FUTURE-PRICED CONVERTIBLE SECURITIES
AND THE OUTLOOK FOR “DEATH SPIRAL”
SECURITIES-FRAUD LITIGATION

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In recent years, many companies in the United States have issued so-called “Future-Priced Convertible Securities.” These companies tend to be small, thinly-traded, and (most importantly) desperate for cash; and they look to the Future-Priced Convertible Security as a necessary means of financing to keep their businesses operating. Future-Priced Convertible Securities are thus credited by some with providing an important form of financing in the marketplace. Yet these securities are also a source of controversy. Many companies have wound up regretting issuing these instruments, after watching their stock values tumble and their market capitalizations dry-up subsequent to issuing these securities. Issuers have even started to sue.3

Many issuers of Future-Priced Convertible Securities are now suing the very purchasers of these securities alleging, among other things, that the purchasers have violated antifraud provisions of the federal securities laws such as Section 10(b) of the Securities Exchange Act of 1934.4 These cases often allege similar scenarios by which purchasers of the Future-Priced Convertible Securities harmed the issuers, giving rise to a unique appellation for these lawsuits: “Death spiral” litigation.5 These cases are called “death spirals” because purchasers of the Future-Priced Convertible Securities are alleged to have used the securities in manipulative short-selling schemes that extract the market value of the issuing companies, thereby enriching the purchasers at the expense of the issuers and other shareholders.6 These “death spirals” can result in the issuer’s being de-listed from an exchange or even forced to file for bankruptcy.7

This article will analyze six specific death spiral lawsuits with the intention of evaluating the plaintiffs’ securities fraud claims. In so doing, this article hopes to provide insight into the potential success of other lawsuits in an anticipated “wave of litigation” over Future-Priced Convertible Securities.8 Part I of this article provides background information on these securities: What they are, who issues them, who buys them, and what a “death spiral” is. Part II then discusses an important legal issue relating

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2. See infra Part I.D.
5. See Beloreski, supra n. 1, at 19.
6. See infra Part I.D.
8. See Toxic Finance, supra n. 3; Brandon Copple, Sinking Funds: Startups Taken by Convertible Securities Schemes Fight Back, Forbes 46 (June 10, 2002).
to death spirals, the practice and the law of short selling. Next, Part III reviews six specific death spiral cases, analyzing the facts and claims alleged in these lawsuits and providing some basic conclusions of law. The Analysis section, Part IV, then examines the legal merits of these death spiral securities fraud complaints in detail. Using the six lawsuits discussed in Part III as case studies, the Analysis section demonstrates that death spiral litigation claims are potentially meritorious. Moreover, this article will argue at some length that the practice known as “naked short selling” should be declared to be market manipulation if (or more likely “when”) this issue arises in a death spiral action. Finally, Part V reviews the significance of the Securities and Exchange Commission’s recent changes to short-selling regulation in Regulation SHO and the potential for further regulatory changes in the future. This article concludes that there are legitimate grievances underlying death spiral lawsuits and that this is an area in which both federal courts and securities regulators should act to protect innocent investors harmed by the operation of Future-Priced Convertible Securities.

9. The reader is reminded at the outset that death spiral lawsuits allege many different claims, including securities fraud and other violations of federal securities laws, civil violations of the Racketeer Influenced and Corrupt Organizations Act (“RICO”), violations of state securities laws, and common law tort, breach of contract, and breach of fiduciary duty claims. The purpose of this article however is to focus narrowly on just the federal securities fraud claims. Thus, all the other claims raised in death spiral lawsuits aside from federal securities fraud are beyond the scope of this study and will not be examined.