Future-Priced Convertible Securities & The Outlook For “Death Spiral” Securities-Fraud Litigation

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In recent years, many companies in the United States have issued so-called "Future-Priced Convertible Securities." These companies tend to be small, thinly-traded, and (most importantly) desperate for cash, and look to the Future-Priced Convertible Security as a necessary means of financing to keep their businesses operating. Future-Priced Convertible Securities are thus credited by some with providing an important form of financing in the marketplace.[1] Yet these securities are also a source of controversy. Many companies have wound up regretting issuing these instruments, after watching their stock values tumble and their market capitalizations dry-up subsequent to issuing these securities. Issuers have even started to sue.

Many issuers of Future-Priced Convertible Securities are now suing the very purchasers of these securities alleging, among other things, that the purchasers have violated antifraud provisions of the federal securities laws such as Section 10(b) of the Securities Exchange Act of 1934.[2] These cases often allege similar ways by which the purchasers of the Future-Priced Convertible Securities allegedly harmed the issuers, giving rise to a unique appellation for these lawsuits: "death spiral" litigation.[3] These cases are called "death spirals" because the investors of the Future Priced Convertible Securities are alleged to have used the securities in manipulative short-selling schemes that extract the market value of the issuing companies, thereby enriching the purchasers at

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[1] *See generally* Beloreshki et al., *The Frontiers of Convertible Financing: An Economic and Legal Perspective on Litigating Future Priced Securities*, NERA Working Paper, July 30, 2003, *available at* http://www.nera.com/_template.cfm?c=6167&o=6066.
[2] 15 U.S.C. 78j (2004).
[3] Beloreshki et al., *supra* note 1, at 19. This issue has also received some coverage in the media, including a recent article in *The Economist* magazine. *See Toxic Finance*, ECONOMIST, Sept. 6, 2003, at 66.

the expense of issuers and other shareholders. These "death spirals" can result in the issuer's being de-listed from an exchange or even forced into bankruptcy.

This paper will analyze six specific death spiral lawsuits with the intention of evaluating the plaintiffs' securities fraud claims. In so doing, this paper hopes to provide insight into the potential success of other lawsuits in an anticipated "wave of litigation" over Future-Priced Convertible Securities.[4] Part I of this paper provides background information on these securities: what they are, who issues them, who buys them, and why. Part II then discusses an important legal issue relating to death spirals, the practice and the law of short selling. Short selling is at the heart of recent litigation over these securities, and a firm understanding of short selling is necessary for this study. Next, Part III reviews six specific death spiral cases, analyzing the facts and claims alleged in these lawsuits and providing some basic conclusions of law. The Analysis section, Part IV, then examines the legal merits of these death spiral securities fraud complaints in detail.[5] Using the six lawsuits discussed in Part III as case studies, the Analysis section demonstrates that death spiral litigation securities claims are potentially meritorious. Moreover, this paper will argue at some length that naked short selling should be declared to be market manipulation if (more likely, when) this issue arises in a death spiral action. Finally, Part V reviews some of the regulatory concerns affecting Future Priced Securities and will discuss the significance of the Securities and Exchange Commission's recently

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[4] *E.g.*, *Toxic Finance*, *supra* note 3, at 66. *See also* Brandon Copple, *Sinking Funds*, FORBES, June 10, 2002, at 46.

[5] The reader is reminded at the outset that death spiral lawsuits allege many different claims, including securities fraud and other violations of federal securities laws, civil violations of the Racketeering Influenced and Corrupt Organizations Act, violations of state securities laws, and common law tort, breach of contract, and breach of fiduciary duty claims. Yet the purpose of this paper is to focus narrowly on just the federal securities fraud claims. Thus, all the other claims raised in death spiral lawsuits aside from issues of federal securities fraud are beyond the scope of this paper and will not be examined.

proposed Regulation SHO. This paper concludes that death spiral lawsuits have merit, though there are complicated legal issues that must be evaluated on the way to a plaintiff's recovery.

Part I – Background

A) What Are Future-Priced ("Death Spiral") Convertible Securities?

Future-Priced Convertible Securities are a recent financial creation issued by many small companies in the United States. These securities have a variety of names, including "Future Priced Securities,"[6] "Floating-Priced Convertibles,"[7] "Private Investments in Public Equities" (variously, "Structured PIPEs," or "Toxic PIPEs"),[8] "Resetting Convertibles,[9] "Floorless Convertibles,"[10] and, ignominiously, "Toxic" or "Death Spiral Convertibles."[11] But all these names refer to essentially the same types of security. (This paper will refer to these instruments as Future-Priced Convertible Securities and Future-Priced Securities interchangeably, or simply "FPS's" for short.)

Future Priced Securities are a form of last-resort financing for companies that cannot raise money through more traditional debt or equity offerings or through bank borrowing.[12] Firms that issue FPS's tend to have no alternative.[13] The following SEC Release provides a general introduction to these securities.

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[6] *See, e.g.*, Beloreshki et al., *supra* note 1, at 1.
[7] *See, e.g.*, Pierre Hillon & Theo Vermaelen, *Death Spiral Convertibles*, J. FIN. ECON. (forthcoming) (manuscript at 2), *available at* http://jfe.rochester.edu/03026.pdf.
[8] *See, e.g.*, Leib M. Lerner, *Disclosing Toxic PIPES: Why the SEC Can and Should Expand the Reporting Requirements Surrounding Private Investments in Public Equities*, 58 BUS. LAW. 655 (2003).
[9] *See, e.g.*, Cynthia Webb, *Help Comes With a High Price*, WASH. POST, April 16, 2001, at E1.
[10] *See, e.g.*, *Toxic Finance*, *supra* note 3, at 66.
[11] *See, e.g.*, Securities & Exchange Commission Press Release 2003-36, *SEC Settles with Rhino Advisors, Thomas Badian*, Feb. 27, 2003, *available at* http://www.sec.gov/news/press/2003-26.htm.
[12] *See, e.g.*, Lee R. Petillon & Robert Joe Hull, REPRESENTING START-UP COMPANIES, § 10:16 (2003).
[13] *See infra* Part I.B.

> Future Priced Securities are private financing instruments which were created as an alternative means of quickly raising capital for issuers. The security is generally structured in the form of a convertible security and is often issued via a private placement. ... The conversion price of the Future Priced Security is generally linked to a percentage discount to the market price of the underlying common stock at the time of conversion and accordingly the conversion rate for Future Priced Securities floats with the market price of the common stock. As such, *the lower the price of the issuer's common stock at the time of conversion, the more shares into which the Future Priced Security is convertible*.[14]

The distinguishing characteristic of FPS's is this convertibility into a *fixed value* of the issuer's common stock. This is, of course, different from traditional convertible securities (whether bonds or preferred stock) that are convertible into *fixed numbers* of shares. For example, a Future Priced Security could be convertible into $10 million of common stock at a future date, thereby giving the holder one million shares at conversion if the stock's price is $10/share or 10 million shares if the security is trading at $1/share.[15] This convertibility into a fixed value of equity with an indeterminate number of shares is the distinguishing characteristic of Future Priced Securities.

Aside from this common feature, Future Priced Securities can contain a variety of rights and obligations for issuers and purchasers because FPS's are ultimately creatures of contract. A recent report by Pierre Hillon and Theo Vermaelen, two professors at the French academy INSEAD, studied 467 Future Priced Securities offerings between 1994 and 1998 and identified a number of common themes among these offerings.[16] This paper adopts some of the common themes identified by these authors into a "classic case" or "standard case" Future-Priced Convertible Security, which this paper will repeatedly

[14] Self-Regulatory Organizations, Securities and Exchange Commission, Exchange Act Release No. 34-41337 (April 27, 1999), *available at* 1999 SEC Lexis 862, at 2 (emphasis added).
[15] *See id.* at 3.
[16] Hillon & Vermaelen, *supra* note 7, at 4.

refer to as a benchmark for studying these instruments. Specifically, “classic case” FPS’s are defined hereinafter to have the following characteristics.[17]

First, and most importantly, the classic case FPS will be convertible into a fixed value of the issuer’s common stock. This is of course the hallmark of a Future Priced Security.[18] Second, FPS’s generally do not pay interest (for bond FPS’s) or dividends (for preferred stock FPS’s) in cash. Instead, they pay “in kind” through a conversion discount—that is, the investor is able to convert the security into a greater value of shares than the face amount invested.[19] This paper will assume an average conversion discount of 15% for the classic case FPS, based on the Hillon/Vermaelen study.[20] Third, the classic case FPS will contain restrictions on the number of shares into which the security is convertible.[21] This cap will be bounded at a minimum by the number of shares authorized by the company’s articles of incorporation but not yet issued and outstanding.[22]

Fourth, FPS contracts usually limit the time periods during which conversion may occur.[23] The contracts create conversion “windows” that smooth the conversions over time to prevent a spike in the average trading volumeof th e company’s common stock. Fifth, and most importantly, *most FPS contracts do not prevent purchasers from short*

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[17] The Hillon & Vermaelen report identified six common characteristics of FPS’s: lock-up periods, conversion discounts, look-back ratios, caps and floors, warrants, and short selling restrictions. *See id.* at 30-33. Many of these are not relevant for purposes of this paper, however, as they relate to the economics of FPS’s, not their legal characteristics.
[18] *See supra* text accompanying notes 14-15.
[19] *See* Hillon & Vermaelen, *supra* note 7, at 3.
[20] The Hillon & Vermaelen study found that the average conversion discount in 467 FPS’s was 15.5%. *See id.* at 30. Thus, a 15% conversion discount would provide a return of 15% if conversion took place exactly one year after the security was issued.
[21] *See id.* at 32.
[22] The reason for this is that the company cannot issue more shares than authorized in its articles of incorporation.

selling. For instance, the Hillon/Vermaelen study of 467 FPS's found restrictions on short selling in only 58 of the offerings.[24] Similarly, out of the six death spiral cases examined in Part III and IV of this paper, only two issuers prevented short selling by the FPS purchasers (while a third attempted to limit it).[25] Thus, our classic case FPS will contain no short selling restrictions.

B) Who Issues Future-Priced Convertible Securities and Why?

Future Priced Securities are a form of last-resort financing for companies that have nowhere else to turn in the marketplace (a finance professor at Columbia University has called them "desperation financing").[26] The issuers of these securities tend to be small, young, and risky technology firms—*i.e.*, firms that have nowhere else to turn.[27] For example, the Hillon/Vermaelen study found that 50% of the 261 companies in the study were either technology or medical service providers and that the average market capitalization of the 467 firms was $67.5 million.[28] It is unclear exactly how many firms have ever issued an FPS, but the number of offerings has evidently dropped-off in recent years from a high of (by one count) 395 offerings worth $3.2 billion in 2000.[29] Companies such as eToys, DrKoop.com, eFax, and At Home are perhaps among the more recognizable names of FPS issuers.[30]

Issuing an FPS is generally done as a last-resort because, as will be examined in Part III and IV of this paper, FPS's leave the issuer open to abuse. The Hillon/

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[23] *See* Hillon & Vermaelen, *supra* note 7, at 30.
[24] *Id.* at 32-33.
[25] *See infra* notes 145-49 and accompanying text.
[26] *See* Janice Revell, *A Most Sinister Form of Financing*, FORTUNE, Dec. 24, 2001, at 160.
[27] *See* Hillon & Vermaelen, *supra* note 7, at 4.
[28] *Id.* at 17.
[29] *See* Matthew McClearn, *The Mysterious World of Death-Spiral Finance*, TORONTO STAR, Oct. 15, 2002, at B1.

Vermaelen report provides empirical evidence for this: 85% of the firms studied saw declines in their stock prices within the first year of issuing an FPS, and these declines averaged 34%.[31] Yet companies may feel that they have no choice but to issue an FPS if the alternative is closing the firm. (This perhaps explains why some companies have issued multiple FPS's, even after suffering stock losses as a result of prior deals.)[32] But the heyday of the Future Priced Security appears to be over. As one market participant has noted, this is "a business that doesn't exist any more, because everybody got tired of losing money. … Public companies themselves have eliminated this from the market. They just won't do these types of deals any more, with anybody."[33]

C) Who Buys Future Priced Securities?

Private investment groups such as hedge funds or venture capital firms are the main purchasers of Future Priced Securities. Issuers of FPS's sell them to private purchasers because this avoids the onerous requirements of a registered securities offering and allows the issuer to achieve its financing objectives quickly and efficiently.[34] Most FPS's thus qualify under one of the many exemptions from registration within the Securities Act of 1933. There are a number of funds that appear to specialize in FPS offerings, including Thomson Kernaghan, Promethean Investment Group, HFTP Investment LLC, Fisher Capital Ltd., Wingate Capital Ltd., and Southridge Capital

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[30] *See* Cory Johnson, *Wall Street's Toxic Tool*, THE INDUSTRY STANDARD, March 19, 2001.
[31] *See* Hillon & Vermaelen, *supra* note 7, at 4.
[32] For example, Nanopierce Technologies, discussed in Part III.A *infra*, issued an FPS to detrimental effect, but then went ahead and issued another FPS one year later. *See* Nanopierce Tech., Inc. v. Promethean Asset Mgmt, LLC, No. 00-CV-6218, 2002 WL 31819207, at 1-2 (S.D.N.Y. Dec. 10, 2001). Similarly, Hillon/Vermaelen report that twenty companies out of 261 in their study issued at least *four* FPS's. *See* Hillon & Vermaelen, *supra* note 7, at 17.
[33] McClearn, *supra* note 29, at B1.
[34] *See, e.g.*, Lerner, *supra* note 8, at 662-64.

Management LLC.[35] One investor that has appeared in news articles regarding FPS's is Mark Valentine, a former chairman of the firm Thomson Kernaghan.[36] Valentine apparently participated in approximately 150 FPS offerings prior to being subject to criminal proceedings by United States and Canadian authorities (and being a defendant in multiple private lawsuits).[37]

D) "Death Spiral" Litigation – Who Is Suing Whom?

It is often the case in securities fraud litigation that purchasers of a security will sue the issuers or underwriters, alleging fraud in the security's offer or sale. But Future Priced Securities litigation—"death spiral" litigation—turns this on its head. In death spiral lawsuits, the *issuers* of FPS's are suing the purchasers (as well as, in come cases, brokers and market makers).[38] Part III and Part IV of this paper examine death spiral litigation in detail, but a few themes may be gleaned at the outset.

Issuers of Future-Priced Convertible Securities are suing the purchasers of these securities, alleging that the purchasers lied to the issuers and manipulated the price of the issuers' common stock through short selling. Purchasers allegedly reaped large short-term profits, at the expense of the company and other shareholders. The basic scheme underlying these "death spiral" claims is quite simple.

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[35] *See Short Sales: Death Spiral Stock Cost Placement Firm $1.2 Million, Suit Alleges*, 9 No. 10 ANDREWS DERIVATIVES LITIG. REP. 3 (April 21, 2003); McClearn, *supra* note 29, at B1. In the author's research, he has come across these names a number of times, often in the context of litigation over FPS's.

[36] *See* McClearn, *supra* note 29, at B1.

[37] *See id.* at B1 (stating that Valentine has been arrested by the Federal Bureau of Investigation and indicted for wire, mail and securities fraud and suspended by Canadian securities authorities).

[38] For instance, JAG Media Holdings, discussed in Part III.A, is suing 152 named defendants, including the purchasers of its Future Priced Security, brokers, and other parties. *See* JAG Media Holdings, Inc. v. A.G. Edwards & Sons, Inc. et al., No. 02-CV-2867 (S.D. Tex.), Plaintiff's Second Amended Complaint and Jury Demand, filed Nov. 22, 2002.

The key to a death spiral scheme is that the FPS purchaser is entitled to a predetermined value of the issuer's common stock through the Future Priced Security. Thus, if the issuer's stock decreases in price, the FPS purchaser is entitled to that many more shares upon conversion. Issuers allege that purchasers have used this to their advantage by, for instance, engaging in massive short selling of the issuers stock to intentionally depress the stock's price. Then, after a few weeks or months when the issuer's stock has fallen (sometimes to nothing), the purchasers convert their FPS's into huge numbers of shares, covering their short positions. Indeed, because of the way FPS's operate, purchasers have an incentive to short sell: the lower the stock's price, the more shares the FPS purchaser can achieve at conversion and, since the return is fixed, the more shares that can be used to cover short-selling positions.

Moreover, FPS purchasers are able to effectuate these "death spirals" because the issuers are small, thinly traded over-the-counter companies thatlikely have too few buyers to sustain the prices of their securities in the face of the FPS purchasers' huge short selling positions. Thus, prices inevitably fall. Part II will also explain how the absence of pricing rules in many of the over-the-counter securities markets means that there are no regulatory barriers to the FPS purchasers' abusive activities. Issuers thus allege that the FPS purchasers reap huge short-term profits by essentially draining the issuer's market capitalization and leaving the issuer and innocent investors with a vastly deflated stock price, making de-listing of the issuer—or even bankruptcy—likely. This set of facts underlying "death spirals" has apparently been repeated many times,[39] and has

[39] *See, e.g.*, McClearn, *supra* note 29.

received the attention of the Securities and Exchange Commission.[40] This paper will now turn to an examination of short selling, the context through which death spirals are alleged to occur.

Part II – The Practice & The Law of Short-Selling

A) The Practice of Short Selling

The basic principles underlying short selling are fairly simple.[41] A short sale is the sale of a security that the seller does not yet own (or owns but chooses not to deliver).[42] The short seller instead *borrows* the security from another market participant, delivering the borrowed security to the short-sale purchaser and thereby completing the short. The short seller will then be obligated to return the securities to the lender—*i.e.*, to "cover" the short—by repurchasing equivalent securities in the marketplace at some later date and delivering these securities to the lender. Covering completes the short sale process: the lender and purchaser each will own the security, while the short seller (hopefully) will earn a profit. The short seller will earn a profit on the short sale if the stock's price falls between the time of the short sale and the time the short seller covers. This also demonstrates that short selling is very risky: if the stock price *rises* after the

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[40] See Securities & Exchange Commission Press Release 2003-26, *supra* note 11, containing the following statement from the Associate Director for the Division of Enforcement: "Certain convertible securities, particularly those referred to as 'toxic' or 'death spiral' convertibles, present the temptation for persons holding the convertible securities to engage in manipulative short selling of the issuer's stock in order to receive more shares at the time of conversion." This press release deals with a settled enforcement action against an FPS investor, Rhino Advisors, and its president, Thomas Badian. This enforcement action derived from the facts of the *Sedona* case, which this paper will examine. *See infra* Part III.A and note 123.

[41] For a discussion of short selling practices, see generally Ralph S. Janvey, *Short Selling*, 20 Sec. Reg. L.J. 270, 271-76 (1992), and IRVING M. POLLACK, SHORT-SALE REGULATION OF NASDAQ SECURITIES 15-18 (July 1986).

[42] It is actually possible to short-sell a security that the investor already owns but chooses not to deliver through a practice known as "selling against the box." Short sales "against the box" otherwise proceed like traditional short sales, but the short seller simply holds-on to the securities it already owns. Short sales

short sale, the short seller will be forced to cover the short sale at a higher price, thereby covering at a loss. And since there is theoretically no limit to how high a stock can climb, the short sellers loss could potentially be huge.

Short selling has existed for centuries in securities and commodities markets[43] and is seen to provide at least two market benefits: market liquidity and pricing efficiency.[44] First, short selling provides market liquidity (*i.e.*, increased trading opportunities) because, other things being equal, short selling increases the number of sellers in the marketplace. This liquidity usually comes from market makers and other market specialists who use short sales to offset (and potentially profit from) occasional contractions in the supply of a security.[45] Second, short selling provides pricing efficiency because arbitrageurs can use short sales to equilibrate the price of a security to its perceived 'correct' value. For example, if an arbitrageur determines (for whatever reason) that the price of a security is too high, the arbitrageur can use short sales as a means of profiting from the expected decline in the security's price. This short selling activity helps the market to price the security 'correctly.'[46] These two perceived short selling benefits (liquidity and pricing efficiency) are accepted by the U.S. Securities and Exchange Commission.[47]

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against the box are generally used to avoid incurring taxes on the sale of a security that the seller already owns or to hedge against risks in a stock portfolio. *See* Janvey, *supra* note 41, at 271 & nn.5, 6.

[43] See POLLACK, *supra* note 41, at 20, stating that the Dutch and English evidently regulated short selling as long ago as the 1600's and 1700's.

[44] Janvey, *supra* note 41, at 272.

[45] *Id.*

[46] For a classic example of short selling in action, see Sullivan & Long Inc. v. Scattered Corp., 47 F.3d 857 (7th Cir. 1995).

[47] *See* Proposed Rules: Short Sales, Securities and Exchange Commission Proposed Regulation SHO, Exchange Act Release No. 34-48709, 68 F.R. 62972, 62974, Nov. 6, 2003, *available at* 2003 WL 22507877 [hereinafter SEC Proposed Regulation SHO].

But just as short selling has market benefits, it is also seen as potentially predatory or abusive. Indeed, concerns about short selling figured prominently in the creation of the United States securities laws in the 1930's.[48] Some commentators at the time excoriated short sellers as "bear raiders" and blamed them for preventing a recovery from the stock market crash of 1929 and for prolonging the effects of the Great Depression.[49] Others argued that short selling was "a necessary feature of an open market for securities"[50] and that it was important to distinguish between legitimate and illegitimate short selling.[51] "Apparently finding it impossible to discover where the truth lay between the extreme views that had been expressed, Congress in §10(a) [of the Securities Exchange Act] simply placed the practice of short selling in registered securities under the plenary rulemaking authority of the [Securities and Exchange] Commission."[52] Section 10(a) of the Exchange Act thus gives the SEC the authority to regulate short selling on the nation's securities exchanges.[53]

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[48] *See* LOUIS LOSS & JOEL SELIGMAN, FUNDAMENTALS OF SECURITIES REGULATION 702 & n.60 (3d ed. 1995). *See also* Jonathan R. Macey et al., 74 CORNELL L. REV. 799, 799 (1989) (stating that, during the drafting of the Securities Exchange Act of 1934, "Representative Adolph Sabath of Illinois wanted to ban all short sales in order to 'eliminate what we term short selling ... the greatest evil that has been permitted or sanctioned by the Government that I know of.'").
[49] *See* 7 LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 3200 & n.214 (3d ed. 1989).
[50] *See id*. at 3200 & n.213.
[51] See Comments of Richard Whitney, NYSE President, 1931, reprinted in Short Sales of Securities, Securities and Exchange Commission Exchange Act Release No. 34-13091 (Dec. 21, 1976), *available at* 1976 SEC Lexis 90, at 11.
[52] *See* LOSS & SELIGMAN, *supra* note 49, at 3201. It is instructive that Congress placed its discussion of short selling in Section 10 of the Exchange Act, "Regulation and Use of Manipulative and Deceptive Devices," and that the subsequent paragraph, Section 10(b), is the Exchange Act's principle antifraud provision.
[53] *See* David C. Worley, *The Regulation of Short Sales: The Long and Short of It*, 55 BROOK. L.R. 1255, 1275 n.75 (1990) ("it appears that the SEC does not have authority under the Exchange Act section 10(a) to regulate the short selling of purely OTC stocks since section 10(a) refers to short sales effected in securities registered on an exchange…"). This limitation remains in the current text of Sec. 10(a). *See* 15 U.S.C. 78j (2004).

As discussed above, the basic principles of short selling are reasonably simple. Yet the practice becomes very complex in the marketplace due to locating and delivery issues and margin requirements. Unfortunately, it is necessary to discuss these complex standards in order to fully appreciate the issues involved with Future Priced Securities litigation. Thus, it is to the details of short selling that this paper now turns.

The reader will recall that short selling is possible because of securities borrowing.[54] To borrow a security, the short seller must have a margin account (as opposed to a 'cash account') with a securities broker.[55] The short seller also must have deposited into this account sufficient money or securities to maintain minimum margin levels required for the account.[56] These minimum margin levels differ for various market participants. For instance, individuals must maintain margin levels of 150% of the value of any short selling activity in their margin accounts, while market makers and self-clearing brokers need only be able to cover their net short-sale positions every day.[57]

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[54] *See* POLLACK, *supra* note 41, at 15 ("Technically, a short-sale transaction begins with the decision to borrow securities, since the short seller's broker should have reason to believe he can borrow the stock before executing an order.").

[55] *See, e.g.*, Mark Hulbert, *Season for Shorting?*, FORBES, Oct. 15, 1990, at 231; Ray Brady, *Selling Short: Not for the Faint of Heart*, NATION'S BUS., March 1987, at 63.

[56] NYSE Rule 431 and NASD Rule 2520 require that a "minimum margin" of $2,000 be deposited into any customer's margin account before margin trading (and short selling) may begin, though brokers may require higher deposits. The NASD recently increased its margin requirement for "day traders" to $25,000. See "Investing with Borrowed Funds: No 'Margin' for Error," available from the NASD website, www.nasd.org.

[57] *See* Janvey, *supra* note 41, at 273 & n.8 ("The Federal Reserve's Regulation T specifies the amount of money that brokers can lend to their customers for the purchase of securities 'on margin,' and it also specifies the additional cash 'margin' that an investor must deposit or borrow in order to make a short sale. The present margin requirement on most short sales is 150 percent, meaning the broker must hold the proceeds of the sale (100 percent), and the investor must deposit or borrow an additional 50 percent. Short sales by exchange specialists and market makers, and proprietary short sales by self-clearing brokers, are exempt from this requirement."). Since market makers and self-clearing brokers will potentially have many off-setting orders, they are required only to maintain a net position that would allow them to cover all open short sales each day. *See* POLLACK, *supra* note 41, at 16.

Once the account is established and a short-sell order is made, the short seller's broker takes over. It is the broker's responsibility to execute the short sale by locating securities to borrow.[58] Brokers can accomplish this by borrowing the securities from other customers' margin accounts, from other brokers, or from institutions that agree to lend their securities.[59] "Securities lending for this purpose is highly organized, and usually the seller's broker has no problem borrowing the necessary shares, either from other customers' margin accounts or from another broker."[60] If the securities are borrowed from another broker or from an institutional lender, the borrowing broker will be required to transfer 100% of the value of the borrowed securities in cash to the lender.[61] *This is the lender's incentive to lend the securities.* "These funds are held in interest-bearing assets by the stock lender to increase his rate of return on his investment in the underlying security loaned out, or, in the case of a lending broker, to reduce the margin funds borrowed from banks."[62] For the securities lender, this provides the use of 'free money.'[63]

At this point, shares have been located for borrowing, margin has been posted with the lender, and the short sale is then executed. This process is transparent in the marketplace: the purchaser on the other side of the trade will ordinarily have no

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[58] *See* 12 C.J.S. *Brokers* § 72 (2003).
[59] *See* POLLACK, *supra* note 41, at 16. If the broker borrows securities from another customer's account, there is no requirement to notify the customer. The reason for this is that when a customer sets up a margin account, the customer must agree to allow her securities to be leant by the broker. *See* Janvey, *supra* note 41, at 275.
[60] Janvey, *supra* note 41, at 274. Typically, the actual securities will come from the accounts of broker-dealers or institutional investors. *See id.* at 271-72 & n.5.
[61] *See* POLLACK, *supra* note 41, at 16.
[62] *Id.*
[63] *See* Stock Strategies: Short Selling, GlobalInvestor.com, *available at* http:magazine.globalinvestor.com/static/intro/text/school_24.html.

indication that he is buying securities that are being sold short.[64] But the shares will not actually be borrowed at this time. Instead, the shares will be borrowed only when the trade *settles*, which can be up to five business days after *execution*. If for some reason the short seller's broker becomes unable to borrow shares at settlement, no shares will be delivered to the purchaser and a "fail-to-deliver" will result.[65] Fails-to-deliver occur at market clearing agencies whenever an executed trade fails to settle, and they appear in the account of the selling broker.[66] A fail-to-deliver is still a valid trade, it just means that no payment will be made by the purchaser (nor received by the short seller) until the seller's broker acquires the securities, delivers them to the purchaser, and settles the trade.[67] As will be shown in Part IV, fails-to-deliver are an important issue in death spiral litigation.[68]

The process of short selling also increases beneficial ownership of a security. Beneficial ownership is the legal right to own a security and, while a short sale is open—that is, until it is covered and both the purchaser and the lender receive their shares—short selling temporarily increases beneficial ownership because both the lender and the purchaser have a legal right to the same shares. The lender never loses its right to the shares by lending them yet the purchaser acquires a right to the lender's shares upon execution of the short sale.[69] This increased beneficial ownership will occur even if there is a fail-to-deliver (because fails-to-deliver are still valid trades) and will exist until the short seller covers the short sale. What is more, short sellers do not need to cover

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[64] *See* LOSS & SELIGMAN, *supra* note 48, at 699.
[65] Janvey, *supra* note 41, at 274 n.9.
[66] *See id.*
[67] *See, e.g.*, Fail to Deliver, NetExchange Client Investment Glossary, *available at* http://www.netxclient.com/universal2/invest_glosry_FFh.htm.
[68] *See infra* text accompany notes 288-98.

quickly. (This is an important point for a short seller planning the "death spiral" of a company.) Short sales may remain open for as long as the lending broker allows, and the short seller's only responsibility is to maintain its margin with the lender. (The reader will recall that lenders have an incentive to keep a short open because this provides them with the use of the short sellers margin—'free money.')[70] "A genuine securities short seller, who borrowed the security she has delivered, may hold her position as long as she is able to meet her margin calls—indefinitely, if she has the financial wherewithal to withstand a significant rise in the price of the security."[71]

B) The Law of Short Selling

1. Securities Listed on a National Exchange

As previously indicated, Congress placed its instructions with respect to short selling in Section 10(a) of the Securities Exchange Act.[72] This gives the SEC authority to create rules governing short sales on national securities exchanges, but by its terms applies only to the exchanges.[73] SEC short-selling rules created under Sec. 10(a) thus only govern short sales of securities traded on an exchange registered pursuant to Section 12(b) of the Securities Exchange Act (such as the New York Stock Exchange or American Stock Exchange).[74]

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[69] *See* Janvey, *supra* note 41, at 274. Of course, the short sale never results in more shares being outstanding, nor does it increase the total number of shares in the company, which can only be done by amending the company's articles of incorporation.
[70] *See supra* note 63 and accompanying text.
[71] Richard D. Friedman, *Stalking the Squeeze: Understanding Commodities Market Manipulation*, 89 MICH. L. REV. 30, 45 n.36 (1990).
[72] *See supra* notes 52 and accompanying text.
[73] *See supra* notes 53 and accompanying text
[74] The SEC's short selling rules apply only to securities that are registered on the national exchanges and do not apply to over-the-counter securities that have exchange-trading privileges. *See generally* Securities Exchange Act Release No. 34-22975, 51 F.R. 8801 (March 14, 1986). *See also*, Janvey, *supra* note 41, at 278.

There are three basic SEC short selling rules.[75] First, Rule 3b-3 defines the term "short sale": "'short sale' means any sale of a security which the seller does not own or any sale which is consummated by the delivery of a security borrowed by, or for the account of, the seller."[76] This definition parallels the working definition and description of short selling outlined by this paper above.[77] The second SEC rule is Rule 10a-1,[78] which provides the SEC's substantive regulation of short sales. First adopted in 1938, Rule 10a-1 contains the SEC's "tick test."[79]

The tick test is a pricing rule that was designed to prevent short selling from depressing the market values of securities. The SEC adopted the tick to achieve three objectives: (1) to allow unrestricted short selling in an advancing market; (2) to prevent short selling at successively lower prices, thereby limiting the ability of short sellers to drive-down stock prices; and (3) to prevent short sellers from accelerating a declining market by exhausting all remaining bids at one price.[80] Rule 10a-1 does this by prohibiting short sales at or below the last market price for the security, unless this price is above the *next preceding* market price. This is a complicated standard and is best understood through an example. Say, for instance, that market sales occur at $49.85 and then $50. The tick test would then allow for an infinite number of short sales at $50 (because this is above the last market sale price, which was in turn above the next

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[75] *See* LOSS & SELIGMAN, *supra* note 49, at 3203. There are also thirteen exceptions to these SEC rules that allow for short selling activity the SEC deems to be beneficial, but these exceptions are not important to the analysis in this paper. *See generally* Janvey, *supra* note 41, at 278-79.
[76] 17 C.F.R. § 240.3b-3 (2004).
[77] See *supra* note 42 and accompanying text. *Cf.* Worley, *supra* note 53, at 1257 (discussing the definition of "short sale").
[78] 17 C.F.R. § 240.10a-1 (2004).
[79] *See* SEC Proposed Regulation SHO, *supra* note 47, at 62978.
[80] *See* Notice of Adoption of Amendments to Rules 10a-1 and 10a-2, Securities Exchange Act Release No. 34-11468, June 12, 1975.

preceding sale price). But if the two sales were $49.85 and $49.80, the tick test would prevent any short sales below $49.85 (because the last market sale price was below its next preceding sale price)."[81] The tick test thus necessarily requires real-time monitoring of pricing data to evaluate acceptable and unacceptable short-sale trades.[82]

The third SEC short-selling rule is a delivery rule, Rule 10a-2,[83] but it is not germane to the analysis in this paper.[84] Instead, a more important delivery rule for purposes of this paper is the New York Stock Exchange's delivery rule. NYSE Rule 440C.10 mandates that all brokers executing short sales on the exchange must locate stock available for borrowing prior to executing the trade.[85] This rule therefore should prevent intentional fails-to-deliver (also known as "naked short selling," discussed in detail below).[86]

2. Securities Traded in the Over-the-Counter Market

Short selling regulation in the over-the-counter ("OTC") market is unrelated to short selling regulation on national securities exchanges. The reason for this is that the SEC's Section 10(a) authority does not extend to the OTC markets.[87] "Although the

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[81] *See* LOSS & SELIGMAN, *supra* note 49, at 3203-04.
[82] The operation of the tick test can become quite complicated. For a more detailed examination of how Rule 10a-1 operates, see Worley, *supra* note 53, at 1259-62.
[83] 17 C.F.R. § 240.10a-2 (2004).
[84] Rule 10a-2 prohibits brokers or dealers from, among other things, lending securities to effect a sale that is marked long under Rule 10a-1. For a discussion of Rule 10a-2, see Worley, *supra* note 53, at 1264-65.
[85] *See, e.g.*, SEC Proposed Regulation SHO, *supra* note 47, at 62976.
[86] For a discussion of naked short selling, see *infra* Part II.B.3.
[87] *See supra* note 53. The SEC evidently could adopt short selling rules for the OTC markets based on other powers afforded to it by the securities laws, however it has not done so. *See* Worley, *supra* note 53, at 1275 n.75 ("Moreover, it appears that the SEC does not have authority under the Exchange Act section 10(a) to regulate the short selling of purely OTC stocks since section 10(a) refers to short sales effected in securities registered on an exchange. Nevertheless, the SEC presumably would have such authority under section 15(c)(1) or (2), 15 U.S.C.A. 78o, which, unlike section 10(b), 15 U.S.C.A. 78j, grant[s] to the SEC the authority to define the terms 'manipulative,' 'deceptive,' and 'fraudulent.' While sections 15(c)(1) and (2) only apply to transactions effected by broker-dealers, the SEC could prohibit them from effecting transactions for others in contravention of an OTC short sale rule.").

Commission has regulated short sales since 1938, that regulation has been limited to short sales of exchange-listed securities."[88] Thus, none of the aforementioned SEC rules apply to the following discussion.

There are four distinct markets that make up the over-the-counter stockmarket. The principle market is the Nasdaq National Market ("NNM").[89] This is the over-the-counter listing for major industrial companies, and is distinct from the Nasdaq SmallCap Market, which lists smaller companies.[90] There are two other OTC markets as well, the Nasdaq Over-the-Counter Bulletin Board ("OTCBB") and the Pink Sheets.[91] Short selling regulation of these four over-the-counter markets is bifurcated into two basic regimes: the rules for Nasdaq National Market and the rules for the three other three.

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[88] *See, e.g.*, Self-Regulatory Organizations, Securities Exchange Act Release No. 34-48967, 68 F.R. 75299, Dec. 30, 2003, *available at* 2003 WL 23021289. The SEC has been reviewing the issue of short-selling regulations of OTC securities for many years. Since the SEC does not have explicit authority to draft an OTC short-selling rule under Sec. 10(a) it would have to do so indirectly. In 1974, as part of changes in the securities markets ordered by Congress, the SEC changed Rule 10a-1 to make it applicable to all securities listed on the new "Consolidated Tape" in the nascent national market system. This would ostensibly include OTC securities reported as part of the Consolidated Tape, however the SEC 'temporarily' exempted OTC securities from the short-sale rule until the NASD could confirm that the OTC market was ready for it. *See* Notice of Adoption of Amendments to Rules 10a-1 and 10a-2 Under the Securities Exchange Act of 1934, Securities Exchange Act Release No. 34-11468, June 12, 1975, *available at* 1975 WL 162899. This never happened. Then, in 1985, the SEC issued additional Releases potentially broadening the scope of Rule 10a-1 further in covering OTC securities. Again, however, OTC securities escaped SEC regulation. In March 1986, the SEC adopted a permanent amendment exempting transactions in OTC stocks from the short sale rule. *See* Worley, *supra* note 53, at 1274-75.

[89] *See, e.g.*, www.nasdaq.com.

[90] The listing standards for the NNM and SmallCap markets are based on a complex of factors, but, basically, Nasdaq National Market companies will have market capitalizations of over $50 million while SmallCap companies will have capitalizations below $50 million. *See* Nasdaq Stock Market, Listing Requirements and Fees, *available at* http://www.nasdaq.com/about/nasdaq_listing_req_fees.pdf. In terms of the numbers of companies in each market, there are currently about 2,600 NNM stocks and only about 680 SmallCap stocks. *See* Nasdaq Market Classification, *available at* http://www.nasdaqnews.com/MarketData/News_mrktdata_home.htm.

[91] There are many thousands of OTCBB and Pink Sheet companies, which are very small, largely unregulated issuers. *See, e.g.*, Gregory Zuckerman, *Heard on the Street: OTC Trading Surges as Speculation Makes a Comeback*, WALL ST. J., Oct. 10, 2003, at C1 (indicating that there are approximately 3,400 OTCBB stocks); Jeff D. Opdyke, *More Blue Chips Hit the Pink Sheets*, WALL ST. J., Jan. 21, 2003, at D1 (indicating that there are approximately 3,300 Pink Sheet stocks).

a. Short Selling in the Nasdaq National Market[92]

Since the SEC's Section 10(a) authority does not extend to the OTC markets,[93] it took rulemaking from the National Association of Securities Dealers to provide short selling regulation for the Nasdaq National Market. This occurred ten years ago.[94] In 1994, the SEC approved NASD Rule 3350, which has much the same function as Rule 10a-1 but which is applicable to the Nasdaq National Market.[95] Rule 3350 is similar to the SEC's tick test in that it prevents short sales from exerting downward pricing pressure on a security. It does this by requiring that all short sales in the NNM be at or above the recent market "inside bid" (*i.e.*, the highest current bid price in the market).[96] Rule 3350 is reinforced by another NASD rule, Rule 3370. Rule 3370 is a delivery rule and instructs that no NASD member shall execute a short sale unless the member makes an "affirmative determination" that the member will receive the security from the customer or can borrow the security on behalf of the customer.[97] Rule 3370 thus parallels NYSE Rule 440C.10 in the attempt to prevent intentional fails-to-deliver.[98] Finally, NASD Rule

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[92] The Nasdaq recently applied to the SEC to become a regulated securities "exchange." *See* The Nasdaq Stock Market, Inc.; Notice of Filing of Application for Registration as a National Securities Exchange Under Section 6 of the Exchange Act, Securities Exchange Act Release No. 34-44396, June 7, 2001, *available at* 2001 WL 629346. If this occurs, then of course the regulation of NNM securities will become subject to the SEC's exchange rules just like all exchange-traded securities. *See* SEC Proposed Regulation SHO, *supra* note 47, at 62979.

[93] *See supra* notes 53 and 87.

[94] *See* Self-Regulatory Organizations, Securities Exchange Act Release no. 34-34277, June 29, 1994, *available at* 1994 WL 317379. Rule 3350 was originally issued on a temporary basis, but has been re-authorized multiple times and thus has been continuously operative to the present. *See* Self-Regulatory Organization Notice, Securities Exchange Act Release No. 34-48967 (Dec. 30, 2003).

[95] *See* Self-Regulatory Organization Notice, Securities Exchange Act Release No. 34-48967 (Dec. 30, 2003).

[96] *See id.*

[97] *See* Rule 3370, available through the NASD Manual Online at: http://cchwallstreet.com/nasd.

[98] *See supra* notes 85-86 and accompanying text.

11830 addresses the problem of fails-to-deliver by preventing short sales of securities for which significant fails-to-deliver have built up at a market clearing agency.[99]

The regulatory regimes for exchange-traded securities and Nasdaq National Market securities are thus similar in design. Both employ a price-maintenance rule, and both have broker delivery requirements. But as will be seen below, the short selling regime for SmallCap, OTCBB, and Pink Sheets stocks is different in one critical respect: it lacks a pricing rule such as the tick test or bid test. This is a significant difference, and impacts death spiral litigation.

b. Short-Selling in the Nasdaq SmallCap Market, Over-the-Counter Bulletin Board, and Pink Sheets

In contrast to the regulated exchanges and, more recently, the NNM, the SmallCap Market, Over-the-Counter Bulletin Board and Pink Sheets are not subject to any short-sale pricing rule.[100] Rule 10a-1 does not apply because these are OTC markets, NASD Rule 3350 does not apply because it is limited to the Nasdaq National Market,[101] and there are no substitutes. Thus, the companies in these three OTC markets (which are, of course, all small issuers) lack the single most important form of short selling regulation, a pricing rule. Given the SEC's three rationales for the pricing rules,[102] it appears clear that small companies need and deserve these protections at least as much as larger, more seasoned issuers. Yet the small OTC markets receive no help from regulators. These three markets are subject to other NASD rules such as the delivery requirements listed

[99] *See* SEC Proposed Regulation SHO, *supra* note 47, at 62977. NASD Rule 11830 restricts short sales where over 10,000 fails to deliver have accumulated and this is at least 1/2% of the issuer's total shares outstanding.
[100] *See, e.g.*, LOSS & SELIGMAN, *supra* note 49, at 3215; SEC Proposed Regulation SHO, *supra* note 47, at 62972.
[101] *See* NASD Rule 3350, *available at* http://cchwallstreet.com/nasd.

above,[103] however this provides only incidental short selling regulation and is far less protective of price manipulation than Rule 10a-1 or Rule 3350.

3. Naked Short Selling

A final short selling issue that appears in the context of death-spiral litigation is the topic of "naked short selling." Naked short selling is the practice of short-selling a security without borrowing the shares necessary to make delivery to the purchaser. A naked short will thus result in a fail-to-deliver securities to the purchaser.[104] Although intentional naked short selling implicitly violates a selling broker's locate-and-delivery obligations under rules such as NYSE Rule 440C.10 and NASD Rule 3370 (see above), naked short selling is not *per se* illegal.[105] The reason for this is that securities are not always available for borrowing, even when a broker reasonably expects them to be, and thus a certain amount of naked short selling is virtually inevitable.

When brokers arrange a short sale, they do not actually target specific shares held in a specific account that will be used to settle the short. Instead, brokers execute short sales in reliance upon lists that identify how easy securities are to borrow.[106] Short sale positions are then netted against each other each day in a complex clearing system.[107] It is thus entirely possible that a broker may perform her duty and reasonably believe that she has located securities for the short sale, only to find that, on the settlement date, no

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[102] *See supra* text accompanying note 80.
[103] *See* NASD Rule 3370, 11380, *available at* http://cchwallstreet.com/nasd.
[104] *See* SEC Proposed Regulation SHO, *supra* note 47, at 62974 ("Naked short selling is selling short without borrowing the necessary securities to make delivery, thus potentially resulting in a 'fail to deliver' securities to the buyer."). This paper has previously discussed fails-to-deliver, see *supra* text accompanying notes 64-67.
[105] *See* Worley, *supra* note 53, at 1282 ("Naked short selling by NASD-member broker-dealers that are registered with the SEC is not in and of itself illegal.").
[106] *See* SEC Proposed Regulation SHO, *supra* note 47, at 62976.
[107] *See* Worley, *supra* note 53, at 1278.

securities are available for delivery. If this occurs, the seller and purchaser on either side of the as-yet-uncompleted short sale then may desire to keep the short sale open rather than cancel the short or clear it through other means.[108] And there is ordinarily no limit on how long the short may remain unsettled.[109] Thus, naked shorts may linger and accumulate at the securities clearing agencies.[110]

It is unclear when, if at all, naked short selling is unlawful,[111] and this paper can find no court case that definitively addresses this point.[112] The SEC's position is also unclear. In 2003, the SEC reaffirmed a prior Exchange Act Release on naked short selling from 1962,[113] but the exact contours of the Commission's views are muddy. For instance, the recent SEC Release states: "The Commission issued a prior statement cautioning broker-dealers that where the broker-dealer has sold short, but did not, for a substantial period of time, effect the offsetting purchase transactions for purpose of delivery, this could generally involve violations of the anti-fraud provisions of the Federal

[108] For instance, the seller may not want to settle the trade by borrowing from a different lender (assuming securities can be located) as this may have to be done at higher cost. Nor would the seller choose to settle the short by purchasing securities in the open market, as this would cancel-out the short position. Similarly, the purchaser (who is awaiting delivery on the short sale) may not want to cancel the lawful trade nor demand delivery, because a demand would force the purchaser to conduct a buy-in, which has costs for the purchaser. *See* Worley, *supra* note 53, at 1279.
[109] *See* Worley, *supra* note 53, at 1278 ("Unless the purchaser or its clearing broker-dealer demands delivery of the stock, it may be carried as a fail-to-deliver until the seller decides to purchase or borrow the stock for delivery to complete the short.").
[110] SEC Proposed Regulation SHO, *supra* note 47, at 62975.
[111] *Compare* 2 THOMAS LEE HAZEN, LAW OF SECURITIES REGULATION § 14.22 (4th ed. 2004) ("Uncovered, or 'naked,' short sales are manipulative and hence in violation of the 1934 Act.), *with* Worley, *supra* note 53, at 1282 ("Naked short selling by NASD-member broker-dealers that are registered with the SEC is not in and of itself illegal.).
[112] *See generally* Sullivan & Long, Inc. v. Scattered Corp., 47 F.3d 857 (7th Cir. 1995) (implying that a market maker's intentional naked short selling that did not violate exchange rules is not unlawful); In re Olympia Brewing Co. Lit., 613 F. Supp. 1286, 1295 (N.D. Ill. 1985) (dismissing naked short selling allegation for want of evidence without evaluating the underlying legal issue).
[113] *See* SEC Proposed Regulation SHO, *supra* note 47, at 62975 n.29.

securities laws."[114] This shows that the SEC considers naked short selling to be potentially fraudulent, but provides no useful guidance as to the boundaries of the illegality. For example, it does not instruct what level of scienter is required and whether persons other than brokers can engage in fraudulent naked short selling. The one-page 1962 Release is similarly unhelpful.[115]

Part III – Review Of Six FPS Actions: Facts and Claims Alleged & A Few Court Decisions

This paper will now review six Future Priced Securities cases to begin the analysis of death spiral litigation. Five of these cases are from the Southern District of New York and are discussed in subparagraph "A" below.[116] The sixth case, *GFL v. Colkitt*, is a case out of Pennsylvania and will be examined separately in subparagraph "B." *GFL* reached a final judgment before the United States Court of Appeals for the Third Circuit and, as will be demonstrated, has important precedential value for other FPS litigation.[117]

The purpose of this review is to identify the common facts and claims alleged in these cases as well as the legal conclusions that may be drawn from them. As indicated at the outset of this paper, these cases raise a variety of claims, including federal and state securities violations, civil violations of the Racketeering and Corrupt Organizations Act ("RICO"), and common law tort, breach of contract, and breach of fiduciary duty

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[114] *See* SEC Proposed Regulation SHO, *supra* note 47, at 62975 n.29, citing Short Sales of Securities, Securities Exchange Act Release No. 34-6778, April 16, 1962.
[115] *See* Short Sales of Securities, Securities Exchange Act Release No. 34-6778, April 16, 1962, *available at* 1962 WL 69297.
[116] *See infra* notes 120-24.
[117] *See infra* Part III.B.

claims.[118] Yet this paper reviews only the federal securities fraud claims filed under Section 10(b) of the Securities Exchange Act.

A) Five Future-Priced Securities Cases from the Southern District of New York

To investigate the topic of Future Priced Securities litigation, this paper examines five specific complaints that have been filed in the Southern District of New York in recent years. This paper reviews these complaints like a court evaluating a motion to dismiss—*i.e.*, this paper assumes as true all allegations in the complaints and considers publicly available information, such as the securities filings from these companies available from the Securities and Exchange Commission's EDGAR database system.[119]

1. The Issuers and Their Future Priced Securities

The following table identifies these five cases, by plaintiff and defendant. In each case, of course, the plaintiffs were issuers of Future Priced Securities suing the purchasers of their securities. The table also identifies the markets in which the issuers' securities were traded, which, as indicated above, determines the level of short selling regulation involved.

[118] *See infra* Part III.A.2.
[119] The SEC's EDGAR database may be accessed at: www.sec.gov/edgar/searchedgar/companysearch.html.

Plaintiff (FPF Issuer)	*Defendant (FPS Purchaser)*	*Market*
Internet Law Library, Inc.	Southridge Capital Mgmt., *et al.*	OTCBB[120]
Log On America, Inc.	Promethean Asset Mgmt., *et al.*	NNM[121]
Nanopierce Technologies, Inc.	Southridge Capital Mgmt., *et al.*	OTCBB[122]
Sedona, Corp.	Ladenburg Thalmann, *et. al.*	SmallCap[123]
JAG Media Holdings, Inc.	A.G. Edwards & Sons, Inc., *et al.*	OTCBB[124]

This table shows that four of the five companies traded in the less regulated over-the-counter markets, so their securities were not protected by the SEC's or NASD's short sale pricing rules.[125] Furthermore, because these issuers were small companies, it is reasonable to conclude that their stocks were thinly traded—*i.e.*, the companies had low average daily trading volume—and that the companies were not widely followed by securities analysts.[126]

[120] *See* Internet Law Library, Inc. v. Southridge Capital Mgmt. LLC, et al., No. 01-CV-06600 (S.D.N.Y.), Plaintiff's Original Complaint and Request for Injunction, filed July 20, 2001, ¶ 12 [hereinafter Internet Law Library Complaint].
[121] *I.e.*, Log On America traded in the Nasdaq National Market. *See* Log On America, Inc. v. Promethean Asset Mgmt. LLC, et al., No. 00-CV-6218 (S.D.N.Y.), Complaint and Jury Demand, filed Aug. 18, 2000, ¶ 1. (Note: there was a subsequent Amended Complaint filed in the *Log On America* action, however the author was unable to obtain it from the Southern District of New York Clerk of the Court's office.)
[122] *See* Nanopierce Tech. Inc. v. Southridge Capital Mgmt. LLC, et al., No. 02-CV-0767 (S.D.N.Y.), First Amended Complaint, filed June 24, 2002, ¶ 1 [hereinafter Nanopierce Complaint].
[123] *I.e.*, Sedona traded in the Nasdaq SmallCap market prior to issuing its Future Priced Security. *See* Sedona Corp. v. Ladenburg Thalmann, et al., No. 03-CV-3120 (S.D.N.Y.), First Amended Complaint and Jury Demand, filed July 18, 2003, ¶ 102 [hereinafter Sedona Complaint].
[124] *See* JAG Media Holdings, Inc. v. A.G. Edwards & Sons, Inc. et al., No. 02-CV-2867 (S.D. Tex.), Plaintiff's Second Amended Complaint and Jury Demand, filed Nov. 22, 2002 [hereinafter JAG Media Holdings Complaint]. *See* JagNotes.com Securities Purchase Agreement, dated June 12, 2000, Sec. 3(e), available at: http://www.sec.gov/Archives/edgar/data/1089029/000088981200002829/0000889812-00-002829-0003.txt.
[125] *See supra* text accompanying notes 100-03.
[126] These facts are relevant for the Analysis section. Specifically, the complaints indicate that Internet Law Library's market capitalization prior to its FPS offering was approximately $200 million (*see* Internet Law Library Complaint, *supra* note 120, ¶ 23), Log On America's was approximately $140 million (*see* Log On America Complaint, *supra* note 121, ¶ 2), and Sedona's was approximately $280 million (*see* Sedona Complaint, *supra* note 123, ¶ 66). The Nanopierce and JAG Media Holdings complaints do not provide such information. Also, based on a review of financial websites, none of these five companies is currently being followed by a securities analyst, though the author was unable to determine whether these companies were followed by analysts *when they issued their Future Priced Securities.* However, this appears unlikely based on their small market capitalization, poor finances, and limited market power.

There are other common themes among these companies as well. These issuers were all small technology companies, desperate for cash when they issued their Future Priced Securities. Internet Law Library's business was offering legal research services over the internet, and it operated at a loss, had negative cash flows, and warned investors that it might never achieve profitability.[127] It therefore sought a $28 million FPS to keep its business going.[128] Log On America was another internet company and was similarly cash-poor: "We have incurred net losses since our inception and anticipate continuing losses."[129] By comparison, Nanopierce Technologies' held a series of patents that it hoped to commercialize, but it knew these might never become marketable.[130] Sedona sold business software and claimed to have a solid business plan based on, among other things, a strategic partnership with IBM Corp. Nevertheless, it too operated at a loss[131] and agreed to a $50 million FPS to finance planned growth.[132] Finally, JAG Media Holdings (known prior to issuing its FPS as "JagNotes.com") issued a $10 million FPS to finance a financial television program related to its internet financial advisory business.[133]

[127] *See* Internet Law Library Form S-1, filed Dec. 22, 2000, ("We expect net losses and negative cash flows to continue for the foreseeable future as we continue to incur significant operating expenses and make capital investments in our business. We may never generate sufficient revenues to achieve profitability."), *available at* http://www.sec.gov/Archives/edgar/data/3959/000093066100003254/0000930661-00-003254-0001.txt

[128] *See* Internet Law Library Complaint, *supra* note 120, ¶ 130.

[129] *See, e.g.*, Log On America Form S-3, filed May 23, 2000, Risk Factors, *available at* http://www.sec.gov/Archives/edgar/data/1074927/0000889812-00-002465-index.html.

[130] *See* Nanopierce Technologies Form S-3/A, filed May 23, 2000, Prospectus & Risk Factors*, available at* http://www.sec.gov/Archives/edgar/data/827161/0000927356-00-001187-index.html.

[131] *See* Sedona 1999 Form 10-K, filed May 30, 2000, Consolidated Statement of Cash Flows, *available at* http://www.sec.gov/Archives/edgar/data/764843/0000950116-00-000719-index.html.

[132] *See* Sedona Complaint, *supra* note 123, ¶¶ 44 & 56.

[133] *See* JAG Media Holdings Complaint, *supra* note 124, ¶¶ 160 & 162.

It may be assumed that the company hoped this investment would mitigate its otherwise large operating losses.[134]

In addition to the issuers being small and financially weak, their Future Priced Securities generally shared the characteristics of this paper's "classic case" FPS discussed earlier.[135] The following is not an exhaustive analysis, but provides some examples to demonstrate these points. As a threshold matter, it is important to note that these companies did not need to seek shareholder approval prior to issuing their Future Priced Securities. For example, Internet Law Library had 100 million shares authorized under its articles of incorporation but only 35 million outstanding at the time of its FPS, so its directors were well within their authority to issue an FPS capped at 30.7 million shares.[136] The directors of Sedona had similar authority to issue that company's future-priced convertible preferred stock due to a large number of authorized but un-issued shares.[137]

These five FPS deals parallel this paper's "classic case" FPS. First, of course, they provide an opportunity for profit. These companies did not pay dividends or interest on their FPS's (since they all have limited—negative—cash flows), but instead compensated investors with conversion discounts.[138] Internet Law Library's conversion discount, for instance, was a minimum of 20%. Thus, its investors had a reasonable

[134] *See* JagNotes.com Form 10-QSB, filed March 16, 2000, Condensed Consolidated Statement of Cash Flows, *available at* http://www.sec.gov/Archives/edgar/data/1089029/0000889812-00-001211-index.html.
[135] The reader will recall that this paper's "classic case" FPS is convertible security, stock or bond, that is convertible into a fixed amount of the issuer's stock, at a conversion discount of 15%. Furthermore, the classic case FPS caps the number of shares the stock can be converted into and contains conversion windows. Finally, there are no short selling restrictions in the classic case FPS. *See supra* text accompanying notes 18-24.
[136] *See* Internet Law Library Form S-1, filed Dec. 22, 2000, Prospectus & Plan of Distribution, *available at* http://www.sec.gov/Archives/edgar/data/3959/000093066100003254/0000930661-00-003254-0001.txt.
[137] *See, e.g.*, Sedona Form S-3, filed June 26, 2000, Description of Preferred Stock, *available at* http://www.sec.gov/Archives/edgar/data/764843/000095011600001517/0000950116-00-001517-0001.txt.

expectation of at least a 20% return.[139] The other companies provided similar benefits, though the details of their conversion discounts are unclear. (For example, the Nanopierce and Log On America complaints both state that the purchasers of their FPS's were entitled to conversion discounts, however the complaints do not identify how much each discount would be.)[140]

The purchasers of the Future Priced Securities also made representations and warranties, both oral and written, in connection with their FPS purchases. In three of these offerings the purchasers allegedly made representations about their "investment intent" with respect to the FPS offerings.[141] These representations were made either in writing via the securities purchase agreement[142] or orally during negotiations, or both.[143] Furthermore, the purchasers made representations about their abilities and willingness to finance the FPS deals as well as about their prior business and investment practices.[144] (The issuers thus sought to know 'what sort of investors they were dealing with.') Most importantly, though, only two of the five offerings restricted short selling by the FPS purchasers: Internet Law Library[145] and Sedona[146] prohibited short selling through their

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[138] *See, e.g.*, Sedona Form S-3, filed June 26, 2000, Dividend Policy, *available at* http://www.sec.gov/Archives/edgar/data/764843/000095011600001517/0000950116-00-001517-0001.txt.

[139] *See* Internet Law Library Form S-1, *supra* note 136, at 24. The conversion is variable, but is at least a 20% discount.

[140] *See* Nanopierce Complaint, *supra* note 122, ¶ 17; Log On America Complaint, *supra* note 121, ¶ 19. The complaints do not state what the conversion discount was and the author unable to calculate these himself because of the extreme complexity of the conversion calculations.

[141] The three are *Log On America*, *Internet Law Library*, and *Sedona*. *See* Log On America Complaint, *supra* note 121, ¶ 30; Internet Law Library Complaint, *supra* note 120, ¶ 14; Sedona Complaint, *supra* note 123, ¶ 54.

[142] *See* Log On America Complaint, *supra* note 121, ¶ 30.

[143] *See* Internet Law Library Complaint, *supra* note 120, ¶ 14.

[144] *See* Log On America Complaint, *supra* note 121, ¶ 56; Internet Law Library Complaint, *supra* note 120, ¶ 14; Nanopierce Complaint, *supra* note 122, ¶ 34; Sedona Complaint, *supra* note 123, ¶ 50.

[145] *See* Internet Law Library Complaint, *supra* note 120, ¶ 14c; Internet Law Library Securities Purchase Agreement, filed Dec. 22, 2000, Sec. 5.12 Certain Trading Restrictions, *available at* http://www.sec.gov/Archives/edgar/data/3959/000093066100003254/0000930661-00-003254-0003.txt.

securities purchase agreements, while the Nanopierce[147] and JAG Media Holdings[148] FPS offerings permitted short selling without restriction. The Log On America offering took a middle route and prevented uncovered (*i.e.*, naked) short selling.[149]

Finally, these companies share one other unfortunate similarity: their stock prices fell dramatically in the months after issuing their FPS's. Internet Law Library's shares fell from $7/share to $0.12/share in the ten months after its FPS offering.[150] Log On America's stock similarly fell from $17/share to $2.50/share in less than six months,[151] while Nanopierce's stock fell by 60% within just three months.[152]

2. Legal Claims Alleged Against the FPS Purchasers

In these five cases, the FPS issuers alleged many causes of action against the purchasers. Some of these claims are common to all the complaints, while others are raised in only case. In aggregate, though, the issuers allege violations of federal and state securities laws, violations of the Racketeering Influenced and Corrupt Organizations Act ("RICO"), and violations of common law. But because the purpose of this paper is to analyze only the federal securities fraud claims, this paper will not examine the RICO, state securities law, breach of contract, tort, and breach of fiduciary duty claims. Instead, this paper focuses only on the federal securities fraud claims filed under Section 10(b) of the Securities Exchange Act of 1934 ("Exchange Act") and Rule 10b-5 promulgated thereunder. (Thus, this paper ignores the following Exchange Act claims filed in these

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[146] *See* Sedona Complaint, *supra* note 123, ¶ 62.
[147] *See* Nanopierce Purchase Agreement, dated Oct. 20, 2000, *available at* http://www.sec.gov/Archives/edgar/data/827161/000092735600001950/0000927356-00-001950-0006.txt
[148] *See* JAG Media Holdings Securities Purchase Agreement, *available at* http://www.sec.gov/Archives/edgar/data/1089029/000088981200002829/0000889812-00-002829-0003.txt.
[149] *See* Log On America Complaint, *supra* note 121, ¶ 32 & Exhibit A-Securities Purchase Agreement, ¶ 4n.
[150] *See* Internet Law Library Complaint, *supra* note 120, ¶ 22.
[151] *See* Log On America Complaint, *supra* note 121, ¶ 2.

actions: market manipulation in violation of Section 9;[153] Section 13 and 16(a) reporting violations; violations of the Section 16(b) short-swing trading restrictions; and Section 20(a) control-person liability.)[154]

a. Misrepresentation Claims

The first federal securities fraud claim common to all the complaints is misrepresentation in violation of Section 10(b) and Rule 10b-5.[155] These are fact dependent allegations and so will not be exhaustively retold here. However, the following provides a brief overview of some of these allegations.

Internet Law Library alleged fraud based on alleged oral misrepresentations by the purchasers of its FPS, Southridge Capital *et al*. Internet Law Library's claim is thus a form of fraud-in-the-inducement: the company alleges that, but for the purchasers' oral misrepresentations during preliminary negotiations, the company never would have issued the FPS to these investors. Specifically, the company alleges the following misrepresentations: (1) that the purchasers intended and would be able to provide $28 million in financing for the FPS; (2) that they would not short sell for one year (later

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[152] *See* Nanopierce Complaint, *supra* note 122, ¶ 11.
[153] Two complaints raise claims of market manipulation in violation of Sec. 9 of the Exchange Act, 15 U.S.C. § 78i. *See* JAG Media Holdings Complaint, *supra* note 124, ¶ 188; Internet Law Library Complaint, *supra* note 120, ¶ 28. These claims are clearly not actionable, however, because these companies trade on the over-the-counter market while Sec. 9 only applies to *exchange-traded* securities. *See* LOSS & SELIGMAN, *supra* note 48, at 943 ("In contrast to the relatively elaborate structure of § 9 that Congress erected to deal with manipulation of the market for securities registered on exchanges, the only statutory bases for dealing with the manipulation of unregistered securities are the general antifraud provisions of the 1934 Act…."). As with the short selling regulations discussed earlier, this then illustrates another area in which small companies traded in the over-the-counter market (*i.e.*, FPS issuers) receive less protection under the federal securities laws than do large, exchange-traded companies (*i.e.*, companies that would never consider issuing an FPS).
[154] *See generally* Internet Law Library Complaint, *supra* note 120; Log On America Complaint, *supra* note 121; Nanopierce Complaint, *supra* note 122; Sedona Complaint, *supra* note 123; and JAG Media Holdings Complaint, *supra* note 124.

reduced to six months) or otherwise manipulate the price of the company's stock; (3) that the purchasers had long-term investment interest in the company and were not purchasing for resale; (4) that the purchasers had engaged in other FPS deals and created value for those companies; and (5) that the purchasers were not the subject of lawsuits.[156]

Nanopierce Technologies alleged a similar cause of action—*i.e.*, that but for purchasers' misrepresentations, the company never would have issued its FPS. Unlike the Internet Law Library complaint, however, Nanopierce based its allegations on the purchasers' *omissions* of material information.[157] Specifically, Nanopierce labeled as material omissions the purchasers' failure to disclose: (1) their intention to manipulate Nanopierce stock; (2) their intention to providing the full amount of financing; (3) their intention to "attempt to take control over Nanopierce"; (4) their "pattern and practice" of manipulating the stock of other companies; (5) an adverse jury verdict in another FPS case; and (6) testimony by the purchasers in other court actions that they tend to liquidate their stock positions in FPS deals.[158]

b. Market Manipulation Claims

The second set of Section 10(b) claims common to all the death spiral complaints are allegations that purchasers violated Section 10(b) and Rule 10b-5 through "market

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[155] *See* Internet Law Library Complaint, *supra* note 120, ¶¶ 29-30; Log On America Complaint, *supra* note 121, ¶¶ 63-72; Nanopierce Complaint, *supra* note 122, ¶¶ 58-64; Sedona Complaint, *supra* note 123, ¶¶ 107-113; JAG Media Holdings Complaint, *supra* note 124, ¶¶ 189-190.
[156] *See* Internet Law Library, Inc. v. Southridge Cap. Mgmt., LLC, *et al.*, 223 F. Supp. 2d 474, 478 (S.D.N.Y. 2002); *see also* Internet Law Library Complaint, *supra* note 120, ¶ 14.
[157] *See* Nanopierce Complaint, *supra* note 122, ¶¶ 32 & 34.
[158] *See* Nanopierce Tech., Inc. v. Southridge Cap. Mgmt., LLC, *et al.*, 2002 WL 31819207 (S.D.N.Y. 2002), at 3; *see also* Nanopierce Complaint, *supra* note 122, ¶¶ 32 & 34.

manipulation."[159] Market manipulation is a legal term of art but implies that a defendant has engaged in a scheme to control or artificially affect the price of a security.[160] Here, FPS issuers allege that their FPS purchasers engaged in such market manipulation by improperly short selling the issuers' equity securities, thereby causing the "death spirals."

The Log On America complaint provides an example of this argument. Log On America claimed that Promethean *et al.*caused a classic death spiral for the company — that, notwithstanding limitations on the amount of short selling allowed under the Securities Purchase Agreement, the defendants engaged in "massive" short selling to depress the price of Log On America's stock.[161] This short selling activity therefore allegedly lays bare the purchasers' alleged misrepresentations that they had "investment purposes" in buying the FPS.[162] Furthermore, Log On America alleged that the defendants "painted the tape" (created the illusion of market activity through pre-arranged trades in the company's stock), engaged in wash sales (rigged sales), and intentional naked short selling as part of their effort to deflate the value of Log On America's stock.[163] The effect of this manipulative scheme, the company claimed, was to enrich the purchasers at the expense of the company.[164]

> [T]he Defendants have guaranteed themselves completely risk-free profits and effective control of [Log On America] by structuring and implementing this scheme …. By having forced the price of [Log On

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[159] *See* Internet Law Library Complaint, *supra* note 120, ¶¶ 29-30; Log On America Complaint, *supra* note 121, ¶¶ 63-72; Nanopierce Complaint, *supra* note 122, ¶¶ 65-69; Sedona Complaint, *supra* note 123, ¶¶ 114-118; JAG Media Holdings Complaint, *supra* note 124, ¶¶ 189-190

[160] *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 199 (1976). Market manipulation is explained in more detail in Part IV.B. There is a specific section of the securities laws prohibiting market manipulation, Section 9 of the Securities Exchange Act, however this only applies to securities traded on an exchange and so is inapplicable to the companies in this study. *See supra* note 153.

[161] Log On America Complaint, *supra* note 121, ¶ 32.

[162] *Id.* ¶ 32.

[163] *Id.* ¶ 36.

[164] *Id.* ¶ 38.

> America] common stock from over $17 per share in February 2000 to $2.50 per shares in August 2000 through their short sales, Defendants not only assured themselves of millions of dollars in profit (*i.e.* for every share shorted at $17 and covered with stock artificially reduced to below $2 per share, Defendants made $15), but effective control of [Log On America] and its valuable assets.[165]

Other of the death spiral complaints examined herein make similar arguments. For instance, JAG Media Holdings, Internet Law Library, and Sedona all allege similar market manipulation schemes. First, JAG Media Holdings alleges a wide conspiracy by purchasers, brokers, and market makers, to manipulate its stock through massive naked short selling.[166] Although by the terms of JAG's securities purchase agreement the FPS purchasers were not prevented from short selling,[167] JAG alleges that the defendants' naked short sales created large fails-to-deliver in the market clearing system and that this amounts to actionable market manipulation.[168] This is a unique legal theory as-yet untested in a court of law.[169] Second, Sedona filed suit against twenty-seven named defendants, including the FPS purchasers and an associated broker-dealer and market clearing firm,[170] whom Sedona alleges all conspired to manipulate Sedona's stock:[171] "Sedona was in a position to be an industry leader when it was preyed upon by the defendants who orchestrated its downfall."[172] Although JAG cannot point to a clause in its securities purchase agreement that limits short sales, the reader will recall that the Internet Law Library and Sedona securities contracts both prohibited FPS purchasers

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[165] *Id.* ¶ 37.
[166] *See id.* ¶ 182.
[167] *See generally* JagNotes.com Securities Purchase Agreement, dated June 12, 2000, and Sec. 2(a), *available at* http://www.sec.gov/Archives/edgar/data/1089029/000088981200002829/0000889812-00-002829-0003.txt.
[168] *See* JAG Media Holdings Complaint, *supra* note 124, ¶¶ 163 & 169.
[169] *See infra* text accompanying notes 287-98.
[170] *See id.* ¶¶ 2-28, 98, 99.
[171] *See id.* ¶¶ 116-18, 134.

from short selling.[173] These companies thus allege market manipulation through violations of the short selling restrictions in their securities purchase agreements.[174] (Sedona also alleges that investors engaged in unlawful naked short-selling and other manipulative conduct.)[175]

The only one of the five issuers discussed herein that did not allege market manipulation through short selling was Nanopierce Technologies.[176] Instead, Nanopierce argued that its FPS purchaser manipulated its stock through large open-market sales—that is, that they just sold large amounts of stock in an attempt to depress its price.[177] These sales reportedly accounted for 40% of Nanopierce trading volume over seven months and allegedly drove the stock's price from $2.63/share to $0.51/share.[178]

3. Current Status of These Cases

Out of these five cases, *Sedona* and *JAG Media Holdings* are still in the pleadings stage and have not yet heard motions to dismiss.[179] But the other three actions have all heard motions to dismiss. These motions to dismiss will be examined in Part IV of this paper, however it suffices at this point to recognize that in all three cases the courts

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[172] *See id.* ¶ 44.
[173] *See supra* notes 145-46.
[174] *See* Internet Law Library Complaint, *supra* note 121, ¶ 19 & 29-30; Sedona Securities Purchase Agreement Sec. 5.2, *available at* http://www.sec.gov/Archives/edgar/data/764843/000095011600001404/0000950116-00-001404-0004.txt
[175] *See* Sedona Complaint, *supra* note 123, ¶¶ 114-18.
[176] *See* Nanopierce Tech. Inc. v. Southridge Capital Mgmt LLC, Case No. 02-CV-0767, 2002 WL 31819207 (S.D.N.Y. Oct. 10, 2002) at n.6 (stating that Nanopierce dropped this claim at oral argument). Perhaps this was because there were no restrictions on Southridge's ability to short sell in the securities purchase agreement. *See* Nanopierce Purchase Agreement, dated Oct. 20, 2000, *available at* http://www.sec.gov/Archives/edgar/data/827161/000092735600001950/0000927356-00-001950-0006.txt.
[177] *See* Nanopierce, 2002 WL 31819207 at 8.
[178] *See* Nanopierce Complaint, *supra* note 122, ¶ 45 & table, p.14-18.
[179] As of February 18, 2004, the docket reports for *Sedona* and *JAG Media Holdings* indicate that no motions to dismiss have been heard by the courts. *See* Civil Docket for Case #: 1:03-CV-03120, Sedona Corp. v. Ladenburg Thalmann, et al., (S.D.N.Y, J. Swain); Civil Docket for Case #: 02-CV-2867, JAG Media Holdings, et al. v. A.G. Edwards & Sons, et al., (S.D.N.Y., J. Gilmore).

allowed the litigation to move forward and did not reject the issuers' Section 10(b) misrepresentation and market manipulation arguments. *Log On America* was dismissed without prejudice for being insufficiently pled,[180] and then settled by the parties.[181] *Internet Law Library* survived the defendant's motion to dismiss[182] but was eventually dismissed by the court for discovery violations.[183] *Nanopierce* is thus the only case among the five to have both heard a motion to dismiss and to remain active in the courts.[184]

B) *GFL Advantage Fund, Ltd. v. Colkitt*[185]

Aside from these actions in the Southern District of New York, there is another case that deserves attention in this paper, *GFL Advantage Fund, Ltd. v. Colkitt*. *GFL* is a 2001 decision in another Future Priced Securities case and is the only action (so far) to reach a final judgment in a federal court of appeals.[186] Furthermore, *GFL* contains a lengthy analysis of Section 10(b) market manipulation claims in the context of death

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[180] *See* Log On America, Inc. v. Promethean Asset Mgmt. LLC, et al., 223 F. Supp. 2d 435, 438 & n.2 (S.D.N.Y. 2001) (stating that the complaint is dismissed without prejudice for being insufficiently pled but that the court was in no way ruling upon the ultimate merits of the complaint).

[181] *See* Civil Docket for Case #: 00-CV-06218, Log On America, Inc. v. Promethean Asset Mgmt. LLC, et al., (S.D.N.Y., J. Berman), Item # 39: Memo-Endorsement of Settlement Agreement, filed Feb. 6, 2002. The author has come across two other FPS actions that have also settled. The other two cases are Ariad Pharmaceuticals, Inc. v. Promethean, et al., 99-CV-10794 (S.D.N.Y., J. Wood) (*see* Ariad Pharmaceuticals Jan. 14, 2000 8-K, *available at* http://www.sec.gov/Archives/edgar/data/884731/0000950135-00-000141-index.html), and Intelect Communications v. HFTP Investments, et al., 99-CV-04338 (S.D.N.Y., J. Chin) (*see* Intelect June 8, 1999, Form 8-K, *available at* http://www.sec.gov/Archives/edgar/data/316672/0000890566-99-000868-index.html).

[182] *See generally* Internet Law Library, Inc. v. Southridge Cap. Mgmt, LLC, et al., 223 F. Supp. 2d 474 (S.D.N.Y. 2002).

[183] Internet Law Library's complaint was ultimately dismissed with prejudice by the district court on July 8, 2003, but not for reasons germane to this paper. The court dismissed the complaint as to all defendants for "plaintiffs' repeated and flagrant disregard for the Court's [discovery] orders." *See* Civil Docket for Case #: 1:01-CV-06600, Internet Law Library Inc. et al. v. Southridge Cap., et al. (S.D.N.Y., J. Carter), Item #161: Opinion.

[184] *See* Nanopierce Tech., Inc. v. Southridge Cap. Mgmt. LLC et al., Case No. 02-CV-0767, 2002 WL 31819207 (S.D.N.Y. Oct. 10, 2002); Civil Docket for Case #: 1:02-CV-00767, Nanopierce Tech. Inc. v. Southridge Cap., et al. (S.D.N.Y., J. Sand).

[185] 272 F.3d 189 (3d Cir. 2001).

spiral litigation and, as a decision of a court of appeals, should have precedential value for the market manipulation claims discussed above.[187] But, as will be demonstrated, *GFL* poses a potential legal hurdle for FPS issuer/plaintiffs.

1. *GFL v. Colkitt* – Facts of the Case & Relevance to Death Spiral Litigation

The facts of *GFL* parallel the facts of death spiral cases discussed in Part I and Part III.A above,[188] but with a one twist. *GFL* is like our classic case in that it involves a small issuer (two companies, actually) that suffered after issuing a Future-Priced Convertible Security. The twist is that, instead of the companies issuing the FPS's themselves, the majority shareholder and founder of the two companies created the FPS as collateral for a personal loan.[189] But this difference does not distinguish *GFL's* market manipulation analysis from other FPS litigation because market manipulation is not made more or less fraudulent based on who issues a security; instead, the focus of a market manipulation analysis is on the defendant's conduct with respect to the market.[190] Thus, *GFL* should have precedential value in resolving market manipulation claims in death spiral litigation.

The basic facts of *GFL v. Colkitt* are these: Douglas Colkitt was a doctor and businessman who founded two medical services companies, EquiMed, Inc. and National

[186] The author has found no other FPS case that has reached a federal court of appeals.
[187] Of course, *GFL* is binding precedent only in the Third Circuit, however this paper assumes that it will have precedential value in the Southern District of New York as well to guide the resolution of the five death spiral cases discussed in Part III.A above.
[188] *See supra* Part I.A, I.B, & III.A.
[189] There are procedural differences in *GFL* as well, but these are irrelevant. Specifically, GFL Advantage Fund was an FPS purchaser and was suing to enforce the FPS against the issuer. This is immaterial, however, because the court evaluated the issuer/defendant's counterclaims for non-enforcement of the FPS the same as it would if the issuer had been a plaintiff suing to void the FPS.
[190] See the discussion of market manipulation in Part IV.B, *infra*.

Medical Financial Services Corp. ("EquiMed" and "National Medical").[191] As the founder of these two companies, Colkitt was the majority shareholder and owned 73% of EquiMed stock and 38% of National Medical stock.[192] At the time, EquiMed traded on the Over-the-Counter Bulletin Board,[193] while National Medical traded on the Nasdaq National Market.[194]

In order to pursue other business opportunities Colkitt sought to turn his large stockholdings in these companies into cash. Eventually, he turned to GFL Advantage Fund for financing.[195] GFL and Colkitt signed two notes, one for $3 million and another for $10 million, which paid interest and allowed GFL to convert the notes into shares of EquiMed and National Medical stock at a discount to the market rate.[196] Importantly, the notes did not restrict GFL's right to short sell EquiMed or National Medical stock.[197]

Over the next few months, GFL began exercising its conversion rights.[198] At the same time, however, GFL allegedly began short selling the stock of both companies, leading to significant drops in the value of EquiMed and National Medical stock.[199] Watching the value of his companies disappear, Colkitt eventually decided not to honor GFL's conversion rights and GFL sued. Colkitt then counterclaimed against GFL asking the district court to void the FPS contracts on the grounds that GFL had manipulated the

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[191] *See GFL*, 272 F.3d at 194.
[192] *Id.*
[193] *See, e.g.*, EquiMed, Inc., Press Release dated July 21, 1998, contained within July 28, 1998 8-K Report, *available at* http://www.sec.gov/Archives/edgar/data/892493/0000892493-98-000006.txt (indicating that EquiMed stock was traded on the Over-the-Counter Bulletin Board under the symbol "EQMD").
[194] *See, e.g.*, National Medical Financial Services Prospectus, dated Sept. 9, 1996, *available at* http://www.sec.gov/Archives/edgar/data/934548/0000912057-96-020093.txt (stating that "The Common Stock [of National Medical] [was] quoted on the Nasdaq National Market under the symbol 'NMFS'.").
[195] *See GFL*, 272 F.3d at 194-95.
[196] *See* GFL Advantage Fund, Ltd. v. Colkitt, Case No. 4:97-CV-0526, 2000 U.S. Dist. Lexis 21747 at 7-9 (M.D. Pa. July 17, 2000).
[197] *Id.* at 9.

price of EquiMed and National Medical stock through its short sales. But the court rejected this argument, holding that short selling *by itself* cannot be market manipulation: "it is not permissible to infer from short sales alone that the party engaging in short sales is engaged in market manipulation …."[200] The district court therefore dismissed Colkitt's counterclaims and, enforcing the FPS, ordered Colkitt to pay $21 million in principal and accrued interest to GFL.[201]

2. *GFL v. Colkitt* – Implications for Death Spiral Litigation

The Third Circuit Court of Appeals affirmed the district court's judgment.[202] The court held that Colkitt's claim failed "because he cannot demonstrate that GFL engaged in any *deceptive or manipulative conduct* by injecting false inaccurate information into the marketplace or [by] creating a false impression of supply and demand for the stock."[203] Citing the Seventh Circuit's decision in *Sullivan & Long v. Scattered*,[204] the Third Circuit provided the following guidance:

> Unfortunately for Colkitt, [] short selling is lawful, and courts have held that short selling, even in massive volume, is neither deceptive nor manipulative when carried out in accordance with SEC rules and regulations. Therefore, to make out a claim of market manipulation, Colkitt must present evidence that GFL engaged in some other type of deceptive behavior in conjunction with its short selling that either injected inaccurate information into the marketplace or created artificial demand for the securities. Colkitt has offered nothing but evidence that GFL engaged in lawful short sales of National Medical and EquiMed, which

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[198] *GFL*, 272 F.3d at 195.
[199] *Id.* at 195-96.
[200] *See GFL*, 2000 U.S. Dist. Lexis 21747 at 17.
[201] *Id.* at 39.
[202] *See GFL*, 272 F.3d at 215-16. The court reversed the district court on a narrow point, finding that Colkitt did not need to show an effect on the prices of the EquiMed and National Medical securities due to GFL's short selling in order for his claims to survive a motion to dismiss (though this would eventually be necessary if Colkitt's claims were to ever succeed). *Id.* at 206.
[203] *Id.* at 207 (emphasis added).
[204] Sullivan & Long, Inc. v. Scattered Corp., 47 F.3d 857, 864 (7th Cir. 1995).

> alone is insufficient to prevail on a claim of market manipulation in violation of Section 10(b) and Rule 10b-5.[205]

GFL thus instructs that short selling, without more, is not a "manipulative device" within the meaning of Section 10(b) and Rule 10b-5 and therefore short selling by itself cannot be a basis for a Section 10(b) market manipulation claim.[206] But the case leaves open an important question for death spiral litigants: "What 'more' is required?"

Part IV – Analysis

This paper will now analyze the securities fraud claims raised in death spiral cases. As indicated in Part II above, there are two main causes of action, misrepresentation claims and market manipulation claims. This paper begins with an analysis of misrepresentation claims and groups these claims into three broad categories: misrepresentative investment intent, violations of promises with respect to short selling, and misrepresentations about business practices. This paper will show that all three classes of argument have merit and (assuming relevant facts can be proved) potentially allow death spiral plaintiff/issuers to recover from defendant/purchasers. Next, this paper will examine the market manipulation claims, showing that these too are valid. As part of the analysis, this paper will argue that naked short selling is market manipulation and therefore that plaintiffs such as JAG Media Holdings who assert this cause of action assert valid *prima face* claims. The analysis discusses naked short selling at some length because this is an as-yet-untested theory in the courts of the United States and, if established, would be significant to the future of death spiral litigation.

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[205] *GFL*, 272 F.3d at 211 (citation omitted).
[206] *Id.* at 211.

A) Misrepresentation In Violation of Section 10(b)[207] of the Securities Exchange Act and Rule 10b-5[208] Promulgated Thereunder

1. Standing to Sue, Elements of a Successful Claim, & Facial Validity of the Actions

As a threshold matter, FPS issuer/plaintiffs will have standing to sue the assorted defendants in death spiral actions (purchasers, brokers, and market makers) under the federal securities laws. In the context of Section 10(b) and Rule 10b-5 litigation, courts have upheld the broad applicability of these anti-fraud provisions to many types of securities actions. For instance, as early as 1971 the Supreme Court stated that Section 10(b) "protects corporations as well as individuals who are sellers of a security."[209] Furthermore, Section 10(b) allows for lawsuits based on private placements (*i.e.*, it is not restricted to sales in the secondary markets)[210] and there is no limitation within these anti-fraud provisions on the types of defendants that may be sued. Instead, Section 10(b) is a broad "catch-all" anti-fraud provision.[211] Thus, the question for FPS issuers in death

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[207] Section 10(b) of the Exchange Act states:
"It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange--
(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered … any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors." 15 U.S.C.A. § 78j (2004).

[208] Rule 10b-5 promulgated under Section 10(b) reads:
"It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
(a) To employ any device, scheme, or artifice to defraud,
(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security." 17 C.F.R § 240.10b-5 (2004).

[209] Superintendent of Ins. of New York v. Bankers Life and Casualty Co., 404 U.S. 6, 10 (1971). *See also* Kaplan v. Utilicorp United, Inc., 9 F.3d 405, 407 (5th Cir. 1993) ("Standing to bring a private damages action under Section 10(b) and Rule 10b-5 is limited to persons who are defrauded in connection with the purchase or sale of securities. This limitation is satisfied by showing 'a nexus between the defendant's actions and plaintiff's purchase or sale.'" (internal citations omitted)).

[210] *Id.* at 12.

[211] Ernst & Ernst v. Hochfelder, 425 U.S. 185, 202 (1976).

spiral litigation is simply whether the elements of the cause of action will be met as against each defendant.

To state a cause of action for misrepresentation under Section 10(b) and Rule 10b-5, a plaintiff must demonstrate five things:[212] (1) a misrepresentation of a material fact or an omission of a material fact necessary to make information not misleading; (2) in connection with the purchase or sale of a security by the plaintiff; (3) made by the defendant, acting with scienter; (4) upon which the plaintiff reasonably relied; and (5) that caused the plaintiff to suffer damages.[213] Based on these elements, FPS issuers have potentially successful claims for Section 10(b) misrepresentation against FPS purchasers. The reason for this is that all these elements may be potentially pled and proved at trial: stated broadly, if an FPS issuer can show that an FPS purchaser intentionally or recklessly deceived the issuer into selling the FPS and that the issuer suffered damages as a result, the issuer will be able to recover from the purchaser under Section 10(b).

But to say that these claims have facial validity does not provide much insight into death spiral lawsuits. This paper thus focuses its analysis on the central legal question in these claims, *materiality.* Materiality is the most important factor in the analysis of death spiral misrepresentation claims because materiality is a question of law[214] whereas the other elements (reliance, scienter, "in connection with," purchaser/seller, damages) are questions of fact—*i.e.*, if can the FPS issuer show that it directly relied on specific

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[212] This is a basic introduction into a Section 10(b) and Rule 10b-5 cause of action, however some familiarity with these provisions is assumed on the part of the reader.
[213] *See, e.g.*, Halperin v. eBanker USA.com, Inc., 295 F.3d 352, 356-57 (2d Cir. 2002); Newton v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 259 F.2d 154, 173 (3d Cir. 2001).
[214] *See, e.g.*, Ganino v. Citizens Utilities Co., 228 F.3d 154, 162 (2d Cir. 2000) (stating that materiality is a mixed question of law and fact). This paper of course assumes away evidentiary issues and practical problems of proof at trial. Instead, this paper accepts as true the facts alleged in death spiral complaints (see Part III) and attempts to determine whether these complaints have merit.

misstatements by the defendants in connection with offering of its FPS to the defendant and that, in so relying, it suffered damages, the issuer can recover. But materiality is a legal question that focuses attention on whether, even assuming the misrepresentations were actually made, they are something that the law and the courts should care about. Such is the focus of this paper.[215]

The test for materiality is provided by Supreme Court precedent. Specifically, two Supreme Court cases, *TSC Industries v. Northway*[216] and *Basic Inc. v. Levinson*,[217] provide guidance on how to evaluate the materiality of an alleged misrepresentation. These cases instruct that a misrepresentation is material if, based on the total mix of information, there is a substantial likelihood that a reasonable investor would consider the information significant in deciding how to act.[218] This test will now be applied to the misrepresentations alleged in the five death spiral cases discussed in Part III.A above.

2. Evaluating Death Spiral Misrepresentation Claims

The misrepresentation claims raised by the five death spiral actions from the Southern District of New York studied in this paper can be broadly categorized into three groups: misrepresentations as to investment intent, misrepresentations as to short selling intentions, and misrepresentations as to prior business practices.[219] The *Log On America* litigation provides a useful starting point for analyzing these arguments because this case

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[215] The elements of a Section 10(b) cause of action often blend into one another. In particular, the concept of materiality and reliance are interconnected. With this in mind, this paper focuses its analysis of death spiral misrepresentation claims on questions of materiality, discussing the other Section 10(b) elements as necessary.
[216] 426 U.S. 438 (1976).
[217] 485 U.S. 224 (1988).
[218] *See id.* at 231-32.
[219] *See generally* Log On America Complaint, *supra* note 121; Internet Law Library Complaint, *supra* note 120; Nanopierce Complaint, *supra* note 122; Sedona Complaint, *supra* note 123; JAG Media Holdings Complaint, *supra* note 124.

raises all three issues.[220] First, Log On America alleged that the purchasers of its convertible security misrepresented in the securities purchase agreement that they were investing in the FPS to acquire stock "for investment only and not with a view toward, or for resale in connection with, the public sale or distribution thereof."[221] Instead, the company asserts, the defendants had no such "investment intent" at all but planned from the outset to manipulate the price of LOA stock downward and profit from its fall.[222] Second, Log On America alleges that the defendants misrepresented their intentions with respect to short selling in that they promised to make only limited short sales[223] knowing that this was false.[224] Third, the company asserts that purchasers made a material omission when they failed to disclose "lawsuits asserted against them by similarly situated issuers" in other FPS contexts.[225]

The district court evaluated Log On America's argument and dismissed it as insufficiently pled.[226] First, with respect to the investment intent issue, the court ruled that Log On America did not specify how the defendants' investment representations gave rise to actionable misconduct[227] because language in the securities purchase agreement effectively nullified Log On America's averments.[228] Second, the court held that since the securities purchase agreement had allowed short sales (with restrictions) and Log On America failed to demonstrate any violations of these rules, the company failed to allege actionable misrepresentations as to the defendants' short selling intentions.[229] Third, the court was silent on the issue of whether the defendants had a

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[220] *See supra* note 121.
[221] *See* Log On America Complaint, *supra* note 121, ¶ 30.
[222] *See id.* ¶ 68.
[223] *See id.* ¶ 31.
[224] *See id.* ¶¶ 32 & 34.

duty to disclose to the company that other lawsuits had been filed against them in connection with similar FPS offerings.[230] This paper will now evaluate these three legal issues in detail.

a. Can Deceptive Statements as to "Investment Intent" Be a Section 10(b) Misrepresentation?

The first claim raised in *Log On America* is a charge that the defendants violated Section 10(b) of the Exchange Act by misrepresenting their "investment intent"—*i.e.*, that the FPS purchasers committed fraud in deceiving LOA about their intentions with respect to their investment in Log On America's Future Priced Security. This is a common claim by FPS issuer/plaintiffs (of the six cases identified in this paper, three complaints raise such allegations)[231] and this paper now reviews the merits of this argument.

Future Priced Securities are volatile instruments, and companies that issue them often fail. A wise issuer will therefore want to divine the FPS purchaser's investment intentions and to determine, if possible, whether the purchaser might attempt to abuse the

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[225] *See id.* ¶ 66.
[226] *See* Log On America, Inc. v. Promethean Asset Mgmt., et al., 223 F. Supp. 2d 435, 452 & 438 n.2 (2001) (noting that the court was not ruling on the merits of Log On America's causes of action, just the sufficiency of its pleadings).
[227] *Id.* at 444. The author identified three separate misrepresentation allegations in Log On America's complaint, however the district court evaluated its claims under only two headings: short selling and investment intent. *See id.* at 442-45.
[228] *Id.* at 443 (showing that the Securities Purchase Agreement stated: "Buyer does not agree to hold any of the securities for any minimum or other specific term.").
[229] *See id.*
[230] The court makes no mention of this issue in its Decision and Order, and only refers to Log On America's alleged material omissions briefly. *See id.* at 443 n.2. It is the author's opinion that the court overlooked this issue because it was not sufficiently identified as a separate claim for misrepresentation in the complaint. Instead, the court evaluated all allegations of material misrepresentations and omissions together.
[231] The three are *Log On America*, *Internet Law Library*, and *Sedona*. *Nanopierce* alleges related misrepresentations, but not "investment intent" directly. *See* Log On America Complaint, *supra* note 121, ¶ 32; Internet Law Library Complaint, *supra* note 120, ¶ 14; Sedona Complaint, *supra* note 123, ¶ 54. *See*

FPS by using it as the basis for short sales. To protect against this risk issuers ask for confirmation of the purchasers' intentions during negotiations over the FPS and by the terms of the securities purchase agreement. Log On America, for instance, asked the purchasers of its FPS to profess their investment intent both during contract negotiations and in writing.[232] Nevertheless, it is important to verify that these are *material* issues within the meaning of the securities laws that, if misrepresented, can form the basis for a Section 10(b) cause of action.

It appears clear that these claims are material. Recalling the basic standard for materiality (information that a reasonable person would consider important in deciding how to act),[233] investment intent with respect to an FPS offering is highly relevant because the issuer will want to know whether the purchaser is likely to cause a death spiral subsequent to investing in the FPS. (Looked at another way, no company would issue an FPS to an investor who baldly stated that it was only interested in using the FPS as the basis for large short selling of the issuer's stock) This conclusion is supported by caselaw. First, of the three complaints studied in this paper that argued investment intent,[234] two proceeded through motions to dismiss and in neither case did the court throw-out these claims as being immaterial (which the courts could have done).[235]

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also Nanopierce Tech. Inc. v. Southridge Capital Mgmt. LLC, No. 02-CV-0767, 2002 WL 31819207 at 3 (S.D.N.Y. Oct. 10, 2002).

[232] *See* Log On America Complaint, *supra* note 121, ¶ 32.

[233] *See supra* text accompanying notes 216-18.

[234] *See supra* note 231.

[235] *See* Internet Law Library, Inc. v. Southridge Capital Mgmt., LLC, 223 F. Supp. 2d 474, 480-86 (S.D.N.Y. 2002) (holding that Internet Law Library's misrepresentation claims sufficiently plead a cause of action so as to survive defendants' motion to dismiss); Log On America, Inc. v. Promethean Asset Mgmt., LLC, 223 F. Supp. 2d 435, 443-45 (S.D.N.Y. 2001) (dismissing Log On America's investment intent argument because other clauses in the securities purchase agreement negated this claim by allowing Promethean to dispose of assets at any time). Given that *Internet Law Library* survived the motion to

Second, this conclusion is supported by relevant securities law precedents such as the Supreme Court's decision in *Wharf (Holdings) Ltd. v. United Int'l Holdings, Ltd.*[236] *Wharf* involved a misrepresentation claim in which the purchaser of a security sued the seller alleging that the seller violated Section 10(b) when it sold the security while secretly never intending to honor the terms of the agreement.[237] The Supreme Court upheld the claim and allowed recovery against the seller, finding that the secret intention to violate the terms of the securities purchase agreement was a material misrepresentation in connection with the sale of a security.[238]

To say that misstatements about investment intent can be a material misrepresentation with the meaning of Section 10(b) does not complete the analysis, however. Since these allegations include both oral and written misstatements in the context of negotiating and executing securities purchase agreements, there are important contract law principles that will determine whether the misstatements should even be considered part of the securities contract. First, there is a question of definiteness. Courts will need to evaluate exactly what statements the defendants are alleged to have made to determine if these statements are sufficiently definite so as to proscribe particular conduct.[239] Second, the parol evidence rule may potentially bar recovery for strictly oral misrepresentations where there was a contrary written agreement.

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dismiss, this demonstrates the merit of the investment intent argument, because if this allegation had been immaterial the court properly should have dismissed it at that stage of the trial.

[236] 532 U.S. 588 (2001).

[237] *See id.* at 590.

[238] *See id.* at 596-97.

[239] *See* 166 Mamaroneck Ave. Corp. v. 151 East Post Road Corp., 575 N.E.2d 104, 105 (N.Y. 1991) ("The doctrine of definiteness or certainty is well established in contract law. In short, it means that a court cannot enforce a contract unless it is able to determine what in fact the parties have agreed to.").

Under general contract-law parol evidence principles, where a written agreement differs from oral statements of a party during negotiations, the written agreement will control. This is especially true when there is a merger clause in the contract stating that the writing is the entire agreement of the parties.[240] In the context of securities fraud actions under Section 10(b), however, courts may choose not to apply the parol evidence rule quite so rigorously. The Second Circuit Court of Appeals, for instance, has doubted the correctness of applying parol evidence principles in the context of securities fraud cases because this could shield fraudulent oral misrepresentations, defeating the basic purpose of Section 10(b).[241] Other courts, however, retain a stricter adherence to the parol evidence rule, even in the context of securities offerings.[242]

It therefore appears that claims of deceptive "investment intent" in death spiral litigation can reasonably be decided for or against FPS issuers, depending upon the facts and circumstances in each case and the willingness or unwillingness of a court to adhere to principles such as the parol evidence rule. In terms of the cases studied in this paper, this renders support to Sedona Corp.'s allegations that the purchasers of its FPS violated Section 10(b) when they made oral misrepresentations of being "long-term investors" only interested in the "best long-term interest of Sedona"[243] while the text of its securities purchase agreement reinforced this notion.[244] These oral and written misrepresentations

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[240] *See, e.g.*, Global Intellicom v. Thomson Kernaghan & Co., 1999 WL 544708, at 11 (July 27, 1999) (holding that claims of oral misrepresentations in connection with a securities offering were not actionable where the securities offering contained contrary language and a merger clause).
[241] *E.g.* Caiola v. Citibank, 295 F.3d 312, 330 n.9 (2d Cir. 2002) (stating that the importation of parol evidence principles into the context of securities fraud cases is "questionable" because this acts to defeat the purposes of the antifraud provisions).
[242] *See id.* (discussing alternate court decisions on point); *see also supra* note 239.
[243] *See* Sedona Complaint, *supra* note 123, ¶ 43.
[244] *See* Sedona Securities Purchase Agreement Sec. 3.1, *available at* http://www.sec.gov/Archives/edgar/data/3959/000093066100003254/0000930661-00-003254-0003.txt.

taken together appear to be material and therefore justify recovery against the defendants (provided that Sedona can to establish the definiteness of these misrepresentations).[245]

b. Is an Intentional Violation of a Promise or Restriction on Short-Selling a Section 10(b) Misrepresentation?

The preceding discussion shows that it is difficult to predict the outcome of misrepresentation claims over statements of "investment intent," in part because of questions of definiteness. In contrast, violations of more definite contract terms, such as prohibitions against short selling, have a more predictable outcome. A number of death spiral complaints allege Section 10(b) misrepresentation in that purchasers (and occasionally brokers and market makers as well) misrepresented to the issuers that they would not sell the issuers' stock short and then did exactly that.[246] These claims should be actionable as 10(b) misrepresentation where the issuer can show an intentional violation of a contracted-for short-selling restriction in a securities purchase agreement. Claims based on oral misrepresentations may be valid as well.

An intentional violation of a substantive clause in a securities purchase agreement will be actionable under Section 10(b) where the clause was material to the agreement.

> Making a specific promise to perform a particular act in the future while secretly intending not to perform that act may violate Section 10(b) where the promise is part of the consideration for the transfer of securities. Such a promise, however, must encompass particular actions and be more than a generalized promise to act as a faithful fiduciary.[247]

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[245] *Cf.* One-On-One Enterprises, Inc. v. Caruso, 848 F.2d 1283 (D.C. Cir. 1988) (holding that an integration clause in securities contract nullified prior oral misrepresentations about the "long-term" investment horizon of purchaser rendering the oral misrepresentations not actionable).

[246] *Log On America*, *Internet Law Library*, and *Sedona* alleged this directly. *See* Log On America Complaint, *supra* note 121, ¶ 31; Internet Law Library Complaint, *supra* note 120, ¶¶ 14 & 17; and Sedona Complaint, *supra* note 123, ¶ 68. Nanopierce evidently alleged this and then dropped it at trial. *See* Nanopierce Complaint ¶ 32; 2002 WL 31819207 at 4 n.6.

[247] Luce v. Edelstein, 802 F.2d 49, 55 (2d Cir. 1986) (internal citations omitted) *reaffirmed in* Mills v. Polar Molecular Corp., 12 F.3d 1170, 1176 (2d Cir. 1993) ("The failure to carry out a promise made in connection with a securities transaction is normally a breach of contract. It does not constitute fraud unless,

Short selling restrictions are such material promises. Issuers demand these restrictions in order to prevent death spirals and this is an issue that a reasonable issuer would consider significant in deciding whether to issue the security.[248] Thus, where a purchaser and issuer sign a securities purchase agreement that prohibits or restricts short sales by the purchaser and the purchaser then violates those contract terms, a Section 10(b) cause of action will arise.

But to show actionable securities fraud in this context, the issuer will have to demonstrate that the purchaser intended to break this provision *at the time the offering was made*. Simply showing that a purchaser violated short selling restrictions in a securities purchase agreement is not enough; that would be breach of contract, but not securities fraud.[249] Instead, the plaintiff must show that the defendant never intended to abide by the short selling restrictions. This is necessary because of the "in connection with a purchase or sale of securities" requirement under Section 10(b)—that is, if the issuer cannot show that the purchaser made a material misrepresentation about its intentions to abide by short selling restrictions in a securities purchase agreement, there will be no securities fraud because the misrepresentation did not occur in connection with the sale.[250]

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when the promise was made, the defendant secretly intended not to perform or knew that he could not perform.").

[248] *See supra* notes 216-18 and accompanying text.

[249] *See, e.g.*, Broad v. Rockwell Int'l Corp., 614 F.2d 418, 438-39 (5th Cir. 1980) (discussing and demonstrating that not every breach of a securities contract is a securities fraud).

[250] *See supra* notes 212-13 and accompany text. This discussion demonstrates how these Sec. 10(b) concepts are interrelated. Also, because of the Private Securities Litigation Reform Act of 1995, plaintiffs also must plead with particularity facts giving rise to a strong inference of defendants' scienter. *See* 15 U.S.C. § 78u-4 (2004); Pirraglia v. Novell, Inc., 339 F.3d 1182, 1187-88 (9th Cir. 2003).

The analysis for strictly oral misrepresentations is different, however, and proceeds under the framework laid out in subparagraph (a) above. As indicated in that discussion, FPS issuers will have a cause of action if a court decides to admit parol evidence associated with the securities offering.[251] Turning to the cases in this paper, the *Internet Law Library*[252] litigation provides an example of these principles at work. In *Internet Law Library*, the court rejected the defendants' motion to dismiss, finding that the company's misrepresentation claim was actionable when it was based on misstatements about short selling intentions.[253] Although the facts of *Internet Law Library* indicate that there were short selling restrictions in its securities purchase agreement, the text of the decision indicates that the court was unconcerned with whether the short-selling promises were oral or written.[254] The court, finding this to be a material misrepresentation, adopted a liberal interpretation of the parol evidence rule and allowed the claim.

c. Is Failing to Disclose Prior FPS Deals a Section 10(b) Misrepresentation?

A final common complaint of FPS issuers is that purchasers have misrepresented their prior business practices. Specifically, issuers allege that purchasers misrepresented themselves as not having engaged in prior FPS offerings or not having caused "death spirals" before when, in fact, the purchasers had done so repeatedly.[255] These alleged misrepresentations and omissions occurred in the context of negotiations over the FPS offering and are a form of fraud in the inducement: the issuers allege that the purchasers

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[251] *See supra* text accompanying notes 240-42.
[252] *See supra* Part III.A.
[253] *See* Internet Law Library v. Southridge Capital Mgmt., et al., 223 F. Supp. 2d 474, 482 (S.D.N.Y. 2002).
[254] *See id.* at 478-80 & 482.

violated Sec. 10(b) by misrepresenting themselves and that the issuers never would have issued the FPS's if they had known the background of their 'investors.' These claims should be actionable because in a private placement such as an FPS, this information will be material.

In making these claims, FPS issuers must consider two important points. First, the issuers must show that the purchasers lied or omitted information in response to an inquiry from the issuer. The reason for this is that FPS purchasers do not have a duty of disclosure. Courts do not recognize a generalized duty to disclose all material information in the context of negotiating a securities agreement, yet any misrepresentation claim must be rooted in a misstatement or an omission coupled with a duty.[256] Second, the misstatement or omission must not be contradicted by other information available to the issuer, such as through disclosures in the securities offering documents. "Over and again we say that people claiming to be victims of securities fraud may not claim to rely on oral statements inconsistent with written documents (even tedious prospectuses) available to them."[257] If the information that the issuer complains of is contained in writings that were available to the issue, the issuer will be considered to have had constructive notice of these facts and so will have no basis for recovery due to contrary oral misstatements.

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[255] *See* Log On America Complaint*, supra* note 121, ¶ 56; Internet Law Library Complaint, *supra* note 120, ¶ 14; Nanopierce Complaint, *supra* note 122, ¶ 34; Sedona Complaint, *supra* note 123, ¶ 50.
[256] *E.g.*, McCormick v. Fund American Co. Inc., 26 F.3d 869 (9th Cir. 1994).

B) Market Manipulation In Violation of Section 10(b) and Rule 10b-5

1. Elements In A Successful Claim

The second broad category of securities fraud claims raised in the death spiral lawsuits studied in this paper are market manipulation claims. The text of Section 10(b) of the Securities Exchange Act prohibits the use of any "manipulative or deceptive device" in connection with the purchase or sale of a security,[258] and market manipulation claims thus derive from this language. Manipulation in this context is "a term of art" that "connotes intentional or willful conduct designed to deceive or defraud investors by controlling or artificially affecting the price of securities."[259] In particular, the term "market manipulation" refers to fraudulent practices such as wash sales, matched orders, or rigged prices that are intended to mislead investors by creating an artificial appearance of market activity.[260]

To sustain a Section 10(b) market manipulation in the Southern District of New York, a plaintiff must allege the following five elements: (1) that the plaintiff suffered damages; (2) in reliance on the defendant's material misrepresentations, omissions, or scheme to defraud; (3) that the defendant acted with scienter; (4) that this occurred in connection with plaintiff's purchase or sale of a security; and (5) that this was furthered by the defendant's use of the mails or a national securities exchange.[261] This test comes from cases such as *Schell v. Conseco, Inc.*[262] and *Gbbal Intellicom v. Thomson*

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[257] S.E.C. v. Jakubowski, 150 F.3d 675, 681 (7th Cir. 1998).
[258] 15 U.S.C. § 78j (2004).
[259] Ernst & Ernst v. Hochfelder, 425 U.S. 185, 199 (1976).
[260] Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 476 (1977).
[261] *E.g*, Schnell v. Conseco, Inc., 43 F. Supp. 2d 438, 448 (S.D.N.Y. 1999).
[262] *Id.*

Kernaghan & Co.[263] In contrast, the Third Circuit examines market manipulation claims a bit differently. *GFL Advantage Fund v. Colkitt*[264] explains that the elements of a private plaintiff's market-manipulation claim are: (1) the defendant engaged in deceptive or manipulative conduct by injecting inaccurate information into the marketplace or by creating a false impression of supply and demand for a security; (2) in connection with plaintiff's purchase or sale of the security; (3) that the defendant had the purpose of artificially depressing or inflating the price of the security [*i.e.*, acted with scienter]; and (4) that the plaintiff suffered damages (5) in reliance on the defendant's conduct.[265] This paper will evaluate FPS market manipulation claims primarily using the *GFL* standard, because it is the superior test.[266] Nevertheless, this paper will turn to the *Schnell/Global Intellicom* approach for comparison given that most FPS actions will be decided in the Southern District of New York (and so will apply the *Schnell/Global Intellicom* language).[267] In the end, though, these two tests should yield similar results when applied to the same set of facts so it ultimately should not matter which test a court applies.

2. Evaluating Death-Spiral Complaints

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[263] No. 99-CV-0342, 1999 WL 544708 at 7 (S.D.N.Y. July 27, 1999).
[264] 272 F.3d 189 (3d Cir. 2001).
[265] *See id.* at 206-11.
[266] The two tests list the same basic elements, they just express them differently. For instance, the *GFL*-test examines materiality in greater depth (due to the Third Circuit's lengthy examination of short-selling law in its opinion) but ignores Sec. 10(b)'s link to the use of the mails, a national securities exchange, or interstate commerce (because, under modern conceptions of these terms, this statutory hook will always be met in securities cases and so this is a non-issue). The reason *GFL* is superior is that the Third Circuit came up with this test after a lengthy investigation of the law related to 10(b) market manipulation claims and after specific application of the law to an FPS issuer's short-selling claims. *See supra* Part III.B discussing *GFL v. Colkitt.* In contrast, the *Schnell/ Global Intellicom* approach is not so tailored. *Compare GFL*, 272 F.3d at 203-12, *with Schnell*, 43 F. Supp. 2d at 448 *and Global Intellicom*, 1999 WL 544708 at 7.
[267] For example, *Nanopierce*, *Internet Law Library*, and *Log On America* all follow the *Schnell/Global Intellicom* standard (*see* 2002 WL 31819207 at 6; 223 F. Supp. 2d at 487; 223 F. Supp. 2d at 445) notwithstanding the approach taken in *GFL.* These district courts surely apply *Schnell/Global Intellicom* because that is the test applicable in the Second Circuit.

GFL Advantage Fund, Ltd. v. Colkitt is an appropriate starting point to analyze market manipulation claims in the context of death spiral litigation because it is a final judgment from a federal appeals court and is factually similar to this paper's "classic case" FPS.[268] The reader will recall that in *GFL* the majority shareholder of two small companies (Mr. Colkitt) had issued a Future Priced Security as collateral for a loan and was sued by the purchaser for failing to convert it. Mr. Colkitt argued that the conversion should be excused because the purchasers had caused a death spiral in the two companies through massive short selling of their securities.[269] But like most FPS's,[270] Mr. Colkitt had imposed no short selling restrictions, and so the court enforced the FPS.[271] Thus, *GFL*, like *Nanopierce*[272] and *JAG Media Holdings*[273] (and this paper's "classic case" Future Priced Security)[274] involved an FPS offering in which there were no short selling restrictions in the FPS purchase agreement. (The reader is reminded that Sedona[275] and Internet Law Library[276] did contain prohibitions on short selling in their securities purchase agreements while Log On America[277] prohibited naked short selling.)

To begin, the Third Circuit Court of Appeals rejected Mr. Colkitt's market manipulation claim because the court determined that he failed to demonstrate that the purchaser, GFL Advantage Fund, had engaged in any deceptive or manipulative

[268] *See supra* Part III.B. and text accompanying notes 18-25.
[269] *See supra* text accompanying notes 191-201.
[270] *See supra* notes 24-25 and accompanying text.
[271] *See supra* note 197 and accompanying text.
[272] *See supra* note 147 and accompanying text.
[273] *See supra* note 148 and accompanying text.
[274] *See supra* text accompanying note 25.
[275] *See supra* note 146 and accompanying text.
[276] *See supra* note 145 and accompanying text.
[277] *See supra* note 149 and accompanying text.

conduct.[278] The court thus focused its attention on the first element in its five-part test (see above).[279] With respect to "injecting inaccurate information into the marketplace," the court dismissed Colkitt's argument that short sales, by their very nature, "convey to the market participants negative information about the prospects of the firm."[280] Although the court recognized that short sales convey a negative opinion of a stock by the short seller, the court reasoned that they do not distort the market or otherwise inject false information because there is nothing inherently improper about short selling.[281]

The Third Circuit also provided guidance on the issue of "creating a false impression of supply and demand for a security" under its test.[282] Accepting the Seventh Circuit Court of Appeals' rationale of *Sullivan & Long, Inc. v. Scattered, Corp.*,[283] the Third Circuit reasoned that short selling—even massive short selling—does not create a false impression of supply and demand in the market because there are other parties betting against these transactions.[284] "[S]hort selling, even in large volumes, is not in and of itself unlawful and therefore cannot be regarded as evidence of market manipulation."[285] The court concluded that to show market manipulation through short selling a plaintiff would have to show some manipulative factor *in addition to* the short selling; short selling by itself is simply not enough.[286]

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[278] *See* GFL Advantage Fund, Ltd. v. Colkitt, 272 F.3d 189, 207 (3d Cir. 2001).
[279] *See supra* text accompanying note 265.
[280] *See GFL*, 272 F.3d at 208.
[281] *See id*.
[282] *See supra* text accompanying note 265.
[283] 47 F.3d 857, 864 (7th Cir. 1995).
[284] *See GFL*, 272 F.3d at 207.
[285] *Id.* at 209.
[286] *See id.* at 207-208 & 211 ("Therefore, to make out a claim of market manipulation, Colkitt must present evidence that GFL engaged in some other type of deceptive behavior in conjunction with its short selling that either injected inaccurate information into the marketplace or created artificial demand for the securities. Colkitt has offered nothing but evidence that GFL engaged in lawful short sales of National

a. What Does GFL v. Colkitt Instruct About Naked Short Selling Claims?

This therefore begs the question of what would have been sufficient to find actionable market manipulation; what 'else' is required? In particular, one of the interesting claims raised in death spiral lawsuits is that defendants have engaged in naked short selling in order to depress the issuer's stock price and that this should be deemed market manipulation. Of the five death spiral complaints analyzed in this paper, *Sedona* and *JAG Media Holdings* both allege that the defendants engaged in naked short selling and that this should be viewed as manipulative.[287] What is the likely outcome of these claims?

It is unclear based solely on *GFL* whether a court would find naked short selling to be market manipulation, but this paper argues that it should be so declared. There are no court decisions that explicitly support this conclusion[288] (although the SEC considers naked short selling to be a potentially manipulative practice[289] as do some commentators)[290] while, contrarily, there is precedent suggesting that naked short selling is not manipulative.[291]

For example, a court following *GFL* could reason that the intent to cause fails-to-deliver by naked short selling inflates beneficial ownership of a security[292] and therefore creates a "false impression of supply and demand" for the security in violation of the *GFL*

Medical and EquiMed, which alone is insufficient to prevail on a claim of market manipulation in violation of Section 10(b) and Rule 10b-5.").

[287] *See, e.g.*, JAG Media Holdings Complaint, *supra* note 124, ¶ 169.

[288] *See supra* note 112 and accompanying text.

[289] *See supra* notes 113-15 and accompanying text.

[290] *See* HAZEN, *supra* note 111.

[291] *See infra* notes 303-08 and accompanying text.

[292] *See supra* text accompanying note 69.

market manipulation test.[293] A court could also conclude that intentional naked short sales violate market rules (such as brokers' delivery requirements)[294] and therefore "inject false information into the marketplace," similarly violating the *GFL* test.[295] These are potential ways in which naked short selling could be deemed market manipulation. The *GFL* decision lists some practices that courts have held to be market manipulation in other cases, including trading through false accounts, engaging in sham transactions or unreported transactions, and making secret agreements or matched orders.[296] Conspicuously absent from this list is naked short selling (because no court has yet held that naked short selling is a manipulative practice). But naked short selling, like the list of practices enumerated in *GFL* as market manipulations, is a violation of market rules and equitable trading principles.[297] In fact, the notion that naked short selling is manipulative because it violates equitable trading practices underlies the SEC's assessment of this issue.[298] Thus, naked short selling is clearly in the same league as other practices that have previously been declared to be market manipulations. It should be so found.

The problem with this interpretation and application of *GFL*, though, is that it runs headlong into *Sullivan & Long, Inc. v. Scattered, Corp.*[299] *Sullivan & Long* is one of the few cases to deal with the issue of naked short selling and was cited approvingly in

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[293] *See supra* text accompanying note 265.
[294] *See supra* notes 85 & 97 and accompanying text, discussing NYSE Rule 440.10C and NASD Rule 3370.
[295] *See supra* text accompanying note 265.
[296] GFL Advantage Fund, Ltd. v. Colkitt, 272 F.3d 189, 207-08 (3d Cir. 2001).
[297] *See* Short Sales of Securities, Securities Exchange Act Release No. 34-4476 (April 25, 1962), *available at* 1962 WL 69297.
[298] *See id.* ("If a dealer intends not to consummate a transaction promptly, and fails to disclose this intention to his customer, he omits to state to that customer a material fact necessary to make the above representation not misleading, in violation of the antifraud provisions of the Securities Act and the Exchange Act.").
[299] *See* Sullivan & Long Inc. v. Scattered Corp., 47 F.3d 857 (7th Cir. 1995).

GFL.[300] *Sullivan & Long* holds that naked short selling is not in and of itself manipulative under Section 10(b),[301] and so this case is problematic for the position advocated herein and argued by death spiral plaintiffs. If a court is ever to declare that naked short selling is market manipulation, it will need to distinguish or discredit the result in *Sullivan & Long*. This can be done.

Naked short selling should be declared to be a manipulative device in violation of Section 10(b) (*i.e.*, naked short selling should suffice as that 'something more' required under *GFL*)[302] where the naked short seller violates a market rule or equitable trading principle. *Sullivan & Long* can then be distinguished on this point. *Sullivan & Long* involved a lawsuit brought by a securities purchaser against a market maker of LTV Steel Corp for alleged market manipulation of LTV stock.[303] The plaintiff, Sullivan & Long, Inc., claimed that the market maker (Scattered Corp.) engaged in massive uncovered short selling of LTV stock[304] and that this depressed the value of LTV stock, causing Sullivan & Long to lose money.[305] In this way, Sullivan & Long alleged that Scattered caused a sort of death spiral (although Scattered of course had no Future Priced Security through which to cover its short sales).

What Sullivan & Long failed to recognize, however, was that Scattered had an edge: superior information. At the time, LTV was emerging from a bankruptcy reorganization and Scattered knew (because it had read the bankruptcy reorganization plan) that LTV stock would soon be hugely devalued once the reorganization was

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[300] *See GFL*, 272 F.3d at 207.
[301] *See Sullivan & Long*, 47 F.3d at 864-65.
[302] *See supra* notes 285-86 and accompanying text.
[303] *See Sullivan & Long*, 47 F.3d at 859.
[304] *See id.* at

approved.[306] (This information was not secret or proprietary, Scattered was just paying closer attention than other market participants.) Thus, Scattered thus took advantage of this information by short selling LTV stock until it approached the inevitable post-reorganization value.[307]

The Seventh Circuit Court of Appeals found no problem with Scattered's activities because what it was doing was arbitraging the security toward its true value. "The name for what Scattered did is not market manipulation, but arbitrage."[308] But an important factor in this result was that *Scattered had not violated any rules of the securities exchange in conducting its naked short sales.*[309] At the time, the Chicago Stock Exchange (where LTV stock was trading) had no rules preventing naked short selling and Scattered's naked short sales thus did not violate any market rules. This is a sufficient legal reason to distinguish the holding of *Sullivan & Long* from the principles advocated herein.

What is more, there are a number of practical reasons to distinguish *Sullivan & Long* from the rule advocated above with respect to death spiral litigation. First, *Sullivan & Long* involved naked short selling in the market for an exchange-traded security of a large company. LTV stock was listed on the New York Stock Exchange[310] and so was subject to the full panoply of SEC and exchange-related short-selling regulations, including Rule 10a-1's "tick test."[311] Moreover, LTV was a large industrial company

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[305] *See id.* at 859-61.
[306] *See id* at 859-60.
[307] *See id.* at 860-61.
[308] *See id.* at 862.
[309] *See id.* at 861.
[310] *See, e.g.*, *LTV Corp. Files for Protection from Creditors Under Chapter 11*, WALL ST. J. (July 18, 1986) *available at* 1986 WL-WSJ 257412.
[311] *See supra* text accompanying notes 78-81.

with assets of $6 billion,[312] a liquid market for its stock, and extensive coverage on Wall Street and in the financial press. In short, it was appropriate for the Seventh Circuit to decide *Sullivan & Long* from the perspective of the Efficient Capital Markets Hypothesis ("ECMH") and trust that the market was 'finding' the correct value for the stock when Scattered was making uncovered short sales.[313] None of these conditions apply in the context of Future Priced Securities cases, however.

The result in *Sullivan & Long* should be distinguished from death spiral cases because FPS issuers are universally small, financially weak companies, trading in inefficient, illiquid markets that lack regulatory protections such as short-sale pricing rules. Thus, the ECMH does not apply to instruct that the market, if left alone, can be trusted to 'correctly' price the value of FPS issuers' securities. Instead, it is much easier for one market participant to move the price of the stock. It therefore would be inappropriate to allow naked short selling of these securities because there simply will not be sufficient market interest in these companies to maintain the value of their securities in the face of a determined naked short seller. This is borne-out by the fact that FPS issuers almost universally suffer stock declines after issuing their securities[314] and the reasonable inference thatthe massive short selling by FPS purchasers is a cause of this.

A second practical reason to set *Sullivan & Long* aside from death spiral cases is that the defendant in *Sullivan & Long* had virtually perfect pricing information. Scattered

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[312] *See, e.g.*, *LTV Corp. Files for Protection from Creditors Under Chapter 11*, *supra* note 299.

[313] The Efficient Capital Markets Hypothesis as generally proposed states that the price of a stock trading in an efficient market will reflect all publicly available information about the company. Some of the measures of an efficient market for a stock are taken as: large trading volume in the stock (liquidity), a significant number of reviewing analysts, the existence of market makers and arbitrageurs, eligibility to register securities on Form S-3, and historical responsiveness of the stock's price to market news. For a discussion of the ECMH, see Robert G. Newkirk, *Sufficient Efficiency: Fraud on the Market in the Initial Public Offering Context*, 58 U. CHI. L. REV. 1393 (1991).

Inc. had been paying close attention to LTV's bankruptcy filings and knew with virtual certainty that, after the reorganization, the company's stock would become worth only 3 or 4 cents (a significant drop from the previous market price).[315] Scattered therefore could short sell with virtually no risk and it was reasonable, ex post, for a court to view this conduct as efficient and productive: there was an objectively calculable 'correct' market value for LTV stock. But perfect pricing information will rarely exist. And for small companies like FPS issuers that have variable income streams and uncertain business plans, it is highly unlikely that anyone will be able to price the stock as accurately as Scattered priced LTV. Thus, naked short selling of an FPS issuer's stock is much more likely to mark the actions of a stock manipulator than it is to be a sign of a well-informed arbitrageur.

b. Should GFL Be Relied Upon?

The preceding discussion has argued that naked short selling should be declared to be a manipulative practice in violation of Section 10(b) and Rule 10b-5 where it violates market rules and that this result is consistent with caselaw and securities law principles. This is a potentially important legal result in that it would for the first time answer a basic question about the practice of naked short selling. To reach this conclusion, this paper has relied heavily on the reasoning in *GFL Advantage Fund, Ltd. v. Colkitt*, but has not yet examined the basic correctness of that decision. This paper now examines that foundational issue.

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[314] *See supra* text accompanying notes 31-33.
[315] *See* Sullivan & Long Inc. v. Scattered Corp., 47 F.3d 857, 860 (7th Cir. 1995).

As previously indicated, *GFL* stands for the proposition that short selling, without more, is not actionable 10(b) market manipulation.[316] The Third Circuit in *GFL* engaged in a lengthy examination of caselaw to reach this conclusion,[317] and the court's legal analysis will not be retold.[318] The correctness of the decision instead can be demonstrated by positing potential alternate holdings and demonstrating that none of these alternatives would have been sound.

First, the court had to reject Mr. Colkitt's argument that short selling alone could amount to market manipulation because this would have undermined the securities markets. Short selling is permitted under the federal securities laws because it has market benefits[319] and to have declared that it can be manipulative within the meaning of Section 10(b) would potentially criminalize an entire market-wide practice. The court was in no position to do that. Thus, it had to draw lines around permissible and impermissible short selling. This is exactly what its holding does.[320] Second (and more realistically), the court potentially could have accepted some of Colkitt's narrower arguments. For instance, Colkitt argued that the large *volume* of GFL short sales amounted to market manipulation and that the court should could adopt a rule separating legal from illegal short selling by examining a rule with volume restrictions.[321] But rejecting this argument was also proper because this would have involved the court in hopeless line-drawing:

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[316] *See supra* note 206 and accompanying text.
[317] *See* GFL Advantage Fund, Ltd. v. Colkitt, 272 F.3d 189, 202-12 (3d Cir. 2001).
[318] This paper has discussed *GFL* at length and it is not the purpose to simply be a casenote on the validity of the decision. However, this paper concludes that the Third Circuit's legal analysis was correct.
[319] *See supra* note 44-47 and accompanying text.
[320] The court of course might have accepted some of Colkitt's narrower arguments, such as that GFL's use of multiple brokers was evidence of concealment, but those are line-drawing questions that also support the fundamental holding that short selling by itself is not market manipulation. *See* GFL Advantage Fund, Ltd. v. Colkitt, 272 F.3d 189, 210 (3d Cir. 2001).
[321] *See id.* at 209.

how much short selling is 'too much' so as to become manipulative (and how would a court of law even answer this question)? There is only one flaw in *GFL's* analysis, but it does not undermine the decision or discredit the court's holding.[322]

c. What Does This Analysis Imply About Market Manipulation Claims that Allege Violations of a Securities Purchase Agreement?

Based on this discussion, it is apparent that death spiral plaintiff/issuers who argue that a defendant engaged in market manipulation solely by short selling the issuer's stock will not have cognizable claims. Instead, plaintiffs must allege that a defendant also engaged in a manipulative practice, such as naked short selling or one of the practices enumerated in *GFL*.[323] But what about violating the terms of a securities purchase agreement—is that enough? This section takes up this question.

A final issue raised in this analysis is whether short selling can be market manipulation where it is done in violation of a securities purchase agreement. In terms of the death spiral complaints reviewed in Part III of this paper, three companies made such allegations. (Internet Law Library and Sedona argued market manipulation when defendants allegedly violated prohibitions on short selling contained in their securities purchase agreements,[324] while Log On America alleged that the purchasers of its FPS

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[322] The Third Circuit in *GFL* evidently failed to appreciate that SEC short-selling Rules 10a-1 and 10a-2 apply only to exchange-traded securities and do not apply to over-the-counter companies such as EquiMed and National Medical. *See GFL*, 272 F.3d at 212 ("Perhaps, if Colkitt had offered evidence that GFL's short sales violated SEC rules (for instance, if GFL failed to cover properly the short sales in violation of Rule 10a-2, or if GFL made short sales below the last sales price in violation of Rule 10a-1), Colkitt might have been able to establish that GFL's conduct was intentionally or recklessly manipulative or deceptive."). But this minor mistake does not undermine the court's holding (indeed, it is consistent with the holding and, furthermore, supports this paper's argument that naked short selling in violation of market rules is manipulative).

[323] *See supra* note 296.

[324] *See* Internet Law Library, Inc. v. Southridge Capital Mgmt., LLC, 223 F. Supp. 2d 474, 486-87 (S.D.N.Y. 2002); Sedona Complaint, *supra* note 123, ¶ 68.

violated short-selling volume restrictions.)[325] Assuming that the plaintiffs' allegations are true, these claims would certainly amount to breach of contract. But the question of securities fraud is more complex; breach of a securities contract does not *per se* imply securities fraud.[326] Returning to the *GFL* and *Schnell/Global Intellicom* market manipulation tests, the question would be whether violating the terms of a securities contract with respect to short selling amounts to (under *GFL*) "deceptive or manipulative conduct [that] inject[s] inaccurate information into the marketplace or [creates] a false impression of supply or demand," or is (under *Schnell*) a "material misrepresentation, omission, or scheme to defraud."[327] Based on the language of these two tests, it appears that these analyses could generate contrary results, though they ought not do so.

Under *GFL*, these arguments would likely fail. By the language of the *GFL* market manipulation test, it is difficult to see how violating the terms of a securities purchase agreement "injects inaccurate information into the marketplace" or "creates a false impression of supply and demand for a security" because the terms of a bilateral securities contract have no bearing on the market for the security. (In fact, if the terms of the contract were not public, the market would not even be aware of the violation at all.) *GFL* emphasizes the point that the court is looking for an effect *on the market* and so implies that a breach of a securities contract will not amount to market manipulation.[328] In contrast, the language of the *Schnell/Global Intellicom* test is more favorable to these arguments because that test only looks broadly for a material "scheme to defraud." A

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[325] *See supra* note 149; Log On America, Inc. v. Promethean Asset Mgmt., LLC, 223 F. Supp. 2d 435, 444-47 (S.D.N.Y. 2001).
[326] *E.g.*, Broad v. Rockwell Int'l Corp., 614 F.2d 418, 438-39 (5th Cir. 1980).
[327] *See supra* text accompanying notes 261 & 265.

court might accept an FPS issuer's argument that, for instance, a defendant engaged in market manipulation when it promised not to engage in short selling activity and then broke this promise because it was an integral part of a scheme to defraud. These two tests therefore facially support different results, however they ought not produce different outcomes if applied correctly.

These two tests ought to lead to the same result: that these claims are not actionable. This conclusion follows from understanding why the *GFL* test is superior to the *Schnell/Global Intellicom* test. To begin, the *Schnell/Global Intellicom* test was drawn from prior market manipulation caselaw in the Southern District of New York without revision.[329] The courts thus took a general test and applied it to whatever market manipulation claims were raised by the plaintiffs. Yet the lack of refinement of this general test to the specific context of short selling is a major oversight, because short selling is acknowledged as a legitimate market activity. To say that short selling by itself can be part of a 'scheme to defraud' runs contrary to the essential validity of the practice. What is more, the *Schnell/Global Intellicom* test ignores important market manipulation precedents cited in *GFL* including *Santa Fe Indus. v. Green*,[330] *Gurary v. Winehouse*,[331]

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[328] *See GFL*, 272 F.3d 189, 204-05 (emphasizing that the key to market manipulation is injecting false information into the market).

[329] *See* Schnell v. Conseco, Inc., 43 F. Supp. 2d 438, 448 (S.D.N.Y. 1999); Global Intellicom Inc. v. Thomas Kernaghan & Co. et al., 1999 U.S. Dist. Lexis 11378, at 21-22 (S.D.N.Y. 1999).

[330] *See GFL*, 272 F.3d 189, 204-05 (3d Cir. 2001) ("The Supreme Court has indicated that market manipulation 'generally refers to practices, such as wash sales, matched orders, or rigged prices, that are intended to mislead investors by artificially affecting market activity."), citing Santa Fe Indus. v. Green, 430 U.S. 462, 476 (1977).

[331] *See GFL*, 272 F.3d 189, 205 (3d Cir. 2001), quoting Gurary v. Winehouse, 190 F.3d 37, 45 (2d Cir. 1999) ("The gravamen of manipulation is deception of investors into believing that prices at which they purchase and sell securities are determined by the natural interplay of supply and demand, not rigged by manipulators.").

and *In re Olympia Brewing Co. Securities Litigation.*[332] These decisions would have to be squared with any holding that short selling in violation of a securities purchase agreement is market manipulation, but this will be difficult to do. For, as the *GFL* court identifies, these cases also indicate that market manipulation claims must show an effect *on the marketplace.*

Part V – Regulatory Issues

This paper has analyzed some of the common securities fraud claims made by issuers of Future Priced Securities, specifically, misrepresentation and market manipulation in violation of Section 10(b) of the Securities Exchange Act of 1934. As indicated in Part III, these claims generally have merit and it therefore appears clear that death spiral litigation has a future in the district courts of the United States. But there are also important regulatory issues arising out of concerns over Future Priced Securities that have not yet been discussed. The problems caused by Future Priced Securities imply a need for some sort of regulatory response as FPS issuers appear to be routinely abused by the purchasers of these instruments. This is a problem both for the issuers of these companies and for innocent shareholders who are victimized by the devaluation of their investments.[333] But what is to be done?

Future Priced Securities could simply be prohibited by state law—*i.e.*, state corporate laws could be amended to prevent companies chartered there from issuing any securities that are convertible into a fixed value (as opposed to predetermined numbers)

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[332] *See GFL*, 272 F.3d 189, 204 ("Like the district court, GFL relies on *Olympia Brewing*, …, in which the district court emphasized that the 'essential element' of a market manipulation claims is the injection of 'inaccurate information' into the market."), citing In re Olympia Brewing Securities Litigation, 613 F. Supp. 1286, 1292 (N.D. Ill. 1985).

[333] *See supra* note 31 and accompanying text.

of shares. But this appears to be an overly drastic response and would eliminate the valuable role that FPS's play in financing. Companies ought to be able to issue securities that provide investors with confidence that the value of their investment will be protected irrespective of fluctuations in the issuer's stock price. For small issuers that have limited financing choices, Future Priced Securities ought to be an available means of financing to continue operations. The focus of regulation therefore should be to reduce the potential for abuse that now exists.

The Securities and Exchange Commission, responding to complaints from issuers and investors about market abuses by naked short sellers, recently issued for comment Regulation SHO.[334] If adopted as proposed, Regulation SHO will impact Future Priced Securities by overhauling short selling regulation. There are two major changes proposed by Regulation SHO. First, Regulation SHO proposes to abandon Rule 10a-1's "tick test" in favor of a uniform "bid test" for exchange-traded and Nasdaq National Market Securities.[335] This new bid test would be similar to NASD Rule 3350 and is designed to satisfy the same three rationales underlying Rule 10a-1.[336] This change generally would not help issuers of Future Priced Securities, however, because the SEC has exempted the Nasdaq SmallCap, OTCBB, and Pink Sheets markets (where many FPS issuers trade)

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[334] *See* SEC Proposed Regulation SHO, *supra* note 47, at 62974.
[335] *See* SEC Proposed Regulation SHO, *supra* note 47, at 62980-81.
[336] *See id.* at 62980 ("Under the proposed uniform bid test, the price at which a short sale could be effected would move contemporaneously with thee movement of the consolidated best bid."). Footnote 74 of Regulation SHO explains: "if the best bid in a security is $47.00, short selling would be allowed at $47.01 or higher, regardless of whether the immediately preceding bid was $46.99 or $47.01 (i.e., it does not matter whether the current bid is an upbid or downbid from the immediately preceding bid). Also, if the best bid in a security is $47.00, and the last trade price in the security was $47.05, short selling would be allowed at $47.01 or higher (i.e., last sale price is irrelevant)." *Id.* This new bid test differs from NASD Rule 3350, however, in that Rule 3350 focuses on upbids and downbids (*i.e.*, allowing short sales that are upbids and prohibiting short sales that are downbids) while the new rule does away with this restriction. *See id.*

from this rule.[337] Thus, many FPS issuers would continue to have no pricing rule to prevent downward pressure on their securities due to short selling.

Instead, FPS issuers will have to rely on the second major change that would be effected by Regulation SHO, a uniform "locate" rule and "delivery" rule for brokers.[338] The SEC is proposing new Rule 203, "a uniform 'locate' rule applicable to all equity securities, wherever they are traded."[339] This proposed rule would prevent naked short selling by requiring that brokers locate and annotate in writing prior to a short sale where securities are to be borrowed from.[340] Furthermore, the SEC is proposing a new delivery rule "targeted at securities where there is evidence of significant settlement failures."[341] This rule would restrict short selling of securities where fails-to-deliver have accumulated,[342] thereby helping prevent the abuses alleged by Future Priced Securities issuers like JAG Media Holdings.[343] These new rules, applicable to all securities wherever traded, should help prevent death spirals. For instance, the massive naked short selling alleged by JAG Media Holdings would become illegal. Furthermore, other death spiral schemes would be made more difficult because the locate-and-deliver rules would preclude an FPS purchaser from relying on an FPS coming-due months in the future to

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[337] *See id.* at 62981 ("We are not proposing at this time to extend the uniform bid test to securities not currently covered by a short sale price test (i.e., Nasdaq SmallCap, OTCBB, and Pink Sheet securities) in part because these markets have not been subject to the rule in the past. More significantly, we believe that the proposed locate and deliver requirements may address many of the concerns regarding abusive short selling in thinly-capitalized securities trading over-the-counter.").
[338] *See id.* at 62972.
[339] *Id.* at 62976.
[340] *See id.*
[341] *Id.* at 62976.
342 *See id.* at 62977 ("We are incorporating the same threshold currently used in NASD Rule 11830,50, i.e., any security where there are fails to deliver at a clearing agency registered with the Commission of 10,000 shares or more per security, and that is equal to at least one-half of one percent of the issue's total shares outstanding. … The proposed rule would specify that for short sales of any security meeting this threshold, the selling broker-dealer must deliver the security no later than two days after the settlement date.").

cover current short sales. Death spirals would still be possible, but would be made more difficult to effectuate.

Part VI – Conclusion

This paper has shown that death spiral litigation has a clear future in United States district courts. Future Priced Securities issuers can sustain valid claims against the purchasers of these instruments for either misrepresentation or market manipulation in violation of Section 10(b) of the Securities Exchange Act. This would appear to be a just result. The facts and schemes alleged in death spiral complaints strongly suggest that individuals who short-sell on the basis of an FPS are not arbitraging or trading on changed circumstances but instead have preconceived plans by which to profit from a position of power over the company. And since Future Priced Securities have the potential to be useful financing instruments for small companies, regulators should ensure that these securities are not tools of abuse. Regulation SHO, if adopted as proposed by the SEC, would be a substantial step in this direction.

[343] *See supra* notes 166-68 and accompanying text.