsuit was filed against Eckerd alleging billing fraud, hedge fund representatives were present in court, and when the action was announced, J.C. Penney's stock took a 30% dive to the advantage of short-sellers who sold short the stock prior to the suit.

Another case concerning energy company Dynegy involved an employee who informed a short-selling hedge fund of the company's questionable financing activities. The fund took a short position against Dynegy's stock. The employee and the hedge fund, along with a plaintiff's lawyer, conspired to spread negative reports of the firm by contacting the media, a credit-rating agency and the SEC, causing the stock price to plummet. The lawyer's firm subsequently initiated a shareholder suit against Dynegy, leaving the hedge fund with a $150 million bounty.

These cases aren't isolated anomalies, but red flags calling for further scrutiny by the U.S. Securities and Exchange Commission, says Yahya.

"Under the SEC's very broadly construed Rule 10b-5, the SEC has generally pursued two lines of cases, insider trading and market manipulation, such as 'pump and dump' and 'cyber-smear' schemes," says Yahya. "Short-sellers manipulate the market when they spread negative information to make stock prices fall. Short-selling plaintiffs, while they don't spread any false information, still fall into this category by omitting news of the impending suit to the buyer. That silence is the mirror image of spreading false information."

Yahya says this "manipulation by silence" constitutes actionable fraud under Rule 10b-5, and that plaintiffs should be prohibited from short-selling by legally deeming them temporary insiders until they publicly reveal their intention to sue.

But the law, as it is currently construed, doesn't speak specifically on the issue, and because the status of a short-selling plaintiff is legally ambiguous, short-sellers and lawyers engaging in the practice can usually avoid legal sanction.

For one thing, short-selling plaintiffs are not technically "insiders" under any current definition of securities law, because they do not have any fiduciary duties to shareholders.

Nor does a plaintiff's decision to sue after short-selling constitute traditional market manipulation—it's not technically fraudulent in the sense that spreading false negative stories is, since it's really about the omission of information regarding the plaintiff's imminent intent to sue.

However, Rule 10b-5 does mention silence, prohibiting 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."

While the courts may not yet have handed down any rulings on the issue, Yahya says there is nothing preventing courts in the future from deciding that failure to mention the news of an imminent suit is an omission to state a material fact, which is covered by Rule 10b-5. Alternatively, Yahya thinks the SEC should enact a narrowly tailored rule that specifically covers short-selling plaintiffs in order to protect investors.

But some practitioners maintain that a short-selling plaintiff's failure to mention to the public that a lawsuit is on the horizon does not necessarily constitute an omission to state a material fact.

Larry Ribstein, Richard & Marie Corman Professor of Law at the University of Illinois College of Law, says that while the practice may be unjust, it's perfectly legal, because plaintiffs short-sell based on true information that a lawsuit is forthcoming, which is in no way illegal under current law.

"The idea that short-selling without disclosure that you are going to sue is a violation of 10b-5 is absolutely flat-out wrong, and any securities lawyer would agree," says Ribstein. "It's not illegal to trade based on information that nobody else has, what's illegal is doing it in violation of certain SEC rules. When plaintiffs short-sell, they not only possess the information they're trading on, but they're the ones filing suit, which could be seen as an unfair advantage over the rest of the market. But whether you want to call it fair or not, it's not illegal."

Ribstein points out that securities markets are driven by people taking advantage of information they possess, and that financial analysts would in fact say that having inside information is the only justification for trading.

"The law is really pretty clear," he says. "The Supreme Court has said over and over that just because you have information, it's not necessarily illegal inside information. I don't think Congress should change the law, because you do need some ability to trade on nonpublic information. Right now, it's possible the courts could decide there's something wrong with it, but until they do, it's okay. And frankly, I doubt the SEC has the power to pass that kind of rule."

Another question raised by the practice is whether or not the announcement of a lawsuit unequivocally lowers a company's stock price.

According to Yahya, the announcement of a suit has a "definite and substantial impact" on stock prices, because the market discounts the value of the company by the expected cost of the lawsuit, no matter how specious the suit might be.

"When you announce a lawsuit, initially the market doesn't have any information about it, so it has to make a projection about what the outcome will be," says Yahya. "That can still tank stock prices by millions of dollars. Even if you have a fully informed, efficient market that correctly assesses the outcome of a suit, the filing of the suit will still discount a bit of the stock price. Essentially, the market doesn't account for the outcome, even if it could discern the good suits from the bad. But whoever profits, the practice allows frivolous lawsuits to be brought."

But doesn't this assume that lawyers can profit simply by announcing any lawsuit, no matter how improbable?

"Maybe the lawyer could profit a little, but the information has to have some credibility," argues Ribstein. "It has to be a realistic claim and one that the market thinks you'll follow through on. The market is pretty good at evaluating these facts. You can get away with some stuff, because the market's not perfect in the sense that it doesn't always know what's true, but it also picks up clues from a firm's prior reputation."

Moreover, says Ribstein, letting lawyers and plaintiffs in on a piece of the stock market action may even provide them with added incentive to file meritorious lawsuits.

"At least in theory, because lawyers can only profit in the trading market by bringing good lawsuits, allowing them to trade actually gives them incentive to develop the sort of reputations by selecting and prosecuting cases that would increase the stock price when the suits were filed," he says.

Dumping and suing is not the problem in and of itself, says Ribstein, who believes the law already provides all the necessary tools to prevent any extent to which it is accompanied by fraud and manipulation.

"It would be ironic to try to deal with the problem of excessive litigation by adding a whole new area of securities regulation," he says.

But with plaintiffs given double incentive to bring lawsuits in order to harvest double the profits from short-selling and then suing, critics say at the very least, the SEC should investigate the extent to which dumping and suing takes place.

"If this practice is legal, then plaintiffs and their lawyers can profit just by announcing a suit," Yahya argues. "They profit when the stock price drops after the suit is announced. They're unjustly enriched again when they settle or collect a judgment following victory in court."

According to Yahya, that's reason enough to take legal action to bar the practice.

"If I'm a victim of a car accident, I don't get a double recovery," he says. "Why should lawyers?"

And although the law so far has not come down definitely on the specifics of short-selling by plaintiffs, some agencies are starting to take note of the potential ramifications of dumping and suing going unregulated.

In recent years, for example, the Washington Legal Foundation has filed complaints with the SEC and the Department of Justice as part of its Investor Protection Program, requesting the federal agencies investigate whether any federal civil or criminal laws were violated in a federal California case involving questionable conduct between class action attorneys and short-sellers.

--By Erin Marie Daly, erin.daly@portfoliomedia.com

