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# Conspiracy Theory Finds Court Forum

## CEO Files Suit Saying Investors, Analysts Team Up to Sink Companies

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Steven Hirsch and Susan J. Harriman, attorneys at Keker & Van Nest, are defending Arizona-based Gradient Analytics, a securities research firm accused by Overstock.com of driving down its stock price.

Fans of "Star Wars" know Sith Lords as extraterrestrial warriors dedicated to the dark side.

But when CEO Patrick Byrne staged a press conference last year to denounce the Sith Lord that was trying to destroy his online discount department store, he had something different in mind.

The Utah businessman was referring to the collective power of investors, securities analysts and financial journalists to sink the fortunes of publicly traded companies such as his own, Overstock.com.

While Byrne's Sith Lord comment has made him the butt of blogger jokes, Byrne has shown he really means business.

In a lawsuit pending in Marin County Superior Court, Byrne charges that a securities research firm colluded with hedge fund investors who specialize in short-selling — that is, they try to profit by betting companies' shares will fall in value.

Anyone can file a lawsuit, but Byrne's lawyers aren't the only ones taking him seriously. Byrne's conspiracy theory also may have piqued the interest of lawyers at the Securities and Exchange Commission, who took the unusual step earlier this year of issuing subpoenas to well-known financial journalists for telephone records, e-mail and other material related to Overstock. At least one of the reporters, MarketWatch.com columnist Herb Greenberg, had written critically of Overstock.

The lawsuit and the SEC's investigation into possible market manipulation highlight growing tension over the role of stock analysts who are aggressively critiquing poorly performing companies after they were exposed as Wall Street lapdogs in a national scandal three years ago.

Byrne's broadside against short-sellers is also a sign of the times. One of the Enron executives facing criminal charges for the giant energy company's downfall testified in court just last week that the real culprit behind investors' sudden loss of faith in Enron was bad press stirred up by short-sellers.

The Overstock suit survived its first test in March when Superior Court Judge Vernon Smith refused a defense motion to dismiss it as an attempt to stifle free discussion about the health and value of public companies.

That ruling is under review by a state appellate court. But some experts worry that if the case proceeds it will show that irritated executives can retaliate in court anytime they are unhappy with an analyst's report or a hedge fund's position.

"I think there is a concern about companies suing people who say negative things about the company. I think that has a chilling effect," said Jill Fisch, a corporate securities law professor at Fordham Law School in New York. "At the same time, we don't want hedge funds to make money by spreading false negative information about companies."

The Overstock.com lawsuit is not alone in alleging a conspiracy between securities analysts, hedge funds and short-sellers.

A Canadian pharmaceutical company, Biovail Corp., has recently grabbed headlines with a complaint in New Jersey Superior Court seeking $4.6 billion in damages for an alleged stock market manipulation scheme built on biased

# Wall Street Conspiracy Theory Finds Forum in Marin Court

reports about the drug maker's stock.

Targeting one of the same principal defendants in the Overstock case, the Biovail suit blames Arizona-based Gradient Analytics for helping orchestrate attacks on the company's financial well-being that artificially drove down the price of its stock to the hedge funds' advantage.

Gradient, which describes itself as an independent research firm, provides forensic accounting analyses of various publicly traded companies for institutional clients, including mutual funds and hedge funds.

Byrne's dispute with Gradient dates back to 2003, when, according to the complaint, Gradient began publishing negative reports on Overstock, "uniformly giving the company the lowest possible grades." In 2004, Gradient said it would "leave Overstock alone," but by the next year had resumed the negative reports, which became "markedly more critical of Overstock."

According to the complaint, one result of this criticism was a precipitous drop in the company's stock price, from $57 a share in January 2005 to $42 in August.

Byrne has alleged that Gradient worked hand in hand with Rocker Partners, a New Jersey-based hedge fund known for its short-selling strategy, to drive down Overstock's stock price. Rocker has an office in Larkspur, which is why Byrne is suing in Marin County. According to the complaint, Rocker maintained short positions that would have benefited from a decline in Overstock's stock.

Attorneys for Gradient argue that Overstock is using the lawsuit to detract attention from the company's financial problems.

"It all has to do with companies getting upset because they don't like the assessment of what they're doing, honest or not. So they go after the messenger," said Gradient attorney Susan Harriman of San Francisco's Keker & Van Nest. "Overstock's goal is to spend money on the lawsuit, instead of fixing the problem."

People should be worried "that enough money can shut down criticism of public companies," Harriman said.

Wes Christian, an attorney for Overstock, objected to the notion that Byrne's case is an effort to stop analysts from speaking negatively about companies.

"Ultimately, what this is about is the illegal ways in which companies and individuals manipulated stock for their own financial gain," said Christian, a name partner with Christian, Smith and Jewell in Houston.

In the case of Overstock, Gradient's analysts were not the only ones to give the company low marks. An analyst with Pacific Growth Equities expressed concern over the company's inconsistent performance through the years and "meandering path to sustained profitability."

Outside observers say Byrne's suit reflects a backlash against the growing independence of stock analysts and the rising profile of short-sellers.

In recent years, major investment banks have cut back on their securities research departments, finding it less profitable than before. That's made companies like Gradient more important to the market than they were before, according to Hardy Callcott, a litigation partner at Bingham McCutchen in San Francisco.

That shift dates back to the 2003 conflict-of-interest scandal involving a group of Wall Street investment banks that were accused of letting their banking interests influence their stock reports.

Federal and state regulators, including the SEC and New York Attorney General Eliot Spitzer, accused the brokerages of pressuring analysts to issue glowing research reports on companies in an effort to win investment banking business — for example, the opportunity to write their stock offerings and advise on mergers.

The scandal prompted regulators to issue new rules promoting a clearer separation between research and business. In the years since, there has been a notable increase in the number of analysts' "sell recommendations," or negative reports, according to Callcott, who was general counsel to Charles Schwab & Co. before joining Bingham.

That's considered by many to be good for the market. But it does leave analysts vulnerable to litigation — whether their research is legitimate or not. And that, in turn, increases costs.

"If you increase the threat of litigation against research analysts, I think it does create a risk that it's going to be even less attractive to firms to do good independent research," Callcott said. "If you have to factor in a cost of litigation whenever you put out a negative research report, you're going to have less money to hire that next new research analyst."

According to Jesse Fried, a corporate law professor at Boalt Hall, analysts who provide negative research about companies, as long as it's honest, provide a valuable service to the market by keeping stock prices more accurate.

Fried said that short-sellers in particular play an important role in the market.

Though short-sellers don't enjoy the best reputation on Wall Street, the practice of making money on falling stocks is both legal and common. Short-sellers borrow shares of stocks and sell them, expecting the price of the stock to drop. If that happens, they repurchase the stocks at a lower price and pocket the difference after paying the trader they borrowed the shares from.

And even though they've been criticized by some for their role in Enron's collapse, short-sellers have been credited by others with being the first to expose that and other companies' frauds.

"They are keeping the markets honest," Fried said. "This lawsuit is worrisome because it's likely to make it harder for short sellers."

The Associated Press contributed to this report.