Westlaw Today
powered by Reuters

How to guard against a short attack, and how to respond if faced with one

By Richard J. Grossman, Esq., Neil P. Stronski, Esq., and Demetrius A. Warrick, Esq., Skadden, Arps, Slate, Meagher & Flom LLP*

SEPTEMBER 27, 2023

Key points

- To prepare for the possibility of a short seller attack, companies should assess their vulnerabilities, maintain open channels of communication with shareholders, monitor short positions and changes in their shareholder base, and formulate a communications strategy.
- In the face of a short attack, it is vital for a company to respond promptly with detailed evidence to rebut the short seller's accusations point by point.
- Share buybacks and dividend increases may help to restore a share price depressed by a short attack, but there is a risk that these may be seen as superficial defensive moves that do not address fundamental questions about the business.
- Suing the firm or individuals behind a short attack or seeking an intervention by regulators rarely is successful and can backfire, drawing attention to the criticisms.

The nature of short selling attacks and short reports

Short selling attacks create unique challenges for boards, management teams and companies. Unlike traditional long activists, whose ultimate goal is to enhance shareholder value, short activists aim to destroy value. Their goal is to capitalize on a drop in the target company's stock price caused by releasing research purporting to identify unfavorable information about the business.

Responding efficiently and effectively to a short attack is mission critical for boards to protect shareholder value.

The release is typically coupled with a carefully orchestrated media and social media campaign to undermine the financial position and reputation of the company. After depressing the share price, the short activist can acquire shares to cover its short position below the price at which it sold and turn a profit.

Activist short sellers view themselves as investigators, engaging in deep research, eliciting information from insiders and performing physical detective work, to "unearth" material that suggests the company is overvalued. Their reports may claim to expose reporting and accounting issues, undisclosed material information or affiliate transactions, or misconduct by management, among other things.

Short attacks present a clear and present danger for boards by creating uncertainty, negatively impacting investor perceptions of management, the board and the company, and diverting executive and board attention.

It is important to understand whether the short campaign has gained traction with the company's investor base.

Responding efficiently and effectively to a short attack is mission critical for boards to protect shareholder value. It requires foresight to identify potential attack vectors, and advanced preparation so that a company is well positioned to respond effectively on short notice. Here we provide tips on how to prepare for and respond to such attacks, as well as pitfalls to avoid.

Understanding vulnerabilities and preparing in advance for short attacks

Boards are keen to understand and identify the factors that may invite a short attack, and indicators that an attack is on the horizon.

Potential vulnerabilities may include rapid or unexpected turnover at the executive level; regulatory scrutiny or investigations; industry-wide vulnerability or a recent history of short/long activist attacks at competitors; indications of improper financial reporting or internal controls; and, perceived or real, poor operating performance or poor execution of the strategic plan.

Advanced preparation by the board, with support from management and outside advisors, is key. Boards and management teams should:

- Conduct risk and vulnerability assessments to identify potential attack vectors for short activists.

- Track industry and market trends and sentiments to ensure that management has an accurate understanding of the current landscape and how that may affect the company.
- Monitor accumulations of short positions and keep a keen eye on traditional and non-traditional investor platforms.
- Remain attuned to the conversation in the market around the business.
- Understand investors' views of performance, strategy and governance to help build value and respond to any investor concerns.
- Develop a robust communication strategy to articulate the company's short- and long-term strategic plans, highlighting progress toward goals through steady, coordinated news flow and disclosure in advance of any short seller's campaign — measures that will help undermine the credibility of a short attack if there is one.

Key considerations when responding to a short attack

By employing a thorough and proactive approach, companies can protect their credibility and even reinforce investor confidence. Here are ways to respond when faced with a short attack:

Research and profile the short activist

While a short seller's objective is clear, boards and management teams should research the short seller's current and past campaigns to identify patterns of practice, particularly in scenarios where there is advance warning that an attack is on the horizon. In short campaigns, information is gold and a better understanding of the short activist and its playbook will aid in the company's defense.

Communication and engagement are key

Communication is paramount, and companies will need to rapidly execute an investor outreach program.

As an initial matter, it is important to understand whether the short campaign has gained traction with the company's investor base. Communicating extensively with large shareholders and research analysts is crucial throughout the campaign to guide the response.

Depending on the circumstances, the company will likely need to fashion a timely and transparent response to address the issues raised in the attack. This generally will be in the form of a press release, media statement and Securities and Exchange Commission (SEC) filing, ideally very promptly (*i.e.*, within 24 hours) after the onset of the attack. It may be wise to hire an experienced crisis public relations firm.

The response should expressly refute allegations made in the short attack with direct evidence, supportive data and clear explanations. Categorical, high-level denials, without factual back up, coupled with only an attack on the short-seller itself, is typically ineffective. Methodically addressing each point raised by the short seller shows investors that the company's management has considered the concerns raised and has, where appropriate, taken proactive action to address those.

Financial responses

To counter the impact of a short attack on a company's share price and alleviate shareholder concerns, a board may consider share buybacks or increased dividends. However, while these strategies may be intended to show the board's and management's faith in the strategic plan and underlying strength of the business, there are risks associated with these responses.

While share buybacks offer short-term price support, they do not provide a long-term solution to fundamental concerns raised by the short activist and may be portrayed as a pure defensive measure that further amplifies the criticism.

There is rarely any point to engaging with a short activist.

Similarly, while raising dividends may convey confidence and a commitment to returning capital to shareholders, they may also limit a company's flexibility to make future investments, and they likely fail to address the core issues raised by short sellers. Thus, this strategy, too, could be portrayed as a form of mismanagement or poor decision-making by management and the board.

Potential pitfalls to avoid

Just as careful preparation and a sound response strategy are crucial, it is important for boards to understand what *not* to do in the face of a short attack.

Do not expect to engage with the short activist

There is rarely any point to engaging with a short activist. Unlike traditional long activism campaigns, where the goal is to cause the company to take action to increase shareholder value, the short activist's sole goal is to destroy shareholder value. Consequently, the short activist is not interested in coordinating with or engaging with management to do what is in the best interests of shareholders.

These investors have a thesis and generally are unconcerned with the company's contrary position. Therefore precious time and resources should not be expended attempting to sway short activists to change their positions. Instead, energy should be directed to making the company's case to the broader investor community.

Do not ignore the attack or leave it to shareholders to sort out the truth

In general, it is not in the company's best interests to completely ignore a short attack. Companies should not rely on the investor community to identify how a short activist's claims are incorrect or misleading. Failing to address a short seller report or campaign publicly may increase investor uncertainty and lead investors to assume the truth of the short seller's claims. The onus is on the company to disprove these claims.

Responses should be well-articulated and, although time is of the essence, they should not be impulsive: They should be focused on addressing the substantive criticisms and allegations and not on the activist or its motivations. Any personal attacks or aggressive language toward the short seller are counterproductive and may be viewed as unprofessional and unbecoming of the company's leadership, lending support to the short campaign.

In rare circumstances, if there has been no notable impact on the company's stock price and if the campaign has not gained traction with the company's investor base or the media, a company may consider not responding. In such instances, responding could simply put the spotlight on the short seller's allegations.

Even if the board deems that a public response is unwarranted, the short campaign should be carefully tracked, and the company should remain prepared to respond if circumstances change.

Think twice before pursuing legal action or regulatory intervention

In most cases, suing short sellers is not an effective response strategy, even though there will often be an understandable desire to bring claims for defamation, stock manipulation or other unlawful practices. In practice, these lawsuits are costly, time-consuming, add to the uncertainty surrounding the stock and, in light of the evidentiary burdens, are rarely successful. Moreover, the discovery process may require the company to unveil sensitive information, and litigation may attract additional media attention to the short seller's accusations.

The same drawbacks apply to efforts to obtain regulatory intervention, for instance, by alerting regulators such as the SEC of inappropriate conduct such as market manipulation. In practice, such efforts generally are not productive, and may in fact lead to additional regulatory scrutiny or investigation of the company, potentially distracting the board and management and playing into the short seller's hands.

The bottom line

Success against a short attack is most likely to result from a carefully crafted response to the substantive issues presented in the campaign and not from time- and resource-consuming litigation, regulatory intervention or other actions that do not address the substance of the attack.

About the authors



Richard J. Grossman (L) is a partner in **Skadden, Arps, Slate, Meagher & Flom LLP**'s mergers and acquisitions group with a focus on proxy contests, responses to shareholder activists, corporate governance matters, M&A and leveraged buyouts. **Neil P. Stronski** (C) is also a partner in the firm's mergers and acquisitions group with a concentration on M&A, corporate governance, shareholder activism, securities law and general corporate matters. **Demetrius A. Warrick** (R), also a partner in the firm's mergers and acquisitions group, focuses on M&A, corporate governance, responses to shareholder activism and proxy contests. The authors are all based in the firm's New York office. This article was originally published Sept. 6, 2023, on the firm's website. Republished with permission.

This article was published on Westlaw Today on September 27, 2023.