

# **Press Release**

**Washington Legal Foundation**

**Advocate for freedom and justice®**

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**FOR IMMEDIATE RELEASE**

**December 22, 2003**

## **WLF FILES COMPLAINT WITH SEC AND DOJ TO INVESTIGATE SHORT SELLING OF COMPANY IN SECURITIES CLASS ACTION CASE**

The Washington Legal Foundation (WLF) filed a complaint with the Securities and Exchange Commission (SEC), the U.S. Department of Justice (DOJ), and the U.S. Attorney's Office in San Francisco, California, requesting those federal agencies to investigate whether any federal civil or criminal laws were violated with respect to short selling of the stock of Terayon Communication Systems, Inc. (Terayon), and related conduct in a class action securities fraud lawsuit filed against the company by Milberg Weiss Bershad Hynes & Lerach.

WLF's complaint centers around a securities class action lawsuit (*In re Terayon Communication Systems, Inc. Securities Litigation*) pending in federal court in San Francisco before U.S. District Court Judge Marilyn Hall Patel. Judge Patel has raised troubling questions about the genesis of the case and the role of two parties seeking lead plaintiff status and Milberg Weiss. According to a news article in the *San Francisco Chronicle*, "Double-Whammy in Stock Fraud Suit: Short sellers trash, then sue, Santa Clara tech firm," (Nov. 9, 2003), the lawsuit was filed against Terayon on April 13, 2000, the day after the stock dropped 26 percent in value. A subsequent motion was filed by Milberg Weiss to have five persons named as lead plaintiffs in the case, two of whom included Cardinal Partners, a hedge fund managed by general partner Cardinal Investment Company of Dallas, Texas, and a Cardinal employee. After the motion was granted and Milberg Weiss was appointed lead counsel, it was discovered that Cardinal had previously sold short 400,000 shares of Terayon from August 3, 1999 to early 2000, exposing it to losses of \$80 million if the stock price did not drop. Evidence subsequently obtained in the case during discovery suggests that another Cardinal employee had instituted what he described as a "Game Plan," a systematic and coordinated effort beginning in January 2000 to drive the value of the stock down in order to make a profit.

According to the *Chronicle* news account and as alleged in court documents submitted with WLF's complaint, some of the questionable tactics used by Cardinal employees to drive down the value of the stock included 1) filing multiple letters with the SEC against Terayon claiming the company "blatantly" lied in SEC filings about the prospects of its cable modem technology being certified by CableLabs for the modem industry; 2) discrediting the company with analysts and financial reporters, and getting them to publish negative stories about Terayon in the *Wall Street Journal* and *Fortune Magazine*; 3) posting negative information about Terayon on a Yahoo! message board under an alias; and 4) posing as a financial analyst with a fictitious name during an April 11,

2000 conference call and raising questions critical of the company with Terayon management and securities analysts.

In these kind of securities class actions, the chief complaint is that shareholders were injured by the sudden drop in the value of the stock once negative inside information was released to the public that should have been released earlier. Here, however, Cardinal's goal was to drive the price of the stock down by claiming that it knew all along the allegedly negative inside information about the company. The initial question is whether there is a conflict of interest between the interests of short-sellers and those who purchased the stock for a long-term investment hoping the stock would rise.

At the hearing to disqualify the two Cardinal lead plaintiffs held on September 8, 2003, Judge Patel was clearly troubled by the arrangement. "[It] disturbs me the people who are going to drive the litigation are in fact people who are betting on the stock going down," Judge Patel told an attorney from Milberg Weiss. She was also troubled by the fact that Cardinal did not disclose its short positions in the stock and the role of Milberg Weiss in the litigation. "The problem I have is that it raises questions about what was going on here. What did Milberg Weiss know before the complaint was filed. . . . I think it's utterly amazing we have this lengthy complaint and with all of the excruciating details and the stock just drops the day before [the suit is filed]." Judge Patel ended the hearing by noting that "I think it may well be appropriate to have a couple of depositions taken of people at Milberg Weiss, find out exactly what was going on." A ruling by Judge Patel on the motion to disqualify is expected to be issued after the new year.

WLF's complaint was filed as part of its INVESTOR PROTECTION PROGRAM launched earlier this year with the filing of a similar complaint now pending with the SEC to investigate the short-selling of J.C. Penney stock shortly before the filing of a class action lawsuit against Eckerd Drug Stores which was owned by J.C. Penney. The goals of WLF's INVESTOR PROTECTION PROGRAM are comprehensive: to protect the stock markets from manipulation; to protect employees, consumers, pensioners, and investors from stock losses caused by abusive litigation practices; to encourage Congressional and regulatory oversight of the conduct of the plaintiffs' bar with the securities industry; and to restore investor confidence in the financial markets through regulatory and judicial reform measures. WLF was called upon to testify earlier this year before a congressional committee on the need to prevent short-sellers and plaintiffs' attorneys from manipulating the stock price of a company to the detriment of the company's shareholders and employees.

WLF is a nonprofit public interest law and policy center based in Washington, D.C., with supporters nationwide. Since its founding 25 years ago, WLF has become the nation's preeminent center for public interest law, advocating free-enterprise principles, responsible government, property rights, a strong national security and defense, and a balanced civil and criminal justice system, all through WLF's Litigation Department, Legal Studies Division, and Civic Communications Program.

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