Pleading loss causation based on short-seller reports

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In fraud-on-the-market cases, plaintiffs must point to a "corrective disclosure" in order to plead and prove that (1) "the truth became known," and (2) the revelation caused the fraud-induced inflation in the stock's price to be reduced or eliminated, which plaintiffs are then unable to recuperate. *Dura Pharms., Inc. v. Broudo*, 544 U.S. 336, 347 (2005). A recent analysis of securities fraud complaints indicates that in 2021, "about 14% of plaintiffs' alleged corrective disclosures rel[ied] on stock price declines linked to short-seller reports." Nessim Mezrahi et al., "More Securities Class Actions May Rely On Short-Seller Data," Law360 (Jan. 10, 2022).

The question that arises is when (if ever) should courts consider short-seller reports as corrective disclosures sufficient to plead loss causation?

Short-sellers "operate by speculating that the price of a security will decrease," and thus courts have recognized that they "have an obvious motive to exaggerate the infirmities of the securities in which they speculate." *Long Miao v. Fanhua, Inc.*, 442 F. Supp. 3d 774, 801 (S.D.N.Y. 2020) (citation omitted). Perhaps unsurprisingly then, although some of the short-seller reports resulted in a statistically significant single-day residual stock price decline, according to the Law360 analysis, "about 38% of stock drops driven by short-sellers [did] not exhibit back-end price impact" at all — suggesting that the short-seller report did not reveal any new information to the market or that the information was not viewed as material. *See* Mezrahi, *supra*.

The question that arises is when (if ever) should courts consider short-seller reports as corrective disclosures sufficient to plead loss causation?

Historically, circuit court decisions have shaped the working limitations of what can constitute a corrective disclosure. First, corrective disclosures may come from a variety of different sources: defendants, government agencies, whistleblowers, analysts, investigative reporters, or other knowledgeable third parties. *See, e.g., Metzler Inv. GMBH v. Corinthian Colls., Inc.*, 540 F.3d 1049, 1064 (9th Cir. 2008); *Norfolk Cnty. Ret. Sys. v. Cmty. Health Sys., Inc.*, 877 F.3d 687, 695 (6th Cir. 2017); *Pub. Emps.' Ret. Sys. of Miss. v. Amedisys, Inc.*, 769 F.3d 313, 322 (5th Cir. 2014).

However, "the commencement of an SEC investigation, without more, is insufficient to constitute a corrective disclosure." *Loos v. Immersion Corp.*, 762 F.3d 880, 890 (9th Cir. 2014) (quoting *Meyer v. Greene*, 710 F.3d 1189, 1201 (11th Cir. 2013)), as amended (Sept. 11, 2014).

Second, a corrective disclosure may come through a series of partial disclosures. *See, e.g., Pub. Emps.' Ret. Sys. of Miss.*, 769 F.3d at 322; *In re Williams Sec. Litig.-WCF Subclass*, 558 F.3d 1130, 1137-38 (10th Cir. 2009). That said, a disclosure generally is not considered "corrective" if it contains information entirely derived from publicly available sources of which an efficient market is presumably aware. *Loos*, 762 F.3d at 889.

Recently, in I*n re BofI Holding, Inc. Securities Litigation*, the 9th U.S. Circuit Court of Appeals provided a two-step framework for addressing whether blog posts written by a short-seller on the website "Seeking Alpha" could serve as a corrective disclosure. 977 F.3d 781, 794-97 (9th Cir. 2020), *cert. denied*, 142 S. Ct. 71 (2021). In Step One, the court addressed whether the report contained "new information." Each of the blog posts asserted that the information disclosed was derived from publicly available sources.

The 9th Circuit determined that "[a] disclosure based on publicly available information can…constitute a corrective disclosure" when the plaintiff is able to "plead with particularity facts plausibly explaining why the information was not yet reflected in the company's stock price," interpreting this to mean that shareholders needed to allege particularized facts that market participants had not — *not could not have* — done the same analysis. *Id.* at 794-95.

In Step Two, the 9th Circuit considered several factors to determine that "[a] reasonable investor reading these posts would likely have taken their contents with a healthy grain of salt." *In re BofI*, 977 F.3d at 797. The more anonymous the source of the report, the harder it is for plaintiffs to characterize it as a corrective disclosure. *See id.; see also In re Nektar Therapeutics Sec. Litig.*, 34 F.4th 828 (9th Cir. 2022) (denying anonymous, short-seller reports for corrective disclosure); *In re LexinFintech Holdings Ltd. Sec. Litig.*, No. 3:20-cv-1562-SI, 2021 WL 5530949 (D. Or. Nov. 24, 2021) (weighing anonymity against being corrective disclosure);

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cf. Hurst v. Enphase Energy, Inc., No. 20-cv-04036-BLF, 2021 WL 3633837 (N.D. Cal. Aug. 17, 2021) (finding short-seller reports that were not anonymous could constitute corrective disclosures).

Further, the self-serving nature of reports from short-sellers with a "financial incentive" discourages some courts from finding them to be corrective disclosures. *In re BofI*, 977 F.3d at 797; *In re Nektar*, 34 F.4th at 828; *Jedrzejczyk v. Skillz Inc.*, No. 21-cv-03450-RS, 2022 WL 2441563 (N.D. Cal. July 5, 2022). Finally, any disclaimers on the accuracy or completeness of the information contained in the reports cast doubt on its legitimacy as a corrective disclosure. *See Garcia v. J2 Glob., Inc*, 2021 WL 1558331 (C.D. Cal. Mar. 5, 2021); *In re Nektar*, 34 F.4th at 828; *In re LexinFintech*, 2021 WL 5530949, at *15 (noting that the reports contained a broad disclaimer on every page that states all statements therein were opinions).

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Following *In re BofI*, several decisions in the 9th Circuit have applied the *BofI* framework, concluding in some cases that the short-seller reports did not act as corrective disclosures either because they did not pass Step One's requirement of nonpublic information or Step Two's reliability considerations. *See, e.g., Grigsby v. BofI Holding, Inc.*, 979 F.3d 1198 (9th Cir. 2020) (holding the short-seller report was not a corrective disclosure because its analysis required no expertise beyond what a typical market participant would possess and could not pass Step One); *In re Nektar*, 34 F.4th at 840 (finding the anonymous short-seller report with disclaimers could plausibly provide new information but failed Step Two's factors); *In re LexinFintech*, 2021 WL 5530949, at *15 (same).

In other cases, courts have concluded that the plaintiff adequately alleged a corrective disclosure on the grounds that the report contained complex analyses and specialized research providing insights that plaintiffs adequately alleged to be new information. *See, e.g., In re QuantumScape Sec. Class Action Litig.*, 580 F. Supp. 3d 714, 732 (N.D. Cal. 2022); *Garcia v. J2 Glob., Inc.*, No. 2:20-cv-06096-FLA (MAAx), 2021 WL 1558331, at *22 (C.D. Cal. Mar. 5, 2021).

The *BofI* framework places the 9th Circuit on the spectrum of approaches to determining whether a report that does not disclose non-public information can be a corrective disclosure. For example, the 2nd and 11th Circuits have adopted bright-line rules, holding that "a corrective disclosure obviously must disclose nonpublic information." *Meyer*, 710 F.3d at 1198 (rejecting a short-seller report as corrective disclosure for failure to disclose nonpublic information); *see also In re Omnicom Grp., Inc. Sec. Litig.*, 597 F.3d 501, 512 (2d Cir. 2010) (holding a "negative characterization of already public information" cannot constitute a corrective disclosure); *Zhong Zheng v. Pingtan Marine Enter. Ltd.*, 379 F. Supp. 3d 164, 177 (E.D.N.Y. 2019) (applying *Omnicom* to hold that a short-seller report was not a corrective disclosure).

The 9th Circuit allows repackaging of public information in short-seller reports to constitute a corrective disclosure in very limited circumstances, and on the other end of the spectrum lies the 10th Circuit, which has not yet squarely addressed the issue. *See In re PolarityTE, Inc., Sec. Litig.*, No. 2:18-CV-00510, 2020 WL 6873798, at *6 (D. Utah Nov. 22, 2020) ("Although the Tenth Circuit appears not to have squarely addressed the issue, various other circuits have held that a corrective disclosure must disclose nonpublic information.").

It is worth noting that, regardless of whether a report is considered a corrective disclosure, previously disclosed information can be grounds for a "truth on the market" defense, in which the defendant "may rebut the presumption that its [alleged] misrepresentations have affected the market price of its stock by showing that the truth of the matter was already known." *Ganino v. Citizens Utilities Co.*, 228 F.3d 154, 167 (2d Cir. 2000).

To the extent short-seller reports continue to play a role in new securities fraud filings, case law will continue to develop in response to the unique issues these cases may present. Also, as indicated, circuits may take differing views on these issues, highlighting the need for careful consideration and informed counsel.

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