GET SHORTY:
DEFAMATION AND REGULATORY CLAIMS AGAINST SHORT-SELLERS IN CANADA

DLA PIPER

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OVERVIEW

Public companies in Canada can reasonably expect a degree of scrutiny by market participants. Analysts might question fiscal projections. Shareholders might question board decisions. Regulators might question the adequacy of the company's disclosure. But perhaps no class of commentator can create more anxiety to a public company than a well-known short-seller issuing a highly critical report. As we have seen in Canada, such reports have resulted in the total collapse of major public companies.

When a short-seller issues a damning report, the company will almost always pursue a public relations response, out of necessity. But inevitably the Board that has been targeted will ask the question: how do we sue the short-seller? Alternatively, the Board may believe the short-seller report contains material misrepresentations and inaccuracies, and will consider complaining to securities regulators.

No consensus has emerged about what response makes sense from a strategic business standpoint. Some believe that if the Board truly has the courage of its convictions, it will not hesitate to advance claims in the courts or before regulators. Others believe that the diversion of management time and energy to chasing short-sellers sends a terrible message to the market that the company is distracted and not properly executing its business strategy.

Layered onto those business concerns is a new legal concern: in Ontario, defamation claims against short-sellers might get summarily dismissed under the province's new anti-SLAPP (strategic lawsuits against public participation) statute. This statute has only been used once in Ontario by a short-seller, and in that case, the CEO's claim against the short-seller survived the preliminary motion. But that outcome arguably turned on the specific facts of that case, and the anti-SLAPP statute still presents a possible challenge to defamation claims against short-sellers.

Canadian companies have yet to find a clear legal path to address short-sellers who issue reports containing facts the company believes to be untrue. And to the extent that a defamation claim was the best option, the viability of that option may have become even less clear.

SHORT SELLING IN CANADA

Short selling is the sale of securities with the intention of repurchasing them at a lower price. Typically, a short-seller will borrow securities from a shareholder (who receives a fee). The short-seller then sells those securities into the market at the current price and repurchases the securities at a later date to settle with the lender. The short-seller preforms these transactions in the hope that the price of the security will decrease between the sale date and settlement date, allowing them to pocket the difference. There are two main reasons for short selling: i) the short-seller believes that the share price is over-valued and wants to profit off its anticipated decline; or ii) the short position is being used as a hedge.

Short-sellers have been criticized for causing market instability and driving down stock prices. Short-sellers are often accused of "short and distort" schemes. A short and distort scheme involves a short-seller taking a short position in a publically traded company and then engaging in a false representation smear campaign in order to drive down the company's share price. The short and distort scheme is essentially the flip-side of a pump-and-dump scheme, whereby a shareholder promotes a company to increase its share price and then sells its shares once the stock has become over-valued. In both cases, the underlying wrongful behaviour relates to feeding misinformation to the public market in a manner that distorts the share price to the commentator's advantage. In both situations, unassuming shareholders are at risk of financial loss. In the case of short and distort schemes, share values are driven down by inaccurate information and during pump and dumps potential shareholders are enticed to buy and existing shareholders are enticed to hold on to shares at inflated values that are not sustainable.

Short-sellers reply that they encourage or require public market accountability, perform comprehensive and timely due diligence, and serve as a check on inflated stock prices. A committee of the International Organization of Securities Commission agreed, in part: "[s]hort selling plays an important role in capital markets for a variety of reasons, including more efficient price discovery, mitigating price bubbles, increasing market liquidity, facilitating hedging and other risk management activities."[1] The value of short-sellers has been demonstrated on occasions when short-sellers have discovered fraud and other malfeasance prior to its discovery in the market generally or actions taken by regulators.

Short-selling has been on the rise in Canada over the past few years. The top 20 short positions in Canada have increased by almost 25% since 2015.[2] And equally important, short-selling reports have gained significant notoriety in Canada. Canadian market darling Sino-Forest Corporation spectacularly collapsed in 2012 after Muddy Waters of California issued a series of damning short reports. Home Capital Group, Asanko Gold, and Exchange Income Corporation are additional recent targets of vocal short-sellers.

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[1] Technical Committee of the International Organization of Securities Commissions, *Regulation of Short Selling: Final Report* (June 2009), p. 5

[2] TSX Markets data, collected July 11 2017.

COMPANY RESPONSES TO SHORT-SELLERS

Companies typically employ one or more types of responses to short-seller attacks: (1) public relations; (2) business strategies; and (3) legal responses. Usually, the most successful responses employ a combination of all three.

In terms of public relations or investor relations, Canadian companies will typically work with a public relations firm or their existing investment relations firm to develop a message to answer short-seller criticisms, to establish a channel of communications to ensure consistency of message, and to deliver the company message to key stakeholder targets through a variety of channels. The company will seek to correct any inaccuracies contained in the short report, and will focus on delivering its core investment strategy messages.

Depending on the nature of the attack contained in the short report, companies may avail themselves of a variety of business strategy measures to thwart the attack.[3] Home Capital launched a $150 million Dutch auction share buyback in the face of a short-seller attack in 2015, resulting in the cancellation of a large number of shares and demonstrated confidence in the company's balance sheet (at least for a year). It also raised its dividend by 9%, resulting in short-sellers having to pay out an additional amount to cover the dividend. Other companies will put themselves in play by announcing that the company is considering strategic alternatives. Others that have had the ability to wait out the storm have simply carried on business and posted strong financial results, which takes much of the sting out of a short report.

There are typically three potential legal responses to a short report.

Conduct an Investigation: First, where misfeasance is alleged at the company, the Board obviously has a responsibility to investigate the facts and take action based on what is learned. Sino-Forest struck an independent committee of the Board to investigate the Muddy Waters allegations. The Intertain Group similarly struck an independent committee after a short-seller issued a critical report. Where the integrity of management is challenged or where insider transactions are alleged, an independent committee free from management influence is almost invariably required. The ongoing investigation by the independent committee also allows the company to defer comments on the allegations, and also provides a channel to deal with any regulators that may be engaged. Finally, an "all-clear" report from a properly conducted independent committee will carry much greater weight with shareholders and regulators alike.

Sue for Defamation: When a short-seller seriously attacks the integrity of a company's senior executives or Board members, the temptation to sue for defamation is almost impossible to overcome. Some believe that they almost have to sue for defamation, for fear that their failure to do so will be viewed as an admission of the short-seller's claims. Canadian CEOs and companies have accordingly sued in the past over critical reports. But the business wisdom of pursuing such a claim is not universally supported, and the efficacy of such defamation claims is disputed. Sino-Forest ultimately became insolvent, and other CEOs have resigned after becoming embroiled with short-sellers. Moreover, there is a risk that the short-seller will maintain its position in the company for a longer period of time after being hit with a defamation claim, in order to avoid reputational risk.

Complain to the Regulators: Another legal response available to the company is to complain to securities regulators that the short-seller is making misrepresentations that are distorting the market for the issuer's securities. Sometimes these complaints are a response to allegations already made by the short-seller to the regulators. However, securities regulators tend to be skeptical of these kinds of complaints against short-sellers, and sometimes have resulted in painting a target on the backs of the company and its directors themselves.[4]

Sometimes, the issuer will employ a variety of these legal strategies at the same time.

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[3] See a useful discussion in the Canadian context in "Five Ways Companies Can Combat Short Sellers", *Financial Post*, Apr. 29 2016

[4] See C.F. Walker and C.D. Forbes, "SEC Enforcement Actions and Issuer Litigation in the Context of a "Short Attack", *The Business Lawyer*, vol. 68 (May 2013), pp. 700-704

ONTARIO'S NEW ANTI-SLAPP LEGISLATION

A new hurdle may have been created by the Ontario government for companies and executives under attack by a short-seller, who seek to fight back with a defamation claim: anti-SLAPP legislation.

A SLAPP suit has been defined as a "lawsuit started against one or more people or groups who speak out or take a position on an issue of public interest. The purpose of a SLAPP is to silence critics by redirecting their energy and finances into defending a lawsuit and away from their original public criticism."[5] Or as one other court put it, "Litigation can be used to suppress freedom of expression and political speech and legitimate acts of protest and dissent […] The anti-SLAPP provisions are designed, among other things, to allow a defendant to bring a motion to have an action dismissed in a summary fashion."[6]

On November 3, 2015, Ontario passed Bill 52 *An Act to amend the Courts of Justice Act, the Libel and Slander Act and the Statutory Powers Procedure Act in order to protect expression on matters of public interest* (the "*Ontario Act*").

Under the *Ontario Act*, the defendant bears the burden of demonstrating that, on a balance of probabilities, the challenged conduct "arises from an expression made by the person that relates to a matter of public interest". The onus then shifts to the plaintiff to demonstrate that there are grounds for believing that the proceeding has "substantial merit" and that the defendant has "no valid defence to the proceeding". To do this, the plaintiff must demonstrate that "there is an objective basis for the belief which is based on compelling and credible information". Finally, the court will consider whether the harm suffered by the plaintiff as a result of the defendant's expression is sufficiently serious that the public interest in permitting the proceeding to continue outweighs the public interest in protecting that expression.

Appeals from a number of lower-court decisions were heard in June 2017, and it can be expected that the Ontario Court of Appeal will provide some guidance on the interpretation of the *Ontario Act* in those cases. However, none of the cases before the Court of Appeal involved short-sellers, so it cannot be expected that specific guidance will be provided in this context.

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[5] *Salewski v. Symons*, 2012 ONSC 1307 at para. 4

[6] *Hudspeth v. Whatcott*, 2017 ONSC 1708 at para. 174

ROUND 1 ON ANTI-SLAPP AND SHORT-SELLERS: *THOMPSON V. COHODES*

The only guidance to date in Ontario that relates to short-sellers and the Ontario anti-SLAPP legislation relates to a public company CEO's long-running lawsuit against a short-seller, Marc Cohodes.[7]

In this case, Mark Thompson, the CEO of a publicly traded company sued Marc Cohodes, a former hedge-fund manager and short-seller of the company for libel. Cohodes brought a motion to dismiss Thompson's claim pursuant to the *Ontario Act*.

The statements alleged to be defamatory by Thompson included a number of Twitter posts by Cohodes, alleging a variety of problems with the company. What got Thompson's attention, however, was Cohodes' reference to Thompson's prior employment with another company and the suggestion that he was somehow implicated in a fraud at that company.

In *Thompson* the court recognized that the "management of a publically traded corporation is a matter of public interest" . The court then considered whether the plaintiff had demonstrated an objective belief of the substantial merit of the claim by looking at the necessary elements of the particular allegation. In *Thompson* the court considered the three elements of libel: that i) the words refer to the plaintiff, ii) the words were published by being communicated to at least one other person and iii) the words complained of were defamatory. Cohodes conceded the first two elements of libel. To establish that Cohodes' comments were defamatory, Thompson had to demonstrate with an objective basis of belief that Cohodes comments tended to lower Thompson's reputation in the eyes of a reasonable person. Cohodes argued that his comments would be construed by the reasonable viewer as expressions of the opinion that the company was a bad investment because its management, including Thompson, has a history of being involved in poorly managed companies. The court disagreed, finding that a reasonable person would interpret Cohodes statements as alleging that Thompson committed fraud, or participated in fraud and thus were defamatory.

The court found that Thompson had demonstrated an objective belief that Cohodes could not prove the "truth of the main thrust of the libel complained of". Thompson provided evidence that he did not engage in any fraudulent conduct during his prior employment. The court found Cohodes' evidence on this issue unconvincing, and accepted Thompson's evidence as establishing that there were no reasonable ground to believe that Cohodes had a valid defence of justification.

The court in *Thompson* also considered the defence of fair comment. To establish a defence of fair comment, the comment must be i) on a matter of public interest, ii) based on fact, iii) recognizable as comment, and iv) fairly made in that a person could honestly make the comment on proved facts. The court found that Cohodes has no defence of fair comment since the statements complained of were statements of fact, not comment. The court stated that comments are statements of opinion, or inherently subjective and debatable inferences from facts, and are distinguished from defamatory statements of fact, which purport to assert objective truth. Furthermore, the defence of fair comment is only available for comments based on facts proven to be true.

Finally, the court determined that the public interest in allowing the proceeding to continue outweighed the public interest in protecting the expression of the defendant. To determine this, the court first looked at the law of libel as it related to the assessment of damages, noting that general damages are presumed from the publication of libel and thus need not be established by actual loss. Thus, the court dismissed Cohodes argument that his comments did not cause any significant decrease in the public company's share price. The court also considered the seriousness of the charge, stating that the "allegation that a plaintiff has committed fraud is treated seriously." The court also considered the importance of the plaintiff's standing in the community and the importance of Thompson's reputation to his profession. Additionally, the court found that the "value of the defendant's expression is low" because the statements focused on the personal conduct of the plaintiff over a decade earlier and because Cohodes did not provide any details to support his claims against Thompson.

As a result, the court dismissed Cohodes' anti-SLAPP motion. Cohodes has filed an appeal to the Ontario Court of Appeal, but the appeal sits in abeyance while the Court of Appeal deals with the other anti-SLAPP cases on its docket.

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[7] 2017 ONSC 2590

CONCLUSIONS

There is no "set play" for companies to deal with short-seller attacks. Sometimes the short-seller report will only be critical of business strategy or financial projections, and in such circumstances the company's response will likely be limited to public and investor relations. Sometimes the short-seller report will allege fraud, insider transactions, or other misfeasance, and in those circumstances, the Board will have to get much more involved to investigate the facts, and dispute them, as appropriate.

As it relates to defamation claims against the short-seller, the business rationale and the legal rationale may diverge. It may make no business sense at all to sue for defamation, even if there is a tenable claim. Conversely, a defamation claim might have little merit in the courts, but for business reasons the company may feel compelled to advance them.

What we can learn from Ontario's limited experience with anti-SLAPP legislation is that this is a tool that short-sellers can reasonably be expected to use in future defamation cases. And why wouldn't they? A short-seller will only need to show that (a) the claim is based on some public comment made by the short-seller; and (b) that the matter is one of public interest. As the Court found in *Thompson*, the management of public companies is likely to be found to be in the public interest. It is difficult to see how a court could say otherwise.

The onus then shifts back to the company or its executives to provide evidence supporting their claim. This gives a free shot at cross-examining the executives at a very early stage in the proceeding. And even if the company or its executives prove that the case has sufficient merit, the only consequence is that the anti-SLAPP motion is dismissed. The case still goes on to the merits. The statute doesn't even give the plaintiff its normal rights to costs for winning a motion: costs are presumptively unavailable in a failed anti-SLAPP motion, unless the judge decides otherwise.

As a result, in addition to any business impediments to launching a defamation claim against a short-seller, the targeted company or its executives will need to consider the legal implications of commencing a claim that is likely to be hit with an anti-SLAPP motion. There may be many cases where a defamation claim still makes sense, but the anti-SLAPP statute provides an additional hurdle that makes it more difficult to arrive at that conclusion.

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