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## Eagle flies above short-sellers

**Lawsuit over Internet postings advances as judge allows discovery****By Mary Ann Azevedo**

Houston Business Journal

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A civil lawsuit filed by Eagle Broadband Inc. in October 2005 has gained momentum from a recent ruling handed down by a California judge.

The League City-based communications technology firm sued 25 anonymous "John Doe" defendants in the Superior Court of California, claiming the group of Internet users manipulated Eagle Broadband's stock price.

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The suit alleges that fraudulent and misleading misinformation was posted on Internet message boards to drive down the value of company stock for the purpose of making quick profits through a practice known as "selling short."

The allegedly false information included filings with the Securities and Exchange Commission, press releases and customer e-mail messages, according to Karineh Khachatourian of Gordon & Rees LLP, a San Francisco law firm representing Eagle Broadband as outside counsel.

Khachatourian says the deceptive data was intended to create fear, uncertainty and doubt about the financial stability of the company.

During January and February 2005, when the information first started

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appearing, Eagle Broadband stock lost 46 percent of its value, falling from 67 cents to 37 cents per share.

The loss of value was the largest in any 60-day period for Eagle Broadband, which trades on the American Stock Exchange under the symbol "EAG."

As the negative Internet messages continued throughout the summer of 2005, the company retained Deidre A. Flaherty with the accounting firm of StoneTurn Group LLP to analyze trading patterns and determine whether they were indicative of a stock scheme.

Based on the findings, Eagle Broadband filed suit in October.

In response, four of the previously anonymous "John Doe" Internet users filed motions to dismiss Eagle's complaint as constitutionally protected freedom of speech on a matter of public interest under California's anti-SLAPP statute.

In March, Judge William J. Elfving of California Superior Court of Santa Clara County shot down that argument by allowing discovery in the case to go forward.

The decision makes sense to attorney Craig Ball, who specializes in electronic discovery and computer forensics.

The Montgomery attorney says it doesn't sound like the defendants should be shielded by the anti-SLAPP law.

Says Ball: "If the company's attorneys can establish that information was fabricated and circulated under false premises, then that's not free speech. Anti-SLAPP is not designed to protect that kind of behavior."

Allowing the lawsuit to proceed is a significant development for several reasons.

Discovery includes production of relevant documents, depositions of parties and potential witnesses under oath, and written requests for admissions of fact.

Attorney Khachatourian says the judge's ruling essentially means that Eagle Broadband, through the discovery process, expects to learn the identities of more "John Doe" defendants and obtain access to their financial and trading records.

In a larger sense, the outcome could play a precedent-setting role in future cases involving electronic dissemination of deceptive information.

Eagle Broadband represents another example of the increasing vulnerability public companies face due to the growing popularity and use of the Internet.

Such incidents have become more frequent, but are nothing new.

The most highly publicized episode to date took place in 2000. A 23-year-old community college student issued a bogus news release that caused Costa Mesa, Calif.-based Emulex Corp. stock to lose more than \$2 billion in value in several hours of trading over one week.

The student made several transactions that yielded a profit of more than \$241,000 in a single day. Charged both with securities and wire fraud, the student was convicted and sentenced to 44 months in prison.

### **Early warning signs**

Early last year, a number of shareholders reported to Eagle Broadband officials unusual activity related to stock trading and internal company correspondence.

The lawsuit outlines the following incidents.

- Jan. 24, 2005 -- A posting by someone identified as "benderandundat" described the company's future as "ugly" and indicated the company

might have to file for bankruptcy and/or sell off assets at "rock bottom pricing."

- Feb. 15, 2005 -- A posting by "team3339" purported to be an e-mail exchange with an executive from a potential Eagle Broadband customer saying the customer had no plans to work with the company.
- June 10, 2005 -- An item posted by "richwill21" on the Yahoo! Finance Message Board was designed to look like an actual Eagle Broadband press release. It stated that the company had been deleted from the Russell 3000 index and included an alleged quote from company Chairman Dave Micek. Eagle Broadband was not listed on the index and issued no press release about being delisted, according to the company.
- Sept. 3, 2005 -- A document designed to emulate an SEC filing was posted by "upanddown100" stating that former Eagle Broadband CEO H. Dean Cubley had placed an order to sell restricted shares. While such an insider sale took place the previous January, the dates were allegedly manipulated to make the filing appear current.

The SEC reportedly is conducting a separate investigation into the matter, according to Eagle Broadband officials.

The federal agency is not authorized to confirm or deny the existence or non-existence of any kind of investigation, according to an SEC spokesman.

### **Posting patterns**

Eagle Broadband called on accountant Deidre Flaherty to determine the relationship, if any, between the Internet postings and stock trading patterns.

Flaherty ultimately concluded the volume of short trading and the number of message board postings exceeded similar activity at publicly traded companies comparable to Eagle Broadband, a provider of broadband, Internet protocol and communications technology and services.

She also linked the postings to the drop in share price from 67 cents to 37 cents in January and February of 2005.

The stock has yet to recover. As of April 18, a share of Eagle Broadband traded at around 7 cents, down from a 52-week-high of 32 cents.

Flaherty's findings point to an organized plan orchestrated by a team of traders to circulate negative information and make profits by selling short.

The short sale of a stock not yet owned by the buyer requires the seller to meet financial obligations for future delivery. In a typical short-selling position, an investor sells borrowed stock hoping the price will fall and allow repurchase of the stock at a profit.

The practice of short selling, while legal, can cross over the line in violation of SEC insider trading regulations that prohibit short sales made for the purpose of manipulating price.

Computer forensics attorney Ball says a lot appears to be going on in the Eagle Broadband case.

Explains Ball: "You expect short sellers to bad-mouth a stock. If they thought much of the issue, they wouldn't be shorting it. And they are free to express opinions, to a degree. But when the representations cross the line from opinion to knowing falsehood couched as material fact, the speech is unprotected and tortious. And when the misconduct extends to fabrication of press releases, you're deep into the realm of criminal activity."

Circulating such information over the Internet, Ball says, potentially opens a perpetrator to federal charges of wire fraud, identity theft and criminal conspiracy.

Eagle Broadband is attempting to prove that the postings were "false and fraudulent statements" that damage the company, shareholders and value of

stock.

Attorney Khachatourian says the company is asking for injunctive relief in a cease-and-desist order against the "John Doe" defendants.

Eagle Broadband also is asking for as yet undetermined damages "to make the company whole," she says.

Now that the California judge has given the green light to pursue discovery, Khachatourian says the company is requesting financial records of the "John Does" who have been identified, and investigating ways to find out who the others are and force them to follow suit.

Says Khachatourian: "We want to trace back and see their trading habits to find further evidence of a 'short and distort' scheme."

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