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Funder, Short-Seller Use Undermines Securities Class Actions

By **Nessim Mezrahi** (August 24, 2020, 3:00 PM EDT)

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Two factors in the securities class action arena are exacerbating the potential for conflicts of interest: the use of and reliance on activist short-seller reports as a basis to initiate securities class action claims, and privileged third-party litigation funding agreements.

These two seemingly distinct factors are related due to their potential to breed systemic conflicts of interest that inhibit the effective private enforcement of our federal securities laws if they are left to proliferate without warranted judicial scrutiny.

First, securities class action plaintiffs attorneys have been hooked by activist short-sellers, whose singular objective is to earn above-market returns through the dissemination of financially incentivized research that drives the decline in stock price of U.S.-listed corporations. Second, the explosive growth of third-party litigation funding is luring class action litigators that have not earned their war chests organically through hard-fought litigation.

Both factors have negative implications for the private securities fraud deterrence regime because they undermine the just pursuit of justice by enabling plaintiffs lawyers to prioritize the objectives of nonlawyers that place capital at risk.

Neither activist short-sellers nor third-party litigation funders have an interest in the pursuit of justice to ensure that allegedly defrauded shareholders attain monetary recompense through the class action recovery process. Nor do they care about the business interruption or reputational costs of our publicly traded corporations and the women and men that are leading these enterprises through the most challenging business environment in over half a century.

Activist short-sellers intentionally deploy market-driving forces that can materially affect a U.S.-listed corporation's market capitalization regardless of whether their published information is factually correct. The decline in stock price that ensues from the purposeful dissemination of negative information by activist short-sellers has captured the attention of aggressive plaintiffs attorneys that seek to initiate class actions for alleged violations of the Securities Exchange Act.

For example, in the 2015 case Harris v. Amtrust Financial Services Inc. in the U.S. District Court for the Southern District of New York, the plaintiffs failed to pursue such claims against Amtrust, by "[r]elying

almost entirely on a negative report published by a short seller that Lead Plaintiff concedes may have been wrong in certain respects and has been proven wrong in others by the passage of time."[1]

According to a recent report by Goodwin Procter LLP, "[m]ost of the securities class action matters brought against these companies focus on disclosures related to operations, transactions, financial guidance, or financial restatements and internal controls. Notably, several of the lawsuits followed purported exposé reports published by activist short-seller stockholders."[2]

Short-seller reports that ignite a company-specific sell-off presents low-hanging fruit for plaintiffs lawyers that seek to pitch institutional investors with minimal investigative efforts and resource outlays. The alignment of activist short-sellers and plaintiff securities class action attorneys is an unintended association that facilitates the increase in frequency of claims that allege violations of the Exchange Act at the expense of directors and officers of U.S.-listed corporations and their insurers.

Last month, the U.S. District Court for the Northern District of California tackled this issue in a securities class action claim against a biopharmaceutical company and concluded that the short-seller report did not sufficiently support the plaintiffs' allegations of falsity by certain directors and officers.

In In re: Nektar Therapeutics, the plaintiffs have so far failed to justify adequate reliance on a short-seller report to substantiate allegations of fraud on the market. The court concluded that because the short-sellers prepared the report based on publicly available data that was already known to participants in the market, the disseminated information could not constitute corrective information that rectified allegedly materially misleading statements or omissions. The court's order granting the defendant's motion to dismiss stated:

> Importantly, however, Plainview indicated that the report was prepared with publicly available data.[3] Thus, the Report cannot constitute new information unknown to the market. Instead, "the mere repackaging of already-public information by an analyst or short-seller is simply insufficient to constitute a corrective disclosure."[4]

U.S. District Judge Haywood S. Gilliam Jr. followed related guidance from the U.S. Court of Appeals for the Second Circuit and the U.S. Court of Appeals for the Eleventh Circuit by concluding that the plaintiffs failed to support that the short-seller report corroborates their allegations of falsity because of "Plainview's [the short-seller] disclosures detailing that it stood to benefit from a poor performance in Nektar's stock price and the lack of any information establishing why Plainview's opinions on the highly-technical matters at issue here are reliable."[5]

Increased reliance on activist short-seller reports by securities class action plaintiffs attorneys presents a systemic conflict of interest that may in fact lead to meritless class action claims at the expense of directors and officers of U.S.-listed corporations. The Northern District of California's position on the matter has been documented in the order granting defendants' motion to dismiss:

> As the Eleventh Circuit aptly observed, "If every analyst or short-seller's opinion based on already-public information could form the basis for a corrective disclosure, then every investor who suffers a loss in the financial markets could sue under § 10(b) using an analyst's negative analysis of public filings as a corrective disclosure. That cannot be—nor is it—the law." Meyer, 710 F.3d at 1199.[6]

The materialization of stock drop declines in U.S.-listed companies places activist short-sellers and investors' counsel with similarly situated incentives that can blur the line between the entrepreneurial deterrence of corporate fraud and opportunistic class action litigation that credits biased research with

unvalidated allegations of potential fraud on the market.

The federal judiciary's source of reluctance to accept activist short-seller reports as valid support for allegations of fraud on the market, due to the inherent conflict of interest in the practice, is noteworthy to further examine the use and disclosure of third-party litigation funding arrangements by securities class action plaintiffs attorneys. Economic reliance on third-party litigation funders by attorneys that operate on a contingent remuneration model raises ethical issues related to professional judgement and conflicts of interest.

According to the American Bar Association's Commission on Ethics 20/20, Informational Report to the House of Delegates, third-party litigation funding "has the potential to interfere with the lawyer's exercise of candid, objective, independent judgment on behalf of the client."[7] This month, the ABA published their best practices for third party-litigation funding and emphasized the need for transparency and disclosure in securities class actions:

> There will be situations, particularly in securities or consumer class actions, where a sophisticated lawyer will work with a funder. The existence of these relationships is required to be disclosed in some jurisdictions and would likely need to be disclosed in others in order for the funder to be paid by a Settlement Administrator. For example, class action funding arrangements are required to be disclosed by Standing Order of all judges in the United States District Court for the Northern District of California.[8]

The financial success of sophisticated securities class action plaintiffs attorneys is accepted and endorsed by our legal system, not only because of the specialized legal acumen, reputation, and time that these complex matters require — but because the attorneys themselves fund the litigation from their own pocketbook. Inside the securities class action arena, respected litigators put their own money behind the allegations and their tolerance for high risk supports the lucrative contingency fee remuneration structure.

This delicate and well-established compensation model of the securities class action mechanism may be subject to question with the opaque and unregulated infiltration of third-party litigation funding arrangements. According to attorneys at Butler Snow LLP, "[i]ndisputably, third-party funding changes litigation. The question remains: how? And the only way to answer that question is through increased transparency during discovery."[9]

The unchecked and opaque adoption of third-party litigation funding arrangements by securities class action plaintiffs attorneys may alter the high-risk, high-reward remuneration structure of the class action mechanism in America. It boils down to simple economics: By increasing the supply of funding through unaffiliated third parties, investors' counsel effectively opt to share the financial burden and as a result, not only do they lower their own risk but also give up measurable control in their pursuit of justice.

The greater problem of third-party litigation funding by securities class action counsel that operate on contingency is the potential for conflicting recovery interests between allegedly defrauded shareholders and third-party litigation funding entities. According to the American Bar Association, third-party litigation funders have the same incentives as activist short-sellers and hedge funds:

> ALF [third-party litigation funders] are businesses, operated with the goal of maximizing return on investments. The investments are in legal claims, acquired in whole or in part. The interests of a supplier in any given transaction, therefore, will be to maximize the expected value of a legal claim.

> In order to protect their investments and to maximize the expected value of claims, suppliers may seek to exercise some measure of control over the litigation, including the identity of lawyers pursing the claims, litigation strategy to be employed, and whether to accept a settlement offer or refuse it and continue to trial. The efforts of suppliers to maximize the return on their investment may create incentives and effects that differ from what would be expected in a similar case in which ALF funding was not present.[10]

According to Westfleet Advisors, there are 41 commercial third-party litigation funders managing about $9.5 billion in assets whose returns are based on legal outcomes.[11] The Westfleet Advisors report features Bench Walk Advisors, a leading third-party litigation funder that was founded by two deans of the plaintiff securities class action bar. According to their website, Bench Walk Advisors offers funding services to "law firms that do not operate on a contingency model."[12]

According to a recently published report by Allianz, "[f]or the third year in a row, there were more than 400 new U.S. federal securities class actions in 2018/19 (428 – the highest on record), fueled by a high number of claims under the Securities Act of 1933, core filings against non-U.S. issuers, event-driven actions filed by plaintiff law firms and, possibly, the increased use of litigation funding."[13]

According to the U.S. Chamber Institute for Legal Reform, "[a]llowing TPLF [third-party litigation funding] to fester in the class action setting will not only reduce the downside risk to mounting frivolous class actions, but also guarantee that such proceedings deliver even less money for the actual class members."[14]

Unchecked reliance on activist short-seller reports and opaque third-party litigation arrangements by investors' counsel will affect the just pursuit of justice in securities class action litigation. Reliance on both without judicial scrutiny will not only increase the frequency of potentially meritless claims that drive up the costs of defending them but will also constrict monetary recompense due to allegedly damaged shareholders.

The short-term expense of institutionalizing transparency in the burgeoning class action regime will pay for the long-term benefits of stability and certainty, of which we are all in dire need.

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[1] In re: Harris v. Amtrust Financial Services, Inc. et al, Case No. 1:14-cv-00736.

[2] "Update on Securities Litigation Against Cannabis Companies," April 23, 2020, Goodwin Procter, LLP https://www.goodwinlaw.com/files/PracticeReports/Cannabis-2020-YIR/flipbook/index.html?page=1.

[3] See Dkt. No. 66-19 (Ex. 18) at 2 (acknowledging that the information in the Report "is based upon selected public market data.").

[4] In re: Nektar Therapeutics, Case No. 18-cv-06607, Order Granting Defendant's Motion to Dismiss

[5] Id.

[6] Id.

[7] American Bar Association, Commission on Ethics 20/20, Informational Report to the House of Delegates, Pg. 22

https://www.americanbar.org/groups/professional_responsibility/committees_commissions/standingcommitteeonprofessionalism2/resources/ethics2020hompeage/.

[8] American Bar Association, Best Practices for Third-Party Litigation Funding, dated August 2020 (111A). Pg. 6.

https://www.americanbar.org/content/dam/aba/administrative/news/2020/08/2020-am-resolutions/111a.pdf.

[9] "Discoverability of Third-Party Litigation Financing," Katelyn Ashton, Luther Munford, Butler Snow LLP.

[10] American Bar Association, Commission on Ethics 20/20, Informational Report to the House of Delegates, Pg. 22.

[11] Litigation Finance Buyer's Guide, Charles Agee and Gretchen Lowe, Westfleet Advisors, January 30, 2020. https://advantage.westfleetadvisors.com/litigation-finance-buyers-guide.

[12] Bench Walk Advisors. https://benchwalk.com/litigation-finance/who-what-and-why/.

[13] "Collective Actions and Litigation Funding and the Impact on Securities Claims: A Global Snapshot," July 10, 2020, Allianz Global Corporate & Specialty SE https://www.agcs.allianz.com/content/dam/onemarketing/agcs/agcs/reports/AGCS-Collective-Actions-Litigation-Funding.pdf.

[14] "Selling More Lawsuits, Buying More Trouble: Third Party Litigation Funding a Decade Later," U.S. Chamber of Commerce, Institute for Legal Reform, January 2020.