

# Activist Short-Sellers Are The Dark Knights Of Wall Street

By **Francis McConville, William Schervish and Connor Boehme** (December 4, 2023)

When Gotham City is plagued by crime, its citizens turn to its heroes: police commissioner James Gordon, district attorney Harvey Dent and the city's most unlikely hero, Batman.

When Wall Street is plagued by fraud, investors seek justice from the familiar players: the U.S. Securities and Exchange Commission, the U.S. Department of Justice and plaintiff-side securities law firms that seek to recover the losses investors suffer due to corporate misconduct.

But a group of unlikely heroes work in the shadows to expose fraud at its source: the activist short-sellers. These investors act as independent detectives, examining the dark underbelly of Wall Street to find the truth behind the corporate lies.

Activist short-sellers are typically small investment firms with a few employees who are former Wall Street bankers, public accountants or investigative journalists. These firms conduct extensive fraud investigations and publish their findings to the market.

One such successful investigation into Clover Health Investments Corp., a Medicare insurer based in Franklin, Tennessee, culminated in October in a **\$22 million settlement** for harmed investors.

That case started with an activist short-seller named Hindenburg Research releasing an investigative report revealing that Clover Health was the subject of a DOJ investigation for a variety of issues, including illegal kickbacks, deceptive marketing tactics and undisclosed related-party transactions.[1]

The report relied on interviews that Hindenburg Research conducted with numerous witnesses, including former Clover Health employees, doctors who used the company's software and industry experts.

One former employee provided Hindenburg Research with a copy of the DOJ's demand letter to Clover Health. The report also contained facts from other witnesses who explained how the improper business practices were the true drivers of Clover Health's revenue. Once this report was published, the price of Clover Health stock dropped by more than 12%.

Similar to the criticism of Batman's fierce crime-fighting tactics, not everyone approves of the approach used by activist short-sellers. They are often cast as villains or vigilantes by the Wall Street elite because they frequently make money when others are losing.

This criticism has recently led to significant reforms in how short-selling is regulated. In October, the SEC adopted rules requiring institutional money managers with large short positions to file a form detailing these positions at the end of each month.[2] The SEC plans to aggregate this data and publish it for the market. [3] One SEC commissioner stated that the changes could discourage short-selling.[4]



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Despite these criticisms, activist short-sellers, and the proprietary research they publish, can help investors recover losses caused by securities fraud. Indeed, the fallout from the Hindenburg Research report did not end with the stock drop.

Shortly thereafter, a securities fraud lawsuit was filed against Clover Health in Tennessee federal court on behalf of its shareholders who incurred investment losses. According to the complaint, Clover Health misled its shareholders by covering up the DOJ investigation and its illegal business practices.[5] Notably, the complaint recognized that the Hindenburg Research report helped reveal the alleged fraud to the market.

The Hindenburg Research report has proven decisive for advancing shareholders' claims against Clover Health. U.S. District Judge Aleta A. Trauger cited the report's credibility in denying defendants' motion to dismiss the allegations.[6] This is one example of how reports published by activist short-sellers prove critical in creating or bolstering private securities fraud lawsuits.

### **Activist Short-Selling**

Activist short-selling occurs in three steps.

First, an activist like Hindenburg Research typically bets that a stock is overvalued based on the firm's research.[7] The activist places its bet by borrowing the target company's stock from a broker and selling it at the prevailing market price.

Second, the activist publishes its research report alleging undisclosed corporate misconduct at the target company to demonstrate why the target company's stock is overvalued. This report is known colloquially as the short report.

Third, if the short report causes the stock to drop below the sales price, the activist buys back the stock at the lower price, returns the stock to the broker and profits by pocketing the price difference between the sale price and the buyback price.[8]

Importantly, an activist short-seller takes risks like any other investor in the market. The market may not react negatively to the short report. In those cases, the activist can be exposed to massive losses when the stock price increases significantly above the sale price.[9]

Activist short-sellers are most successful when their short reports reveal previously undisclosed facts that support fraud allegations that are material to the target company's financial statements.

These facts are developed through proprietary investigations, which can involve interviewing former employees of target firms, researching their products, analyzing accounting irregularities or even surveilling the target company's operations.

With any investment risk, there is a potential reward. Activist short-selling has proven to be highly profitable in certain cases. For instance, this year, activists made about \$71 million after they released short reports that exposed Icahn Enterprises LP for operating as a Ponzi-like scheme.[10]

These short reports provided compelling evidence that Icahn Enterprises had been materially overstating its asset values and using money taken in from new investors to pay

dividends to old investors.[11]

### **Financial Watchdogs or Vigilantes?**

Activist short-sellers claim to benefit investors by helping ensure that markets are priced efficiently by taking short positions on securities that they believe are overpriced.[12] Further, activists argue that short reports inform the market of previously undisclosed facts, which can help align bloated stock prices with reality.

Activist short-selling has also been the target of considerable criticism, like claims that activists spread false rumors to drive down securities prices or participate in coordinated transactions to lower the price of securities.[13]

Indeed, activists have been subjected to increased regulatory scrutiny over the past few years. In early 2022, the DOJ opened an investigation into 30 activist firms for potential trading abuses.[14]

Subsequently, a top official at the agency indicated that there would be more "activity from [the DOJ] ... involving short sellers," in the near future.[15] Such scrutiny has led to reforms like those implemented by the SEC in October this year to increase transparency in short-selling.

Short reports can also expose activist short-sellers to legal liability in the form of defamation lawsuits from disgruntled target companies. Although these lawsuits typically fail, they can be costly to activists when they succeed, such as one short-seller who wrote about Farmland Partners Inc., a Colorado real estate investment trust. The short-seller settled a defamation case and admitted that his short report contained false statements about the target company.[16]

### **Government Crackdowns**

Despite activist short-sellers' maverick reputation, they have helped maintain law and order in the securities markets. Information disclosed in short reports can trigger government investigations and enforcement actions, which can lead to civil penalties, disgorgement of ill-gotten gains and other legal liabilities for the target companies.

For example, short-seller Scorpion Capital released a short report targeting Ginkgo Bioworks based on dozens of research interviews, including interviews with former company employees, calling the company a colossal scam and focusing on the company's use of related-party transactions.[17] One month later, the company revealed that it had received an inquiry from the DOJ connected to Scorpion Capital's report.[18]

Such government intervention kickstarted by activist short-sellers can rectify fraud in the financial markets and even help make harmed investors whole if regulators recover lost funds which are then returned to investors. But the potential consequences triggered by short reports go beyond government responses, and private law firms play a major role in recovering funds for harmed investors.

### **Securities Fraud Litigation**

Similar to how Gotham's legal authorities coordinate with Batman, securities litigators and activist short-sellers work in conjunction to expose securities fraud. If revelations in a short report lead to a stock drop, as in the Clover Health case, securities litigators can initiate

private lawsuits to help investors recover their losses.

Short reports frequently help investors prove their case by demonstrating two key legal elements under the federal securities laws: that the defendant company issued false statements, i.e., falsity, and that these false statements caused investors' economic loss, i.e., loss causation.

Evidence from a short report can be included in a securities fraud complaint to demonstrate that statements made by a defendant company were false. For instance, say a company claims a new product is effective. Then, an activist short-seller issues a report featuring interviews with employees of that company stating that the product does not work as advertised.

Similarly, say a company has touted its newly constructed factory as a major competitive advantage. Then, an activist short-seller surveils the facility and issues a report with pictures showing that the factory is still in the early stages of construction. In either case, a complaint could reference the short report findings to help prove that the companies' statements were false.

A short report can also provide evidence that the alleged fraud caused investors' losses if the report reveals new information to the market. For instance, say a short report is released revealing that a company overstated its revenues for the past two years, and the company's stock price falls due to this revelation.

If, prior to the short report, investors did not know about these accounting improprieties, a complaint could cite the stock price drop as evidence that the financial misstatements caused investors' losses.

There are many examples of litigations premised on short reports that have recovered millions of dollars for shareholders.[19]

Short-sellers continue to publish short reports that lead to private lawsuits. One market report counted 63 new major short campaigns in the first half of 2023.[20] Several of these have led to class actions, including one against Icahn Enterprises based on the short report discussed above.[21]

### **How Law Firms Analyze Short Reports**

Once the Dark Knights of Wall Street expose corporate fraud, it is up to Wall Street's other watchdogs, including plaintiff-side securities law firms, to help harmed investors.

These firms focus on the strength of the evidence cited in the short reports. Strong evidence includes interviews with credible former employees who provide a high level of specificity, analysis from relevant experts, intelligent accounting analysis that points to indicia of false financial statements, reliable tests performed on products, and evidence of problems at company facilities using pictures and other surveillance techniques.

Such evidence is more likely to introduce new, reliable information to the market and be useful to plaintiffs in a potential securities fraud lawsuit. Weaker short reports, on the other hand, provide only shallow background research and often reiterate public information.

Well-researched, revelatory short reports can serve as a Bat-Signal, calling on justice seekers to right the wrongs of corporate fraudsters. Monitoring Wall Street for fraud

requires constant vigilance, and short reports can be a critical tool for law firms that seek to return money to harmed investors.

Although not every short report presents the telltale signs of fraud, when the occasion calls for it, the firms are ready to team up with Wall Street's most unlikely heroes — the activist short-sellers.

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[1] Hindenburg Research, Clover Health: How the "King of SPACs" Lured Retail Investors Into a Broken Business Facing an Active, Undisclosed DOJ Investigation (Feb. 4, 2021) (the "Clover Health Report").

[2] Paul Kiernan, Hedge Funds Must Tell SEC Which Companies They Sell Short Under New Rules, THE WALL STREET JOURNAL (Oct. 13, 2023).

[3] Id.

[4] Id.

[5] [Bond v. Clover Health Invs., Corp.](#), No. 21-cv-00096 (M.D. Tenn. Feb. 5, 2021).

[6] [Bond v. Clover Health Invs., Corp.](#), 587 F. Supp. 3d 641, 668 (M.D. Tenn. 2022).

[7] Note that Hindenburg Research did not take a position in Clover Health securities but released the report to "demonstrate the role short sellers play in a healthy, functioning market." Clover Health Report. Hindenburg Research frequently takes short positions against the companies it writes about. See, e.g., Hindenburg Research, Icahn Enterprises: The Corporate Raider Throwing Stones From His Own Glass House (May 2, 2023) ("[W]e have taken a short position in units of Icahn Enterprises L.P.") (the "Icahn Enterprises Report").

[8] CONGRESSIONAL RESEARCH SERVICES, SHORT SELLING: BACKGROUND AND POLICY ISSUES (2023).

[9] Id.

[10] Bilal Jafar, Short-sellers make \$38m in one day on Carl Icahn's embattled empire, FINANCIAL NEWS LONDON (Aug. 7, 2023).

[11] Icahn Enterprises Report.

[12] CONGRESSIONAL RESEARCH SERVICES, SHORT SELLING: BACKGROUND AND POLICY ISSUES (2023).

[13] Id.

[14] Katia Porzecanski & Tom Schoenberg, Vast DOJ Probe Looks at Almost 30 Short-Selling Firms and Allies, BLOOMBERG LAW (Feb. 4, 2022).

[15] Tom Schoenberg, US action on short-sellers likely in 'next few months' -DOJ official, REUTERS (May 24, 2023).

[16] Michelle Celarier, Stunning Confessions of a Short Seller, INSTITUTIONAL INVESTOR (June 22, 2021),

[17] Scorpion Capital, Ginkgo Bioworks (NYSE: DNA), PowerPoint Presentation (Oct. 6, 2021).

[18] Dulan Lokuwithana, Ginkgo Bioworks says it received inquiry from DOJ after short seller report, SEEKING ALPHA (Nov. 15, 2021)

[19] In re: Luckin Coffee Inc. Securities Litigation, No. 20-cv-01293 (S.D.N.Y.) (resulting in a \$175 million settlement for plaintiffs); City of Sunrise General Employees' Retirement Plan

v. Fleetcor Technologies, Inc., No. 17-cv-02207 (N.D. Ga.) (resulting in a \$50 million settlement for plaintiffs); Keippel v. Health Insurance Innovations, Inc., No. 19-cv-00421 (M.D. Fla.) (resulting in an \$11 million settlement for plaintiffs).

[20] Activist Short Selling H1 2023, BREAKOUT POINT (Jul. 6, 2023).

[21] Okaro v. Icahn Enterprises L.P., No. 23-cv-21773 (S.D. Fla.).