

# CAUGHT SHORT: SHORT SELLER ACTIVIST FOUND TO HAVE MISLED

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Legal Briefings - By **Baden Furphy and Kam Jamshidi**

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Short seller activism and the use of negative research reports in Australia are on the rise. The NSW Supreme Court has recently handed down its judgment in *Rural Funds Management Limited v Bonitas Research LLC* [2020] NSWSC 61, the first Australian case regarding a short seller negative research campaign. We analyse the Court's decision.

## IN BRIEF

- The NSW Supreme Court has handed down its judgment in *Rural Funds Management Limited v Bonitas Research LLC* [2020] NSWSC 61, the first Australian case regarding a short seller negative research campaign.
- The decision provides useful guidance for listed companies on the conduct of short sellers that publish negative research, including that:
  - The courts will expect short sellers to exercise care in publishing their allegations, including enquiring with the targeted company beforehand.
  - Attempts to circumvent Australian corporations law, for example by only giving access to research to readers outside of Australia, will fail where the statements made are clearly intended to induce persons in Australia.
  - The corporate targets of these short attacks may recover the costs of responding to the short seller campaign, but damages may not compensate for the loss suffered by their shareholders unless shareholders bring their own action.
- ASIC has an important role to play in balancing the benefits for the market of negative research against protecting shareholders from misleading conduct, including by bringing actions on behalf of shareholders affected by short seller misstatements.

# BACKGROUND

Short seller activism and the use of negative research reports in Australia are on the rise. In 2019, there were five negative research campaigns that caused an average decline of ~18% to the share price of the targeted companies.<sup>1</sup>

We have acted for a number of high profile clients the subject of activist campaigns, including Blue Sky on the Glaucus campaign.

In our experience, the legal battle lines between short seller activists and targeted companies have not been clearly defined. In particular, the accountability of short seller activists for misleading research had been untested. Until now.

We have now received judicial guidance on the rules of engagement. In February 2020, Hammerschlag J handed down his judgment in *Rural Funds Management Limited v Bonitas Research LLC* [2020] NSWSC 61. In that decision, the NSW Supreme Court found US-based activist short fund Bonitas Research (**Bonitas**) had contravened the Corporations Act by publishing misleading information on the Rural Funds Group (**Rural Funds**).

The decision is a welcome development, and should give boards and legal and investor relations teams stronger footing in combating negative research campaigns.

The key findings from the *Rural Funds* decision include:

- The courts will expect short sellers to exercise care in publishing their allegations, including enquiring with the targeted company beforehand.
- Attempts to circumvent the Australian corporations law, for example by only giving access to research to readers outside of Australia, will fail where the statements made are clearly intended to induce persons in Australia.
- The corporate targets of these short attacks may recover for the costs of responding to the short seller campaign, but damages may not compensate for the loss suffered by their shareholders.

There is an important role for ASIC to play to balance the benefits for the market of negative research against protecting shareholders from misleading conduct, including by bringing actions on behalf of shareholders affected by short seller misstatements.

# THE BONITAS CAMPAIGN AGAINST RURAL FUNDS

Bonitas' attack on Rural Funds was typical of the short seller playbook. In August 2019, the short seller published research claiming Rural Funds had misstated its financial performance and that its securities were worthless.

Key claims made by Bonitas in its research that the Court ultimately found to be misleading included that Rural Funds Management had:

- artificially inflated its income;
- dishonestly received certain income to the detriment of the unitholders of the Rural Funds Trust, which it managed; and
- breached the Rural Funds Trust's constitution regarding the cap on management fees.

Shortly after Bonitas published its research, Rural Funds responded with a rebuttal of the allegations, supported by an independent investigation by Ernst & Young.

Bonitas took steps aimed at avoiding the Australian corporations law from applying to its research. For example, those accessing the research were required to confirm they resided outside of Australia. This gave rise to an unsatisfactory state of affairs, where some shareholders could access the report and others could not – creating information inefficiencies in the market for Rural Funds' securities.

Rural Funds securityholders were vulnerable. Their securities fell 42% on the day the Bonitas research was released, only to recover 40% in the following days where they have settled. During this volatility, Australian securityholders were notionally not permitted to access the Bonitas report, creating information asymmetry in the market.

## JURISDICTIONAL QUESTION

Rural Funds commenced proceedings against Bonitas in the NSW Supreme Court in October 2019.

The Bonitas response to the litigation was defiant:

*“You have commenced litigation in Australia and invited us to participate. We respectfully decline the invitation. Australian courts have no jurisdiction over us, and we will contest the enforcement of any orders or judgments you obtain...”*

Bonitas' dismissiveness raised the question – are short seller activists really above our corporations laws?

A position whereby offshore funds are not governed by the laws designed to keep our markets efficient, would clearly be an unlevel playing field. Corporate targets of negative research campaigns are bound by a strict disclosure and liability regime. It must follow that short sellers too are accountable for their statements in order to preserve the integrity of our markets.

The NSW Supreme Court has now confirmed this; short sellers will be held accountable where their statements are intended to induce persons in Australia.

The position is analogous to the conclusion reached in defamation cases involving the publishing of material offshore but available on the internet. A 2002 High Court case is authority for Australian defamation laws applying to material published on the internet, as the damage to reputation occurs within Australia.

## **BONITAS' CONTRAVENTIONS**

In respect of Bonitas' misleading statements set out above, the NSW Supreme Court held that Bonitas and its CEO had breached the following sections of the Corporations Act that prohibit a person from:

- a. Section 1041E: making false or misleading statements likely to induce a person to dispose financial products where the person making the statement does not care whether the statement is true or false;
- b. Section 1041F: inducing a person to deal in financial products by publishing a statement, if the person is reckless as to whether the statement is misleading; and
- c. Section 1041H: engaging in conduct in relation to a financial product that is misleading or deceptive.

Rural Funds also sought a finding that Bonitas had contravened section 1041D, with the aim of having profits made by Bonitas as a result of the conduct included in the assessment of damages. That section requires that:

- information be circulated to the effect that the price for securities is likely to fall;

- the fall in price be because of a transaction in respect of the securities; and
- the transaction constitutes a contravention of section 1041E and 1041F.

Hammerschlag J did not find a breach of section 1041D in this case. The Court held that Section 1041D required both the dissemination of information and a transaction that contravenes section 1041E and 1041F. In this case there was no such transaction.

## **RECOVERING SHAREHOLDERS' LOSS - A ROLE FOR ASIC**

Section 1041(I) of the Corporations Act permits a person who suffers loss as a result of the contravention of the above provisions to recover damage from any person involved in the contravention. Rural Funds relied on this provision to seek to recover its costs in responding to the Bonitas research. The Court is yet to assess damages in the case.

Of course, the greater quantum of loss is likely to have been suffered by Rural Funds securityholders that sold their securities soon after the release of the Bonitas report.

Rural Funds is unable to recover loss on behalf of those shareholders, and while a class action supported by a litigation funder is possible, litigation funders have not been active in this space, presumably in part due to the lack of judicial guidance in the area.

Interestingly, it is open for ASIC to exercise its power under section 50 of the *Australian Securities and Investments Commission Act 2001* (Cth) to bring proceedings against Bonitas on behalf of the affected Rural Funds securityholders, if ASIC believes it is in the public interest to do so. Use of the power has been rare.

We believe that the market would benefit from ASIC taking action on behalf of affected securityholders in the Rural Funds matter, particularly in circumstances where the Court has already held that the conduct amounted to a contravention of the Corporations Act. Doing so would give ASIC the opportunity to remedy the loss of affected shareholders, focus the minds of short sellers publishing research and secure further jurisprudence in this emerging area.

To date, the corporate regulator appears to have largely let these situations play out on the grounds that the short sellers have a role to play in correcting market inefficiencies. The weight of that view must be balanced against protecting markets from being misled or even manipulated. Taking action on behalf of affected securityholders would help better balance these competing priorities.

## **TIME FOR REGULATORY GUIDANCE**

Longer term, we believe ASIC has an important role to play in providing guidance for short sellers on acceptable and unacceptable conduct. ASIC of course provides significant guidance on disclosure obligations in the context of takeovers, and we believe a lot of the principles and concepts could be applied analogously to the content of short seller research.

For example, the market would benefit from guidance on expectations regarding the basis necessary to support a claim and obligations to correct disclosure that is proven to be inaccurate or misleading. Further, clear guidance on the need for full disclosure of the invested position of persons publishing such research would allow readers to clearly identify vested interests.

## **CONCLUSION**

Bonitas claimed the Rural Funds' litigation was an attempt to abrogate the First Amendment right to freedom of speech in the US Constitution. We are supportive of that freedom of speech, provided it does not cut across the principle of efficient and informed markets.

Ultimately, short sellers will continue to be part of the Australian corporate landscape. The *Rural Funds* decision is a timely message that short sellers are not above our corporations law.

*Herbert Smith Freehills have acted for a number of high profile clients the subject of activist campaigns.*

## **ENDNOTES**

1. The targets of the negative research in 2019 were Wisetech Global, Rural Funds Group, AVZ Minerals, Treasury Wine Estate and CIMIC.

## **KEY CONTACTS**

If you have any questions, or would like to know how this might affect your business, phone, or email these key contacts.



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