

THE TOXIC CONVERTIBLE: ESTABLISHING MANIPULATION IN THE WAKE OF SHORT SALES

INTRODUCTION

The recent collapse of the NASDAQ market has left many newly public companies still in their development stage hoping that the long dormant public offerings market will soon awaken. Many of these fledgling companies are in dire need of additional capital but have few options in the wake of the recent economic downturn. Some have resorted to a new species of financing, called the toxic convertible, to raise capital in the absence of alternative options. Companies that turn to the toxic convertible are usually in financial trouble and are hoping for short-term aid.¹ While this kind of financing is a boon for some, the toxic convertible is often the final nail in the coffin for troubled companies.² Recently, there have been a number of cases in which companies using toxic convertibles have alleged that investors backing this type of financing engaged in market manipulation to the detriment of the company and the investing public.

Two of the most important provisions in the U.S. Securities and Exchange Commission (“SEC”) arsenal for policing toxic convertibles³ are § 9⁴ and § 10(b)⁵ of the Securities Exchange Act of 1934. Both provisions target manipulative practices and may be useful in litigation against investors that use short selling to manipulate the market while involved in toxic convertible financing.

Because the use of toxic convertibles to raise capital is a recent phenomenon, there has been little case law related to how securities laws regulate the behavior of parties involved in the financing. Consequently, companies who allege manipulation under either § 9 or § 10(b) have almost no guidance as to how to prove their claims. This Comment addresses how a

¹ Stock Patrol, *At Death's Door*, at <http://www.stockpatrol.com/buyer/articles/deathspiral.html> (Mar. 12, 2002).

² Robert C. Friese & Jahan P. Raissi, *Junk Equity Deals Can Harm Stock*, NAT'L L.J., Feb. 15, 1999, at B7.

³ 15 U.S.C. § 78a-mm (2000).

⁴ *Id.* § 78i.

⁵ *Id.* § 78j.

company can employ both § 9 and § 10(b) to prove market manipulation when investors abuse toxic convertible financing.

Part I defines a toxic convertible and explains how an investor who buys a toxic convertible can manipulate the market for the underlying stock by aggressively selling the stock short. Part II discusses the history and purpose of the 1934 Act. Part III focuses on § 9 of the 1934 Act and explains how it could be a legitimate tool to police market manipulation against unscrupulous toxic convertible financiers. Finally, Part IV examines the history, purpose, and the potential use of § 10(b) and Rule 10b-5 of the 1934 Act in toxic convertible manipulation claims.

I. CONVERTIBLE FINANCING

Not all publicly traded companies have the ability to raise capital through traditional methods of financing such as secondary public offerings or loans from investment or commercial banks. In lieu of these traditional methods, companies frequently turn to alternative financing structures. Some of these alternative structures involve obtaining capital from venture capitalists, who are key players in financing high risk ventures.⁶

A. *Standard Convertible Preferred Financing*

One type of financing structure, convertible preferred financing, entails issuing preferred securities⁷ to venture capitalists in exchange for capital.⁸ A common characteristic of convertible preferred stock⁹ is the stockholder's ability to convert the preferred stock into common stock.¹⁰ Companies employ two methods to determine how many new shares they must issue to complete a conversion of the preferred stock. When the convertible security financing

⁶ Curtis J. Milhaupt, *The Market for Innovation in the United States and Japan: Venture Capital and the Comparative Corporate Governance Debate*, 91 NW. U. L. REV. 865, 870 (1997).

⁷ Preferred stock is "[a] class of stock giving its holder a preferential claim to dividends and to corporate assets upon liquidation but that usu. carries no voting rights." BLACK'S LAW DICTIONARY 1430 (7th ed. 1999).

⁸ Dave Price, *Hard-up for Cash? Beware of 'Toxic Convertibles'*, PROFITS J., Nov. 1998, at 18.

⁹ A convertible security is "[a] security (usu. a bond or preferred stock) that may be exchanged by the owner for another security, esp. common stock from the same company, and usu. at a fixed price on a specified date." BLACK'S LAW DICTIONARY 1358-59 (7th ed. 1999).

¹⁰ Richard Korman, *If 'Toxic Convertibles' Drive Up, Watch Out for Sinkholes*, N.Y. TIMES, May 17, 1998, § 3, at 4. Common stock is "stock entitling the holder to vote on corporate matters, to receive dividends after other claims and dividends have been paid (esp. to preferred shareholders), and to share in assets upon liquidation." BLACK'S LAW DICTIONARY 1428 (7th ed. 1999).

employs a fixed ratio for the conversion, then the company must convert the convertible security into common stock based on a fixed price.¹¹ If the conversion ratio is based on fluctuating market prices, then the amount of common stock the company issues to the convertible security holder depends on the price of the stock at the time of the conversion request.¹²

B. Antidilution Provisions

Once a company has issued a convertible security, it retains the ability to dilute the value of that conversion feature. Dilution of the conversion feature results in a transfer of wealth from the convertible security holders to holders of common stock.¹³ However, convertible security buyers are not without protection. Antidilution provisions, included in modern convertible securities or in the charter or indenture creating them, protect the amount and character of the underlying security received in a conversion.¹⁴ Typically, venture capitalists demand the protection afforded by these antidilution provisions.¹⁵

Conventional antidilution provisions come in two forms: the “full-ratchet” provision and the “weighted average” provision.¹⁶ A full-ratchet provision provides that if a company issues one share of stock at a lower price or the option to purchase the stock at a lower aggregate price, the conversion price of the preferred stock decreases, or “ratchets down,” to the lower price.¹⁷ The decrease in the conversion price occurs regardless of the number of shares of stock the company issues at the lower price.¹⁸ A weighted average provision also reduces the conversion price of preferred stock but takes into account how many shares or rights the company issues in the dilutive financing.¹⁹ Hence, if a company issues only one or two new shares of stock, the conversion price

¹¹ SEC, *Convertible Securities*, at <http://www.sec.gov/answers/convertibles.htm> (last modified Feb. 27, 2003).

¹² *See id.* (explaining less conventional convertible security financings).

¹³ Marcel Kahan, *Anti-Dilution Provisions in Convertible Securities*, 2 STAN. J.L. BUS. & FIN. 147, 147 (1995).

¹⁴ Stanley A. Kaplan, *Piercing the Corporate Boilerplate: Anti-Dilution Clauses in Convertible Securities*, 33 U. CHI. L. REV. 1, 2 (1965).

¹⁵ Fredric D. Tannenbaum, *Major Battlegrounds in Venture Capital Transactions (Part 2)*, 45 PRAC. LAW. 79, 81 (1999).

¹⁶ JOSEPH W. BARTLETT, *VENTURE CAPITAL: LAW, BUSINESS STRATEGIES, AND INVESTMENT PLANNING* § 9.4(c), at 175–76 (1988).

¹⁷ *Id.* at 176. The aggregate price of an option to purchase a share of stock is the exercise price of the option plus the price of what is paid for the option. *Id.*

¹⁸ *Id.*

¹⁹ *Id.*

will not decrease much, but if a company issues many shares, the conversion price will decrease greatly.²⁰ Consequently, a weighted average antidilution provision is less punishing than a full-ratchet provision. Both full-ratchet and weighted average provisions can be powerful tools in the hands of venture capitalists, ensuring their percentage of a company's stock is not overly diluted.

C. Toxic Convertible Financing

Less conventional convertible security financing structures utilize a conversion ratio that is based on fluctuating market prices.²¹ Hence, a company will know how many shares of stock to issue only when the convertible security holder requests a conversion. In addition, if the price of the underlying stock decreases, the company has to issue more stock to the holder of the preferred securities if there is a conversion request.²² Deals that use conversion ratios based on fluctuating market prices and that do not have a price floor are commonly referred to as toxic convertibles within the industry.²³ Because the convertible security holder benefits²⁴ when the stock price drops, toxic convertibles present a major opportunity for abuse.²⁵ Thus, many companies enter into toxic convertible financing deals to raise capital only as a last resort.²⁶

D. Toxic Convertibles and Short Selling

One common abuse of toxic convertibles occurs when the holder of a convertible preferred security sells the company's shares short in the hope of driving down the stock price.²⁷ A short sale is the "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."²⁸ Typically, the short-seller borrows stock from a broker-dealer to deliver to the purchaser and then

²⁰ *Id.*

²¹ SEC, *supra* note 11.

²² Stock Patrol, *supra* note 1.

²³ Price, *supra* note 8, at 18. Toxic convertibles deals are also known as *death spiral financing* and *floorless convertibles*. SEC, *supra* note 11.

²⁴ See discussion *infra* Part I.D.

²⁵ Stock Patrol, *supra* note 1.

²⁶ Joseph McCafferty, *New Regs for Deadly Convertibles: Deadly Convertibles Are Eyeballed by the NASD*, at <http://www.cfo.com/Article?article=1557> (Dec. 1, 1998).

²⁷ Stock Patrol, *supra* note 1.

²⁸ 17 C.F.R. § 240.3b-3 (2004).

closes out his position by purchasing replacement stock on the open market to return to the broker-dealer.²⁹

An investor sells short when the investor believes that the price of the stock will decrease.³⁰ If the stock price decreases, the short-seller will profit by keeping the difference between the value of the shares borrowed from the broker-dealer and the cost of the shares purchased on the open market after the stock price decreased.³¹ If the price of the stock eventually declines to zero because the stock becomes worthless, the investor will not have to purchase the stock on the open market to close out his position, and the investor gets all his money out in cash.³²

Short-selling serves two important purposes in the market: It improves the efficiency of securities pricing, and it increases liquidity.³³ Conversely, short-selling can have a negative impact on the market. A large increase in the short interest in a stock can create the impression in the market that the stock is overvalued or, more damagingly, that there is something wrong with the company.³⁴ When this occurs, investors who own the stock will be persuaded to sell, and potential purchasers will be dissuaded from buying because of the implicit message a large short interest in the stock conveys to the market.³⁵

²⁹ Ralph S. Janvey, *Short Selling*, 20 SEC. REG. L.J. 270, 271 (1992).

³⁰ *Id.* at 270.

³¹ See *The Fool FAQ: Shorting Stocks*, MOTLEY FOOL, at <http://www.fool.com/FoolFAQ/FoolFAQ0033.htm> (last visited Feb. 21, 2005). For example, assume an investor sells short 100 shares of Company A's stock at \$20 per share. The value of these shares is \$2000. If the price of Company A's stock drops to \$10 per share, then the investor can purchase the stock on the market to return the borrowed stock to the broker-dealer. The cost to purchase the stock on the market after the price decrease is \$1000. Hence, the investor will earn a profit of \$1000 (\$2000 minus \$1000). See *id.*

³² Janvey, *supra* note 29, at 273.

³³ Jonathan R. Macey et al., *Restrictions on Short Sales: An Analysis of the Uptick Rule and Its Role in View of the October 1987 Stock Market Crash*, 74 CORNELL L. REV. 799, 811 (1989).

³⁴ Dagen McDowell, *Squeeze Play: What Happens When Short-Selling Goes Bad*, at <http://www.thestreet.com/funds/deardagen/1047862.html> (Aug. 21, 2000).

³⁵ *Id.* Investors determined to make the price of a security drop through short sales create an impression in the market that owners of the security are willing to sell it at a higher price than the market is offering. See James J. Cramer, *The Long and Short of It*, at <http://www.thestreet.com/comm.ent/wrongtactics/1051399.html> (Aug. 23, 2000). For example, assume that owners of a security are offering the security for sale on the market for \$5. The short-seller will offer the security for \$5 1/8 on the market. Rational investors will accept the lower offer of \$5, but the short-seller will continue to offer the security at \$5 1/8. The effect of this strategy is that investors will assume that there are other investors that want to sell the security so badly that they are willing to sell it at a higher price than the current market price. This will turn the buyer off the stock and cause the price of the security to decrease because overall buyer interest will drop. See *id.*

Consequently, the price of the stock will drop. If there is a subsequent increase in the number of short orders of the stock, the cycle will continue, creating a downward spiral in the price of the stock. This problem is even more pervasive when the stock is not heavily traded because price adjustments in a thin market are more abrupt than in a robust one.³⁶ Hence, when an investor sells a large number of shares short, the price of a thinly traded stock will decrease more sharply than that of a heavily traded stock.

The implications of selling a stock short are evident in the context of a toxic convertible deal. If the holders of a convertible security sell enough shares of the underlying stock short, the price of the underlying stock will decrease. The convertible security holder's conversion price is then reset to the new price of the stock.³⁷ The convertible security holder can then issue a conversion notice to the issuing company at the lower conversion price to cover the short order, deliver the stock necessary to cover the short order at a lower price, and keep the difference as profit.³⁸ The lower the price of the stock, the more money the convertible security holder can earn from selling short and converting his preferred stock into common stock, and the more shares the company has to issue to him.³⁹

The hallmark of the toxic convertible is the convertible security holder's ability to bypass market forces. The convertible security holder is selling the stock short in the public market, driving the price down, but obtaining the stock to cover his short sale in a private transaction, thereby avoiding placing any upward pressure on the price of the stock.⁴⁰ This opportunity to manipulate the stock price creates an incentive for the convertible security holder to sell the stock short and drive down the price, in the hopes of

³⁶ William J. Brodsky, *The Globalization of Stock Index Futures: A Summary of the Market and Regulatory Developments in Stock Index Futures and the Regulatory Hurdles Which Exist for Foreign Stock Index Futures in the United States*, 15 NW. J. INT'L L. & BUS. 248, 280 (1994).

³⁷ James J. Cramer, *A Deal with the Devil*, at <http://www.thestreet.com/comment/wrongtactics/1050749.html> (Aug. 23, 2000).

³⁸ *Id.*

³⁹ *Id.*

⁴⁰ The relation between trading and the stock price depends upon the existence of a bid-ask spread. Daniel R. Fischel & David J. Ross, *Should the Law Prohibit "Manipulation" in Financial Markets?*, 105 HARV. L. REV. 503, 516 (1991). The bid price is the maximum price a customer can sell a particular security and the ask price is the minimum price a customer can buy a security. *Id.* Sequential transactions on the sell side will not result in price changes, but sequential transactions on the buy and the sell sides will cause a price change. Because buy and sell orders arrive randomly, there will be temporary price changes. *Id.* Generally, "buy orders will be associated with price increases and sell orders will be associated with price decreases until these price changes are reversed by trades on the other side of the bid-ask spread." *Id.*

generating a large profit and obtaining overwhelming control of the company.⁴¹

II. THE 1934 ACT: THE HISTORY AND PURPOSE BEHIND THE STATUTE

If a convertible security shareholder engages in short sales, the question arises whether the short sales constitute manipulation under current federal securities laws. Extensive short trading is not itself unlawful,⁴² but when it is done with a manipulative intent, it can become a violation of federal securities law.

One of the most important pieces of legislation addressing manipulation of the stock market is the 1934 Act. The 1934 Act was preceded by the Securities Act of 1933,⁴³ which targeted abuses involving offers and sales of new issues or distributions of outstanding securities.⁴⁴ The 1934 Act was directed toward three major goals: (1) regulating exchanges and over-the-counter markets; (2) preventing fraud and manipulation; and (3) having the Board of Governors of the Federal Reserve System control securities credit.⁴⁵

In fact, many of the provisions in the 1934 Act are directed toward conduct that influences security prices.⁴⁶ The 1934 Act deals with activities that directly affect security prices, including: (1) the development of public opinion; (2) trading decisions based on public opinion; and (3) the matching of trade decisions in transactions and the dissemination of the prices at which these transactions occur.⁴⁷

One activity the 1934 Act specifically targets is short sales of stock.⁴⁸ Public opinion in the wake of the market crash of 1929 pointed to short selling, which occurred at the height of speculation, as a prime culprit in the collapse.⁴⁹ Congress did not ignore this change in public opinion. By the beginning of

⁴¹ See Price, *supra* note 8, at 18.

⁴² *In re Olympia Brewing Co. Sec. Litig.*, 613 F. Supp. 1286, 1292 (N.D. Ill. 1985).

⁴³ Securities Act of 1933, 15 U.S.C. § 77a–bbbb (2000).

⁴⁴ ALAN R. BROMBERG & LEWIS D. LOWENFELS, *BROMBERG AND LOWENFELS ON SECURITIES FRAUD & COMMODITIES FRAUD* § 2.10 (2d ed. 2004).

⁴⁵ LOUIS LOSS & JOEL SELIGMAN, *FUNDAMENTALS OF SECURITIES REGULATION* 46 (5th ed. 2004).

⁴⁶ Steve Thel, *Regulation of Manipulation Under Section 10(b): Security Prices and the Text of the Securities Exchange Act of 1934*, 1988 COLUM. BUS. L. REV. 359, 376.

⁴⁷ *Id.*

⁴⁸ Steve Thel, *The Original Conception of Section 10(b) of the Securities Exchange Act*, 42 STAN. L. REV. 385, 410 (1990).

⁴⁹ *Id.* at 410–11.

1934, Congress focused on creating stock market legislation that would spotlight “short sales, margin trading, and pools.”⁵⁰

On February 9, 1934, President Roosevelt recommended that Congress enact legislation to regulate the country’s exchanges.⁵¹ That same day, Senator Duncan Fletcher introduced the Cohen Bill, which would evolve over several months into the 1934 Act.⁵²

The 1934 Act contains two of the most important antimanipulation provisions in the federal system, § 9⁵³ and § 10(b).⁵⁴ Although the purpose of the 1934 Act is to eradicate manipulative practices, the terms *manipulation* and *manipulative* are not defined comprehensively in the text of the statute.⁵⁵ In fact, judicial interpretation has been the prime mechanism for providing a working definition of manipulation. One definition states that manipulation “connotes intentional or willful conduct designed to deceive or defraud investors by controlling or artificially affecting the price of securities.”⁵⁶ Furthermore, manipulation usually involves efforts to artificially stimulate demand for a stock or create a false impression of actual trading activity.⁵⁷ According to the U.S. Supreme Court, *manipulation* is a term of art reflecting Congress’s intent “to prohibit the full range of ingenious devices that might be used to manipulate securities prices.”⁵⁸

⁵⁰ *Id.* at 423–24.

⁵¹ *Id.* at 425.

⁵² *Id.* at 425–26. Sam Rayburn, a member of the House of Representatives and Chairman of the House Commerce Committee, introduced the bill in the House. *Id.* at 426. The 1934 Act was initially called the Cohen bill when Rayburn introduced it because Benjamin Cohen, an attorney working at the request of President Roosevelt’s staff, had primary drafting responsibilities in its early stages. *Id.* at 415, 424.

⁵³ 15 U.S.C. § 78i (2000).

⁵⁴ *Id.* § 78j. According to the SEC, most manipulation cases are brought under § 9(a)(2) and § 10(b). Lewis D. Lowenfels, *Sections 9(a)(1) and 9(a)(2) of the Securities Exchange Act of 1934: An Analysis of Two Important Anti-Manipulative Provisions Under the Federal Securities Laws*, 85 NW. U. L. REV. 698, 706 (1991).

⁵⁵ However, § 9 of the 1934 Act does contain a non-exhaustive list of manipulations that would be prohibited. 15 U.S.C. § 78i.

⁵⁶ Ernst & Ernst v. Hochfelder, 425 U.S. 185, 199 (1976).

⁵⁷ See, e.g., SEC v. N. Am. Research & Dev. Corp., 424 F.2d 63 (2d Cir. 1970) (involving a suit by the SEC against a company for using a manipulative device because company progress reports included false and misleading statements).

⁵⁸ Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 477 (1977).

While there is no comprehensive definition of manipulation, it is clear that the function of the Securities statutes is “to give a greater degree of definiteness to the concept of manipulation and to supply an enforcement and preventive mechanism.”⁵⁹

III. SECTION 9 AND ITS IMPACT ON TOXIC CONVERTIBLES

Congress effectuated this goal by passing § 9 of the 1934 Act. Section 9 expressly provides a civil remedy for purchasers or sellers of a registered security on a national exchange who are victims of unlawful market manipulation.⁶⁰ Section 9 includes two provisions, each of which addresses different ways of manipulating securities.

The first provision, § 9(a)(1), was in the 1934 Act originally and has not been modified since the 1934 Act was passed.⁶¹ Section 9(a)(1) prohibits practices such as *wash sales*⁶² and *matched orders*⁶³ that are effected “[f]or the purpose of creating a false or misleading appearance of active trading in any security registered on a national securities exchange, or a false or misleading appearance with respect to the market for any such security”⁶⁴ This provision does not apply to toxic convertibles, as a security conversion is neither a wash sale nor a matched order.

The second provision, however, § 9(a)(2), is broader in scope and proscribes a wider range of manipulative activities.⁶⁵ In fact, § 9(a)(2) has been called “the very heart of the act,”⁶⁶ and could have important implications

⁵⁹ LOSS & SELIGMAN, *supra* note 45, at 934–35.

⁶⁰ 15 U.S.C. § 78i(e).

⁶¹ BROMBERG & LOWENFELS, *supra* note 44, § 2.11.

⁶² “A ‘wash sale’ is a securities transaction in which, by the intent of the parties, there is no change in the beneficial ownership.” Lowenfels, *supra* note 54, at 699.

⁶³ Lowenfels provides the following definition:

“Matched orders” are orders entered for the purchase of a security with the knowledge that an order or orders of substantially the same size at substantially the same price have been or will be entered at substantially the same time for the sale of such security and vice versa with respect to sale and purchase.

Id.

⁶⁴ 15 U.S.C. § 78i(a)(1).

⁶⁵ Lowenfels, *supra* note 54, at 706.

⁶⁶ *Id.* (citing HOUSE COMM. ON INTERNAL & FOREIGN COMMERCE, 77TH CONG., REPORT ON PROPOSALS FOR AMENDMENTS TO THE SECURITIES ACT OF 1933 AND THE SECURITIES EXCHANGE ACT OF 1934, at 50 (1941)).

in toxic convertible manipulation cases. Section 9(a)(2) makes it illegal to effect, alone or with one or more other persons, a series of transactions in any security registered on a national securities exchange . . . creating actual or apparent active trading in such security, or raising or depressing the price of such security, for the purpose of inducing the purchase or sale of such security by others.⁶⁷

The purpose of § 9(a)(2) is “to outlaw not only pool operations, but ‘every other device used to persuade the public that activity in a security is the reflection of a genuine demand instead of a mirage.’”⁶⁸

A. Defining a Series of Transactions Under § 9(a)(2)

The first element of a § 9(a)(2) violation—that the defendant must effect a series of transactions in a registered security on a national exchange—is met by a defendant in a toxic convertible case in which there is a complaint of market manipulation. Courts have defined *series* to mean as few as three purchases on two successive days.⁶⁹ In a toxic convertible case, the likelihood that at least three transactions are involved is extremely high. For convertible security holders to have an effect on the market by short-selling a stock, there must be a large volume of short interest.⁷⁰ Consequently, it is likely that a convertible security holder will engage in a series of transactions to create a large short position.

B. The Creation of Active Trading and Raising or Depressing the Price of a Security Under § 9(a)(2)

The second element of § 9(a)(2) prohibits two activities, either of which must occur to constitute a violation: (1) “creating actual or apparent active trading in such security” or (2) “raising or depressing the price of such security.”⁷¹ In a toxic convertible manipulation scenario, both activities happen, although it is clear that only one need occur to have a claim.⁷²

⁶⁷ 15 U.S.C. § 78i(a)(2).

⁶⁸ LOSS & SELIGMAN, *supra* note 45, at 938 (quoting S. REP. NO. 73-1455, at 54 (1934)).

⁶⁹ Lowenfels, *supra* note 54, at 708.

⁷⁰ See discussion *supra* Part I.D.

⁷¹ Lowenfels, *supra* note 54, at 708 (citing 15 U.S.C. § 78i).

⁷² See *id.* (noting that the two activities are alternative grounds to satisfy § 9(a)(2)).

1. *The Creation of Active Trading*

One indicator of the creation of actual or apparent trading activity is artificial stimulation in the market of the security such that the activity appears to be a natural result of supply and demand.⁷³ For example, purchasing a vast majority of shares to sustain the price of a security demonstrates that the alleged manipulator is artificially stimulating the market for a security.⁷⁴

To date, there are no cases in which a court has held that depressing a price through a high volume of short sales creates actual or apparent activity within the meaning of § 9(a)(2). Nevertheless, a toxic convertible manipulation case may still be brought under § 9(a)(2) because a toxic convertible security shareholder does artificially stimulate the market. In a toxic convertible, the alleged manipulator sells the security in the public market but then acquires stock to cover the short sale by converting his preferred securities into common stock in a private transaction with the issuing company.⁷⁵ Under the assumption that stock prices reflect investors' reactions to available information,⁷⁶ an alleged manipulator prevents the market's reaction to what would have been a purchase on the public market by converting his preferred stock to cover his short sale in a private transaction. Hence, the manipulator is injecting information into the market that the stock is worth selling, but the information that the stock is worth buying is not available for other investors to observe because his buying transaction is private. This mechanism creates an artificial view that the stock price is dropping due to natural market forces when, in fact, the alleged manipulator's buying transaction is not reflected in the market at all.

⁷³ SEC v. Resch-Cassin & Co., 362 F. Supp. 964, 978 (S.D.N.Y. 1973). Section 9(a)(2) "was aimed at preventing an individual from dominating the market in a stock for the purpose of conducting a one-sided market at an artificial level for its own benefit and to the detriment of the investing public." *Id.* (quoting *Crane Co. v. Westinghouse Air Brake Co.*, 419 F.2d 787, 794 (2d Cir. 1969)).

⁷⁴ SEC v. Sayegh, 906 F. Supp. 939, 946-47 (S.D.N.Y. 1995). Because the defendants were manipulating over-the-counter securities within the meaning of § 9(a)(2), they were guilty of a Rule 10b-5 violation. *Id.*

⁷⁵ See discussion *supra* Part I.D.

⁷⁶ The Efficient Market Hypothesis posits that stock prices reflect the available information in the market. See Frank Partnoy, *Why Markets Crash and What Law Can Do About It*, 61 U. PITT. L. REV. 741, 748 (2000). If information is not reflected in stock prices, rational investors will buy and sell stock until the information is reflected. If prices reflect all the available information, then they will change only in response to previously unavailable information. As a result, changes in prices are random responses to an investor injecting new information into the market. *Id.*

2. *Raising or Depressing the Price of a Security*

For the second alternative activity, once a price change occurs, however minute,⁷⁷ a plaintiff must show that the alleged manipulator caused the price change.⁷⁸ Indicia of causation include: “(a) price leadership by the manipulator; (b) dominion and control of the market for the security; (c) reduction in the floating supply of the security; and (d) the collapse of the market for the security when the manipulator ceases his activity.”⁷⁹ None of the indicia are dispositive in proving that the alleged manipulator caused the price change in the security, but each is characteristic of an attempt to manipulate security prices.⁸⁰ The following sections will discuss factors (b) and (d), which are the two most easily met in a toxic convertible manipulation case.

a. *Domination and Control of the Market*

One key characteristic of a toxic convertible financing scheme is that the alleged manipulator eventually will have dominion and control of the market for a particular stock. This occurs when the convertible security holder engages in a high volume of short sales. Because the stock of issuing companies that employ toxic convertibles is typically thinly traded, there is very little activity in the market for that stock.⁸¹ Consequently, the convertible security holder provides a great majority of the activity when engaging in a large concentration of short sales.⁸² As a result, the convertible security holder will dominate the market for the underlying security, and he will increase the number of shares he owns, diluting the shares of other stockholders.⁸³ Eventually, the convertible security holder will own a majority of the outstanding shares of the stock.⁸⁴

⁷⁷ See LOSS & SELIGMAN, *supra* note 45, at 939 (noting that even a small change in price will suffice).

⁷⁸ Lowenfels, *supra* note 54, at 709.

⁷⁹ SEC v. Resch-Cassin & Co., 362 F. Supp. 964, 976 (S.D.N.Y. 1973).

⁸⁰ See *id.* Short selling generally increases the floating supply of the security, causing a reduction in price. This is the mirror image of the third factor. However, because no factor is dispositive and each factor characterizes a potential attempt to manipulate security prices, manipulation of the security price may still occur. *Id.* at 977.

⁸¹ See discussion *supra* Part I.D.

⁸² See discussion *supra* Part I.D.

⁸³ Price, *supra* note 8, at 19.

⁸⁴ *E.g.*, Internet Law Library, Inc. v. Southridge Capital Mgmt., LLC, 223 F. Supp. 2d 474, 479–80 (S.D.N.Y. 2002) (noting that the defendant, a financier and the principal backer of a toxic convertible deal, eventually succeeded in converting 139.02 shares of preferred stock into 3,137,907 shares of common stock).

Whether the sale of a significant percentage of the outstanding stock suggests dominion or control of the market for a security is determined by case law. In *SEC v. Sayegh*,⁸⁵ trading that accounted for 90% of the volume of trading in a security was considered domination and control of a market.⁸⁶ Similarly, in a disciplinary hearing before the National Association of Securities Dealers, domination and control of the market for a security was found where a broker-dealer accounted for 89% of the total sales volume.⁸⁷ In addition, the Second Circuit Court of Appeals noted that “[w]hen domination is sustained over such an extended period of time, evidence of manipulation is strong.”⁸⁸ That same court asserted that the “extent to which an investor controls or dominates the market at any given period of time cannot be viewed in a vacuum.”⁸⁹ Hence, determining domination and control of a market depends on the context in which the convertible security holder is trading. The Second Circuit Court of Appeals’s elaboration on domination is the only working definition of domination and control of a market where an investor engaged in a large volume of short sales and was later charged with manipulation.

b. Collapse of the Market

The next factor—the collapse of the market for the security when the alleged manipulator ceases his activity—is present in toxic convertible manipulation cases. Once the convertible security holder has finished converting his preferred stock, the price of the stock has decreased sharply, and, in many cases, new investors are unwilling to buy the stock because of the

⁸⁵ 906 F. Supp. 939 (S.D.N.Y. 1995).

⁸⁶ *Id.* at 944.

⁸⁷ *In re Leeds*, 51 S.E.C. 500, 502 (1993). The defendant was a broker-dealer who underwrote an initial public offering and proceeded to buy back a number of shares of the public company after they had been newly issued. *Id.* at 501; *see also* *SEC v. Resch-Cassin & Co.*, 362 F. Supp. 964, 977 (S.D.N.Y. 1973) (finding domination and control of the market for a security where a dealer-broker purchased directly or indirectly purchased approximately two-thirds of the total market of a stock); *In re Shearson, Hammill & Co.*, 42 S.E.C. 811, 822 (1965) (finding that registrant’s domination of the market for its stock consisted of sales of 147,701 shares and principal purchases of 147,269 shares together with agency purchases of 40,470 shares and agency sales of about the same number of shares).

⁸⁸ *United States v. Mulheren*, 938 F.2d 364, 371 (2d Cir. 1991).

⁸⁹ *Id.* The court further found that “[t]he percent of domination must be viewed in light of the time period involved and other indicia of manipulation.” *Id.* The court listed two examples of when an investor would dominate the market: (1) trading that constituted more than 50% of the trading volume over a one-year period; and (2) trading that accounted for 28.8% of the daily volume of transactions over a four-month period. *Id.* (citing *United States v. Gilbert*, 668 F.2d 94, 95 (2d Cir. 1981); *United States v. Stein*, 456 F.2d 844, 846 (2d Cir. 1972)).

massive dilution.⁹⁰ The problem with defining this factor through judicial precedent is that no toxic convertible manipulation cases have been adjudicated under § 9(a)(2).

The Southern District of New York, however, held that when the price of a stock drops rapidly within a few weeks, the market for the stock has collapsed for the purposes of § 9(a)(2).⁹¹ In a toxic convertible, the market for the issuing company's stock does collapse because the convertible security holder exerts an enormous amount of pressure downward on the stock price through short sales.⁹² In addition, the issuing company has issued so many shares of common stock to the convertible security holder that other investors will be dissuaded from buying the company's stock.⁹³ While cases fail to provide certainty on this element in a toxic convertible context, establishing the collapse of the market in the wake of a toxic convertible is not difficult.

c. Defining a Purpose To Induce Others To Buy or Sell a Security

The most contentious requirement of a § 9(a)(2) violation is that there must be a showing of a purpose to induce others to buy or sell the security.⁹⁴ A purpose to induce equates to what courts and commentators commonly call a manipulative purpose.⁹⁵ Manipulative purpose is the most difficult to establish of § 9(a)(2)'s three requirements.⁹⁶

Part of the difficulty is evidentiary in nature: A court cannot read the mind of an alleged manipulator to determine the purpose behind his trading activity. The Second Circuit stated that there is manipulative purpose “[w]hen a person who has a ‘substantial, direct pecuniary interest in the success of a proposed offering takes active steps to effect a rise in the market’”⁹⁷ While the Commission has stated that a finding of manipulative purpose can be based on

⁹⁰ Price, *supra* note 8, at 18.

⁹¹ *Resch-Cassin*, 362 F. Supp. at 977 (finding a collapse of the market for a security where the price of the stock dropped from \$17.50 to \$2.00 at the time of the trial).

⁹² See discussion *supra* Part I.D.

⁹³ See discussion *supra* Part I.D.

⁹⁴ LOSS & SELIGMAN, *supra* note 45, at 939. The other federal securities laws that are not aimed at preventing market manipulation, such as § 10(b) or § 14(e), do not have this requirement, but instead require proof of scienter. Lowenfels, *supra* note 54, at 711.

⁹⁵ See Lowenfels, *supra* note 54, at 711.

⁹⁶ *Id.*

⁹⁷ *Crane Co. v. Westinghouse Air Brake Co.*, 419 F.2d 787, 795 (2d Cir. 1969) (quoting *In re Fed. Corp.*, 25 S.E.C. 227, 230 (1947)).

inferences from circumstantial evidence,⁹⁸ some courts still reject this approach.⁹⁹

With the uncertainty surrounding a determination of manipulative purpose, it becomes even more difficult for an issuing company in a toxic convertible manipulation case to establish a § 9(a)(2) violation against convertible security holders. Courts have found that certain practices constitute evidence of manipulative purpose, including:

an option to buy successive blocks of stock at stepped-up rates, frequently effecting the opening and closing transactions of the day, buying on the exchange and selling over-the-counter, sending out misleading bullish literature or paying touts to recommend the stock, or arranging for the issuer to declare a dividend during the manipulation.¹⁰⁰

Among these types of transactions, a toxic convertible most closely resembles one in which an investor buys a security on an exchange and sells it over-the-counter. This practice is similar to the mechanism by which a convertible security holder earns profits through a toxic convertible. A convertible security holder acquires the securities to cover his short orders by exercising his conversion rights, while the original order to sell the security short is done through a public market transaction.¹⁰¹

*Crane Co. v. Westinghouse Air Brake Co.*¹⁰² is the case most similar to a toxic convertible scenario. In *Crane*, the Second Circuit Court of Appeals held that distortions in the security price created by an investor selling securities in secret off-market transactions in conjunction with its pecuniary interest in the transactions was sufficient to establish a manipulative purpose under § 9(a)(2).¹⁰³ While convertible security holders obtain stock through conversion rather than buying it in the market, the inherent effect is the same:

⁹⁸ See generally *In re Fed. Corp.*, 25 S.E.C. 227 (finding prima facie manipulative purpose when a plaintiff showed that a person with an interest in the success of an offering took active steps to affect a rise in the market price).

⁹⁹ Lowenfels, *supra* note 54, at 713 (citing *Chris-Craft Indus., Inc. v. Piper Aircraft Corp.*, 480 F.2d 341 (2d Cir. 1973); *Trane Co. v. O'Connor Sec.*, 561 F. Supp. 301 (S.D.N.Y. 1983)).

¹⁰⁰ William R. McLucas & Alma M. Angotti, *Market Manipulation*, 22 REV. SEC. & COMMODITIES REG. 103, 107 (1989) (citing *Crane*, 419 F.2d at 793-95; *United States v. Minuse*, 114 F.2d 36 (2d Cir. 1940); *R.J. Keoppe & Co. v. SEC*, 95 F.2d 550, 552 (7th Cir. 1938)).

¹⁰¹ See discussion *supra* Part I.D.

¹⁰² 419 F.2d 787.

¹⁰³ *Id.* at 795.

Investors get a distorted view of the market and engage in transactions based on an erroneous belief that the price of the stock reflects all the transactions in the stock.

To date, there has not been a case in which selling a stock short and effectuating a sharp decrease in price has been found to create an inference of manipulative purpose. However, *Crane* indicates that the judiciary is willing to assert that one-sided transactions¹⁰⁴ combined with a strong pecuniary interest in the effect of a stock price increase can establish manipulative purpose.

III. SECTION 10(B) AND RULE 10B-5: THEIR ROLES IN TOXIC CONVERTIBLE LITIGATION

In contrast to the scarcity of litigation under § 9, there have been a number of suits involving toxic convertible financing for market manipulation under § 10(b) and Rule 10b-5. The pertinent text regarding manipulation claims under § 10(b) of the 1934 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, or any securities-based swap agreement . . . 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.¹⁰⁵

Although the Supreme Court has labeled § 10(b) a “catchall,”¹⁰⁶ the SEC was not satisfied with the reach of the statute and promulgated Rule 10b-5 in

¹⁰⁴ A one-sided transaction is a market transaction that is partnered with an off-market transaction.

¹⁰⁵ 15 U.S.C. § 78j (2000).

¹⁰⁶ *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 203 (1976). Thomas G. Corcoran, one of the sponsoring drafters of § 10(b), described this portion of the 1934 legislation as “a catchall clause to prevent manipulative devices,” and referred to the desirability of empowering the SEC to deal with such practices. See Ronnie J. Schwartz, Note, *Northland Capital Corp. v. Silver*, 735 F.2d 1421 (D.C. Cir. 1984), 58 TEMP. L.Q. 735, 735 n.3 (1985).

1942.¹⁰⁷ The SEC adopted Rule 10b-5, the newest of the major antifraud provisions apart from § 14(e),¹⁰⁸ under the authority of § 10(b) of the 1934 Act.¹⁰⁹ The SEC promulgated Rule 10b-5 to ensure that companies and individuals who engaged in fraud during a purchase of stock were prohibited from buying securities.¹¹⁰

In practice, Rule 10b-5 requires plaintiffs to prove several elements to establish a violation. For historical reasons, many of the elements of a Rule 10b-5 cause of action are derived from common law fraud.¹¹¹ Generally, the first three elements of a claim—misrepresentation or nondisclosure, materiality, and scienter—determine whether a claim exists.¹¹² The rest of the elements—privity, reliance, and causation—determine whether the law can compensate the victim of the claim.¹¹³ While the Supreme Court has yet to rule on a toxic convertible case, the Third Circuit and the Southern District of New York have both established guidelines for determining liability in toxic convertible manipulation cases.¹¹⁴

A. *The Third Circuit's Definition of a Manipulation Claim*

The Third Circuit Court of Appeals first attempted to delineate the elements of a market manipulation claim within the context of toxic

¹⁰⁷ Ryan D. Adams, Comment, "Where There Is a Will, There Is a Way": *The Securities and Exchange Commission's Adoption of Rule 10b-5*, 47 LOY. L. REV. 1133, 1139–40 (2001).

¹⁰⁸ Section 14(e) prohibits "fraudulent, deceptive, or manipulative acts or practices, in connection with any tender offer." 15 U.S.C. § 78n(e).

¹⁰⁹ BROMBERG & LOWENFELS, *supra* note 44, § 2:18. Rule 10b-5 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,

(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).

¹¹⁰ BROMBERG & LOWENFELS, *supra* note 44, § 2:19. Rule 10b-5 purported to close "a loophole in the protections against fraud administered by the Commission by prohibiting individuals or companies from buying securities if they engage in fraud in their purchase." Adams, *supra* note 107, at 1140.

¹¹¹ BROMBERG & LOWENFELS, *supra* note 44, § 7:1.

¹¹² *Id.*

¹¹³ *Id.*

¹¹⁴ Plaintiffs suing under § 10(b) and Rule 10b-5 have brought the majority of toxic convertible cases either in the Southern District of New York or the Third Circuit.

convertible financing in *GFL Advantage Fund, Ltd. v. Colkitt*.¹¹⁵ In this seminal case, the defendant, an entrepreneur who was seeking capital, contracted with the plaintiff, a lender, for financing.¹¹⁶ The plaintiff arranged for the capital but structured the financing as a toxic convertible deal.¹¹⁷ The plaintiff sued the defendant for breach of contract because the defendant failed to convert the convertible securities into common stock.¹¹⁸ The defendant asserted an affirmative defense that the plaintiff had engaged in securities fraud and market manipulation by depressing stock prices through its concentrated short sales.¹¹⁹

The district court granted summary judgment in favor of the plaintiff, holding that it could not infer that the plaintiff had manipulated the market simply because the plaintiff had engaged in a substantial amount of short selling.¹²⁰ Specifically, the court noted that “short selling can help move an overvalued stock’s market price toward its true value, thus creating a more efficient marketplace in which stock prices reflect all available relevant information about the stock’s economic value.”¹²¹

In reviewing the case, the Third Circuit Court of Appeals enumerated the elements of a market manipulation claim: (1) the manipulation must be in connection with a sale or purchase of securities; (2) the alleged manipulator must have injected inaccurate information into the market or created a false impression of supply and demand for the security; and (3) the manipulator must have engaged in the behavior for the purpose of artificially depressing or inflating the price of the security.¹²²

Recently, in *Jones v. Intelli-Check, Inc.*,¹²³ the District Court of New Jersey elaborated on the Third Circuit’s stance on manipulation. The court emphasized that there are two types of claims available to parties under § 10(b) and Rule 10b-5: (1) misrepresentation or omission of material facts; and (2) market manipulation.¹²⁴ The court laid out the elements of a market

¹¹⁵ 272 F.3d 189 (3d Cir. 2001).

¹¹⁶ *Id.* at 194–95.

¹¹⁷ *Id.* at 195.

¹¹⁸ *Id.* at 197.

¹¹⁹ *Id.*

¹²⁰ *Id.* at 198.

¹²¹ *Id.* at 208.

¹²² *Id.* at 207.

¹²³ 274 F. Supp. 2d 615 (D.N.J. 2003).

¹²⁴ *Id.* at 626. The Court listed the elements of a misrepresentation or omission claim in its opinion as well:

manipulation claim in light of the Third Circuit Court of Appeals's holding in *GFL Advantage Fund* and the established law on Rule 10b-5 pleading:

- [T]o state a claim of market manipulation, a plaintiff must plead that:
- (1) in connection with the purchase or sale of securities,
 - (2) defendant engaged in deceptive or manipulative conduct by injecting inaccurate information into the marketplace or creating a false impression of supply and demand for the security,
 - (3) for the purpose of artificially depressing or inflating the price of the security;
 - (4) that plaintiff reasonably relied on the artificial stock price;
 - (5) that plaintiff's reliance proximately caused plaintiff's damages;
 - (6) that defendant acted with scienter.¹²⁵

The first three elements of a market manipulation claim are different from a standard misrepresentation or omission claim. The substantive difference between the elements is due to a more relaxed pleading standard for plaintiffs alleging manipulation because often the facts of a manipulation scheme are known only to the alleged manipulators.¹²⁶

B. The Southern District of New York's Definition of a Manipulation Claim

In a series of cases within the past five years, the Southern District of New York spelled out the elements of a market manipulation claim under § 10(b) and Rule 10b-5. The most important of these cases, and the one that the court relies upon the most heavily, was *Global Intellicom, Inc. v. Thomson Kernaghan & Co.*¹²⁷

In *Global Intellicom*, the plaintiff corporation "undertook a series of offerings of convertible preferred stock,"¹²⁸ and the defendants purchased the

To state a securities fraud claim for misrepresentation or omission of material facts, a plaintiff must plead:

- (1) that defendant made a misstatement or an omission of a material fact,
- (2) in connection with the purchase or sale of a security,
- (3) upon which plaintiff reasonably relied;
- (4) that plaintiff's reliance was the proximate cause of the injury suffered; and
- (5) that defendant acted with scienter.

Id.

¹²⁵ *Id.* at 627–28.

¹²⁶ *Id.* at 629 (citing *Internet Law Library, Inc. v. Southridge Capital Mgmt., LLC*, 223 F. Supp. 2d 474, 486 (S.D.N.Y. 2002)).

¹²⁷ 1999 U.S. Dist. LEXIS 11378 (S.D.N.Y. July 26, 1999).

¹²⁸ *Id.* at *3.

convertible preferred stock.¹²⁹ The plaintiff alleged that the defendants engaged in misrepresentation and market manipulation in violation of § 10(b) of the 1934 Act.¹³⁰ The court, in evaluating the claims, cataloged the elements of a manipulation claim:

- (1) damages,
- (2) caused by reliance on defendants' misrepresentations or omission of material fact, or on a scheme by the defendants to defraud,
- (3) scienter,
- (4) in connection with the purchase or sale of securities,
- (5) furthered by the defendants' use of the mails or any facility of a national securities exchange.¹³¹

The opinions that followed in the Southern District of New York each cited *Global Intellicom* regarding what constituted a manipulation claim under § 10(b) and Rule 10b-5.¹³² Although the Southern District of New York and the Third Circuit enumerate different elements,¹³³ the substantive interpretation of those different elements is similar in toxic convertible manipulation cases.

C. *The Requirement of Standing*

Before a plaintiff can argue a manipulation claim in court, the plaintiff must establish that he or she has standing to bring the suit.¹³⁴ In *Blue Chip Stamps v. Manor Drug Stores*,¹³⁵ the Supreme Court held that a plaintiff bringing a Rule 10b-5 claim must be a purchaser or seller of a security to state

¹²⁹ *Id.* at *4.

¹³⁰ *Id.* at *19.

¹³¹ *Id.* at *21–22.

¹³² See *Nanopierce Techs., Inc. v. Southridge Capital Mgmt., LLC*, 2002 U.S. Dist. LEXIS 24049 (S.D.N.Y. Oct. 10, 2002); *Internet Law Library, Inc. v. Southridge Capital Mgmt., LLC*, 223 F. Supp. 2d 474, 487 (S.D.N.Y. 2002); *Log On Am., Inc. v. Promethean Asset Mgmt., LLC*, 223 F. Supp. 2d 435, 445 (S.D.N.Y. 2001).

¹³³ Both the Southern District of New York and the Third Circuit share certain literal elements in their respective definitions of a manipulation claim including: (1) the transaction in question must be in connection with the purchase or sale of a security; (2) reliance; and (3) damages. See discussion *supra* Part III.A–B. The differences in the definitions are that the Third Circuit requires the alleged manipulator to inject inaccurate information into the market or create a false impression of supply or demand of the security in conjunction with the purpose of artificially inflating or depressing the price of the security, whereas the Southern District of New York requires the alleged manipulator to make a material misrepresentation or omission, or engage in a scheme to defraud in conjunction with scienter. See discussion *supra* Part III.A–B.

¹³⁴ Standing is a constitutional requirement for a civil action. *Lujan v. Defenders of Wildlife*, 504 U.S. 555, 560 (1992). The Court elucidated a three-prong test for standing: “First, the plaintiff must have suffered an ‘injury in fact’—an invasion of a legally protected interest” This injury must be “concrete and particularized” and “actual or imminent, not ‘conjectural’ or ‘hypothetical.’” Second, “there must be a causal connection between the injury and the conduct complained of.” Third, “it must be ‘likely,’ as opposed to merely ‘speculative,’ that the injury will be ‘redressed by a favorable decision.’” *Id.* at 560–61.

¹³⁵ 421 U.S. 723 (1975).

a cause of action.¹³⁶ The holding in *Blue Chip Stamps* effectively eliminates an investor's ability to bring a Rule 10b-5 claim where a fraudulent or manipulative practice affected merely the investor's decision not to buy or sell a security.¹³⁷

In a toxic convertible manipulation case, the key issue is whether conversion of a convertible security is a "sale" such that the issuer has standing to bring a claim. The 1934 Act states that a security encompasses an investment contract,¹³⁸ and it defines a "purchase" to include "any contract to buy, purchase, or otherwise acquire."¹³⁹ Similarly, a "sale" includes "any contract to sell or otherwise dispose of."¹⁴⁰ Consequently, individuals who convert securities are sellers of securities.¹⁴¹ However, there is no precedent holding that an issuer of a security is a purchaser or seller of a security such that the issuer has standing.

The District Court for the Southern District of New York implied that an issuer of convertible securities does not necessarily have standing to bring a manipulation claim.¹⁴² Nevertheless, that same court has since ruled on toxic convertible manipulation claims without addressing whether standing impedes an issuing company from bringing suit.¹⁴³ Given the judiciary's lack of attention to standing in toxic convertible manipulation cases, plaintiffs who have issued convertible securities and want to bring a manipulation claim under § 10(b) and Rule 10b-5 should not necessarily view establishing standing as a prohibitive obstacle.

¹³⁶ *Id.* at 730–31.

¹³⁷ *See, e.g.,* Calenti v. Boto, 24 F.3d 335, 339 (1st Cir. 1994) (holding the plaintiff's claim untenable because he had neither bought nor sold a security; rather, the defendant only affected his right to buy securities in an articles of incorporation document).

¹³⁸ 15 U.S.C. § 78c(a)(10) (2000).

¹³⁹ *Id.* § 78c(a)(13).

¹⁴⁰ *Id.* § 78c(a)(14). In addition, the 1933 Securities Act defines the term "sale" to include "every contract of sale or disposition of a security or interest in a security, for value." *Id.* § 77b(a)(3). The term "offer to sell" includes "every attempt or offer to dispose of, or solicitation of an offer to buy, a security or interest in a security, for value." *Id.*

¹⁴¹ LOSS & SELIGMAN, *supra* note 45, at 858 (citing *Drachman v. Harvey*, 453 F.2d 722, 737 n.2 (2d Cir. 1971) (en banc) (holding that the term "purchase" has a broader meaning in the 1934 Act than in the Investment Company Act)).

¹⁴² *See* Log On Am., Inc. v. Promethean Asset Mgmt., LLC, 223 F. Supp. 2d 435, 446 (S.D.N.Y. 2001).

¹⁴³ *See, e.g.,* Nanopierce Techs., Inc. v. Southridge Capital Mgmt., LLC, 2002 U.S. Dist. LEXIS 24049 (S.D.N.Y. Oct. 10, 2002). Additionally, the Third Circuit has not explicitly elaborated on whether an issuer of convertible securities is prohibited from bringing suit based on a lack of standing. *See, e.g.,* GFL Advantage Fund, Ltd. v. Colkitt, 272 F.3d 189 (3d Cir. 2001) (failing to address standing requirements for a toxic convertible market manipulation claim outside of the § 29(b) context).

D. The Third Circuit: Injecting Inaccurate Information into the Marketplace

In the Third Circuit, once a claimant establishes standing to bring a manipulation claim under § 10(b) and Rule 10b-5, it must prove that the defendant injected inaccurate information into the market or created “a false impression of supply and demand for the security.”¹⁴⁴ A party engaging in concentrated short sales alone is not necessarily guilty of injecting inaccurate information into the market or creating a false impression of supply and demand.¹⁴⁵

The Third Circuit has made it clear that short sales alone, even in great volume, are entirely lawful when a party carries them out in accordance with SEC rules and regulations.¹⁴⁶ Hence, to prove a manipulation claim, an issuer of toxic convertibles must establish that the defendant investor employed a deceptive device in conjunction with the short sales to effectuate the injection of inaccurate information into the market or the creation of a false impression of supply and demand.¹⁴⁷

Specifically, in *GFL Advantage Fund*, the court noted several examples of deceptive devices, including: unauthorized placements,¹⁴⁸ parking of customer stock,¹⁴⁹ violating Rule 10a-1 by selling short “‘below the price at which the last sale’ of the security was reported,”¹⁵⁰ painting the tape,¹⁵¹ sham transactions, and false and misleading registration statements.¹⁵²

¹⁴⁴ Jones v. Intelli-Check, Inc., 274 F. Supp. 2d 615, 628 (D.N.J. 2003).

¹⁴⁵ See *GFL Advantage Fund*, 272 F.3d at 207.

¹⁴⁶ *Id.* at 211.

¹⁴⁷ *Id.*

¹⁴⁸ *Id.* at 207. An example of an unauthorized placement is when a broker-dealer places blocks of securities in his or her customers' accounts without the customers' authorization. *United States v. Russo*, 74 F.3d 1383, 1387 (2d Cir. 1996).

¹⁴⁹ *GFL Advantage Fund*, 272 F.3d at 207. Parking “involves selling a security to another party with an agreement to repurchase it. This ‘parking’ is illegal to the extent it is designed to conceal ownership of the security to generate tax losses, mount a takeover attempt, or similarly avoid federal law reporting requirements.” Joseph E. Bauerschmidt, Note, “Mother of Mercy—Is This the End of RICO?”—*Justice Scalia Invites Constitutional Void-for-Vagueness Challenge to RICO “Pattern”*, 65 NOTRE DAME L. REV. 1106, 1107 n.7 (1990).

¹⁵⁰ *GFL Advantage Fund*, 272 F.3d at 208. Rule 10a-1 is an SEC rule that sets limits on short selling. 17 C.F.R. § 240.10a-1 (2004). Rule 10a-1 is called the “uptick rule,” and it “prohibits short sales of exchange-listed stocks except on or after a price ‘uptick.’” Janvey, *supra* note 29, at 277. The short-seller has to find a buyer who is willing to pay at least one-eighth of a point more than the last sale price, or if the last sale price was an increase, a buyer who will pay the same price. *Id.* Rule 10a-1 is intended to prevent short selling from driving down the price of the stock, but an investor can evade this rule by trading in stocks that are also traded on foreign exchanges, over-the-counter, or in the NASDAQ system. *Id.* In a toxic convertible, the convertible security holder generally will not violate Rule 10a-1, as long as he offers the security at least one-eighth of a

While a convertible security holder might not engage in these types of manipulations, engaging in short sales may be a manipulation if the convertible security holder also acquires stock through conversion in a private transaction. In *Crane Co. v. Westinghouse Air Brake Co.*,¹⁵³ the Second Circuit found that a potential bidder manipulated the market when the bidder engaged in off-the-market sales while buying extraordinary amounts of stock in the market.¹⁵⁴ The chief complaint, as the court noted, was that the potential bidder had concealed from the public “the true situation as to the market it was making.”¹⁵⁵ Indeed, the potential bidder had distorted the only source of information for other investors, the stock price, by engaging in private sales off the stock exchange.¹⁵⁶

Because a convertible security holder in a toxic convertible engages in private transactions when he submits his conversion requests but sells short in the public market, he necessarily is injecting inaccurate information into the market. The convertible security holder’s transactions distort the price of the stock, resulting in a false view of the market for other investors.

E. The Southern District of New York: Misrepresentation or Omission or a Scheme To Defraud

The Southern District of New York has tied the elements of a manipulation claim more closely with those of a misrepresentation claim. Specifically, a party alleging a Rule 10b-5 claim is required to show reliance on a misrepresentation, omission of a material fact, or a scheme to defraud by the defendants.¹⁵⁷ Although the final element includes misrepresentations and omissions, the Southern District has pointed to schemes to defraud when it has

point above its last sale price. Because the convertible security holder purposefully asks for a sale price higher than the current market price so that other investors will think the issuing company is a bad investment, it is unlikely he will violate Rule 10a-1. See *supra* text accompanying note 35.

¹⁵¹ *GFL Advantage Fund*, 272 F.3d at 208. Painting the tape is a synonym for a fictitious trade, and “[t]his practice involves entering large orders near the market’s close in order to move the closing price.” Lawrence Damian McCabe, Note, *Puppet Masters or Marionettes: Is Program Trading Manipulative as Defined by the Securities Exchange Act of 1934?*, 61 *FORDHAM L. REV.* S207, S226 (1993).

¹⁵² *GFL Advantage Fund*, 272 F.3d at 208. These examples of deceptive devices came directly from the defendant issuer’s complaint, which listed several cases involving deceptive devices and short sales. *Id.* at 207–08.

¹⁵³ 419 F.2d 787 (2d Cir. 1969).

¹⁵⁴ *Id.* at 793.

¹⁵⁵ *Id.*

¹⁵⁶ *Id.* at 795.

¹⁵⁷ *Global Intellicom, Inc. v. Thomson Kernaghan & Co.*, 1999 U.S. Dist. LEXIS 11378, at *21–22 (S.D.N.Y. July 26, 1999).

addressed manipulation claims in toxic convertible cases.¹⁵⁸ The court has not yet defined a scheme to defraud, but it has implicitly pointed to a scheme as one that entails conduct, rather than explicit representation, to not sell a stock short, or an omission that the alleged manipulator had no intent to hold to an agreement forbidding short-selling.¹⁵⁹ In a toxic convertible manipulation claim, a scheme to defraud is likely to be one that entails deceptive conduct in conjunction with a subjective intent to manipulate the price of the security.¹⁶⁰

While only one case in the Third Circuit elaborates on the types of deceptive devices that might qualify under this last element,¹⁶¹ the Southern District of New York is not as stringent in determining when short sales fall within the purview of deceptive or manipulative conduct. Specifically, the Southern District of New York, incorporating the Third Circuit's requirement of an additional deceptive device besides just short sales, held that a party can establish deceptive conduct through a combination of factors rather than a singular deceptive device.¹⁶² These factors include subjective intent, timing, volume, selling through a nonmarket maker, and a pattern of prior manipulation.¹⁶³

In *Nanopierce Technologies*, the defendant convertible security holders engaged in trading of the issuing company's stock nearly every day for approximately six months.¹⁶⁴ Furthermore, the investors accounted for an average of 36.5% of the daily trading volume and 22.7% of the trading volume for the entire six months.¹⁶⁵ A large amount of the trading took place through

¹⁵⁸ See *Nanopierce Techs., Inc. v. Southridge Capital Mgmt., LLC*, 2002 U.S. Dist. LEXIS 24049, at *28 (S.D.N.Y. Oct. 10, 2002) (referring to defendants' conduct as a scheme); *Internet Law Library, Inc. v. Southridge Capital Mgmt., LLC*, 223 F. Supp. 2d 474, 486 (S.D.N.Y. 2002) (stating that defendants engaged in activities that plaintiffs claimed constituted manipulation); *Log On Am., Inc. v. Promethean Asset Mgmt., LLC*, 223 F. Supp. 2d 435, 445 (S.D.N.Y. 2001) (stating that plaintiff alleged that defendants engaged in manipulative conduct).

¹⁵⁹ *Internet Law Library*, 223 F. Supp. 2d at 486.

¹⁶⁰ *Nanopierce Techs.*, 2002 U.S. Dist. LEXIS 24049, at *30.

¹⁶¹ See *GFL Advantage Fund, Ltd. v. Colkitt*, 272 F.3d 189, 204–05 (3d Cir. 2001).

¹⁶² See *Nanopierce Techs.*, 2002 U.S. Dist. LEXIS 24049, at *30.

¹⁶³ *Id.* This list of factors is based on the allegations of the plaintiff and include: (1) "subjective intent to depress the value" of the plaintiff's stock; (2) "timing of sales beginning the first trading day after closing and continuing until liquidation;" (3) dominant trading in a security for a six-month period; (4) "significant amounts of trading conducted through a non-market maker;" and (5) a pattern of similar investments followed by stock drops. *Id.*

¹⁶⁴ *Id.* at *6.

¹⁶⁵ *Id.* During this period of intense trading, the price of the stock of Nanopierce Technologies dropped from \$2.63 to \$0.51, and the company claimed that it had not released any material adverse information to the public. *Id.*; see also *Crane Co. v. Westinghouse Air Brake Co.*, 419 F.2d 787, 792–93 (2d Cir. 1969) (noting that when defendant bidder purchased 170,200 shares of target company's stock on the last day that

a nonparty who was not a market maker.¹⁶⁶ Finally, in its complaint, the issuing company listed twenty-seven other companies alleged to be victims of the investors.¹⁶⁷

Therefore, a plaintiff bringing a manipulation claim under § 10(b) and Rule 10b-5 likely will have an easier time establishing a claim in the Southern District of New York than in the Third Circuit. While a typical toxic convertible manipulation scheme entails conversion of stock at lower and lower prices, the judiciary has not yet declared this deceptive device sufficient to establish manipulation. However, absent such an assertion, the Southern District of New York's holding is especially pertinent because in most toxic convertible manipulation cases, the facts surrounding the short selling of the preferred convertible holders is the most blatant evidence of manipulation.

F. Scier in the Third Circuit and the Southern District of New York

One of the traditional requirements for a § 10(b) and Rule 10b-5 claim is to show that the defendant had scienter, the requisite state of mind.¹⁶⁸ Scienter is often the most difficult element of a Rule 10b-5 claim to prove.¹⁶⁹ The judiciary has not defined scienter consistently from circuit to circuit.¹⁷⁰ Generally, a plaintiff establishing scienter must prove that the defendant investor had an intent to deceive or manipulate while engaging in the questionable conduct.¹⁷¹ Hence, it is more helpful to analyze scienter within the context of a toxic convertible manipulation claim, particularly in the way both the Third Circuit and the Southern District of New York have ruled on such claims.

Both the Third Circuit and the Southern District of New York require that defendant have the requisite mental state at the time of the manipulation, but neither court has explicitly stated whether purpose is equivalent to scienter. Although the Third Circuit has not listed the element of scienter in its requirements for a manipulation claim under § 10(b) and Rule 10b-5, it does

shareholders of the target company could tender their stock for a rival bidder's tender offer, it resulted in a false impression that there was great demand for the target company's stock).

¹⁶⁶ *Nanopierce Techs.*, 2002 U.S. Dist. LEXIS 24049, at *7.

¹⁶⁷ *Id.*

¹⁶⁸ *Basic Inc. v. Levinson*, 485 U.S. 224, 231 (1988).

¹⁶⁹ *BROMBERG & LOWENFELS*, *supra* note 44, § 7:125.

¹⁷⁰ *See id.*

¹⁷¹ *Id.* § 2:125. The fundamental scienter issue is usually whether negligence is enough to establish the requisite state of mind. *Id.* § 7:125. Negligence is enough in the Eighth, Ninth, and Tenth Circuits, but the Second Circuit has not yet decided the issue. *Id.*

use the term ubiquitously in its analysis.¹⁷² Additionally, the Third Circuit appears to equate scienter with a showing that the alleged manipulator had a purpose of artificially depressing or inflating the price of the security.¹⁷³ The Third Circuit has implied that to establish scienter, or purpose, a party alleging manipulation in a toxic convertible claim would be more successful establishing the requisite recklessness or intentionality if there is an additional deceptive or manipulative device.¹⁷⁴ Furthermore, the Third Circuit has suggested that the definition of a deceptive device would be one that “violated SEC rules.”¹⁷⁵ The Third Circuit has not elaborated beyond this suggestion whether the definition of a deceptive device would encompass a device that does not violate an SEC regulation.

The Southern District of New York unequivocally stated that scienter is a required element for a manipulation claim under Rule 10b-5.¹⁷⁶ Perhaps the most predictive piece of evidence in a manipulation claim involves the alleged representation by the manipulator that he will not engage in short-selling of the security. The Southern District of New York has listed several indicia of scienter that, coupled with this representation, would be sufficient to fulfill the scienter requirement in a toxic convertible manipulation claim. The indicia include: (1) economics of the conversion ratio providing an incentive and opportunity for the alleged manipulators to engage in short-selling; (2) patterns of investments in other companies; and (3) surges in the price of the security and trading volume.¹⁷⁷

For example, in *Global Intellicom, Inc. v. Thomson Kernaghan & Co.*, the conversion formula for the toxic convertible set the preferred stock purchase price at 75% of the five-day average closing bid price of the common stock.¹⁷⁸ The formula enabled the plaintiff investors to get a discount when converting the stock, thereby increasing the amount of stock they would receive. This

¹⁷² *GFL Advantage Fund, Ltd. v. Colkitt*, 272 F.3d 189, 211 (3d Cir. 2001); *Jones v. Intelli-Check, Inc.*, 274 F. Supp. 2d 615, 630 (D.N.J. 2003). In *Jones*, the court never mentions explicitly the element of “purpose” except to list it as an element; instead, the court uses only the term “scienter” throughout its analysis. *Id.*

¹⁷³ See *GFL Advantage Fund*, 272 F.3d at 211.

¹⁷⁴ See *id.* at 212 (noting that if the plaintiff, Colkitt, had shown that the defendant had violated the SEC uptick rule, he could have established the requisite state of mind).

¹⁷⁵ *Id.*

¹⁷⁶ *Global Intellicom, Inc. v. Thomson Kernaghan & Co.*, 1999 U.S. Dist. LEXIS 11378, at *21–22 (S.D.N.Y. July 26, 1999).

¹⁷⁷ *Id.* at *27–28.

¹⁷⁸ *Id.* at *6; see also *GFL Advantage Fund*, 272 F.3d at 195 (noting that defendant issuer had signed two notes where the conversion ratios were 82% and 83%, respectively).

gave them an incentive to drive down the price of the common stock, in part through short-selling the stock.¹⁷⁹

In the same case, the issuing company listed in its complaint approximately ten companies in which one of the plaintiff investors purchased stock, the prices of which decreased sharply after the purchase.¹⁸⁰ The volume of short sales increased during the period after the plaintiff investors entered into the toxic convertible agreement from seven shares in November 1997 to 162,257 shares in March 1998, and the price of the issuing company's stock decreased from \$2.26 to \$0.63 in July 1998.¹⁸¹

In essence, both the Southern District of New York and the Third Circuit require scienter for a valid manipulation claim, which a plaintiff can establish by demonstrating that an alleged manipulator utilized a deceptive device in conjunction with short-selling. However, the Southern District of New York has a broader definition of a deceptive device, which allows for deceptive devices as defined by the factors listed in *Global Intellicom*.¹⁸²

Consequently, an issuing company could establish scienter without having to demonstrate that the convertible security holders engaged in traditional deceptive devices when trading. In a toxic convertible, the issuing company should be able to meet this requirement. The structure of a toxic convertible provides a natural incentive for the convertible security holder to engage in manipulative conduct to maximize profits.¹⁸³ Furthermore, investors who back these types of financing deals tend to be sophisticated and have engaged in them before.¹⁸⁴ Finally, a drop in the stock price and an increase in the trading volume of the stock typically accompany manipulation attempts by the convertible security holders.¹⁸⁵

¹⁷⁹ *Global Intellicom*, 1999 U.S. Dist. LEXIS 11378, at *6.

¹⁸⁰ *Id.* at *16.

¹⁸¹ *Id.* at *17–18; *see also* Internet Law Library, Inc. v. Southridge Capital Mgmt., LLC, 223 F. Supp. 2d 474, 479 (S.D.N.Y. 2002) (stating that defendant convertible security holders had a short position of approximately a million and a half shares at one point during the period of trading in question).

¹⁸² *Global Intellicom*, 1999 U.S. Dist. LEXIS 11378, at *27–28.

¹⁸³ *See* discussion *supra* Part I.D.

¹⁸⁴ *E.g.*, *Global Intellicom*, 1999 U.S. Dist. LEXIS 11378, at *16.

¹⁸⁵ *E.g.*, GFL Advantage Fund, Ltd. v. Colkitt, 272 F.3d 189, 205 (3d Cir. 2001).

G. Defining Reliance in the Third Circuit and the Southern District of New York

A crucial element of a § 10(b) and Rule 10b-5 manipulation claim in both the Third Circuit and the Southern District of New York is reliance.¹⁸⁶ Generally, reliance is tested at the time a plaintiff committed to a transaction.¹⁸⁷ In addition, courts have used a variety of factors to determine when a party's reliance is justified or reasonable:

- (1) the sophistication and expertise of the plaintiff in financial and securities matters;
- (2) the existence of long standing business or personal relationships;
- (3) access to the relevant information;
- (4) the existence of a fiduciary relationship;
- (5) concealment of the fraud;
- (6) the opportunity to detect the fraud;
- (7) whether the plaintiff initiated the stock transaction or sought to expedite the transaction; and
- (8) the generality or specificity of the misrepresentations.¹⁸⁸

Although no single factor is dispositive, the factors offer a useful framework for analyzing direct reliance in different contexts.¹⁸⁹

It may be difficult in certain scenarios for parties to prove direct reliance in the face of an obvious violation of the securities laws.¹⁹⁰ To fix this, courts have relaxed the common law requirement of reliance by allowing parties to substitute indirect reliance or presumed reliance for direct reliance.¹⁹¹ One method of substitution is the fraud-on-the-market theory, which accepts indirect reliance on the integrity of the market.¹⁹² More specifically, fraud-on-the-market theory creates three rebuttable presumptions of reliance: (1) there has been a misrepresentation or fraudulent act that affected the market price;

¹⁸⁶ Jones v. Intelli-Check, Inc., 274 F. Supp. 2d 615, 627–28 (D.N.J. 2003); *Global Intellicom*, 1999 U.S. Dist. LEXIS 11378, at *21. The SEC is not required to establish reliance as an element of a claim under § 10(b) and Rule 10b-5. SEC v. Rana Research, Inc., 8 F.3d 1358, 1359 (9th Cir. 1993).

¹⁸⁷ BROMBERG & LOWENFELS, *supra* note 44, § 7:442.

¹⁸⁸ Zobrist v. Coal-X, Inc., 708 F.2d 1511, 1516 (10th Cir. 1983).

¹⁸⁹ BROMBERG & LOWENFELS, *supra* note 44, § 7:443.

¹⁹⁰ Direct reliance is based on the “traditional notion that the investor must read the documents containing the misstatement in order to be misled.” Barbara Black, *Fraud on the Market: A Criticism of Dispensing with Reliance Requirements in Certain Open Market Transactions*, 62 N.C. L. REV. 435, 438 (1984).

¹⁹¹ *Id.* at 435.

¹⁹² Basic Inc. v. Levinson, 485 U.S. 224, 247 (1988). The fraud-on-the-market theory assumes that consumers have access to nearly perfect market information and that the market price of the stock reflects the available information. Peil v. Speiser, 806 F.2d 1154, 1161 n.10 (3d Cir. 1986).

(2) the plaintiff relied on the price of the stock as indicative of the value of the stock; and (3) the reliance was reasonable.¹⁹³

Interpretation of reliance in this manner renders the investor's knowledge of or actual reliance on the deceptive or manipulative conduct irrelevant.¹⁹⁴ The relevant issue becomes whether the deceptive or manipulative conduct caused the price of the security to rise or fall.¹⁹⁵ Thus, the party alleging a Rule 10b-5 violation would have to prove only that the party was not aware of the conduct in question when it engaged in the transaction.¹⁹⁶

The fraud-on-the-market theory is particularly relevant in light of the Southern District of New York's holding in *Internet Law Library v. Southridge Capital Management*, that issuing companies can use it to establish reliance in a toxic convertible manipulation claim.¹⁹⁷ The court noted that the plaintiffs' reliance on the market to set the price of its stock was reasonable.¹⁹⁸ The implication of this holding is far-reaching. Plaintiffs bringing a toxic convertible manipulation claim may satisfy the reliance element under Rule 10b-5 without demonstrating that the fraudulent conduct actually affected the market price. Because many companies that engage in toxic convertible financing are already in financial trouble,¹⁹⁹ their stock, most likely, is already falling. Proving that a decrease in price is due to short-selling alone would be a difficult task.

While the Southern District of New York has established a standard to evaluate reliance in a toxic convertible manipulation claim, the Third Circuit's case law has failed to elaborate on reliance. In fact, the court addresses

¹⁹³ Jones v. Intelli-Check, Inc., 274 F. Supp. 2d 615, 632 (D.N.J. 2003) (citing Zlotnick v. TIE Communications, 836 F.2d 818, 822 (3d Cir. 1988)).

¹⁹⁴ Daniel R. Fischel, *Efficient Capital Markets, the Crash, and the Fraud on the Market Theory*, 74 CORNELL L. REV. 907, 908 (1989).

¹⁹⁵ *Id.*

¹⁹⁶ *Id.*

¹⁹⁷ See *Internet Law Library, Inc. v. Southridge Capital Mgmt., LLC*, 223 F. Supp. 2d 474, 487 (S.D.N.Y. 2002). The court stated that the plaintiff established reliance in its complaint when it alleged that "[t]he individual plaintiffs were damaged by the defendants' manipulation, because all bought or sold stock during the time when the stock price was artificially depressed by that manipulation, in reasonable reliance on the market price" *Id.* The other cases in the Southern District of New York involving toxic convertible manipulation claims do not address reliance in any substantial manner. See, e.g., *Global Intellicom, Inc. v. Thomson Kernaghan & Co.*, 1999 U.S. Dist. LEXIS 11378, at *31-33 (S.D.N.Y. July 26, 1999).

¹⁹⁸ *Internet Law Library*, 223 F. Supp. 2d at 487.

¹⁹⁹ See discussion *supra* Part I.

reliance only where the plaintiff is the short-seller of securities.²⁰⁰ The court has noted that a short-seller is not entitled to the presumptions of the fraud-on-the-market theory, but that the short-seller may, nevertheless, prove reliance under the same theory.²⁰¹ Because the court has maintained that the fraud-on-the-market theory can establish reliance in a case involving short-selling, it seems appropriate to assume that the Third Circuit would adopt the view of the Second Circuit that an issuing company may use fraud-on-the-market as a plaintiff in a manipulation claim. Nonetheless, an issuing company still should be aware that there is no precedent in the Third Circuit for the use of the fraud-on-the-market theory in a toxic convertible manipulation claim.

H. Causation in the Third Circuit and the Southern District of New York

One of the traditional elements that courts require in Rule 10b-5 claims is causation.²⁰² Typically, private plaintiffs must establish both transaction causation and loss causation.²⁰³ Transaction causation is similar to a but-for or cause-in-fact analysis, whereas loss causation is akin to proximate cause.²⁰⁴ In essence, transaction causation speaks to whether the plaintiff would have entered into a transaction absent the defendant's fraud, while loss causation speaks to whether the connection between the fraud and the plaintiff's damages is significant enough to hold the defendant responsible.²⁰⁵ Plaintiffs normally prove transaction causation by establishing the element of reliance.²⁰⁶ Loss causation is a mechanism to limit damages flowing from a securities fraud by

²⁰⁰ *Jones v. Intelli-Check, Inc.*, 274 F. Supp. 2d 615, 617–18 (D.N.J. 2003) (noting that the plaintiffs, who were investors and lost money when they short-sold the defendant's stock, claimed that the defendant engaged in fraudulent conduct that caused the price of the stock to rise).

²⁰¹ *Id.* at 632. A short-seller may establish reliance under the fraud-on-the-market theory if the short-seller is unaware of the defendant's fraudulent conduct. *Id.* at 632–33.

²⁰² *E.g.*, *Huddleston v. Herman & MacLean*, 640 F.2d 534, 549 (5th Cir. 1981) (“Absent the requirement of causation, Rule 10b-5 would become an insurance plan for the cost of every security purchased in reliance upon a material misstatement or omission.”).

²⁰³ Andrew L. Merritt, *A Consistent Model of Loss Causation in Securities Fraud Litigation: Suing the Remedy to the Wrong*, 66 TEX. L. REV. 469, 471 (1988). Section 101(b) of the Private Securities Litigation Reform Act codified loss causation by adding § 21D(b)(4) to the 1934 Act. *See* Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, tit. 1, § 101(b), 21D(b)(4), 109 Stat. 737, 741 (1995) (codified at 15 U.S.C. § 78u-4(b)(4) (2000)).

²⁰⁴ Charles T. Williams, III, Comment, *Semerenko v. Candant Corp.: Has the Time Come To Prune the “Judicial Oak”?*, 27 DEL. J. CORP. L. 587, 595 (2002).

²⁰⁵ Merritt, *supra* note 203, at 472.

²⁰⁶ *Id.* In the Southern District of New York, reliance is presumed if the court applies the fraud-on-the-market theory. *Fogarazzo v. Lehman Bros.*, 341 F. Supp. 2d 274, 286 (S.D.N.Y. 2004).

requiring that the damages claimed by the plaintiff be a foreseeable consequence of the misrepresentation.²⁰⁷

In applying the two causation theories, the Second Circuit has held that for a plaintiff to get past the summary judgment stage of litigation, it must demonstrate that the fraud caused the plaintiff to enter into the transaction and that the fraud caused the harm the plaintiff suffered.²⁰⁸ The Southern District of New York has elaborated on causation within a toxic convertible context in only one case, *Global Intellicom, Inc. v. Thomson Kernaghan & Co.*²⁰⁹ The court held that the plaintiffs proved transactional causation because defendants represented that they planned to purchase the securities for investment purposes only when they had in fact engaged in a large concentration of short sales.²¹⁰ Conversely, the court held that the plaintiff did not prove loss causation because its pleadings did not allege a cognizable injury that was proximately caused by the representations.²¹¹ Specifically, the court noted that the boilerplate language of “substantial harm” in the plaintiff’s complaint was not sufficient to establish loss causation because it did not relate to the defendants’ representation that they would not engage in a short-selling scheme.²¹²

The Third Circuit has not addressed causation in a toxic convertible manipulation case, but it has addressed it in a standard manipulation claim. In *Jones v. Intelli-Check, Inc.*,²¹³ the District of New Jersey held that the plaintiffs sufficiently pled causation when they alleged that they bought stock at “artificially inflated prices to cover their short sales and were damaged thereby.”²¹⁴ This contrasts with *Global Intellicom*, in which the court rejected the plaintiff’s use of boilerplate language as sufficient to satisfy the loss causation requirement.²¹⁵

²⁰⁷ *Marbury Mgmt., Inc. v. Kohn*, 629 F.2d 705, 708 (2d Cir. 1980). A plaintiff can establish loss causation by proving that the reason for the investment’s increase or decline in value is a result of the defendant’s misstatements. Jill I. Gross, *Securities Analysts’ Undisclosed Conflicts of Interest: Unfair Dealing or Securities Fraud?*, 2002 COLUM. BUS. L. REV. 631, 673.

²⁰⁸ *Weiss v. Wittcoff*, 966 F.2d 109, 111 (2d Cir. 1992).

²⁰⁹ 1999 U.S. Dist. LEXIS 11378 (S.D.N.Y. July 26, 1999).

²¹⁰ *Id.* at *29.

²¹¹ *Id.* at *29–30.

²¹² *Id.* at *30.

²¹³ 274 F. Supp. 2d 615 (D.N.J. 2003).

²¹⁴ *Id.* at 635.

²¹⁵ 1999 U.S. Dist. LEXIS 11378, at *30.

While there is a deficiency of toxic convertible manipulation cases, and courts have not clarified a great number of standards for determining causation, plaintiffs should be wary of the holdings in both *Global Intellicom* and *Jones*. Primarily, plaintiffs should be careful to use language in their complaints that is specific and that substantially describes their injury and its relation to the defendant's conduct.

I. Damages

Finally, both the Third Circuit and the Southern District of New York require damages to prove a manipulation claim under Rule 10b-5. Neither § 10(b) nor Rule 10b-5 contain an express provision dealing with damages,²¹⁶ but § 28 of the 1934 Act limits recovery to "actual damages."²¹⁷ The Supreme Court addressed damages under Rule 10b-5 in two seminal cases, *Affiliated Ute Citizens of Utah v. United States*²¹⁸ and *Randall v. Loftsgaarden*.²¹⁹ These two cases, in conjunction with subsequent lower court decisions, enumerated a number of damage measures, including: (1) the benefit-of-the-bargain rule; (2) the out-of-pocket rule; (3) disgorgement; and (4) rescission.²²⁰ The benefit-of-the-bargain rule states that damages are measured by "the difference between the . . . value of the security purchased or sold and the fair value of the security on the date of the trade."²²¹ The traditional measure of relief for a Rule 10b-5 claim is out-of-pocket relief, which is the difference between the fair value of what the plaintiff received and "the fair value of what he would have received had there been no fraudulent conduct."²²² Damages based on disgorgement provide the plaintiff with the amount of the defendant's unjust enrichment.²²³ Finally, rescissory damages restore "each party to its pre-transaction condition."²²⁴

²¹⁶ BROMBERG & LOWENFELS, *supra* note 44, § 8:2.

²¹⁷ 15 U.S.C. § 78bb(a) (2000).

²¹⁸ 406 U.S. 128 (1972) (involving damages to the seller). The Court awarded damages under § 28 of the 1934 Act and held that the damages should be measured by the difference between the fair value of what the mixed-blood seller received and what he would have received had there been no fraudulent conduct. *Id.* at 155.

²¹⁹ 478 U.S. 647, 655–56 (1986) (holding that rescissory damages may be appropriate in a Rule 10b-5 claim in a suit that involved damages to the buyer).

²²⁰ Michael J. Kaufman, *No Foul, No Harm: The Real Measure of Damages Under Rule 10b-5*, 39 CATH. U. L. REV. 29, 30–31 (1989).

²²¹ *Id.* at 31.

²²² *Id.*

²²³ *Id.*

²²⁴ *Id.*

One of the inherent risks in bringing a toxic convertible manipulation claim is that a plaintiff will be unable to predict accurately the amount or type of damages a court might award. Neither the Third Circuit nor the Southern District of New York has presided over a toxic convertible manipulation case that has moved beyond the summary judgment stage. In light of the lack of precedent in this area, the type and amount of damages a court will award to an issuing company winning a claim of market manipulation are uncertain.

CONCLUSION

There are potentially significant ramifications for companies when they choose to obtain toxic convertible financing. Companies should understand that there is a large incentive within the structure of the financing for convertible security holders to sell the security short to gain short-term profits. If convertible security holders do sell the security short, companies have viable claims under § 10(b) and Rule 10b-5 or § 9 for market manipulation.

While no recent cases have gone to trial, both the Third Circuit and the Southern District of New York have ruled on several toxic convertible manipulation cases in the summary judgment stage. These cases, in conjunction with previous decisions on manipulation claims, offer guidelines for issuing companies in determining whether their claims would be successful.

Yet, because toxic convertible litigation is in its infancy, these guidelines are only starting points. Companies that have been targets of unscrupulous financiers who engage in short sales within the context of a toxic convertible should actively pursue manipulation claims. The structure by which these investors operate in a toxic convertible is manipulative in nature, and such manipulation falls within the boundaries of both § 9 and § 10 of the 1934 Act.

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