

The Legal Status of “Dump & Sue”: Should Plaintiffs and their Attorneys be Prohibited from Trading the Stock of Companies they Sue? – a Law and Economics Approach

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The Law & Economics of “Dump & Sue”: Should Plaintiffs’ Attorneys be Prohibited from Trading the Stock of Companies they Sue? – a Law and Economics Approach

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Abstract

There is some evidence that plaintiffs and their attorneys are profitably short-selling the stock of the companies they intend to sue. The status of such short sales is undecided in the law. Lawsuits against companies can cause large drops in market value, and hence such an action by the plaintiff should cause concern. Plaintiffs, however, are not traditional insiders, and they do not owe the shareholders any fiduciary duties. They can therefore consent to their attorneys also short-selling the stock of the defendant corporation. The attorneys need to receive such permission to avoid misappropriating the information concerning their client’s decision to sue. A plaintiff’s decision to sue after short-selling does not constitute market manipulation in the traditional sense, since the decision to sue is a true fact that causes the drop in the share price as opposed to those who commit fraud by spreading false negative stories about the company. Plaintiffs need, therefore, to be legally deemed temporary insiders until they publicly reveal their intention to sue or actually sue. The reasons for deeming them insiders, and hence prohibiting them from short-selling, are threefold. First, allowing such activities would raise the same concerns regarding market integrity raised by those opposed to insider trading. Second, allowing such short-selling is a form of fraud by silence against those who purchase the shares. Third, allowing short-selling would give the plaintiffs double recovery for their lawsuit, as they could gain a large share of their claim against the company from the profitable short sales in addition to any verdict or settlement. Furthermore, proposals to extend Regulation FD to plaintiff’s attorneys would be ineffective in combating the harm from such short-selling. The law, therefore, through either developments by the courts, regulatory promulgations by the SEC, an act of Congress, or a combination of any of the preceding three mechanisms should be used to treat plaintiffs as insiders until they sue or announce their intention to sue.

The Law & Economics of “Sue and Dump”: Should Plaintiffs’ Attorneys be Prohibited from Trading the Stock of Companies they Sue? – a Law and Economics Approach

Moin A. Yahya

Introduction

The first I had heard of a plaintiff’s lawyer short-selling the stock of a company he was about to sue was in *The King of Torts*,¹ a recent John Grisham novel.² The lead character, a plaintiffs’ attorney short-sells³ the stock of a pharmaceutical company that he is about to sue for a negligently produced drug. When the lawsuit is announced, the price of the stock drops and the attorney profits handsomely.⁴ Later, the attorney is investigated for insider trading, since the information that he based his suit upon came from a stolen document. Fiction *The King of Torts* may be, but it seems that life has been imitating fiction without any repercussions, so far, for any of the potential wrongdoing parties. For example, in a recent lawsuit against Eckerd Drug Stores (Eckerd), owned by J.C. Penney Co. (Penney), there is some evidence of a link between the law firm that sued Eckerd and a New York hedge fund that often takes short positions.⁵ The lawsuit alleged that Eckerd had been engaged in a widespread practice of overcharging for prescription drugs. The lawsuit negatively impacted Penney’s stock by over 30%. While the shareholders took a beating, a short-seller who shorted Penney’s stock before the suit was filed could have profited greatly.

Many short-sellers began hearing rumors that a lawsuit was going to be filed against Eckerd. The idea of the lawsuit came when a druggist for one of the Eckerd drugstores began

¹ JOHN GRISHAM, *THE KING OF TORTS* 186 (2003).

² Professor Stephen Bainbridge had foreseen this issue many years ago. Stephen M. Bainbridge, *Insider Trading Under the Restatement of the Law Governing Lawyers*, 19 IOWA J. L. CORP. 1 (1993).

³ Short-selling is the sale of a security that the seller must borrow, and is usually done when the seller expects the price of the security to fall. Black’s Law Dictionary 560 (Pocket ed. 1996).

⁴ Grisham, *supra* note 1, at 377.

⁵ David Armstrong & Ann Zimmerman, *Sowing Doubts: Battering Penney, A Lawsuit Served Short-Sellers Well*, WALL STREET JOURNAL January 1, 2003 at page A1.

voicing complaints that Eckerd might be overcharging. An analyst with a short-selling New York hedge fund called the druggist and collected information regarding his complaints. The druggist claims that the analyst asked him to speak with a private investigator who was known to work with law firms that file class action securities litigation.⁶

The druggist was also frequently contacted by a doctor-turned-analyst who worked for another broker-dealer located in New York. This analyst contacted the druggist over 30 times and updated him on the steps being taken for the lawsuit, but also supposedly admonished him not to reveal their conversations. The druggist claims that the analyst indicated that he was communicating with the lead plaintiff's attorney prior to the lawsuit being filed. The attorney has refused to answer questions regarding the basis for his interest in Eckerd or whether he had discussed the suit with short-sellers prior to filing the suit. The short-sellers were at the courthouse the day of the filing (or the next day) to receive a copy of the lawsuit from the clerk's office. The short-sellers deny any advance knowledge of the suit. In fact, the short-sellers deny that they personally short-sold Penney's stock, and they refuse to answer whether they had advised any clients to short-sell the stock.

The story does not conclusively show that there was any communication or coordination between the short-sellers and the lawyers, but the circumstances suggest that short-sellers and plaintiffs' attorneys are joining forces. In the past, short-sellers have been blamed for spreading unfavorable rumors concerning companies in which they have short positions.⁷ For example, short-sellers have been accused of coordinating the release of false information⁸ and stirring up

⁶ The analyst denies paying the private investigator.

⁷ Randall Smith, Henny Sender & Charlie Gasparino, *Will Scrutiny of Hedge Funds Lead to Charges?*, WALL STREET JOURNAL, January 24th, 2003 at page C1.

⁸ *Id.*

negative sentiments regarding the companies whose stock they are short-selling.⁹ In the most recent example of this, Chief Judge Patel of the United States District Court for Northern California disqualified the lead plaintiffs in a securities fraud class action when it emerged that the plaintiffs had been short-selling the stock of the defendant corporation.¹⁰ The defendant Terayon manufactures cable modem systems that provide Internet communication services to cable subscribers.¹¹ Terayon was developing a new communications technology, and it was seeking the approval of CableLabs, the consortium that enforces industry standards for such devices.

The lead plaintiffs Cardinal Investment Company (Cardinal), a Texas investment company, and others affiliated with the company decided that Terayon Communications systems (Terayon) was a good candidate for short-selling, and proceeded to sell the stock short.¹² The price of Terayon's stock, however, began to rise. This caused millions of dollars of losses for the plaintiffs. Cardinal and the others allegedly decided to hatch a "game plan" to force the price of the stock to fall. Cardinal and the other lead plaintiffs surmised that CableLabs would not approve of Terayon's new technology. Cardinal began to accuse Terayon of fraudulently misrepresenting that its new technology would be approved, hoping that these allegations would lower the price of the stock. Cardinal contacted *Fortune* magazine and the *Wall Street Journal* and communicated its allegations of fraud to their reporters. News stories appeared in both publications, but nonetheless the price of the stock remained steady. Cardinal then began a letter writing campaign to the SEC and other government agencies accusing Terayon of fraud. Finally,

⁹ Christina Binkley, *Marriott Settles Suit Involving Management Fee*, WALL STREET JOURNAL, July 28th, 2003 at page B3.

¹⁰ *In re Terayon Communications Systems, Inc.*, 2004 WL 413277 (N.D. Cal. 2004). See also Reynolds Holding, *Double-Whammy in Stock Fraud Case: Short-sellers Trash, then Sue, Santa Clara Tech Firm*, SAN FRANCISCO CHRONICLE, November 9th, 2003 at A1.

¹¹ *In re Terayon Communications Systems, Inc.*, 2002 WL 989480 (N.D. Cal. 2002)

¹² Put options were also purchased. A put option is an option to sell a security at a fixed price even (especially) if the market declines. Black's Law Dictionary 459 (Pocket ed. 1969).

through Internet postings they encouraged parties to contact the law firm of Milberg Weiss, a firm that Cardinal had been in communication with for some time, about a potential lawsuit against Terayon. Cardinal posted more stories about the imminence of a lawsuit and claims of fraud by Terayon. All of this was done with an eye to lowering the stock price. At last the stock price dropped, but so did the whole stock market as the tech bubble burst. A suit alleging fraud was filed the next day claiming that the investors had lost millions of dollars due to the fraud of Terayon. The irony of the suit was that Cardinal sought to be the lead plaintiff, when Cardinal had always been determined to see the price of the stock drop without any long position in Terayon's stock. The millions of dollars it lost were due to the price of the stock rising and not because of any fraud inducing Cardinal to buy Terayon stock. Chief Judge Patel recognized the irony and the conflict of interest between Cardinal and other investors who had actually purchased Terayon's stock in dismissing both Cardinal as the lead plaintiff and Milberg Weiss as the lead attorney from the case.

Chief Judge Patel also noted the suspicious circumstances of the suit whereby Cardinal had been in contact with Milberg Weiss long before the date of the suit. It seemed almost as if the suit was planned in advance to drive the share price down to allow for a profitable short-selling by Cardinal. She noted a similar scheme between short-selling plaintiffs and Milberg Weiss in another securities fraud case.¹³

The threat of a suit lowering the price of the defendant's stock has always been a conventional litigation pressure tactic by the plaintiffs' bar. For example, in a lawsuit against the German drug manufacturer Bayer, the plaintiff's attorney Mikal Watts allegedly noted to Bayer's

¹³ Fields v. Biomatrix, 198 F.R.D. 451 (D.N.J. 2000). See also Robert Lenzner & Emily Lambert, *Mr. Class Action*, FORBES February 16th, 2004 at 82 (suggesting that Milberg Weiss has communicated with short-sellers in the past, as well reporting a federal investigation into whether Milberg Weiss paid lead plaintiffs in their many class action lawsuits).

counsel on several occasions that “[Bayer’s] stock price is going to tank”, while another plaintiffs’ attorney suing Bayer suggested that Bayer should “know the impact on ... [its] stock price if [Bayer didn’t] settle.”¹⁴ Similarly, famed plaintiffs’ attorney Richard (Dickie) Scruggs in his suits against the HMOs spoke to many analysts at Wall Street firms, such as Morgan Stanley and Prudential, and urged many institutional investors to force the HMOs to settle the suits with him and other plaintiffs’ attorneys.¹⁵ The share price of most the HMOs involved in the suits had lost half of their value, and Scruggs used this as a tactical tool to try to force the HMOs to settle. The fact that the stock price falls when a suit is launched seems to be used by the attorneys for profit rather than just for pressure.

Despite these incidents, no case law on this subject exists. While the judge in *In re Terayon* disqualified the Cardinal group as lead plaintiff for its short-selling activities and found Cardinal’s actions suspect, she did not suggest that the action was criminal or actionable.¹⁶ Similarly, in *Fields v. Biomatrix*,¹⁷ the judge allowed a group of short-sellers who also held long positions in the stock of the firm they were suing to remain in the plaintiff class. This may suggest that none of this activity is suspect.

Professor Stephen Bainbridge prophetically addressed this issue over ten years ago when he discussed the (then) proposed draft of the Restatement of the Law Governing Lawyers.¹⁸ In his article, he argued that lawyers should never be allowed to use confidential information they obtain through their dealings with their clients to purchase the stock of companies that the client

¹⁴ Monica Langley, *Bayer Fights Back: Bayer, Pressed to Settle a Flood of Suits over Drugs, Fights Back*, WALL STREET JOURNAL, May 3, 2004 at page A1.

¹⁵ Collin Levey, *Three Ways to Shake Down an HMO*, WALL STREET JOURNAL, January 1, 2000 at page A19; Milo Geyelin, *Lawyer Seeks Support for Settlement with HMOs*, WALL STREET JOURNAL, November 22, 1999 at page B2; David Segal, *Tag-Team Lawyers Make Businesses Blink: HMOs Latest to Grapple with Threat of Investor-Scaring Mega-Verdicts*, WASHINGTON POST, November 12, 1999 at page A1; Jim Lafferty, Editorial, *Stock Market ‘Tips’ a Plot to Force Companies to Settle Suits*, VENTURA CITY STAR, November 28, 1999 at page B9.

¹⁶ *In re Terayon Communications Systems, Inc.*, 2004 WL 413277 (N.D. Cal. 2004).

¹⁷ *Fields v. Biomatrix*, 198 F.R.D. 451 (D.N.J. 2000).

¹⁸ Bainbridge, *supra* note 2.

is involved in. He argued that to allow this would violate their ethical duties as well as their duties stemming from their fiduciary and agency relationships with their clients.

The Washington Legal Foundation (WLF), a Washington, D.C. based public interest law firm, has released the only publication, to date, addressing this practice. It published a short article and has sent letters to various regulatory agencies. The article, penned by Victor Schwartz and Peter Bernstein, concluded that existing securities law does not address this type of activity despite the negative impact it has on investors and the market.¹⁹ They recommended that the SEC enact rules requiring plaintiffs' attorneys who communicate with securities analysts to disclose their communications in a manner similar to the requirements of Regulation Fair Disclosure (Regulation FD).²⁰ WLF has addressed numerous letters to the SEC requesting that they investigate the activities of the plaintiffs' attorneys in the *Eckerd* and *Terayon* lawsuits described above. Furthermore, they have also requested that the SEC introduce regulations similar to Regulation FD that would require plaintiffs' attorneys to disclose their communications with analysts.

Perhaps because the phenomenon of plaintiffs' attorneys short-selling the stock of a defendant corporation is recent or not perceived as a common practice, little attention is paid to this by writers, regulators, and the courts. Hence, other than the WLF publications and the article by Bainbridge, little has been written on the subject.

This paper will proceed as follows. In Section II, I will demonstrate why we should be concerned about plaintiffs who short-sell the defendant's stock. Section III will survey the law of securities fraud, specifically looking at insider trading as well as general fraud. I will analyze the status of the plaintiff's attorney in Section IV, while Section V will discuss the status of the

¹⁹ Victor E. Schwartz & Peter D. Bernstein, *Protect Investors from Plaintiffs' lawyers' Stock Manipulation*, 18 WASHINGTON LEGAL FOUNDATION LEGAL BACKGROUNDER (NO. 28), June 27, 2003.

²⁰ 17 C.F.R. 243.100-103 (2005).

plaintiff. Section VI will look at some common law principles to determine whether the plaintiff is engaging in fraud; this will set up Section VII to where I will propose a rule that plaintiffs should be deemed insiders until they disclose that they intend to sue. I will finally conclude.

II. Does it Matter? The Impact of Lawsuits on the Value of the Firm

When a lawsuit against a publicly traded corporation is announced, economic theory predicts that the price of the corporation's shares will fall. To see this, one must understand how the price of a share is derived. A share is an ownership interest in the firm.²¹ The owner of the share, the shareholder, has an ownership claim on the assets of the firm. Among these assets is the stream of income that the firm will earn over its lifetime. The share, therefore, derives its value from the expected flow of income that will accrue to the shareholder.²²

Suppose, for example, there are 100 shares for a particular company, and a shareholder owns one share. This shareholder has a claim to one percent of any of the firm's assets, including future income streams. Ignoring physical assets, suppose the firm earns \$100 a year in net profits and is expected to earn this for the foreseeable future. Then, one share would represent a claim against \$1 a year forever, and the value of the share would be the present value of \$1 a year forever. If the \$1 per share a year in net profits is expected to grow, then the price of the share will be higher, because the price will incorporate this expected growth.

If, on the other hand, there is an indication that the net profits earned by the firm will decline, then the price of the firm's shares should also decline. When a lawsuit is announced, this news forces the market to revise its expectation concerning the profitability of the firm.

²¹ STEPHEN M. BAINBRIDGE, CORPORATION LAW AND ECONOMICS 4 (2002).

²² The methodology for valuing stocks is standard fare in the field of finance. Illustrative of this are ZVI BODIE & ROBERT C. MERTON, FINANCE 234-53 (2000); WILLIAM A. KLEIN & JOHN C. COFEE JR., BUSINESS ORGANIZATION AND FINANCE 316-38 (2004).

Suppose that our hypothetical firm earns \$1 a year per share, and a lawsuit is announced where the market believes that the firm will lose with certainty and have to pay \$10 in damages, or \$0.1 per share. The price of the share will, therefore, diminish by ten cents. If the market believes, however, that the probability that the firm may lose the lawsuit is 50%, then the market will diminish the price of the share by only five cents. If the market believes that the payout will be higher than the \$10 hypothesized, the diminution in share price will be greater than ten cents, and vice versa.

At the very least, because of the cost of litigation, even if the market believes with certainty that the defendant firm will be successful, the price of the shares will have to decline by an amount reflecting the costs of litigation. This means, that a plaintiff's attorney can always force some diminution in the price of a firm's shares simply by announcing a lawsuit, however frivolous it may be. The empirical evidence confirms this.

Several scholars have studied the impact of the announcement of a lawsuit against publicly traded companies on the value of their shares. For example, Bhagat, Bizjak, and Coles studied the impact of lawsuits on the market value of corporations involved in the lawsuit.²³ They compiled a dataset of all lawsuits filed, settlements reached, or verdicts rendered which were reported in the *Wall Street Journal* for the period 1981-83.²⁴ They examined the impact of

²³ Sanjai Bhagat, John Bizjak, & Jeffery L. Coles, *The Shareholder Wealth Implications of Corporate Lawsuits*, 27 FIN. MGMT. 5 (1998). There were some earlier studies that looked at individual cases or a few select cases, and their results are consistent with the Bhagat, Bizjak, & Coles study. See e.g. John Bizjak & Jeffery Coles, *The Effect of Private Antitrust Litigation on the Stock Market Valuation of the Firm*, 85 AM. ECON. REV. 436 (1995); Kathleen Engelmann & Bradford Cornell, *Measuring the Cost of Corporate Litigation: Five Case Studies*, 17 J. LEG. STUD. 377 (1988). In another study, the authors studied the impact of several events in the Texaco-Pennzoil litigation on the value of both plaintiff and defendant's shares. The effect of the announcement, however, was not one of the events. David M. Cutler & Lawrence H. Summers, *The Costs of Conflict Resolution and Financial Distress: Evidence from the Texaco-Pennzoil Litigation*, 19 RAND J. ECON. 157 (1995).

²⁴ Bhagat et al., *supra* note 23, at 10.

the filings on the market value of 618 corporate defendants.²⁵ They classified the cases by whether the lawsuit was filed by another firm, the government, or an individual. Additionally, the cases were classified by the nature of the legal claim: antitrust, breach of contract, corporate governance, environmental claims, product liability, patent infringement, Federal Trade Commission type suits, and SEC type suits.²⁶ They found that defendants lose an average of 0.97% of shareholder value upon the announcement of the filing of a lawsuit, leading the authors to conclude that “plaintiffs can and do damage defendants in a lawsuit.”²⁷ This is a significant drop in shareholder value and is clearly material by any standard. In terms of who brings the suit, they found that government suits against a corporation have the largest impact on the shareholder value, lowering shareholder value of defendant corporations by as much as 1.73%.²⁸ Suits against corporations by non-corporate defendants lowered shareholder value by 0.81%, and suits by other corporations brought an average decline of 0.75%.²⁹ In terms of types of actions, environmental causes of action caused the highest loss in shareholder value (3.08%), followed by SEC type suits (2.71%), patent infringement suits (1.50%), product liability suits (1.46%), and antitrust suits (0.81%).³⁰ The fact that a lawsuit by a government agency can have such a large impact on the defendant’s value may explain why the plaintiff’s in the JC Penney case agitated for the government to investigate Eckerd Drug Stores; a larger drop in the value could be more beneficial to short-sellers who were allegedly in contact with the plaintiff’s attorney.

²⁵ They also examine the impact of the settlements as well as the impact of the filings and settlements on the market value of the plaintiff if it was also a firm. For the purposes of this paper, however, I am only concerned with the impact on the defendant corporation, since the plaintiff and the attorney are usually individuals in the examples described so far.

²⁶ Bhagat et. al., *supra* note 23, at 12.

²⁷ Bhagat et. al., *supra* note 23, at 15. In an earlier study, they found that when a corporation sues another corporation, the defendant’s shareholder value declines by about 1%. Sanjai Bhagat, John Bizjak, & Jeffery L. Coles, *The Costs of Inefficient Bargaining and Financial Distress*, 35 J. FIN. ECON. 221 (1994).

²⁸ Bhagat et. al., *supra* note 23, at 17.

²⁹ Bhagat et. al., *supra* note 23, at 17.

³⁰ Bhagat et. al., *supra* note 23, at 18.

Other studies confirm the general results of Bhagat, Bizjak, and Coles. Muoghalu, Robison, and Glascock found that the announcement of Resource Conservation and Recovery Act and Superfund lawsuits caused an average drop in the defendant's shareholder value by 1.2%.³¹ Cross, Davidson, and Thornton also found that Director and Officer lawsuit announcements lower the shareholder value of the firms that are sued, but their research indicated that the reason for the lawsuits does not affect the magnitude of the loss.³²

In another comprehensive study, David Prince and Paul Rubin studied the impact of product liability litigation on firms in the automobile and pharmaceutical industries.³³ They found that the filing of a lawsuit or a news story that subsequently leads to the filing of a lawsuit has a negative impact on the value of the defendant's firm. In the automobile industry, they found that a lawsuit against one firm lowers the value of all firms in the industry, while a lawsuit in the pharmaceutical industry against one firm increases the value of other firms in the industry.³⁴

In all these studies, the results are clear: the announcement of a lawsuit lowers the market value of the defendant. This means that the plaintiff's attorney who short-sells the defendant's stock is almost guaranteed to profit from this strategy.

³¹ Michael I. Muoghalu, David H. Robison, & John L. Glascock, *Hazardous Waste Lawsuits, Stockholder Returns, and Deterrence*, 57 SOUTH. ECON. J. 357 (1990). See also Michael Muoghalu & John E. Rogers, *The Economic Impact of Superfund's Litigation on the Value of the Firm: An Empirical Analysis*, 16 J. ECON. & FIN. 73 (1992) (finding similar results). In a study of Canadian lawsuits by the various Canadian government agencies against corporations, the announcement of the lawsuit had little impact on shareholder value, but the announcement of the settlement did, suggesting that "enforcement of environmental regulations in the United States is more severe (credible) than in Canada." Benoit Laplante & Paul Lanoie, *The Market Response to Environmental Incidents in Canada: A Theoretical and Empirical Analysis*, 60 SOUTH. ECON. J. 657 (1994).

³² Mark L. Cross, Wallace N. Davidson, & John H. Thornton, *The Impact of Directors and Officers' Liability Suits on Firm Value*, 56 J. RISK & INS. 128 (1989). In another study, Pruitt and Nethercutt found that when an explosive audio-tape containing racial slurs by Texaco executives was released while a racial discrimination suit was pending against Texaco, Texaco shareholders lost \$500 million. Stephen W. Pruitt & Leonard L. Nethercutt, *The Texaco Racial Discrimination Case and Shareholder Wealth*, 23 J. LABOR RESEARCH 685 (2002).

³³ David W. Prince & Paul H. Rubin, *The Effects of Product Liability Litigation on the Value of Firms*, 4 AM. L. & ECON. REV. 44 (2002).

³⁴ In the study of the racial discrimination suit against Texaco, the authors found that the loss in shareholder value did not affect the value of other oil companies. Pruitt & Nethercutt, *supra* note 32.

III. The Law of Securities Fraud

To decide whether there is something inappropriate about a plaintiff or the plaintiff's attorney short-selling the target company's stock, a quick survey of the laws concerning the sale of securities is needed. In this section, I will briefly outline the two basic rubrics under which certain transactions may be considered fraudulent. The two rubrics are (1) general securities fraud and (2) insider trading, which is a subset of general fraud. I will discuss some of the recent developments in the law of insider trading as well as the recently enacted Regulation FD. The discussion of insider trading and its illegality is also accompanied by an examination of the policy reasons behind its prohibition. These policy reasons will be used to evaluate the status of the short-selling plaintiff in the next section. Before proceeding, I shall introduce the term "short-selling plaintiff" to denote a plaintiff who sells short the stock of the corporation he or she is about to sue.

1. General Background on Securities Regulation

Securities were for the most part, regulated at the state level until the 1930s when the perceived need for uniformity via federal laws resulted in the enactment of the Securities Exchange Act of 1934 (SEA).³⁵ The SEA establishes the Securities and Exchange Commission (SEC), and authorizes it to combat illegal securities practices.³⁶ A very powerful section of the SEA, due to its very general language, Section 10(b)³⁷ prohibits the use of "manipulative or deceptive device[s] or contrivance[s] in contravention of such rules and regulations as the [SEC]

³⁵ An excellent source of information on this subject is STEPHEN M. BAINBRIDGE, *SECURITIES LAW: INSIDER TRADING* 7-48 (1999); BAINBRIDGE, *supra* note 21, at 518-609.

³⁶ 15 U.S.C 78j.

³⁷ 15 U.S.C 78j(b).

may prescribe as necessary or appropriate in the public interest or for the protection of investors” when such deception is used “in connection with the purchase or sale of any security.”³⁸

Section 10(b) has been expanded by various rules promulgated by the SEC and various judicial opinions.³⁹ For example, Rule 10b-5,⁴⁰ 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.”

Given the generality of both Rule 10b-5 and Section 10(b), it should be no surprise that these two provisions are the main source of prosecution for market manipulation generally and insider trading specifically.⁴¹ It is these two areas of securities fraud that I discuss in the next two sub-sections.

2. General Manipulation of the Market: What is it, and does it apply?

While Rule 10b-5 and Section 10(b) apply to all types of market manipulation and securities fraud, two types of market manipulation are of interest for the purposes of analyzing the short-selling plaintiff. These are the “pump and dump” and “Cyber-smear” schemes.⁴²

³⁸ Shareholders can bring private suits against those who violate this and other sections of the SEA to recover the ill-gotten profits. 15 U.S.C. § 78t-1. There are criminal penalties for violating section 10(b), which can include fines of up to five million dollars and/or jail time of up to twenty years. 15 U.S.C. § 78ff. Civil penalties may be imposed of up to three times the profits made from trading using the insider information. 15 U.S.C. § 78u-1. In addition, shareholders can also bring private suits against the insiders to recover the profits. 15 U.S.C. § 78t-1.

³⁹ The SEC is authorized to enact regulations to enforce this and all sections of the SEA. 15 U.S.C. 78j(b)(“ any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.”).

⁴⁰ 17 C.F.R. § 240.10b-5.

⁴¹ Other statutory provisions that can be used against fraud include section 9 of the SEA, 15 U.S.C. 78i; section 15(c)(1) of the SEA, 15 U.S.C. 78o(c)(1); section 17(a) of the Securities Act of 1933, 15 U.S.C. 77q(a).

⁴² Richard H. Walker & David M. Levine, “*You’ve Got Jail*”: *Current Trends in Civil and Criminal Enforcement of Internet Securities Fraud*, 38 AM. CRIM. L. REV. 405, 411 (2001).

The “pump and dump” schemes usually involve the spreading of positive false or misleading 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.⁴³ This is done typically on Internet message boards. The “smear and dump” scheme is the reverse of the “pump and dump”, where a short-seller spreads negative false or misleading information about a company driving down the company’s stock price, allowing the profitable covering of the short-position by those spreading the information.⁴⁴ The reason for the term “cyber” is that the Internet has become the preferred mode of these schemes.⁴⁵

One of the most famous “pump and dump” operations was that operated by Jonathan Lebed.⁴⁶ Lebed, who was fifteen years old at the time of his infamy, engaged in his scheme eleven times between August 23, 1999 and February 4, 2000.⁴⁷ He “purchased large blocks of thinly traded microcap stocks and, within hours of making such purchases, sent numerous false and/or misleading messages ... over the Internet touting the stocks he had just purchased.”⁴⁸ His net profit from these schemes was \$272,826.⁴⁹

He would acquire large amounts of stock in a thinly traded company and then post his messages.⁵⁰ His messages were “generally devoid of substantive content” and simply stated that

⁴³ Walker & Levine, *supra* note 42, at 411-12.

⁴⁴ Walker & Levine, *supra* note 42, at 412.

⁴⁵ Walker & Levine, *supra* note 42.

⁴⁶ Walker & Levine, *supra* note 42; In re Jonathan G. Lebed, Securities Release Act No. 33-7891 (Sept. 20, 2000) available at 2000 WL 1353040; Michael Lewis, *Jonathan Lebed’s Extracurricular Activities*, THE NEW YORK TIMES, at page 26 (Feb. 25, 2001); Peter Martin, *A Mask for Every Occasion: The Internet Enables People to Adopt New Social Roles with Ease. Jonathan Lebed is a Precocious Case in Point, says Peter Martin*, FINANCIAL TIMES, at page 19 (July 23, 2001); Peter S. Goodman, *Minor Achievement; Adults Manipulate the Market, So It’s No Surprise That Teens Would, Too*, WASHINGTON POST, at page B02 (Oct. 1, 2000); Marianne Lavelle, *The Cyberscam Kid*, U.S. NEWS AND WORLD REPORT, at page 46 (Oct. 30, 2000);

⁴⁷ In re Jonathan G. Lebed, Securities Release Act No. 33-7891 (Sept. 20, 2000) available at 2000 WL 1353040 *1.

⁴⁸ *Id.*

⁴⁹ *Id.*

⁵⁰ *Id.* at *2.

the stock would “take off,” be the “next stock to gain 1,000%,” or that the stock was “the most undervalued stock ever.”⁵¹ The SEC settled with Mr. Lebed, and he was ordered to disgorge his profits. The SEC founded their claim of fraud against Lebed under Sections 17(a) and 10(b) of the Exchange Act, and SEC Rule 10b-5.⁵² The lesson from the *Lebed* case and numerous others,⁵³ is that simply posting messages, no matter how sparse and devoid of content, seems to

⁵¹ *Id.* at *1.

⁵² *Id.* at *3.

⁵³ Securities and Exchange Commission v. New Energy Corp., Tor Ewald, Geneva Financial Ltd., Marcelino Colt aka Marcelino Colt Vasquez, Magnum Financial, Llc, Michael S. Manahan, Bld Trust, Barclay Davis, Loretta Davis, Burke T. Maxfield, York Chandler, and Hector Campa Acedo, Civil Action No. CV-02-989-MMM (CWX) (C.D. Cal.), Litigation Release No. 18712 (May 14, 2004), available at 2004 WL 1091102; Securities And Exchange Commission v. Dean S. Thomassen, Civil Action No. A03 CA 297H (W.D. Tex.) (May 14, 2003), Litigation Release No. 18690 (May 4, 2004), available at 2004 WL 962718; Securities And Exchange Commission v. John W. Surgent, Barry Abrams, Warren Hemedinger, Scott Piccininni, Paul Tahan, Robert Vitale, Mark Chavez, Sal Puccio, and Victor A. Lessinger, Civil Action No. 04-60493 -Civ (S.D. Fla.) (JIC), Litigation Release No. 18669 (April 16, 2004), available at 2004 WL 835760; SEC v. Lasv Enterprises, Inc., Robert S. Zaba, Robert B. Abbott, and Warren H. Soloski, Civ. Action. No. 04-CV545 (RBW) (District Of Columbia), Litigation Release No. 18655 (April 5, 2004), available at 2004 WL 728120; United States of America v. Larry Stockett, No. CR-S-03-365-LRH(LRL) (USDC D. Nevada); Securities And Exchange Commission v. Larry A. Stockett, No. CV-S-02-0607-PMP-LRL (USDC D. Nevada), Litigation Release No. 18651 (April 1, 2004), available at 2004 WL 715809; U.S. v. Homer Langrill, Crim. No. CR-S-03-0430-HDM-PAL (USDC D. Nevada); U.S. v. Thomas Becker, Crim. No. Cr-S-03-0405-PMP-LRL (USDC D. Nevada); Securities and Exchange Commission v. Homer T. Langrill and Thomas W. Becker, No. CV-S-02-1446-KJD-LRL (USDC D. NEVADA), Litigation Release No. 18492 (December 5, 2003), available at 2003 WL 22885604; Securities and Exchange Commission v. Hitsgalore.Com, Inc., Stephen J. Bradford, Life Foundation Trust, and Jeanette B. Wilcher, Civil Action No. 01-CV-1133 GLT (ANX) (C.D. Cal.) United States v. Jeanette B. Wilcher, Case No. CR03-1098 PHX EHC (D. Ar.), Litigation Release No. 18455 (November 14, 2003), available at 2003 WL 22703057; Securities and Exchange Commission v. 2DOTRADE, Inc., George Russell Taylor, Barry William Gewin AKA Barry Peters, Eric T. Landis, Dominic Roelandt, Michael D. Karsch, L. Van Stillman, David A. Wood, Jr., Clinton Walker, Oxford And Hayes, Ltd., FG & P Consulting, Ltd., Hackney Holdings, Ltd., Weston Partners, Inc., Infiniti Corporate Services, Ltd., Argo Financial, Ltd., 21st Equity Partners, Inc., MCG Partners, Inc., and LMR, LTD., Civil Action Number 3:03-CV-2246-N (GODBEY) (N.D. Texas, Dallas Division) Securities and Exchange Commission v. Craig J. Shaber, Stephen R. Wright, and Bonaventure Capital, Ltd., Defendants, and Aspen International Marketing, Inc. and Wright & GEIS, Inc., Relief Defendants. Civil Action No. 3:03-CV-2247-G(FISH) (N.D. Texas, Dallas Division), Litigation Release No. 18381 (September 30, 2003), available at 2003 WL 22250395; Securities and Exchange Commission v. New Energy Corp., Tor Ewald, Geneva Financial Ltd., Marcelino Colt Aka Marcelino Colt Vasquez, Magnum Financial, LLC, Michael S. Manahan, BLD Trust, Barclay Davis, Loretta Davis, Burke T. Maxfield, York Chandler, and Hector Campa Acedo, Civil Action No. CV-02-989-MMM (CWX) (C.D. CAL.), Litigation Release No. 18328 (September 8, 2003) available at 2003 WL 22083118; S.E.C. v. Rocky Mountain Energy Corporation, Inc., John N. Ehrman, W. Roderick Johnson, Sr., And John W. Ehrman, Jr. (Defendant Solely For Purposes Of Equitable Relief) Case No. H-03-CV-1133 (U.S.D.C., S.D. TEX.), Litigation Release No. 18305, available at 2003 WL 22006260; Securities and Exchange Commission v. Donald John Christensen, II, Jack E. Uselton, Marc R. Tow, George W. Guttman, Joseph M. Blumenthal, And Mountain Energy, Inc., Civil Action No. H-01-3203 (S.D.TEX.), Litigation Release No. 18294 (August 18, 2003), available at 2003 WL 21962008; Securities and Exchange Commission v. Tel-One, Inc, et al., Case No. 02-CV-120-T-30TGW (M.D. Fla.) Sec Files Contempt Action against Defendant George Carapella and Relief Defendants Leonora Carapella and Carapell Capital Corp., Litigation Release No. 18272 (August 6, 2003), available at 2003 WL 21804675. *See also SEC Internet Sweep Nets Nine Companies; All Charged with Securities Fraud*, 6 No. 15 Andrews Sec. Litig. & Reg. Rep. 13 (March 14, 2001); *Iranian and Californian Sentenced for*

be enough to garner an administrative sanction, if not a criminal conviction. While an analogy between the short-selling plaintiff's attorney and Mr. Lebed might be constructed, the more appropriate analogy is the "Cyber-smear" or "smear and dump" scheme.

An example of a "smear and dump" scheme is the case of Mark S. Jakob, a 23 year-old former community college student, who put out a fake negative news release causing the decline of the price of the Emulex Corporation's stock.⁵⁴ He had sold 3000 shares of Emulex short speculating that the price of the shares would drop. The price of the shares rose over 40 per cent after his transaction, and he stood to lose over \$100,000. So Mr. Jakob sent fake news releases to an Internet wire service that distributed corporate news releases. The fake news claimed that the company's chief executive officer had resigned, that the SEC was investigating the firm, and that the company would be revising its earnings. When the fake news was released, the price of Emulex's stock almost immediately plummeted from over \$100 per share to just over \$40 per share. Emulex lost over \$2 billion in market capitalization in just over fifteen minutes. The hoax was eventually corrected, but not before Mr. Jakob profited and many investors, who sold in the panic, lost millions. Ultimately Mr. Jakob was arrested and sentenced to 44 months in jail, in addition to fines and civil penalties.

'Pump and Dump' Scheme United States v. Aziz-Golshani, 6 No. 13 Andrews Sec. Litig. & Reg. Rep. 10 (February 14, 2001); *Organized Crime Implicated in Securities Fraud Arrests*, 5 No. 20 Andrews Sec. Litig. & Reg. Rep. 4 (June 21, 2000); *From 'Momentum Sites' to 'Imposter Cases,' SEC Tackles Internet Fraud*, 5 No. 11 Andrews Sec. Litig. & Reg. Rep. 11 (February 9, 2000); *SEC Files Four Fraud Actions Against Internet Stock Promoters*, 4 No. 14 Andrews Sec. Litig. & Reg. Rep. 3 (March 24, 1999).

⁵⁴ United States Of America v. Mark Simeon Jakob, Cr 00-1002-Dt (C.D. Cal.), Litigation Release No. 16857 (January 8, 2001) available at 2001 WL 15535; Securities And Exchange Commission v. Mark S. Jakob, Civil Action No. Edcv-00-687 Vap (Mcx) (C.D. Cal.), Litigation Release No. 17079 (July 25, 2001) available at 2001 WL 844393; United States v. Mark Simeon Jakob, Cr-00-1002-Dt (C.D. Cal.), Litigation Release No. 17094 (August 8, 2001) available at 2001 WL 892789; Alex Berenson, *Guilty Plea Is Set in Internet Hoax Case Involving Emulex*, THE NEW YORK TIMES, at Section C; Page 3 (December 29, 2000); Alex Berenson, *Suspect Is Arrested in Fake News Case*, THE NEW YORK TIMES, at Section C; Page 1 (September 1, 2000).

Similarly, Fred Moldofsky sold Lucent stock short, and then posted fake press releases on a Yahoo! Finance message board.⁵⁵ He profited when the price of Lucent's stock fell after he released a fake Lucent press release claiming that Lucent expected an earnings shortfall. Lucent's shares fell by 3.6% and knocked off \$1.7 billion of market value. He was charged with securities fraud, and he, like Mr. Jakob, was charged with violating Section 10(b) of the SEA and Rule 10b-5. Other such charges have been laid against individuals who have posted false stories with an eye to profitably short-selling the stock of the companies they smear.⁵⁶

These are but a few examples of schemes that market manipulators engage in, and I leave the analysis of whether the short-selling plaintiff falls into this category until after the discussion of insider trading.

3. Insider Trading: A Brief Introduction

Insider trading is defined as illegally transacting in a corporation's stock to take advantage of one's knowledge of secret information usually acquired through a confidential relationship with the corporation.⁵⁷ The definition does not identify who an insider is, nor does it explain when it is illegal to do so. This is because the question of who is an insider has never

⁵⁵ Securities And Exchange Commission v. Fred Moldofsky, 00 Civ. 2425 (S.D.N.Y.), Litigation Release No. 16493 (March 30, 2000), available at 2000 WL 331883; *Trader Is Arrested In False-Report Case*, THE NEW YORK TIMES, at Section C; Page 2 (March 31, 2000).

⁵⁶ Securities and Exchange Commission v. Nikolai Safavi, Civil Action No. 04-378-RBW (USDC D.C.), Litigation Release No. 18614 (March 9, 2004), available at 2004 WL 431339; In The Matter Of Dale E. Frey, Roger A. Rawlings, and William C. Piontek Administrative Proceeding File No. 3-10310, Release No. 221 (February 5, 2003), available at 2003 WL 245560; In The Matter of Financial Asset Management, Inc., James B. Rader and Debra L. Kennedy, Respondents. Administrative Proceeding File No. 3-10670, Release No. 8052 (January 3, 2002), available at 2002 WL 100569; Securities and Exchange Commission v. Ned C. Sneiderman, (USDC N.D. Cal.), Civil Action No. C-02-0001, Litigation Release No. 17294 (January 3, 2002), available at 2002 WL 10247; Securities and Exchange Commission v. Alexandra Elizabeth Montgomery, William Kenneth Nestor, Frederick Burgess and Harriet Gluck, Civil Action No. CV 97-4219 (E.D.N.Y.), Litigation Release No. 15419 (July 24, 1997), available at 1997 WL 411713; United States v. Marshall Zolp et al. (U.S.D.C., D.N.J., Crim. No. 86-299 (AJL)), Litigation Release No. 11494 (July 23, 1987), available at 1987 WL 757284 (fake non-Internet press releases); United States v. Marshall A. Zolp et al. (U.S.D.C., D.N.J., Crim.No. 86-299 (AJL)), Litigation Release No. 11236 (October 2, 1986), available at 1986 WL 625740 (same).

⁵⁷ Black's Law Dictionary, 320 (Pocket ed. 1996).

been clear and evolves over time. This evolution is a result of the general language and hence the lack of clarity in Section 10(b) and Rule 10b-5.

A series of adjudications by the SEC and the courts agreeing or disagreeing with the SEC's view of who is an insider and what activity is illegal has, over time, defined the insider. At common law an insider was at best a corporate officer, director, or controlling shareholder.⁵⁸ For example the United States Supreme Court invalidated a profitable purchase of stock by an insider, a director and controlling shareholder, from another shareholder, when the insider knew that the price of his stock was going to rise.⁵⁹ Many courts held that an insider's duty to refrain from insider trading flowed from their fiduciary duties to the shareholders (in addition to their traditional duties to the corporation). Insiders, these courts held, should disclose the confidential information to the shareholders or refrain from trading using that information. The main concern was that insiders who obtained information by virtue of their position would be able to profitably trade at the expense of uninformed shareholders. A classical insider, therefore, was and is an officer, director, or controlling shareholder who learns of some non-public confidential information, and hence is prohibited from trading the stock of the company (where he or she is the insider) using that confidential information.

Classical insiders were the group to whom the SEC and the courts initially confined their prohibition against insider trading. Three points must be mentioned before proceeding. The first is that despite the fact that state law was never uniform in holding that classical insiders owed

⁵⁸ There were actually three views of whom an insider is and whether this insider owed any duty to refrain from trading on non-public material information. Most courts held that insiders, such as directors and officers, did not have any duty to shareholders, some held that they had a duty to disclose before trading, while others had a more nuanced view depending on the circumstances under which the insider traded with the shareholder. Bainbridge, *supra* note 21, at 521 (citing *Hooker v. Midland Steel Co.*, 74 N.E. 445 (Ill. 1905) (no duty); *Oliver v. Oliver*, 45 S.Ed. 232 (Ga. 1903) (duty to disclose); *Strong v. Repide*, 213 U.S. 419 (1909) (nuanced view)).

⁵⁹ *Strong v. Repide*, 213 U.S. 419 (1909).

their shareholders a duty to refrain from trading before disclosing,⁶⁰ federal insider trading law has assumed that such a duty does exist.⁶¹ Second, the law of insider trading has assumed that simple non-disclosure by an insider when trading is the equivalent to fraud, even the law in many states usually require more than non-disclosure such as fraudulent concealment.⁶² Third, even though there might be a fiduciary duty from an insider to a shareholder, the existence of such a duty from an insider to a non-shareholder purchaser (i.e. when an insider sells the stock short) was never clear at state law, is not clear from first principles, but nonetheless is the rule under federal insider trading law.⁶³

In the 1960s, however, the SEC began to expand its definition of insider. The SEC initially adopted the position that anyone who possessed non-public material information was an insider and was prohibited from trading using the information absent disclosure.⁶⁴ The United States Court of Appeals for the Second Circuit agreed with this view and announced a broad prohibition against the use of non-public material information in *SEC v. Texas Gulf Sulphur*

⁶⁰ See note 58 *supra*.

⁶¹ Bainbridge, *supra* note 21, at 522.

⁶² *Id.*

⁶³ *Id.*

⁶⁴ The SEC used Rule 10b-5 to tackle non-traditional insider trading when it disciplined a broker, who had learned some non-public information from a company director and then profitably traded based on that information. In *re Cady, Roberts & Co.*, 40 S.E.C. 907 (1961). The broker was neither a director nor an officer of the corporation. The SEC, nonetheless, decided that the broker had violated rule 10b-5. It took an expansive view of the prohibition against manipulative devices. In *re Cady, Roberts & Co.*, 40 S.E.C. 907, 911 (1961):

We have already noted that the anti-fraud provisions are phrased in terms of “any person” and that a special obligation has been traditionally required of corporate insiders, e.g., officers, directors and controlling stockholders. These three groups, however, do not exhaust the classes of persons upon whom there is such an obligation. Analytically, the obligation rests on two principal elements; first, the existence of a relationship giving access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone, and second, the inherent unfairness involved where a party takes advantage of such information knowing it is unavailable to those with whom he is dealing. *In considering these elements under the broad language of the anti-fraud provisions we are not to be circumscribed by fine distinctions and rigid classifications.* Thus our task here is to identify those persons who are in a special relationship with a company and privy to its internal affairs, and thereby suffer correlative duties in trading in its securities. Intimacy demands restraint lest the uninformed be exploited. (emphasis added)

*Co.*⁶⁵ The case announced two broad rules. The first was that whenever an insider possessed material non-public information, the insider could not trade the company's stock unless the information was disclosed to the public.⁶⁶ This is known as the "disclose or abstain" rule. The second rule was that anyone who possessed material non-public information was effectively an insider; subsequently, anyone who had access to confidential information would be prohibited from trading unless the information was disclosed.⁶⁷ It did not matter how the potential trader learnt the information, because the court endorsed the SEC's position that:

anyone who, trading for his own account in the securities of a corporation has "access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone" may not take "advantage of such information knowing it is unavailable to those with whom he is dealing," i.e., the investing public.⁶⁸

At the same time other courts were also announcing expansive views of the scope of rule 10b-5. In *White v. Abrams*, the Ninth Circuit adopted a flexible duty test that made the rule one of negligence rather than fraud and expanded the scope of its application.⁶⁹ The court announced a list of factors that determined the scope of the duty under Rule 10b-5:

[1] the relationship of the defendant to the plaintiff, [2] the defendant's access to the information as compared to the plaintiff's access, [3] the benefit that the defendant derives from the relationship, [4] the defendant's awareness of whether the plaintiff was relying upon their relationship in making his investment decisions and [5] the defendant's activity in initiating the securities transaction in question.⁷⁰

Despite that the Supreme Court overruled *Abrams* when it held that scienter was necessary for rule 10b-5 liability,⁷¹ the courts continued to use the factors to determine the scope of duty owed under the rule. For example, in *Zweig v. Hearst Corp.*,⁷² parties to a corporate merger sued a financial columnist who had published a misleadingly favorable story about one of the

⁶⁵ 401 F.2d 833 (2d Cir. 1968).

⁶⁶ *Id.* at 848.

⁶⁷ *Id.*

⁶⁸ *Id.* (citing *In re Cady, Roberts & Co.*, 40 S.E.C. 907, 912 (1961)).

⁶⁹ 495 F.2d 724 (9th Cir. 1974).

⁷⁰ *Id.* at 735-36.

⁷¹ *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976).

⁷² 594 F.2d 1261 (9th Cir.1979).

corporations whose stock he had profitably purchased. The Ninth Circuit reversed the dismissal by the district court and held that he had violated Section 10(b) of the SEA and rule 10b-5 because he failed to disclose to his readers that he had purchased the stock of the subject of his column and expected to gain personally if they followed his advice. The Court held that the defendant owed the plaintiffs, the parties to the merger who were not readers of defendant's column, a duty because the plaintiffs "were in a position similar to that of [defendant's] readers. [The Plaintiffs] and the readers had strikingly similar stakes in the processes of the market."⁷³ The court went on to state that the plaintiffs when making their deal, had relied on "the existence of an honest market."⁷⁴ This is because

[a] market presumes the ability of investors to assess all the relevant data on a stock, including the credibility of those who recommend it, in creating a demand for that stock. In effect, [plaintiffs] in good faith placed [their] fate in the hands of market investors, including [defendant's] readers. [Plaintiffs] relied on the forces of a fully informed market. Instead, it was forced to sell in a manipulated market.⁷⁵

The court defined the newspaper columnist as a "quasi-insider."⁷⁶ Quasi-insiders, the court explained, are "people who obtain nonpublic information from a source outside a corporation about events or circumstances which will affect the market in the corporation's stock. An example of a 'quasi-insider' would be a Federal Reserve Bank employee who trades with knowledge of an upcoming change in margin rate."⁷⁷ Quasi-insiders are those who possess non-public information obtained from a source outside the corporation that may affect the price of the stock. The court used the *Abrams* factors to decide that the columnist owed market participants a duty to disclose or abstain from trading under rule 10b-5.

⁷³ *Id.* at 1269.

⁷⁴ *Id.*

⁷⁵ *Id.*

⁷⁶ *Id.* at 1267 n.9.

⁷⁷ *Id.* at 1267 n.9.

The United Supreme Court narrowed the scope of the *Texas Gulf Sulphur* rule in *Chiarella v. United States*.⁷⁸ Chiarella was an employee of a financial printer that prepared documents relating to upcoming mergers. The company used codes instead of the names of the companies involved in the mergers, but Mr. Chiarella cracked the codes allowing him to profitably purchase the stock of a target company. The Supreme Court reasoned that since Chiarella was not a traditional insider, he owed no fiduciary duty to anyone, and hence was not guilty of violating Rule 10b-5. The Supreme Court did not address a theory called the misappropriation theory, a theory that Chief Justice Burger argued for in his dissent. Chief Justice Burger argued that the printer had “misappropriated” the confidential information from his employer; he was obligated to keep that information secret due to his employment contract, therefore he should be equally culpable as if an insider had traded on the non-public information.⁷⁹ Anyone who misappropriated material non-public information in breach of an employment, fiduciary or other such duty was under an obligation to refrain from trading on that information, the Chief Justice argued.

The SEC, undeterred by *Chiarella*, continued to pursue the misappropriation theory as a basis for prosecuting outsiders. The Second Circuit adopted the “misappropriation” theory when it held that an outsider with no fiduciary duty to the shareholders could be liable under rule 10b-5 in *United States v. Newman*.⁸⁰ Newman was a securities trader who received non-public information from two investment bankers who had “misappropriated” it from their employers. Soon after, the Supreme Court in *Dirks v. SEC* reversed a censure by the SEC of a securities

⁷⁸ 445 U.S. 222 (1980).

⁷⁹ The SEC effectively overruled the *Chiarella* duty requirement by issuing rule 14e-3, available at 17 C.F.R. § 240.14e-3, that prohibits anyone from trading based on non-public information concerning tender offers if they knew that the information came from an insider.

⁸⁰ *United States v. Newman*, 664 F.2d 12 (2d Cir. 1981).

analyst who told his clients about fraud in a corporation using non-public information.⁸¹ Since the analyst told the information only for the purpose of exposing fraud, he had no fiduciary duty to the shareholders, and neither those who received the information nor the analyst had misappropriated the information. Two aspects of *Dirks* are noteworthy. The first is that the Court looked to the intent of the insider when making the disclosure and opined that courts should focus on “whether the insider receives a direct or indirect personal benefit from the disclosure, such as a pecuniary gain or a reputational benefit that will translate into future earnings.”⁸² The second aspect is the statement by the Court that

[u]nder certain circumstances, such as where corporate information is revealed legitimately to an underwriter, accountant, lawyer, or consultant working for the corporation, these outsiders may become fiduciaries of the shareholders. The basis for recognizing this fiduciary duty is not simply that such persons acquired nonpublic corporate information, but rather that they have entered into a special confidential relationship in the conduct of the business of the enterprise and are given access to information solely for corporate purposes.⁸³

The Supreme Court was beginning to allow the misappropriation theory to seep into its jurisprudence.

The misappropriation theory was tested once more in *United States v. Carpenter*.⁸⁴ A newspaper columnist whose columns influenced the price of stock shared his upcoming column with a friend who traded on this not yet released information and profited. The columnist and his friend were convicted under the misappropriation theory and other fraud theories. The Second Circuit affirmed the conviction on the misappropriation theory, and the Supreme Court upheld the conviction on the general fraud theory but evenly divided over the misappropriation fraud theory, thereby affirming his conviction on both counts.⁸⁵

⁸¹ *Dirks v. SEC*, 463 U.S. 646 (1983).

⁸² *Id.* at 664.

⁸³ *Id.* at 655.

⁸⁴ 791 F.2d 1024 (2d Cir. 1986).

⁸⁵ *Carpenter v. United States*, 484 U.S. 19 (1987).

Not all the Circuit Courts, however, agreed with the misappropriation theory. The Fourth Circuit, for example, rejected the misappropriation theory in two companion cases, *United States v. Bryan* and *United States v. ReBrook*. In *United States v. ReBrook*, the district court denied a motion to dismiss a criminal indictment against a defendant who was charged with insider trading.⁸⁶ The defendant was the attorney for the West Virginia Lottery that had decided to award a lottery contract to a particular company. The defendant profitably purchased stock in the company and informed three of his acquaintances who then also profitably purchased stock in the company. The district court used the misappropriation theory to uphold the indictment. The court decided that the defendant owed the West Virginia Lottery a duty of confidentiality, and by trading on the non-public information he had breached that duty. The conviction on the insider trading charges were eventually reversed by the United States Court of Appeals for the Fourth Circuit court, but only because the Fourth Circuit did not recognize the misappropriation theory at that time.⁸⁷ In the companion case, *United States v. Bryan*, the defendant was the director of the West Virginia state lottery, where he manipulated the lottery corporation into awarding two government contracts to particular companies doing business with the lottery corporation. He then profitably traded the stock of those companies using the confidential information.⁸⁸ His conviction for insider trading on the misappropriation theory was also reversed.

In 1996, the Eighth Circuit also rejected the misappropriation theory in *United States v. O'Hagan*. Mr. O'Hagan was an attorney whose firm represented an acquiring company, Grand Met that was tendering an offer to a target corporation, Pillsbury. O'Hagan purchased stock options and the stock of Pillsbury and then sold them for a \$4 million profit when the offer was

⁸⁶ 837 F. Supp. 162 (S.D. W. Va. 1993).

⁸⁷ 58 F.3d 961 (4th Cir. 1995).

⁸⁸ 58 F.3d 933 (4th Cir. 1995).

publicly announced.⁸⁹ The attorney was convicted in the district court, but the Eighth Circuit reversed, because it did not recognize the misappropriation theory. The Supreme Court heard the government's appeal and reversed the Eighth Circuit thereby upholding the conviction and, more importantly, recognizing the misappropriation theory.

The Court approved the misappropriation theory, and applied it to the *O'Hagan* case as follows: the attorney owed Grand Met, the client of his law firm, a duty of confidentiality, so when he purchased Pillsbury's 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.⁹⁰ It was assumed by the Court that as an attorney O'Hagan owed his client a duty of confidentiality including the duty to refrain from using any confidential information gained from interaction with the client for personal profit without obtaining the client's consent.⁹¹ In *O'Hagan*, the Supreme Court stated that "[t]he misappropriation theory is thus designed to 'protec[t] the integrity of the securities markets against abuses by 'outsiders' to a corporation who have access to confidential information that will affect th[e] corporation's security price when revealed, but who owe no fiduciary or other duty to that corporation's shareholders.'"⁹²

The case left three unanswered questions.⁹³ The first is what if the attorney or misappropriator informed the source of the information to which the attorney owed a duty that he or she was going to trade using the information? Second, what if the source of the information authorized the use of the information to trade? Presumably, the answer to these two questions is

⁸⁹ *United States v. O'Hagan*, 521 U.S. 642 (1997).

⁹⁰ The SEC subsequently enacted two more regulations in 2000: 17 C.F.R. § 240.10b5-1 and 17 C.F.R. § 240.10b5-2. They attempt to define what insider trading and when misappropriation will take place.

⁹¹ See Bainbridge's comments on this.

⁹² 521 U.S. at 653.

⁹³ Bainbridge identified these three issues in Bainbridge, *supra* note 21, at 548.

that the quasi-insider is not liable. Third, what theory did the Supreme Court use to prohibit the misappropriation of insider information? The Court did not clarify whether it was a fiduciary duty theory as put forth in *Chiarella*, a theory of abstain or disclose as in *Texas Gulf & Sulphur*, or a theory of property rights as Judge Winter advocated in *Chestman*. Rather, the Court stated that it was meant to protect the market against abuses by non-traditional insiders. I will defer application of this reasoning to the short-selling plaintiff to a later section.

4. Two More Developments: Rule 10b5-1 & Regulation FD

One unanswered question from *O'Hagan* is when is an insider who possesses material non-public information prohibited from trading? Is it whenever the insider possesses the information or when the insider actually uses the information as the reason for the trade? The SEC has always maintained that it is whenever the insider had the information, regardless of whether the information was the basis of the trade. This is known as the “possession” view of insider trading and stems from the SEC’s original view that anyone, fiduciary or not, who possessed material non-public information should refrain from trading. The Second Circuit initially adopted this view.⁹⁴ Later, however, other courts rejected it. The Eleventh Circuit in *SEC v. Adler* and the Ninth Circuit in *United States v. Smith* adopted the “use test” for both civil and criminal liability, which imposes liability only when the insider actually uses the information as the basis of the trade. In response to this, the SEC enacted Rule 10b5-1 to supplement Rule 10b-5. Rule 10b-5(1)(a)-(b) states that

- (a) General. The “manipulative and deceptive devices” prohibited by Section 10(b) of the Act (15 U.S.C. 78j) and § 240.10b-5 thereunder include, among other things, the purchase or sale of a security of any issuer, on the basis of material nonpublic information about that security or issuer, in breach of a duty of trust or confidence that is owed directly, indirectly, or derivatively, to the issuer of that security or the shareholders of that issuer, or to any other person who is the source of the material nonpublic information.

⁹⁴ Cite.

(b) Definition of “on the basis of.” Subject to the affirmative defenses in paragraph (c) of this section, a purchase or sale of a security of an issuer is “on the basis of” material nonpublic information about that security or issuer if the person making the purchase or sale was aware of the material nonpublic information when the person made the purchase or sale.⁹⁵

Part (b) of Rule 10b-5(1) re-iterates that the SEC prohibits any insider who possesses material non-public information from trading the stock of the company, even if the trade was not motivated by the information. No court has adjudicated whether the language of Section 10(b) in fact authorizes this rule.

The SEC, when passing Rule 10b5-1 in October 2000, also passed Regulation Fair Disclosure⁹⁶, which requires issuers of securities to disclose any information they wish to disclose to either all or no one.⁹⁷ The regulation was passed by the SEC in response to a perceived lack of a level playing field in the securities market. Corporations were perceived to be disclosing sensitive information to a select group of analysts while the average investor was left out. Thus Regulation FD requires that if any material information is disclosed at all, it must be disclosed to all.

5. Why is Insider Trading Illegal?

Before deciding whether plaintiffs should or can be deemed insiders, it is instructive to list some of the arguments that scholars have advanced in favor of or against the prohibition of insider trading. Looking at these reasons will be useful in deciding where to fit the plaintiff.

Henry Manne first proposed that insider trading should be legal on two grounds. The first is that allowing insiders to trade will push the price of the stock in the correct direction. This will be beneficial to existing shareholders, since they will see more information in the price

⁹⁵ 17 C.F.R. § 240.10b-5-1(a)-(b).

⁹⁶ 17 C.F.R. 243.100-103 (2004).

⁹⁷ See e.g. Caroline F. Hyaday, Note, *Shedding Light on Wall Street: Why Reg. F.D. is Appropriate in the Information Age*, 81 BOSTON U.L. REV. 843 (2001); Scott Russell, Note: *Regulation Fair Disclosure: The Death of Efficient Capital Market Hypothesis and the Birth of Herd Behavior*, 82 BOSTON U.L. REV. 527 (2002).

of their shares. For example, if the price of a company's stock is currently \$10, and the insider learns that of some good news that will raise the price of the share to \$20 when the news is revealed, then if the insider starts to purchase shares based on the non-public information, the purchase will start to push the price of the shares upwards. The price will rise from \$10 to \$11, for example, and this will signal to the market that some good news is on the way. Had the insider not been allowed to purchase any shares, the market would think that the correct share price is \$10, and some shareholders might be inclined to sell the stock. If the insider is allowed to purchase the shares, then an existing shareholder may decide not to sell the shares if the price starts rising. The argument is the same if the news is bad, and the insider decides to short-sell or dumps his or her holdings.

The corporation may not be able to adequately compensate the insider, who is typically an officer, because of difficulties in negotiating a compensation formula that encourages the officer to undertake an optimal amount of effort to maximize the value of the firm. By allowing the insider to take advantage of non-public information, information the insider may have had a role in creating, the insider can be compensated. The evidence for these propositions is mixed at best with many studies showing that when insiders trade no such price corrections take place.⁹⁸

On the other hand, however, scholars have argued that insider trading harms investors by undermining their confidence in the integrity of the market. Proponents of this theory argue that non-insider investors will become wary of purchasing any stock in a corporation if they think that an insider is selling the shares. This leads to a reduction in what the insider can sell the shares for, and hence the insider receives less compensation from the market for his or her effort. This leads to a further lack of effort, which means that the insider will focus more on maximizing

⁹⁸ See e.g. Roy Schotland, *Unsafe at Any Price*, 53 VA. L. REV. 1425 (1967). Bainbridge, *supra* note 35 cites some more.

profits from insider trading than on generating wealth for the corporation. In addition to the harm caused by insiders not exerting the proper level of effort, this could ultimately lead to a non-functioning securities market. Empirical evidence shows that there is some truth to this argument.⁹⁹

Judge Ralph Winter of the Second Circuit and Professor Bainbridge developed another theory of why insider trading is prohibited. It is known as the property rights theory and argues that the information upon which the insider bases his or her trades is actually the property of the corporation. The information belongs to the corporation; therefore the insider is stealing the information when a trade is made.¹⁰⁰ Allowing the insider to use information, which is a scarce and costly commodity, will diminish the incentives to produce information for the benefit of the corporation thereby depriving the shareholders of profit maximizing opportunities. The rationale in *O'Hagan*, however, did nothing to clarify whether this indeed was the theory under which non-classical insiders were prohibited from trading. In his analysis of whether an attorney was allowed to trade using information gleaned from the client, Professor Bainbridge (writing before the *O'Hagan* decision) argued that the client possesses a property right in the information regarding the suit. Bainbridge constructed a hypothetical bargain where he surmised that the client would most likely want any information concerning the suit to be the client's property, and furthermore, any attorney would agree to such a bargain *ex ante*

⁹⁹ Julian Du & Shang-Jin Wei, *Does Insider Trading Raise Market Volatility?*, 114 ECON. J. 916 (2004) (finding that countries with more insider trading have more volatile stock markets). See also Tomasz P. Wisniewski, *Reexamination of the Link between Insider Trading and Price Efficiency*, 28 ECON. SYSTEMS 209 (2004); Raymond P.H. Fishe & Michel A. Robe, *The Impact of Illegal Insider Trading in Dealer and Specialist Markets: Evidence from a Natural Experiment*, 71 J. FIN. ECON. 461 (2004); Utpal Bhattacharya & Hazem Daouk, *The World Price of Insider Trading*, 57 J. FIN. 75 (2002); Lisa K. Meulbroek, *An Empirical Analysis of Illegal Insider Trading*, 47 J. FIN. 1661 (1992).

¹⁰⁰ Professor Bainbridge used this theory to argue that attorneys should be prohibited from using information attorneys learn from their clients to trade even if the trade is not detrimental to the client. Bainbridge, *supra* note 2.

Armed with these three theories of why insider trading should be illegal: the harm to the corporation itself, the property rights theory, and the fraud in sale theory, it is possible to evaluate the status of the short-selling plaintiff and his attorney.

IV. Analysis of The Short-Selling Plaintiffs' Attorney

The decision in *O'Hagan* and the language in *Dirks* (or *ReBrook* if the Fourth Circuit had adopted the misappropriation theory) makes it clear that attorneys cannot use confidential information gleaned from a client to profit.¹⁰¹ This suggests that the attorneys who sold JC Penney's stock short and the short-sellers who received the information from the attorneys could be liable for insider trading under the misappropriation theory.

An attorney owes the client a duty of confidentiality. Furthermore, the decision of whether to sue in the first place is the quintessential decision that only the client can make. If the client was thinking of suing a defendant, but had not publicly stated so, it would be unethical for the attorney to disclose this fact to anyone.¹⁰² The duty of confidentiality would require that the attorney not disclose any such information, unless the client consents. A psychiatrist, who used the information learnt from his patient, was guilty of insider trading on the misappropriation theory for violating the oath of confidentiality to the patient.¹⁰³ Thus an attorney who uses the information obtained from the client to profitably short-sell the stock of a defendant corporation the client intends on suing should likewise be guilty of insider trading. Furthermore, if the attorney discloses the information to another short-seller, the short-seller is equally guilty of insider trading for misappropriating confidential information.

¹⁰¹ Professor Bainbridge's analysis was done prior to the *O'Hagan* decision, but nonetheless coincides with the outcome that an attorney may not trade on the confidential information obtained from a client. Bainbridge, *supra* note 2.

¹⁰² Model Rules of Professional Conduct, Rule 1.6.

¹⁰³ *United States v. Willis*, 737 F. Supp. 269 (S.D.N.Y. 1990).

The more interesting question is what if the client consents to the attorney using the information?; or for that matter, what if the client is the one short-selling? The present case is unique in that the plaintiff is an outsider who did not receive the information from the corporation, but rather, is the source of the information itself. The answer to this is not clear, at least from an insider trading point of view. The Supreme Court in *O'Hagan* seemed to suggest that if the client has consented, all would be legitimate.¹⁰⁴ Perhaps this is true. But that does not settle the status of the plaintiff who does the short-selling. For if it is legal for the plaintiff to short-sell, then giving permission to the attorney is also legal. If, conversely, it were illegal for the plaintiff to sell short, then giving permission to the attorney would not immunize the transaction.

In the actual cases against those accused of insider trading under the theory of misappropriation, one assumption that the courts have been working under is that the client would have never consented to the misappropriator using the information. This is akin to reconstructing the hypothetical bargain that Professor Bainbridge used to construct the property rights theory of why an attorney should not trade using the client's information. For example, in the *O'Hagan* case, the defendant misappropriated information belonging to the client concerning the client's merger with the firm whose stock the defendant bought. If the client were merging with another firm, the client firm would not want that information to become public since such publicity would lead to large changes in the prices of both firms. Such change could affect the success of the proposed merger. And even though, there might be an instance where a particular acquirer may want or allow someone else to purchase more shares in the target company, *a priori*, all potential acquirers would want to commit to a certain set of rules such as a the lack of secret purchases or premature disclosure before any talks of a merger. In merger talks, it is

¹⁰⁴ Bainbridge, *supra* note 21, at 548.

important that secrecy be maintained, because if the news became public before the deal was finalized, another bidder could come in and successfully outbid the initial company. Deciding what price to offer and what terms to use in the deal requires enormous resources, and once the news of the price and terms of the deal are leaked, a rival acquirer can free-ride on the research of the first acquirer and use that information to make a rival bid without incurring the cost. So while the acquirer may have the temptation to purchase more shares, after the deal is done or is pending, and let its employees and agents such as lawyers purchase more shares (in order to diminish the number of shares that it needs to bid on and to remove more shares from potential rivals), *ex ante*, the acquirer would want to commit to secrecy and non-disclosure of such information. Likewise, the target company would also demand secrecy since it would be looking out for the best interests of its shareholders. It would also want the acquirer to refrain from allowing secret purchases by the acquirer's insiders and misappropriators, so it would probably insist on such terms before entering into any deal. Hence, a hypothetical bargaining scenario can be constructed whereby it makes sense to prevent attorneys such as Mr. O'Hagan from purchasing the stock of his client's target.

Similarly in the psychiatrist case, the patient would not have wanted that information to become public. Patients speak freely to their psychiatrists expecting confidentiality, and needless to say it would be akin to professional betrayal to find out that their psychiatrist had purchased stock with that information. Again, even if a particular client would not mind that their doctor profited using information revealed in their session (perhaps as a means of extra compensation), *a priori*, we could argue that patients would demand that no such information be used.

In the short-selling attorney case, however, a plaintiff who is angry with a company and is about to sue it may not care too much if the news is made public. If anything, the plaintiff may want the price to fall as a pressure tactic to force the defendant to settle, just as in the *Bayer* story discussed above. In such a case any theory that attempts to find liability with a short-selling plaintiff's attorney must also be able to find liability with a short-selling plaintiff. Otherwise, the plaintiff can always consent to the attorney short-selling, since the plaintiff has little incentive to keep the information secret. In the misappropriation examples from the case law, the insider from whom the misappropriator learnt the information did owe some duty of confidentiality stemming from a statutory or legal requirement. In this case, little statutory or legal requirements govern the behavior of plaintiffs. The plaintiff is free to shout in the street "I plan on suing the company", tell his friends, file the suit earlier than planned, or withdraw the suit completely. The bottom line is that unless the attorney short-sells without the permission of the client, little from the classical law of insider trading prohibits the conduct in question, because the plaintiff is free to short-sell and is not necessarily adverse to the attorney doing the same.

V. Analysis of The Short-Selling Plaintiff

My survey of the law has identified two potential rubrics under which the short-selling plaintiff's conduct may fall. These are Regulation FD and fraud and market manipulation including insider trading. In that order I will discuss whether the conduct of the plaintiff can be proscribed.

1. Regulation FD for Plaintiffs and their Lawyers: Will it Help?

Recall that the Washington Legal Foundation has recommended that the SEC enact an equivalent of Regulation FD for plaintiffs' attorneys to require them to disclose any conversations they may have with market analysts. Alternatively, Regulation FD could be expanded to include plaintiffs' attorneys in addition to corporate insiders. The question is whether this proposal can curb the conduct of the short-selling plaintiffs and their attorneys?

The quick answer is no. There are several reasons. First, Regulation FD itself applies only to the issuers of securities and not to the analysts, since it was passed according to the powers granted to it by sections 13(a) and 15(d) of the SEA, among others.¹⁰⁵ Hence, how Regulation FD could apply to trial lawyers communicating with analysts is not clear. The SEC does have the power to regulate investment companies through the Investment Companies Act, so perhaps it is feasible for the SEC to regulate such communications. The trial attorneys and the plaintiffs, however, do not come under the reach of Regulation FD or the statutory provisions. Any extension of Regulation FD, therefore, would have to come from the SEC's general power to regulate the securities market. Furthermore, if the plaintiff or the plaintiff's attorney simply wished to sell the defendant's stock short without any communications with the analysts, Regulation FD or its equivalent for attorneys would have no impact. What is needed is a rule that requires all plaintiffs and their attorneys to disclose their intention to sue before short-selling.

Another problem is that Regulation FD was never meant to be part of the anti-fraud arsenal provided by section 10(b) of the SEA and the corresponding Rule 10b-5,¹⁰⁶ but fraud, or at least the appearance of fraud, is precisely what is going on here. The idea behind Regulation

¹⁰⁵ Scott Russell, Note, *Regulation Fair Disclosure: The Death of Efficient Capital Market Hypothesis and the Birth of Herd Behavior*, 82 BOSTON U.L. REV. 527, 533 (2002).

¹⁰⁶ *Id.*

FD was to provide the whole market with any information disclosed, in order to give everyone the opportunity to digest the information. What the plaintiffs and their attorneys are doing when they short-sell the defendant's stock is to prosper at the expense of shareholders because of an event that they caused exclusively. If there were no lawsuit, there would be no drop in price. Whether this is truly fraud or not, I will leave for a later section, but suffice it to say that Regulation FD was not designed to combat fraud. Again, if the plaintiff sold the defendant's stock short there would be no issue of selective disclosure, and Regulation FD would not apply. Furthermore, it seems that currently a violation of regulation of FD gives no private cause of action.¹⁰⁷ And while some recent SEC enforcement of Regulation FD has resulted in severe penalties, private enforcement of anti-fraud statutes and rules provides extra incentive to monitor the wrongdoers.¹⁰⁸ In fact, one commentator has stated that the "SEC should target the real problem: the trading rather than the disclosure."¹⁰⁹

Hence, what is needed is a rule that prevents market manipulation by the plaintiffs and their attorneys. This means that those SEA provisions and their corresponding rules with respect to fraud are the ones that must be used to combat the problem of the short-selling attorney.

2. Does Short-Selling by the Plaintiff Constitute Market Manipulation and Fraud?

Before discussing general market fraud and manipulation, I will address the status of plaintiffs as insiders. Plaintiffs are not insiders, unless they happen to be officers or directors. They, therefore, owe no fiduciary duties to shareholders or future shareholders. This makes the case of insider trading against the short-selling plaintiff a hard one. But insider trading is only one subsection of the prohibition against fraud in the securities market. The examples of "pump

¹⁰⁷ *Id.*

¹⁰⁸ *Id.*

¹⁰⁹ Russell, *supra* note 105, at 552 (2002).

and dump” and “Cyber-smear” discussed above are also examples of prohibited fraudulent conduct.

The cases of “pump and dump” and “Cyber-smear” all involved an individual who profited after spreading false and misleading stories. A plaintiff who is about to sue a company, will cause the price of the company’s stock to fall, and will consequently be able to profitably short-sell the stock (or whoever sells the stock short based on a tip from the attorney). The question, therefore, is whether the plaintiff is analogous in culpability to the cases above of the short-sellers who spread false stories? On the one hand, at a basic level, the two seem quite similar. The plaintiff causes the price of the stock to fall as do the spreaders of false information. The act of suing a company will cause some fall in the price of the stock, and this fall can be as large as those caused by the short-selling false news spreaders. On the other hand, there is one major difference between the two. The short-sellers spreading the false information are spreading information, while the plaintiff’s attorneys is engaging in an act. Furthermore, the information is false, while the act is true and based on some underlying set of facts. Hence, while there is a superficial analogy between the smearing short-seller and the short-selling plaintiff’s attorney, the analogy breaks down. Had the attorney not sold the stock short, there would be no question regarding the legality of filing the suit; whereas even if the individuals spreading false information had not sold the stock short, the spreading of the false news would still be a criminal act.

Unless there is absolutely no basis for the underlying suit, in which case the attorney risks sanctions by the court, any lawsuit is presumed to have some merit as long as the attorney had some good faith belief in the validity of the suit.¹¹⁰ This means that the underlying act of suing

¹¹⁰ In Texas, for example, to obtain sanctions, the lawsuit must be both frivolous and brought in bad faith. TEX. R. CIV. PROC. 13; GTE Comm. Sys. Corp. v. Tanner, 856 S.W.2d 725, 731 (Tex. 1993).

the company would not be fraudulent. Then again, plaintiffs' attorneys have filed numerous frivolous suits and have escaped any judicial sanctions (such as Rule 11 of the Federal Rules of Civil Procedure).¹¹¹ Do these frivolous non-sanctionable suits indicate that the short-selling plaintiff and the attorney are acting fraudulently? And what of suits that have no merit under current jurisprudence, but the plaintiffs and their attorneys genuinely believe they have a chance of winning? Suppose they sue and short-sell the stock at the same time. Immediate profit from short-selling is certain, and there may be a high probability that the suit will be dismissed. Have they manipulated the market? This is not an easy question to answer. The attorneys acting in good faith did not intend to defraud the market since they genuinely believed the merits of their case. This suggests that perhaps such conduct is not fraudulent.

Furthermore, the variation among states in their standards for when frivolous suits can be sanctioned means that a plaintiff who desires to only lower the price of the stock has to file the lawsuit in the state court of the jurisdiction least hostile to frivolous suits. The manipulative plaintiff does not have to worry about removal to federal court, because the only motive behind the plaintiff's suit is to lower the price of the stock. Once the suit is announced, the plaintiff can profitably settle the short position and withdraw the suit.

A more problematic case arises when an attorney files a lawsuit with a good faith belief in the merits *and* with the intention of causing the price of the stock to fall enabling a profitable short-sale.¹¹² This is a harder case to analyze. Is it fraud to trade the stocks of a corporation with

¹¹¹ For a survey of such provisions, see Byron C. Keeling, *Toward a Balanced Approach to "Frivolous" Litigation: A Critical Review of Federal Rule 11 and State Sanctions Provisions*, 21 PEPP. L. REV. 1067 (1994). See also Jerold S. Solovoy et. al., *Symposium: Happy (?) Birthday Rule 11: Sanctions under Rule 11: A Cross-Circuit Comparison*, 37 LOY. L.A. L. REV. 727 (2004). For a general overview of how lawyers have pushed the frontiers of legal theories, see WALTER OLSON, *THE RULE OF LAWYERS* (2003); KIP VISCUSI, *REGULATION THROUGH LITIGATION* (2002); WALTER OLSON, *THE LITIGATION EXPLOSION* (1991).

¹¹² There is some case law regarding the availability of sanctions for lawsuits that have a legitimate basis in law but that are brought with improper motives. See Barbara C. Kruzansky, *Note: Sanctions for Non-Frivolous Complaints?*

the intent that the price of the stock will fall (or rise for that matter) fraud? If there was a fraudulent act, the answer would be yes. But here there is no fraudulent act. The plaintiff is actually filing a lawsuit, and in my hypothetical the suit has merit.

What if the plaintiff and the attorney do not have a good faith belief in the merits of the case, but are simply suing in order to lower the price of the shares to allow for the profitable short-sale? This is arguably akin to the Terayon scenario. In this case, perhaps the short-selling plaintiff has committed securities fraud. But the reader should note that only where it is clear that there is absolutely no merit legally or factually to the plaintiff's case can there be a definite statement that the short-selling plaintiff has committed fraud. This inquiry, however, would require the court to look at the underlying suit to judge whether the suit was frivolous. Given the lack of sanctions even when the suit seems frivolous, a court trying to decide if the short-selling plaintiff committed fraud would have to either defer to the lack of sanctions or investigate the merits of the original suit. This would be a costly affair. What is needed is a clearer way to either allow or prohibit the plaintiff from selling short the stock of their targets. This, I argue is why plaintiffs should be deemed insiders, even though they do not fit into either the classical insider or the misappropriation model.

VI Other Legal and Economic Considerations for Analysis of Securities Fraud

Having established that a plaintiff is neither an insider nor is committing fraud (in the traditional securities law sense of the word), the other question is whether the short-selling plaintiff is committing fraud under other areas of the law, such as tort law or contract law. It is important to remember that the purpose of securities law is to ensure honest markets where fraud

Sussman v. Bank of Israel and *Implications for the Improper Purpose Prong of Rule 11*, 61 ALB. L. REV. 1359 (1998).

and other deceptive devices are minimized. If what constitutes fraud under the law of torts or contract is being committed, then surely securities law ought to combat it. The short selling plaintiff when selling the security to another purchaser is not an insider (nor has misappropriated the information from an insider), and hence owes no fiduciary duty to the purchaser. The short-selling plaintiff, however, is engaged in a contract for sale, and is therefore subject to the laws of contract and torts.

The law in many states held that insiders did not necessarily have a fiduciary duty to shareholders (or for that matter non-shareholders to whom the insider sold their shares short), and some courts held that unless there was some face-to-face transaction then perhaps a fiduciary duty might arise (a fact that is absent in today's electronic trading environment).¹¹³ Nonetheless, federal insider trading law has proceeded on the assumption that all insiders do owe current and future shareholders fiduciary duties even when the trading is done in an impersonal market.¹¹⁴ Whether this is to combat fraud or to protect the firm's property rights in the information is unclear. Nevertheless, federal law has marched down this path.

If the purpose of federal securities law is to prevent fraud, then the law of torts concerning fraud must be examined to see if non-disclosure by a seller can be considered fraud. Generally speaking, non-disclosure was not considered fraudulent or actionable, as the common law was resistant to mandate all disclosures in sales' contracts, and it is no accident that statutory law has filled that void.¹¹⁵ Nonetheless, there is some support in earlier common law for the requirement to disclose latent defects although nineteenth century common law seemed to favor

¹¹³ Bainbridge, *supra* note 21.

¹¹⁴ Stephen M. Bainbridge, *Incorporating State Law Fiduciary Duties Into The Federal Insider Trading Prohibition*, 52 WASH. & LEE L. REV. 1189 (1995); Stephen M. Bainbridge, *Insider Trading Regulation: The Path Dependent Choice Between Property Rights And Securities Fraud*, 52 S.M.U. L. REV. 1189 (1999).

¹¹⁵ Joseph D. Calamari & Joseph M. Perillo, *THE LAW OF CONTRACTS*, §9.20, at 335 (4th ed. 1998).

the *caveat emptor* approach.¹¹⁶ Modern tort law, however, has recognized that in some instances non-disclosure can be fraudulent. Section 551(1) of the Restatement (Second) of Torts states that

One who fails to disclose to another a fact that he knows may justifiably induce the other to act or refrain from acting in a business transaction is subject to the same liability to the other as though he had represented the nonexistence of the matter that he has failed to disclose, if, but only if, he is under a duty to the other to exercise reasonable care to disclose the matter in question.

The Restatement does not define when the seller is under a duty to disclose, but some illustrations from the case law can help in understanding when the duty to disclose arises.

Consider the case of *Ollerman v. O'Rourke Co., Inc.*,¹¹⁷ where the Supreme Court of Wisconsin held that a plaintiff purchaser of a residential lot, who alleged that the vendor had not disclosed the existence of a hidden well under the land surface, stated a cause of action for intentional misrepresentation even though the vendor simply did not disclose the existence of the well. The Court recognized that the law used to be that for arm's length transactions, there was no duty to disclose. Societal norms, however, the Court observed, dictate that fairness and good faith dealings be weaved into the law. The Court cited approvingly Dean Prosser's observation of a

rather amorphous tendency on the part of most courts toward finding a duty of disclosure in cases where the defendant has special knowledge or means of knowledge not open to the plaintiff and is aware that the plaintiff is acting under a misapprehension as to facts which could be of importance to him, and would probably affect his decision.¹¹⁸

The facts of *Ollerman* and the reasoning cited are quite applicable to the short-selling plaintiff.

An imminent lawsuit that will bring certain harm to the stock being sold short seems a far more relevant fact that should be disclosed than the existence of a well below the land surface.

¹¹⁶ *Id.* at 338. The maxim that "a sound price warrants a sound commodity" while not applied consistently did require that a seller who made a representation and then discovered some facts that were different from those represented was required to update the information to the buyer prior to consummating the transaction. *Id.*

¹¹⁷ 288 N.W.2d 95 (Wis. 1979).

¹¹⁸ *Id.* at 102 (quoting PROSSER, LAW OF TORTS 697 (1971)). See also W. Page Keeton, PROSSER AND KEETON ON TORTS, § 110, at 736-40 (5th ed. 1984).

Reasonable minds may disagree over whether a purchaser would deem the existence of well to be sufficiently important to affect the decision to purchase and the price to pay, but no one would disagree over whether a purchaser of stock would deem information about an impending lawsuit that will lower the stock price to be important.

Consider also the case of *Caldwell v. Pop's Homes, Inc.*¹¹⁹ A purchaser of a mobile home sued the seller who neglected to disclose the fact that the park where the mobile home was located was going to be sold and all mobile homes located there would have to move. The Court of Appeals of Oregon reversed a judgment notwithstanding the verdict after the jury returned a verdict in favor of the purchaser. 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 is interesting to note that the silence was with respect to a future action by a third party, namely the park owner. The Court held that silence with respect to a third party's future action can constitute fraud especially if the silence is motivated by a desire to effectuate a sale that may not have taken place if the information was disclosed. It seems that the Court looked at whether the sale would have taken place had the critical information been disclosed, as opposed to whether disclosure of the information might have affected the price. Since the purchaser wanted to live in the park, he would not have bought the mobile home had he known he would have to move.

The Court also cited several other cases where silence regarding the actions of a third party constituted fraud.¹²⁰ In one case,¹²¹ the court held that when the defendant sold real property, a portion of which was included in condemnation proceedings, and did not disclose this

¹¹⁹ 634 P.2d 471 (Ore. App. 1981).

¹²⁰ *Whitlatch v. Bertagnolli*, 609 P2d 902 (Ore. App. 1980); *Paul v. Kelley*, 599 P2d 1236 (Ore. App. 1979); *Johnson et ux v. Cofer*, 281 P2d 981 (Ore. 1955); *Musgrave et ux v. Lucas et ux*, 238 P2d 780 (Ore. 1951); *Hansen v. Holmberg*, 156 P2d 571 (Ore. 1945).

¹²¹ *Whitlatch*, 609 P2d 902.

information to the plaintiff, the plaintiff had a cause of action. In another case,¹²² the defendant sold a hotel without disclosing that the hotel was about to lose its permit in a few days, and in another case,¹²³ the defendant sold a beer tavern without disclosing that the supply of beer by the brewery supplying the tavern was about to be curtailed. In the latter two cases, the courts held that a cause of action for fraud could be maintained. In all of these cases, silence with respect to a future act by a third party was held to be fraudulent. It seems, therefore, that if the seller were silent about his or her own future action, it would be a fraudulent transaction.¹²⁴

What determines whether silence regarding the seller's future act is fraudulent seems to be whether the purchaser would have actually proceeded with the transaction, or perhaps demanded a much lower price. A purchaser who buys a mobile home with the intention of staying in the park where the home is located would clearly regard the information that the park was about to be sold as crucial to his decision to purchase the home. Similarly, a purchaser who buys a piece of property that is about to be condemned, a hotel that will lose its permit or a beer tavern that will lose some of its beer would consider such information as critical, fundamental, and material to the decision to purchase in the first place.

The economics literature also can provide some insight into when disclosure should be mandated. Professor Hirshleifer provided such insight over thirty years ago,¹²⁵ when he

¹²² Johnson, 281 P2d 981.

¹²³ Hansen, 156 P2d 571.

¹²⁴ See also Solorzano v. First Union Mortgage Co., 2005 WL 415963 (Dist. Ct. App. Fla. 2005) (failure to disclose housing code violation stated claim for fraudulent nondisclosure); Wengert v. Thomas Meyere, Inc., 152 S.W.3d 379 (Mo. Ct. App. 2004) (failure to disclose of existence on lot of severe water drainage problem); Mitchell v. Christensen, 31 P.3d 572 (Utah 2001) (non-disclosure of leaks in swimming pool); Ralston Purina Co. v. McKendrick, 850 S.W.2d 629 (Ct. App. Tex. 1993) (non-disclosure of termination at will provision in dealer contracts). For earlier cases and a very influential article on the development in the law of fraudulent non-disclosure, see W. Page Keeton, *Fraud – Concealment and Non-Disclosure*, 15 TEX. L. REV. 1 (1936).

¹²⁵ Jack Hirshleifer, *The Private and Social Value of Information and the Reward to Inventive Activity*, 61 AM. ECON. REV. 561 (1971). See also Anthony T. Kronman, *Mistake, Disclosure, Information, and the Law of Contracts*, 11 J. LEG. STUD. 1 (1978); Randy E. Barnett, *Rational Bargaining Theory and Contract: Default Rules, Hypothetical Consent, the Duty to Disclose, and Fraud*, 15 HARV. J. L. PUB. POL'Y 783 (1992); JULES COLEMAN, *RISKS AND WRONGS* (1992).

differentiated between “foreknowledge” and “discovery”. Discovery is information that requires investment in time, effort, and other mechanisms to reveal the information that is hidden, while foreknowledge is information that will be revealed eventually with little effort on anyone’s part. The information that comes from discovery is also wealth creating, while the information from foreknowledge is simply wealth re-distributing. Discovery is socially beneficial, so the law should be structured to encourage discovery by creating the right incentives for those who can engage in discovery to do so. In contrast, since foreknowledge is simply information enabling the possessor to re-distribute wealth away from the non-possessors, there are no compelling reasons to encourage acquiring foreknowledge.¹²⁶

Professor Shavell uses this insight to conclude that a seller who possesses foreknowledge should be required to disclose such information to reduce the incentive for wastefully acquiring information that is not wealth creating.¹²⁷ Professor Eisenberg also reaches a similar result whereby he proclaims that “[a]n actor should be required to make disclosure to correct a counterparty's mistaken tacit assumption unless: the actor is a buyer, the information is more than mere foreknowledge,”¹²⁸

Having established that non-disclosure can rise to the level of fraud, the next section will now establish that the short-selling plaintiff is committing fraud as defined by federal securities law.

¹²⁶ An excellent discussion of Hirshleifer and disclosure is found in Melvin A. Eisenberg, *Disclosure in Contract Law*, 91 CAL. L. REV. 1645 (2003).

¹²⁷ Steven Shavell, *Acquisition and Disclosure of Information Prior to Sale*, 25 RAND. J. ECON. 20 (1994).

¹²⁸ Eisenberg, *supra* note 126 at 1687. Even Professor Randy Barnett who argues against mandatory disclosure does so only for “extrinsic” information. Barnett, *supra* note 125 at 795.

VII. Is the Short-Selling Plaintiff Committing Fraud?

It remains necessary, in the present case, to establish that the plaintiff owed a duty of confidentiality to the shareholders of the defendant corporation since the plaintiff is not an insider in any traditional sense of the word. Cases dealing with “misappropriation” usually involve a lawyer, investment banker or another agent of an insider who is involved with the corporation. But could a plaintiff be considered a quasi-insider? Recall that quasi-insiders are those who possess non-public information obtained from a source outside the corporation that may affect the price of the stock. The plaintiff has not obtained any information from anywhere; rather, the plaintiff is the source of the information. The plaintiff is the cause of the information and as such owes the shareholders no fiduciary duty (unless perhaps the plaintiff was a shareholder). For this reason, unless the attorney was the one selling the stock short without the consent or knowledge of the client, it is hard to make a case against the attorney.

Therefore, there needs, to be a special category for the short-selling plaintiff and the attorney. They need to be deemed constructive or temporary insiders at least until news of the lawsuit is made public. Otherwise a perverse situation exists. No one can make a misleading statement regarding a company whose stock they sell short, but instead they can short-sell the stock of a company and then sue the company causing the price of its stock to fall. Fraudulent columnists and analysts as well as the cyber-smearers would simply need a lawyer and a broker to carry out what is otherwise forbidden.

With this potential mischief in mind, one should also bear in mind that the Supreme Court has been very flexible in interpreting section 10(b) in order to “effectuate its remedial purposes.”¹²⁹ This is because “[a]mong Congress’ objectives in passing the Act was to ensure honest securities markets and thereby promote investor confidence” after the market crash of

¹²⁹ SEC v. Zanford, 535 U.S. 813 (2002)

1929. More generally, Congress sought “to substitute a philosophy of full disclosure for the philosophy of *caveat emptor* and thus to achieve a high standard of business ethics in the securities industry.”¹³⁰ This analysis is similar to the Supreme Court of Wisconsin’s analysis in *Ollerman*,¹³¹ where is decided to replace the traditional common law rule of no duty to disclose with a rule requiring disclosure when the information concealed was material to the transaction.

Similarly, in the case of *Zweig v. Hearst Corp.*¹³² the court looked at the need for honest markets when holding a journalist liable for insider trading.¹³³ Shareholders who purchase shares from the short-selling plaintiff do so with the belief that the market is honest and free of manipulation. While it is true that anyone buying a share does so with a certain assumption of risk to follow, no shareholder would purchase a share from someone who is about to be the cause of the demise of their shares’ value immediately after the trade is consummated. It would be akin to a terrorist or a saboteur who intends on destroying the company’s assets short-selling the company’s shares just before carrying out his actions. No purchaser would ever consent to such a trade. While the plaintiff would not traditionally owe any fiduciary duty to those whom he sold the shares to, nonetheless, just as the courts have imposed a duty on insiders (who did not traditionally owe any duties to purchasers) to abstain from short-selling based on insider information, so should the courts prohibit plaintiffs from similar transactions. Those courts that have found for plaintiffs under the theory of fraudulent non-disclosure would probably find against the short-selling plaintiff. And just as the federal courts did not pay attention to the variations among states with respect to their laws of whether insider owed shareholders fiduciary duties precluding them from insider trading, so should the federal courts pay attention to the

¹³⁰ *Id.* (citations omitted) (emphasis in original).

¹³¹ See text associated with note 117 *supra*.

¹³² 594 F.2d 1261 (9th Cir.1979).

¹³³ See text associated with note 72 *supra*.

underlying aim of preventing fraud regardless of any variation among states with respect to the law of fraudulent non-disclosure.

The short-selling plaintiffs are in a similar position to Mr. O'Hagan when the Supreme Court held that "[t]he misappropriation theory is thus designed to 'protec[t] the integrity of the securities markets against abuses by 'outsiders' to a corporation who have access to confidential information that will affect th[e] corporation's security price when revealed, but who owe no fiduciary or other duty to that corporation's shareholders.'"¹³⁴ Here the plaintiff is the outsider who does not owe any fiduciary duty to the shareholders, but who has confidential information, namely the intent to sue, that will adversely affect the stock price when revealed.

Using Professor Bainbridge's property hypothetical bargain metaphor can also be helpful in the analysis. The question is would someone purchase shares from an insider who had some certain and relevant information about the diminution in the value of the shares, especially if the source of the diminution is an imminent act by the seller? The answer is no. The reader should note that there is a difference between someone purchasing an item that may or may not depreciate in value due to uncertainty on both sides of the transaction. This is typical in the sale of goods and shares in the marketplace. There is a difference, however, between someone who purchases a diamond from a dealer at current market price where both sides do not have a certain view of where the price will be tomorrow and someone who purchases a diamond from a dealer where the dealer knows that the item is not a real diamond but rather a fake. In the former, the contract of sale has allocated the risk of price fluctuation on the parties (the purchaser buys the upside potential while seller buys the security against the downside risk), while in the latter there is fraudulent misrepresentation. A purchaser who purchased an item under fraudulent circumstances would be entitled to elect from a host of remedies including rescission, the benefit

¹³⁴ 521 U.S. at 653.

of the bargain damages, and restitution. Restitution, which is the disgorgement of the gain to the wrongdoer, is the normal remedy in many fraudulent misrepresentation cases.

In the case of the terrorist short-selling stock, the purchaser would never have consented to such a purchase had he known that the seller was about to devalue the stock. Similarly, the purchaser of shares from a plaintiff who will soon sue the company would never have entered into such a transaction.

It seems intuitive, that a purchaser buying shares from a plaintiff who short-sells the stock of a company that he or she is about to sue, would consider information regarding the potential lawsuit as critical. While everyone who buys a stock takes on the risk of a drop in its price, no one would purchase shares in a company that is about to be sued by the seller. Such a drop in price is almost certain, and as some of the studies I cited at the beginning of the paper show, the drop can be substantial. In fact, the short-selling plaintiff would only short sell if he or she thought that there would be a substantial drop in the price. Hence, it is almost tautological that a purchaser would never buy stock from a short-selling plaintiff.

In addition to justifying restitution against the short-selling plaintiff on the grounds of fraud, the target corporation should be able to assert restitution (especially if the purchasers of the stock do not) on the grounds that the plaintiff suing the company owes the shareholders generally a duty of no double recovery. This is not a duty in the typical sense of the word, but rather it is a principle from the law of remedies. The courts have always been careful to fashion remedies both legal and equitable that avoid double recovery. A plaintiff who sues a company and short sells the stock at the same time will be enriching himself twice.

To see this, consider the following example. Suppose the plaintiff has a 100% certain claim of \$1,000,000 against a company, and suppose the market correctly assesses the

probability and magnitude of the suit. At the moment of the suit's announcement, the market value of the firm should fall at least by \$1,000,000. If the plaintiff were able to short-sell every share, or more likely a fraction of the shares, then the plaintiff would have profited by \$1,000,000 or the fraction thereof. The plaintiff will recover the full \$1,000,000 from the lawsuit, and now will also recover the extra amount reflecting the market's assessment that the firm will be losing the million dollars. The plaintiff has recovered twice from the same event.

Generally speaking, where such double recovery takes place, the defendant is usually entitled to restitution. Restitution is a remedy for an unjust enrichment, which is exactly what the plaintiff has experienced: an unjust enrichment at the expense of the shareholders to whom he sold the shares. The shareholder will not only have to bear the pro-rata cost of paying the plaintiff his claim, the plaintiff is recovering twice after misrepresenting the sale to the purchaser.

There are three factors combined that make the case for deeming a plaintiff a constructive insider. The first is the fact that the plaintiff can manipulate the price of the shares by timing the announcement of the lawsuit. The second is that the shareholder who purchased the shares would never have done so if aware of an impending suit, and could make the case for rescission on the grounds of fraudulent misrepresentation. Third, the plaintiff who sues will be recovering twice if allowed to profitably short-sell the defendant's stock. These three factors suggest that the public policy reasons are very strong in this situation, and demand that plaintiffs and their attorneys refrain from trading until they announce their suit or the intention of launching it.

Furthermore, just as the empirical evidence on insider trading revealed more volatility and perhaps less liquidity in markets where insider trading is permitted, allowing plaintiffs to short-sell their targets would also create mistrust and inefficiency in the market. Purchasers

would be leery of shares in companies who could be potential targets of lawsuits, not just because the company might be sued, but because the seller could be the very person who will sue immediately after the sale takes place.

The law and economics research of Shavell and Eisenberg also lends support to the argument for deeming the short-selling plaintiff an insider. The act of suing is mere foreknowledge, not discoverable information. In fact, allowing the plaintiff to short-sell allows double recovery and thereby creates an overincentive for the plaintiff to sue. The arguments in favor of insider trading, namely providing insiders with the incentive to discover valuable information for the firm, do not hold here. The result, if the plaintiff were allowed to short-sell, would be for more lawsuits and short-selling.¹³⁵

For all of these reasons, the plaintiff should be deemed a temporary insider until the decision to sue is made public either by the filing itself or by an announcement of the intention to sue. The next question, therefore, is what path can the law take to achieving this desired result?

If the courts deem the plaintiffs as constructive or deemed insiders, the courts could take the approach they have taken with respect Rule 10b5-1. If the courts adopt the “possession” theory of insider trading, i.e. that trading while in possession of non-public material information is enough for insider trading liability, then a potential plaintiff who sells a defendant corporation’s stock short and then sues may be liable under this theory of liability. All plaintiffs would be required to abstain from short-selling the defendant corporation, which would mean that short-sellers who decided to sue after executing a short sale would be prohibited from suing no matter how legitimate the suit. On the other hand, if the “use” theory prevails, then by analogy only plaintiffs who short-sell and then sue in order to profit will be liable. Incidental

¹³⁵ Even Barnett’s argument against mandatory disclosure in sales was only for extrinsic information. *See* note 128 *supra*. Here, the plaintiff’s decision to sue is not extrinsic information; it is an endogenous decision that is motivating the sale itself.

plaintiffs, i.e. those who were short in the market and then decided to sue for other reasons, would be exempt from liability. Examples of these incidental plaintiffs include short-sellers who suddenly develop a legitimate dispute with the corporation such as a breach of contract or a tort claim. For example, a short-seller may be using a drug manufactured by a company in which he maintains a short position in without even knowing that the company is the manufacturer. If the drug were to harm the short-seller, then under this scenario, the short-seller would be permitted to sue. The suit is motivated by actual recovery rather than a profit from the short sales. Under the “possession” theory, if applied to plaintiffs, the short-seller in the hypothetical would be prohibited from suing, unless he cancelled his short position.¹³⁶

Not to prohibit plaintiffs and their attorneys from trading their target’s stock would yield perverse results. Instead of the Cardinal group spreading the bad news about Terayon to force its price to drop, all they would have to do is simply sue for any plausible cause of action. Instead of Jonathan Lebed or Jakob spreading false rumors in their “pump and dump” or “dump and smear” schemes, all they would have to do is sue the firms after short-selling their stock. They could have sued the company after executing a short sale, then re-purchased the stock cheaply followed by announcing the withdrawal of the suit prompting a profitable rise in price of the stock.

The result must be, therefore, that all plaintiffs are deemed insiders before they sue or announce their lawsuit to the public. If the courts do not wish to extend the laws covering fraud and insider trading to plaintiffs, then either the SEC through its regulatory promulgations or Congress through legislation should act.

¹³⁶ Implicit in this paper is that suits that have a *de minimus* impact on the value of the firm would be permitted by short sellers. Examples of such suits could include small-claims lawsuits.

VIII. What the Law should be and Concluding Thoughts

If the courts decline to adopt the view that plaintiffs are insiders until they announce their intention to sue or actually commence the suit, then the door is open for the SEC or Congress to act. Whatever arguments might exist in favor of insider trading generally, they do not apply here; all of the arguments against insider trading, however, are applicable. Therefore, plaintiffs and their attorneys should not be allowed to trade in the stocks of their targets and by extension anyone who receives such information from either of the parties should also be prohibited from trading.