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Securities fraud plaintiffs rely on short seller reports at their peril

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Allegations drawn from short seller reports have become a recurring and prominent feature of putative federal securities fraud class action complaints. By one count, more than 20% of securities class action complaints filed in 2021 relied on short seller research.[1] Some plaintiffs rely almost exclusively on short seller analysis. They do so at their peril.

A. Short sellers and short seller reports

Short sellers predict that a security will decline in value and "short" the security — *i.e.*, they sell borrowed stock with the hopes of buying it back at a lower price in the future. Certain short sellers do not merely wait for a stock price to decline after placing their short bets.

Instead, they take matters into their own hands, preparing and publishing purported "research" reports detailing their rationales for expecting a stock price decline in the hopes of triggering or accelerating a market reaction.

B. Short seller reports and pleading fraud: The *DraftKings* decision

As courts have held, allegations drawn from short seller reports generally cannot, standing alone, support a claim for federal securities fraud. That is true not only because of the bias inherent in short sellers' analyses but also because the assertions contained in short seller reports are often (i) insufficiently specific to satisfy the heightened pleading standard applicable to claims for federal securities fraud and (ii) unverified by plaintiffs' counsel.

The recent decision in *In re DraftKings Inc. Securities Litigation*, No. 21 Civ. 5739 (PAE), 2023 WL 145591 (S.D.N.Y. Jan. 10, 2023), illustrates the point.

DraftKings is a fantasy sports, sports entertainment and sports betting company that became publicly traded through a three-way business combination with a special purpose acquisition company (SPAC) and SBTech (Global) Limited.

The complaint in *DraftKings* alleged that SBTech, which DraftKings acquired as part of the business combination, secretly operated in "black-market" jurisdictions — *i.e.*, markets in which gambling was illegal. The complaint further alleged that DraftKings concealed this conduct from investors, thus artificially inflating the company's stock price in violation of the securities laws.

The plaintiffs based their allegations supporting this alleged misconduct almost entirely on a report by aptly named short seller Hindenburg Research. The court held that this reliance was a fatal defect mandating dismissal. As Judge Engelmayer explained:

> [A]t the threshold, it is important to note a global deficiency spanning the SAC's theories of fraud. The SAC's claims as to SBTech's business practices are virtually entirely based on the Hindenburg Report, which in turn was largely based on unsourced or anonymously sourced allegations.

The SAC's threadbare sourcing and the conclusory quality of these factual allegations and attributions are ultimately fatal to all of its § 10(b) or § 20(a) claims, whether based on DraftKings's statements about its compliance with law or its failure to disclose SBTech's ostensible black-market activity and revenues.

Some courts have expressly observed that "[a]llegations concerning … unnamed confidential sources of damaging information require a heavy discount."

In arriving at this conclusion, Judge Engelmayer applied the well-established framework that courts have implemented to test "confidential" witness statements in securities fraud and other complaints.

1. Inherent unreliability of confidential witness allegations

As a preliminary matter, Judge Engelmayer noted in *DraftKings* that short seller accounts "must be considered with caution" given that short sellers have "an economic interest in driving down the company's stock price."

This caution is all the more warranted where a short seller report in turn relies on unsourced witness statements, as was the case in the Hindenburg Report at the heart of the *DraftKings* complaint. Courts have long recognized the inherent unreliability of confidential witness statements, which may involve paid witnesses, reflect only the views of "naive or disgruntled employees" drawn "into gossip sessions" by investigators hired by entrepreneurial plaintiffs, or

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simply get lost in translation.[2] Indeed, some courts have expressly observed that "[a]llegations concerning ... unnamed confidential sources of damaging information require a heavy discount."[3]

2. Sufficiency of confidential witness allegations

In part due to the inherent unreliability of confidential witness testimonials, federal courts have set forth criteria for evaluating statements attributed to unidentified sources at the pleading stage.

For example, plaintiffs must allege facts to show that their confidential witnesses possess first-hand knowledge of the information attributed to them.[4] As such, plaintiffs must describe witnesses' "positions and/or job responsibilities" "sufficiently to indicate a high likelihood that they actually knew facts underlying their allegations."[5] In addition, plaintiffs must allege concrete facts supplied by confidential witnesses supporting their statements.[6]

The decision in DraftKings *addressed — and rejected — the plaintiffs' attempts to use a short seller report to plead falsity.*

The court in *DraftKings* held that the Hindenburg Report — and the embedded confidential statements on which it relied — did not meet these standards. The report cited numerous statements of purported former employees of SBTech, yet did "not specify these employees' positions, length of employment, location of employment, or their respective roles or sources of knowledge."

Furthermore, the statements were "general in nature" and therefore "devoid of details leading themselves to corroboration."

3. Plaintiffs' failure to investigate and corroborate confidential witness allegations

Courts have also held that plaintiffs' counsel must independently verify confidential witness statements. That is because plaintiffs' counsel has a "'personal, non-delegable responsibility' under Rule 11 [of the Federal Rules of Civil Procedure] to validate the truth and legal reasonableness of the papers filed.'"[7]

As applied to confidential witness statements, counsel must actually speak to alleged "confidential witnesses and know[] who they are."[8] Accordingly, courts have routinely declined to credit confidential witness statements copied by plaintiffs from pleadings in other actions without independent verification.[9]

The plaintiffs in *DraftKings* failed this test, too. As the court observed, plaintiffs' counsel admittedly had "not confirmed *any* of the attributions to unnamed sources in the Hindenburg Report." To be sure, the plaintiffs attested that they "attempted to confirm" the statements by "reaching out" to the founder of Hindenburg Research "but [were] unable to do so."

The verification requirement is not, however, satisfied by a plaintiffs' counsel's unsuccessful efforts, which cannot "salvage" unattributed and uncorroborated statements for purposes of Rule 11 and the PSLRA.

C. Short seller reports and pleading loss causation: *Bofl Holding* and *Nektar*

The decision in *DraftKings* addressed — and rejected — the plaintiffs' attempts to use a short seller report to plead falsity, *i.e.*, that the issuer's disclosures contained material misstatements or omissions, and fraudulent intent. In other cases, plaintiffs rely on short seller reports principally to plead loss causation, alleging that a short seller publication revealed a fraud to the market that caused a stock price decline.

As the Ninth Circuit has recently stated, plaintiffs must meet a "high bar" in using short seller reports to plead a corrective disclosure for purposes of loss causation.[10] Plaintiffs must first allege facts that would enable the court to "'plausibly infer that the alleged corrective disclosure provided new information to the market that was not yet reflected in the company's stock price.'"[11]

"This is normally difficult with a short-seller report that uses publicly available information because a corrective disclosure 'must by definition reveal new information to the market that has not yet been incorporated into the [stock] price.'"[12] Even if a short seller report introduces new information to the market, however, it may not suffice to constitute a corrective disclosure where "'it is not plausible that the market reasonably perceived [the reports] as revealing the falsity of [the defendant's] prior misstatements.'"[13]

Applying these standards, the Ninth Circuit has on multiple occasions deemed allegations based on short seller reports insufficient to plead loss causation.

In *In re Bofl Holding, Inc. Securities Litigation*, 977 F.3d 781 (9th Cir. 2020) ("*Bofl Holding*"), the plaintiff relied on a series of blog posts authored by anonymous short sellers and published on website *Seeking Alpha* that allegedly caused stock price declines. The blog posts purported to identify evidence that the defendant issuer, a financial institution, had more lax underwriting standards than those disclosed to investors.

At the outset, the court explained that, although the blog posts relied on "nominally public information," that fact did not "preclude them from qualifying as corrective disclosures." That is because "[s]ome of the posts required extensive and tedious research involving the analysis of far-flung bits and pieces of data" that other investors were unlikely to undertake and thus it was plausible that the posts provided new information to the market.

Nonetheless, the court held that the posts did not constitute corrective disclosures. The court reasoned that "[a] reasonable investor reading these posts would likely have taken their contents with a healthy grain of salt " because they were authored by "anonymous short-sellers who had a financial incentive to convince others to sell."[14]

In *In re Nektar Therapeutics Sec. Litig.*, 34 F.4th 828 (9th Cir. 2022), the Ninth Circuit likewise held that an anonymous short seller report could not serve as a corrective disclosure for purposes of loss causation. The court noted that the report may have "provid[ed] new information to the market" by "pull[ing] together disparate sources and connect[ing] data in ways that were not plainly obvious."

But, applying *Bofl Holding*, the court in *Nektar* reasoned that a reasonable investor would have discounted the short seller report because its authors were motivated by their own financial interests, remained anonymous and included disclaimers as to the accuracy of the report's contents.

Under *Bofl Holding* and *Nektar*, the opening to plead a corrective disclosure based on a short seller report is narrow.[15] Allegations based on reports of short sellers whose reports are published anonymously and who do not attest to the accuracy of their reports' contents are unlikely to suffice.[16]

D. Concluding observations

Plaintiffs in putative securities fraud class actions will undoubtedly continue to rely on short seller commentary, blog posts and reports. And, to be sure, some courts may credit these allegations.[17]

Indeed, just last month the First Circuit, in affirming a jury verdict finding an individual liable for securities fraud, expressly rejected the defendant's "contention that his statements were rendered categorically immaterial by his identifying himself as a short seller in his reports [containing the alleged misstatements]."[18] But the decisions in *DraftKings*, *Bofl Holding* and *Nektar* make clear that plaintiffs face headwinds in attempting to support a securities fraud claim based on the "musings" of "self-interested" short sellers.[19]

Notes

[1] Nessim Mezrahi & Stephen Sigrist et al., *More Securities Class Actions May Rely On Short-Seller Data*, Law360 (Jan. 10, 2022 7:07 PM), http://bit.ly/3Y7Od4y.

[2] *City of Pontiac Gen. Emps.' Ret. Sys. v. Lockheed Martin Corp.*, 952 F. Supp. 2d 633, 638 (S.D.N.Y. 2013); see also *City of Livonia Emps.. Ret. Sys. & Loc. 295/Loc. 851 v. Boeing Co.*, 711 F.3d 754, 760 (7th Cir. 2013) (Posner, J.) (admonishing plaintiff's counsel where confidential witness "denied virtually everything that the investigator had reported," which warranted dismissal with prejudice); *Higginbotham v. Baxter Int'l, Inc.*, 495 F.3d 753, 756-57 (7th Cir. 2007) (Easterbrook, J.) ("Perhaps these confidential sources have axes to grind. Perhaps they are lying. Perhaps they don't even exist.").

[3] *Boeing*, 711 F.3d at 759; accord *Ind. Elec. Workers' Pension Tr. Fund Ibew v. Shaw Grp., Inc.*, 537 F.3d 527, 535 (5th Cir. 2008); *Higginbotham*, 495 F.3d at 756; *Rossy v. Merge Healthcare Inc.*, 169 F. Supp. 3d 774, 782 (N.D. Ill. 2015).

[4] See, e.g., Jones v. Perez, 550 F. App'x 24, 28 (2d Cir. 2013) ("[N]one of the confidential witnesses assert direct knowledge [of views] held by defendants."); Glaser v. The9, Ltd., 772 F. Supp. 2d 573, 594 (S.D.N.Y. 2011) ("[P]laintiffs make no allegation that [its] sources ever had contact with anyone at [defendant company.]").

[5] Glaser, 772 F. Supp. 2d at 590.

[6] *See, e.g., Zucco Partners, LLC v. Digimarc Corp.*, 552 F.3d 981, 998 (9th Cir. 2009) ("[G]eneralized claims about corporate knowledge are not sufficient[.]").

[7] *Touchstone Strategic Tr. v. Gen. Elec. Co.*, No. 19-CV-1876 (JMF), 2022 WL 4536800, at *2 (S.D.N.Y. Sept. 28, 2022) (alteration in original) (citation omitted).

[8] *In re Lehman Bros. Sec. & Erisa Litig.*, Nos. 09 MD 2017 LAK et al., 2013 WL 3989066, at *4 (S.D.N.Y. July 31, 2013).

[9] *See, e.g., Touchstone*, 2022 WL 4536800, at *2 ("[C]ourts 'generally do not consider averments taken directly from uncorroborated allegations embedded in a complaint in another action or parroted allegations for which counsel has not conducted independent investigation.'" (alteration in original) (quoting *Amorosa v. Gen. Elec. Co.*, No. 21-CV-3137 (JMF), 2022 WL 3577838 (S.D.N.Y. Aug. 19, 2022))); *VNB Realty, Inc. v. Bank of Am. Corp.*, No. 11 Civ. 6805(DLC), 2013 WL 5179197, at *7 (S.D.N.Y. Sept. 16, 2013) (rejecting confidential witness statements copied from other complaints); *Lehman Bros.*, 2013 WL 3989066, at *4 (same).

[10] *In re Nektar Therapeutics Sec. Litig.*, 34 F.4th 828, 839 (9th Cir. 2022).

[11] *Id*. (quoting *In re Bofl Holding, Inc. Secs. Litig.*, 977 F.3d 781, 795 (9th Cir. 2020)).

[12] *Id*. (alteration in original).

[13] *Id*. at 840 (alteration in original) (quoting *Bofl Holding*, 977 F.3d at 795).

[14] Less than a month later, the Ninth Circuit in *Grigsby v. Bofl Holding, Inc.*, 979 F.3d 1198 (9th Cir. 2020), again held that a Seeking Alpha short seller report did not constitute a corrective disclosure. The court reasoned that the short seller's "analysis did not require any expertise or specialized skills beyond what a typical market participant would possess," included a "disclaimer that the author 'makes no representation as to the accuracy or completeness of the information,'" and "encouraged investors to do their own research." *Id*. at 1208 (citation omitted).

[15] The Eleventh Circuit has taken an even more categorical approach than the Ninth Circuit, holding that, where a short seller report is based "entirely" on "publicly available information" it cannot constitute a loss causation event. *Meyer v. Greene*, 710 F.3d 1189, 1199 (11th Cir. 2013) (explaining that "the mere repackaging of already-public information by an analyst or short-seller is simply insufficient to constitute a corrective disclosure"). The Second Circuit has held in an unpublished opinion that a short seller report that conveyed publicly available information "not readily accessible to investors" in addition to non-public information constituted a corrective disclosure. *Lea v. TAL Educ. Grp.*, 837 F. App'x 20, 28 (2d Cir. 2020).

[16] Compare *In re LexinFintech Holdings Ltd. Sec. Litig.*, No. 3:20-cv-1562-SI, 2021 WL 5530949, at *15 (D. Or. Nov. 24, 2021) (holding that posts authored by anonymous short sellers that included disclaimers as to accuracy did not constitute corrective disclosures), with *Garcia v. J2 Glob., Inc.*, No. 2:20-cv-06096-FLA (MAAx), 2021 WL 1558331, at *22 (C.D. Cal. Mar. 5, 2021) (deeming short seller reports corrective disclosures where "authored by two named firms" and where reports expressed confidence in their conclusions).

[17] *See, e.g., In re Hebron Tech. Co. Sec. Litig.*, No. 20 Civ. 4420 (PAE), 2021 WL 4341500, at *3, *13 (S.D.N.Y. Sept. 22, 2021) (holding that reliance on short seller report did not mandate dismissal where complaint also relied on counsel's independent investigation); *Lewy v. SkyPeople Fruit Juice, Inc.*, No. 11 Civ. 2700(PKC), 2012 WL 3957916, at *13 (S.D.N.Y. Sept. 10, 2012) ("Plaintiffs further allege that plaintiffs' own research corroborated the Absaroka [short seller] report[.]").

[18] *SEC v. Lemelson*, No. 22-1630, 57 F.4th 17, 28 n.9 (1st Cir. 2023).

[19] *Nektar*, 34 F.4th at 832.

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