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Securities lawsuits premised on short-seller reports come up short

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Short-seller reports frequently lead to stock price drops that give rise to securities class action lawsuits. Plaintiffs who rely on short-seller reports to allege securities fraud are facing a skeptical reception by the 9th U.S. Circuit Court of Appeals.

For the fourth time in the last four years, the 9th Circuit has rejected a securities fraud complaint that attempts to satisfy the loss causation pleading requirement by citing reports published by short sellers of a company's stock that purport to reveal negative facts about the company.

The 9th Circuit's recent decision in *Espy v. J2 Global, Inc.* makes clear that allegations based on short-seller reports fail to state a claim if the reports do not "relate back" to alleged false or misleading statements — and therefore reveal the statements' falsity — or if they are based entirely on already-public information that requires no expert analysis to understand.

In *J2 Global*, the plaintiff, a shareholder of international information services company J2 Global, Inc. brought claims under Section 10(b) of the Securities Exchange Act. The plaintiff alleged that J2 made materially misleading statements to investors (i) about a 2015 acquisition, when it omitted certain alleged details about the acquired company, including that it was a shell start-up and that it was acquired from a J2 employee as part of his compensation; (ii) about a 2017 investment, when it omitted certain facts about alleged conflicts of interest and management fees; and (iii) that, while purporting to grow through multiple acquisitions, disguised the poor performance of those acquisitions by accounting for them on a consolidated basis.

In particular, the complaint alleged that the J2 Ireland and Everyday Health acquisition were underperforming.

The plaintiff alleged that the "truth" was revealed — causing J2's stock price to decline — when well-known short-sellers of J2 stock, Citron Research and Hindenburg Research, respectively, published reports "detailing the failures of J2's acquisition model" and "arguing that J2's opaque acquisition approach has opened the door to egregious insider self-enrichment." Both reports were based entirely on already-public information.

A judge of the United States District Court for the Central District of California dismissed the complaint, concluding that the plaintiff failed to allege sufficiently that the defendants acted with an intent to defraud. The plaintiff appealed. The 9th Circuit affirmed the district court's conclusion with respect to intent to defraud. And although the district court had not reached the issue, the 9th Circuit also concluded that the plaintiff had failed to plead sufficiently that the alleged misrepresentations had caused his loss.

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In particular, the court noted that to state a claim, the plaintiff was required to plead with particularity that the alleged misstatements, "as opposed to some other fact, foreseeably caused" the plaintiff's loss. To do that, plaintiffs often attempt to identify "one or more corrective disclosures, which occur when information correcting the misstatement or omission that is the basis for the action is disseminated to the market."

Plaintiffs must show that the corrective disclosures revealed, in whole or in part, the alleged truth concealed by the alleged misstatements and caused the stock price to decline. When the disclosures are based on analysis of already-public information, the plaintiff must "allege particular facts plausibly suggesting that other market participants had not done the same analysis," so that the information was not already reflected in the market price of the stock by the time of the disclosure.

Concerning the Citron Research report, the court reasoned that it stated J2 needed acquisitions and used money generated from legacy businesses to prop up its financials, and that "the market was not paying any attention to the bottom line or the quality of businesses J2 Global is aggregating." While this may be "negative information," it did not "relate back" to the alleged misstatements in the complaint.

Again, the alleged misstatements had to do with a 2015 acquisition, a 2017 investment, and consolidated accounting hiding certain underperforming assets. The Citron Research report did not specifically mention any of these and therefore could not have corrected statements about them.

As for the Hindenburg report, it was "more tethered to J2's alleged misrepresentations and omissions," but it was based on a "careful reading of public documents, including J2's investor presentations, press releases, employees' LinkedIn profiles, board members' resumes, public corporate records, and SEC filings."

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The analysis it drew from these sources required "no expertise or specialized skills beyond what a typical market participant would possess." The plaintiff failed to plead particularized facts demonstrating that the analysis was not reflected in J2's stock price before the Hindenburg report was published. Therefore, the plaintiff failed to plead loss causation.

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In 2020, in *In re BofI Holding, Inc. Securities Litigation*, the court concluded that anonymous blog posts may have "provided new information to the market," but they did not qualify as corrective disclosures because they were "authored by anonymous short-sellers who had a financial incentive to convince others to sell" and included a disclaimer as to their accuracy.

Also in 2020, in *Grigsby v. BofI Holding, Inc.*, the court concluded that the report was anonymous, contained a disclaimer, and, like the Hindenburg report in *J2 Global*, was based on information in public documents that did not require any expertise or specialized skill to analyze.

Then, in 2022, in *In re Nektar Therapeutics Securities Litigation*, the court rejected allegations stemming from a report by a named short-seller firm, Plainview Research, that failed to name its author or provide any contact information that would allow investors to verify the report's reliability.

All three prior decisions depended in part on the fact that the short-seller report was anonymous and therefore inherently lacking credibility. *J2 Global* is the first decision to reject short-seller reports based entirely on their contents — their inability, even at the pleading stage, to demonstrate that the alleged false statements caused the plaintiff's loss.

J2 Global demonstrates the 9th Circuit's increasing skepticism when securities fraud class actions follow declines in a company's stock price caused, not by any revelation of fraud, but by those with an obvious motive to see the stock price decline. While it is unlikely such suits will disappear completely, challenging such suits on the basis of the plaintiff's failure to allege loss causation appears to be an increasingly viable argument when defendants seek to dismiss such suits.

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