Dear Burford Capital: Short Sellers are Important Players in Fulfilling Justice

By Daniel Yu, Founder of Gotham City Research

INTRODUCTION

This past week, shares of Burford Capital, the largest publicly listed litigation finance firm in the world, fell as much as 70% in a matter of two days. Such a sudden decline in share price is an exceedingly rare event. I know firsthand as I have overseen similar sized declines in two (formerly) European listed companies – Quindell PLC and Let's Gowex SA – whose shares fell in reaction to Gotham City Research's reports.

Burford Capital's responses to recent developments – referring to activist short selling as a "fundamental menace" and suggesting that there has been "market manipulation" – remind us of Quindell and Let's Gowex's responses. These knee jerk reactions miss an inconvenient truth: short selling serves an important role in the fulfillment of justice, as does litigation finance. Practitioners of justice, whether they are market participants or legal professionals, should therefore react to scrutiny with humility and grace, especially when there are matters of public interest involved. In this piece, I cover:

- How short sellers further justice, and are therefore distant cousins of litigation financiers;
- Frequently asked questions, and our responses to them;
- Our thoughts on Burford Capital.

Activist short selling is when short selling, aided by free speech, help fulfill justice

What is activist short selling? Activist short selling is nothing more than the marriage of short selling and free speech. Activist short sellers are profiteers, but so are litigation financiers (and all other corporate actors). Just because a profit motive drives both short selling and litigation finance, does not mean there are no public benefits resulting from both activities.

I believe that activist short sellers throughout history have furthered justice by providing the public with new and often contrarian opinions and facts – usually at significant personal, reputational, legal, and financial risk – information that the public would otherwise not be privy to. I have seen this resulting information discovery lead to the fulfillment of justice in the following ways (Please see our FAQ for a more detailed explanation):

- Financial crime prevention
- Justice in the commercial marketplace
- Civil/criminal prosecution of companies and their executives
- Corporate governance reform and enhanced financial disclosures
- Accountability in the court of public opinion

Justice is furthered when activist short selling lives out the true meaning of its creed:

"Speak truth to power."

and

"Comfort the afflicted, afflict the comfortable."

Frequently Asked Questions ("FAQ")

1. **Are you short BUR or are you receiving any compensation to write this?** *We are not short the shares of BUR; we currently have no position in any BUR or related securities. We are not being paid to write this statement.*

2. **Have you communicated with any of the recent public short sellers about Burford?** No, *we have not discussed Burford Capital with any of the public short sellers.*

3. **If you are not receiving any compensation to write this statement, why write?** *Several reasons; first, we feel gratitude towards the United Kingdom, Spain, and their respective public audiences. We feel that these countries and their respective people treated us with utmost dignity and respect – for the most part – during the Quindell and Let's Gowex sagas.*
Second, I have some strong opinions about both short selling and litigation finance. Third, we have been considering engaging with the public on a more frequent basis – perhaps in the form of white papers and editorials rather than focus strictly on the dissemination of issuer-specific research reports. We felt that the Burford situation was a good opportunity for us to finally initiate this pursuit.

4. **What makes you qualified to opine on short selling and litigation finance?** *Litigation finance and short selling are highly esoteric topics. Yet I happen to be familiar with both crafts. With regards to short selling, our track record speaks for itself. Regarding litigation finance, 2 years before I founded Gotham City Research, I wrote a private research note about Acacia Research ("ACTG"), a litigation finance company listed on NASDAQ, boasting a multi-billion dollar value.*

   In that short research note dated November 2010, I wrote that ACTG may provide a good short-selling opportunity. As beginner's luck would have it, ACTG shares indeed peaked soon after, and shares since declined over 90%. With this existing familiarity of the industry, we researched Burford Capital ("BUR") very closely in 2018. My familiarity with litigation finance – coupled with great research by my team – helped us come to hold informed and nuanced opinions about BUR.

5. **How does activist short selling further justice?**

- ***Financial crime prevention***– *Had Gotham City Research not exposed Quindell, Gowex, and other companies' wrong-doing, these companies would have de facto stolen billions of additional money from investors. We know for a fact that Let's Gowex was looking to do so.*
- ***Accountability in the court of public opinion*** – *Good companies should trade at premium valuations, and bad companies should trade at a discount. The shares of companies targeted by short sellers often end up trading at a discount. This advantages the scrupulous players, and punishes the unscrupulous ones. See academic financial research.*
- ***Justice in the commercial marketplace*** – *Good companies deserve goodwill from their commercial counterparties (customers, suppliers, etc.). Bad companies do not. See Valeant Pharmaceuticals.*
- ***Civil/criminal prosecution*** – *In some cases, the suspicious behaviors short sellers identify lead to the prosecution of publicly traded companies and their management teams. See Enron.*
- ***Corporate governance reform*** – *Executives and board members may be replaced. Corporate practices, overall disclosures, accounting/financial reporting may be enhanced.*

Our opinions and observations about Burford Capital and its shares:

1. After we evaluated BUR last year we shorted the shares, but decided not to publicly share our findings in the form of a Gotham City Research dossier. I am of the view that it is foolish to own shares at a meaningful premium to book value per share, for the following reasons:
    a. I believe that high growth financial companies, whose markets values trade at extreme premiums to book value, tend to experience disappointing returns, over the long term.
    b. Burford shares and litigation finance exhibited signs to us, last year, of being in the bubble stage of a multi-year boom / bust cycle.
    c. I don't think Burford is able, in coming years, to consistently deliver sufficient returns on capital that would merit a meaningful premium to book value per share. If I am wrong, and the company is able to grow book value per share at a sufficiently high growth rate, its shares will rise, and the company will have earned it.
2. Public scrutiny of Burford Capital was long overdue. The company has had the privilege of raising cheap public capital and enjoying an absurdly high valuation (from this vantagepoint, Burford Capital reminds us of Aurelius Equity Opportunities, whose shares are listed in Germany). The recent public skeptics/short sellers should be applauded for their work.
3. I commend Burford for putting together a conference call in response to the short report in a timely fashion. However, I also found some of their responses concerning:
    a. To paraphrase, the "we are lawyers, therefore (by inference) we are trustworthy" statement was very disturbing. When questions about dishonesty are met with ad hominem, appeal to authority responses, the risk of deception is high, according to former CIA/FBI intelligence officials.
    b. The explanation the company provided as to how the CFO became CFO seemed plausible but fails to explain why she has remained so. Seeing that Burford's accounting is in question, the company's response and tone to questions about the CFO were concerning.
    c. If Burford truly "listens" to investors as it claims, they should clarify or offer greater/additional disclosures. I can think of a few ways they can enhance disclosure without jeopardizing their cases.
    d. The response regarding changing their share listing from AIM to the main listing was not confidence inspiring.
4. We think Burford is inappropriately financed. Litigation assets – whose associated cash flows' size and timing are notoriously unpredictable – should not be financed with debt. This poses a real risk of an eventual asset/liability mismatch nightmare.
5. BUR should view the recent public scrutiny as an opportunity to improve its disclosures and governance.
6. Companies do not fail because of short sellers; I have not heard of a single example where that has been the case.