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UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF CALIFORNIA

BEAVER COUNTY EMPLOYERS
RETIREMENT FUND, et al.,

Plaintiffs,

v.

TILE SHOP HOLDINGS, INC., et al.,

Defendants.

Case Nos. 16-mc-80062-JSC
16-mc-80076 JSC

**ORDER RE: GOTHAM CITY
RESEARCH LLC'S COMPLIANCE
WITH SUBPOENAS**

Re: Dkt. No. 1

The present discovery dispute arises out of a putative securities class action pending in the United States District Court for the District of Minnesota. See *Beaver County Employers Retirement Fund v. Tile Shop Holdings, Inc.*, No. 14-cv-786-ADM-TNL (D. Minn.). Plaintiffs initiated the lawsuit following the publication of a negative report about defendant Tile Shop Holdings, Inc. ("Tile Shop") by Gotham City Research, LLC ("Gotham"), an investor who shorted Tile Shop stock. Both Plaintiffs and Defendants served third-party subpoenas on Gotham seeking documents and depositions. When Gotham failed to comply with the subpoenas, the parties filed separate actions to compel Gotham's compliance. See *Beaver County Employers Retirement Fund v. Tile Shop Holdings, Inc.*, No. 16-80062 (Plaintiffs' action); *Beaver County Employers Retirement Fund v. Tile Shop Holdings, Inc.*, No. 16-80076 (Defendants' action). The actions have been related and Gotham filed a joint opposition to the parties' separate motions to compel. Gotham objects to both subpoenas as shielded from production by the journalist privilege, seeking trade secrets, and as an undue burden.

The pending motions ask the Court to decide whether the federal qualified journalist privilege applies to an investor whose publications are limited to negative reports about the companies in which the investor has taken a short position. Having considered the parties' written submissions and having had the benefit of oral argument on June 2, 2016, the Court finds that the

United States District Court
Northern District of California

1 privilege does not apply to Gotham on the record presented here. The Court thus GRANTS
2 Plaintiffs’ motion in part, but DENIES Defendants’ motion because notwithstanding Gotham’s
3 unsuccessful privilege assertion, Defendants have not shown the relevance of the information they
4 seek.

5 **BACKGROUND**

6 Tile Shop is a specialty retailer of manufactured and natural stone tiles and related
7 accessories. (No. 16-80062, Dkt. No. 2-5 at ¶ 2.) In November 2013, Gotham, a company which
8 “focuses on due diligence-based investing,” published a report on its website regarding the Tile
9 Shop entitled: “Tile Shop: Like Crazy Eddie’s, but with an Undisclosed Related Party & a Chinese
10 Twist.” (No. 16-80062, Dkt. No. 2-3.) The Report disclosed that Tile Shop employee Fumitake
11 Nishi owned Beijing Pingxiu (“BP”), Tile Shop’s largest supplier, and that Nishi was the brother-
12 in-law of Tile Shop CEO Robert Rucker. (Id. at 9, 13, 16.¹) The Report suggested that Tile Shop
13 had not disclosed these relationships and that BP may only exist as a “phantom company” to allow
14 Tile Shop to engage in accounting manipulations and overstatement of earnings. (Id. at 9, 17.)
15 Gotham had taken a short position in Tile Shop stock prior to issuance of the Report. (Id. Dkt. No.
16 11-2 at ¶ 28.)

17 In the aftermath of Gotham’s report, Tile Shop stock price dropped by 39%. (Id., Dkt. No.
18 2-5 at ¶ 7.) Tile Shop thereafter launched an internal investigation which concluded that the
19 alleged relationships revealed in the Report were accurate, but that CEO Rucker did not have
20 knowledge of his brother-in-law’s involvement in BP. (Id.)

21 Plaintiffs’ putative class action lawsuit, filed shortly after the stock drop, alleges that Tile
22 Shop failed to disclose “several material, related-party relationships.” (Id. at ¶ 4.) In particular,
23 Plaintiffs allege that Tile Shop failed to disclose the relationship between Rucker and Nishi, the
24 relationship between Nishi and BP, and Nishi’s relationship with two other Tile Shop suppliers.
25 Plaintiffs allege that Rucker and other Tile Shop executives either knew or should have known of
26 Nishi’s relationship with BP and these other suppliers. (Id. at ¶ 8.) Plaintiffs contend that Tile
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28 ¹ Record citations are to material in the Electronic Case File (“ECF”); pinpoint citations are to the
ECF-generated page numbers at the top of the documents.

1 Shop’s failure to disclose these relationships violated various securities laws as did the misleading
2 and false statements Tile Shop made in its financial statements. (Id. at ¶¶ 99-158.)

3 Discovery is ongoing in the underlying action. Of relevance here, Plaintiffs propounded
4 document and deposition subpoenas to Gotham seeking (a) documents and communications that
5 identify all sources about the Rucker/Nishi relationship “including but not limited to” persons who
6 supplied the information; (b) names of former Tile Shop employees referred to in the Gotham
7 report; (c) documents and communications regarding the Report’s statement that ex-employees
8 say that Nishi and Rucker are related; and (d) all documents concerning the nature, scope and/or
9 extent of BP’s relationship with the Tile Shop, Nishi and/or Rucker, including any documents
10 obtained concerning such matters in connection with preparing the Gotham Report. (No. 16-
11 80062, Dkt. No. 2-1 at 9-10; Dkt. No. 2-2 at 6.) At oral argument, and with the Court’s
12 encouragement, Plaintiffs’ narrowed their request to the identity of Gotham’s sources regarding
13 Nishi’s involvement with BP. Defendants, for their part, seek a wider-range of information,
14 including Gotham’s Tile Shop trading reports. (No. 16-80076, Dkt. No. 2-5 at 11; Dkt. No. 2-6 at
15 28.) Gotham objects to both subpoenas.

16 LEGAL STANDARD

17 Federal Rule of Civil Procedure 26(b) allows a party to obtain discovery concerning any
18 nonprivileged matter that is relevant to any party’s claim or defense provided that it is
19 “proportional to the needs of the case, considering the importance of the issues at stake in the
20 action, the amount in controversy, the parties’ relative access to relevant information, the parties’
21 resources, the importance of the discovery in resolving the issues, and whether the burden or
22 expense of the proposed discovery outweighs its likely benefit.” Fed. R. Civ. P. 26(b)(1). Parties
23 may seek discovery within the scope of Rule 26(b) by deposing a witness pursuant to Rule 30 or
24 serving requests for production of documents pursuant to Rule 34.

25 Rule 45, in turn, governs discovery of nonparties by subpoena. The scope of discovery
26 under Rule 45 is the same as under Rule 26(b). Fed. R. Civ. P. 45 Advisory Comm.’s Note
27 (1970)); Fed. R. Civ. P. 34(a). A court must quash or modify a subpoena that requires disclosure
28 of privileged or other protected matter if no exception or waiver applies or that subjects a person
to undue burden. Fed. R. Civ. P. 45(d)(3)(A)(iii)(iv). A court may quash or modify a subpoena

1 which would disclose a “trade secret or other confidential research, development, or commercial
2 information.” Fed. R. Civ. P. 45(d)(3)(B).

3 Generally, “[t]he party issuing the subpoena must demonstrate that the information sought
4 is relevant and material to the allegations and claims at issue in the proceedings.” *Optimize Tech.
5 Solutions, LLC v. Staples, Inc.*, No. 14-MC-80095, 2014 WL 1477651, at *2 (N.D. Cal. Apr. 14,
6 2014).

7 **DISCUSSION**

8 Gotham objects to both subpoenas on the same grounds: (1) that the information sought is
9 protected by the journalist privilege, (2) that responding to the subpoenas would require Gotham
10 to divulge trade secret confidential business and operational information, and (3) that the
11 subpoenas impose an undue burden.

12 **I. Plaintiffs’ Motion to Compel**

13 **A. Identification of Gotham’s Sources**

14 Plaintiffs seek the identity of Gotham’s sources about Nishi’s involvement with BP given
15 that Rucker denies knowing his brother-in-law owned and operated BP. They contend that these
16 potential witnesses are relevant to establish scienter. “[I]f employees or business partners were
17 aware of Nishi’s ownership and operation of BP, Tile Shop executives—including Nishi’s brother-
18 in-law, CEO Robert Rucker . . . were also likely aware.” (Dkt. No. 1 at 2.)

19 **1) The Journalist Privilege**

20 “[W]hen facts acquired by a journalist in the course of gathering the news become the
21 target of discovery, a qualified privilege against compelled disclosure comes into play.” *Shoen v.
22 Shoen*, 5 F.3d 1289, 1292 (9th Cir. 1993) (“*Shoen I*”). “Rooted in the First Amendment, the
23 privilege is a recognition that society’s interest in protecting the integrity of the newsgathering
24 process, and in ensuring the free flow of information to the public, is an interest of sufficient social
25 importance to justify some incidental sacrifice of sources of facts needed in the administration of
26 justice.” *Id.* (internal quotation marks and citation omitted). A person may invoke the journalist’s
27 privilege if the person had “the intent to use material—sought, gathered or received—to
28 disseminate information to the public and such intent existed at the inception of the newsgathering

1 process.” *Id.* at 1293. Gotham bears the burden of showing that it may assert the privilege. *Id.* at
2 1296.

3 Plaintiffs contend that Gotham does not qualify for the journalist privilege because it only
4 publishes reports about companies in which it has taken a financial position prior to publication.
5 The Court agrees. Gotham chooses which reports to publish based on its own trading needs.
6 Daniel Yu, Gotham’s “founder, publisher, and editor,” declares that if through its research it finds
7 that “a company’s reported financial information or business information is materially misleading,
8 then Gotham takes a short position in the company’s stock before issuing its report.” (Dkt. No.
9 11-2 ¶ 6.) Thus, its decision to publish is based on its needs; specifically, whether it has decided
10 to take a short position in the target of its investigation, and not on whether the report is
11 newsworthy. Newsworthiness and its needs may overlap, but the primary motivation for
12 Gotham’s publication is to disseminate the negative information so that it can profit on its short
13 position.

14 The Court therefore finds that Gotham does not have the intent at the inception of its
15 newsgathering process “to use material—sought, gathered or received—to disseminate
16 information to the public.” *Shoen I*, 5 F.3d at 1293. Instead, the Court finds that Gotham’s intent,
17 as attested to by Mr. Yu, is to disseminate the information to the public only if “a company’s
18 reported financial information or business information is materially misleading” and Gotham has
19 taken a short position in the company. (No. 16-80062, Dkt. No. 11-2 ¶ 6.) Mr. Yu’s assertion that
20 “[w]henever Gotham gathers information about a company, it is [Gotham’s] intent to publish that
21 information to the public” and that “Gotham has published the results of its findings about all the
22 companies it investigated” (*id.* at ¶¶ 2, 5), does not persuade the Court otherwise. Mr. Yu does not
23 dispute that Gotham had taken a short position in all of the companies on which it published
24 reports. Indeed, Gotham’s website advises the reader to “assume that as of the publication date of
25 the reports found on this website, GOTHAM CITY RESEARCH LLC stands to profit in the event
26 the issuer’s stock declines.” See <https://gothamcityresearch.com/> (last visited May 31, 2016).
27 Gotham’s Tile City Report also makes the same disclosure. (No. 16-80062, Dkt. No. 2-3 at 3.)
28 And Mr. Yu does not attest that if the information Gotham gathered about a company is otherwise
newsworthy, although not revealing materially misleading financial information, Gotham will still

1 publish a report. Nor does he attest that if for whatever reason Gotham is unable to take a short
2 position in a company it will still publish a report. The Court therefore finds that Gotham has not
3 and would not publish a report about a company in which it does not have a financial interest. On
4 this record, the journalist privilege does not apply.

5 The circumstances here are similar to *In re Fitch, Inc.*, 330 F.3d 104 (2d Cir. 2003). There,
6 the Second Circuit held that Fitch, a company in the business of analyzing and rating securities
7 and debt offerings, could not invoke the journalist privilege. Fitch argued “that it conducts
8 research, fact-gathering, and analytical activity that is directed towards matters of general public
9 concern, just like any journalist,” and that it makes its information available to the public for free
10 on its website. *Id.* at 109. The court held, however, that Fitch only writes about its own clients—
11 the issuers who pay Fitch a fee—and that this fact weighed against treating Fitch like a journalist.
12 The court reasoned that “Fitch’s information-disseminating activity does not seem to be based on
13 a judgment about newsworthiness, but rather on client needs.” *Id.* The same is true for Gotham.
14 Gotham’s information-disseminating activity is not based on a judgment about newsworthiness,
15 but rather on its own financial needs and whether it can make a profit by shorting the company on
16 which it publishes its report. This motivation is substantively no different from Fitch only
17 publishing reports on clients who pay it to analyze their issues and thus weighs against a finding
18 that the privilege applies.

19 The Fitch court was also persuaded by Fitch’s role in structuring the transactions which it
20 was rating. *Id.* at 110-11. Although not explicitly stated by the court, the concern seemed to be
21 that Fitch was therefore not independent of the companies it was rating. Gotham’s short position
22 in the companies on which it publishes reports raises the same concern. Given its financial
23 interest in the share price of the companies on which it reports, Gotham is not independent;
24 indeed, Gotham makes that explicit in the reports and on its website. The Court is not suggesting
25 that the journalist privilege automatically does not apply to anyone who has a financial interest in
26 the subject of the publication at issue; rather, under the circumstances here, where Gotham only
27 publishes reports on companies in which it has first taken a short position, it is not entitled to
28 shield relevant information from discovery.

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In re Pan Am Corp., 161 B.R. 577 (S.D.N.Y 1993), a case involving whether the S & P, a ratings agency, could assert the journalist privilege, is distinguishable. There, the court found that the record did not support a finding “that economic factors predominate [the S & P’s] rating activities” because the S & P did not limit its ratings to companies who paid it a fee; instead, the S & P rated all stock issues and debt financings regardless of whether the issuer requested the ratings or paid a fee. *Id.* at 583; see also *Fitch*, 330 F.3d at 109 (distinguishing *Pan Am* on the grounds that the S & P, unlike *Fitch*, rated all stock issues). Not so here. *Gotham* only publishes reports on companies in which it has taken a short position.

That *Gotham* itself takes the short position, rather than being paid by an investor who takes the short position, is a difference without a distinction. In both circumstances the judgment on whether to publish is not based on newsworthiness, but rather on whether the publication is likely to affect the stock price of the report’s target.

* * *

On the record before the Court *Gotham* has not met its burden of showing that the qualified journalist privilege applies.

(2) Compelling Need

Even if the journalist privilege applied, it is only a qualified privilege. The privilege can be overcome if the requesting party can demonstrate a sufficiently compelling need for the journalist’s materials. *Shoen I*, 5 F.3d at 1296. “[A] civil litigant is entitled to requested discovery notwithstanding a valid assertion of the journalist’s privilege by a nonparty only upon a showing that the requested material is: (1) unavailable despite exhaustion of all reasonable alternative sources; (2) noncumulative; and (3) clearly relevant to an important issue in the case.” *Shoen v. Shoen*, 48 F.3d 412, 416 (9th Cir. 1995) (“*Shoen II*”).

Plaintiffs contend they have exhausted all reasonable alternative sources and that *Gotham*’s identification of its sources regarding *Nishi*’s relationship to *BP* is critical to establishing scienter. There is no question that the information sought—the identity of potential witnesses—is relevant. Whether Plaintiffs have a compelling need for this information hinges on whether Plaintiffs have attempted to obtain this information from other sources and whether it is cumulative.

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Gotham suggests that Plaintiffs must depose all the ex-employees who worked during the time period in question, Rucker, his wife, other family members, board members and Tile Shop executives, business associates and anyone else who might have known, but this is plainly not required by Shoen. Gotham’s reliance on *Goldberg v. Amgen*, 123 F.Supp.3d 9 (D. D.C. 2015), is unavailing. There, the court emphasized that “this is not the kind of case where the possible alternative sources are indefinite in number or so ill-defined as to make it utterly unreasonable to expect a party to meet the exhaustion requirement,” but there were a discrete list of 25 or 26 individuals who might have the information sought. *Id.* at 18. Here, in contrast, the universe of individuals with potentially relevant information is much broader because as of the time of the Gotham report Tile Shop had 1,214 employees and countless business partners. Discovery closes in less than a month, and Plaintiffs have already taken several depositions, including of Rucker. They have a need for the names of other witnesses with potentially relevant information.

On the question of cumulativeness, Gotham notes that Plaintiffs’ complaint alleges that they already have ex-employee sources who have confirmed that “Rucker and other Tile Shop executives knew or reasonably should have known about the involvement of Rucker’s family members—particularly Nishi—in operating BP and supplying product to the Company.” (No. 16-80062, Dkt. No. 2-5 at ¶ 36.) But that allegation is not the same as alleging possession of dispositive, undisputed evidence that Rucker knew of Nishi’s involvement with BP. The identity of the potential witnesses is not cumulative.

In sum, even if the Court were to find that the journalist privilege applied, Plaintiffs have a sufficiently compelling need for the identities of Gotham’s sources for its report about Nishi’s involvement with BP.

3) Trade Secret Protection

Gotham also complains that its sources are a protected trade secret. “Broad allegations of harm, unsubstantiated by specific examples or articulated reasoning, do not satisfy the Rule 26(c) test.” *Beckman Indus., Inc. v. Int’l Ins. Co.*, 966 F.2d 470, 476 (9th Cir.1992) (quotations and citations omitted). Gotham has not shown that the information sought here—the specific sources for its report about Nishi’s relationship to BP—is a protected trade secret. In any event, as stated at oral argument, the Court is ordering that the information be disclosed pursuant to an attorneys’

1 eyes only protective order, and the parties are directed to the Northern District of California's
2 model protective orders. Such protections alleviate any trade secret concerns. The protections are
3 also appropriate because how Plaintiffs obtained the names of potential witnesses—that is, that
4 they received the information from Gotham—is irrelevant. What is relevant is what the potential
5 witnesses say about Nishi, BP and Tile Shop. Plaintiffs cannot know what they say until Plaintiffs
6 know who they are.

7 **4) Undue Burden**

8 The relief the Court is ordering—Gotham's identification of its sources for its assertion
9 regarding Nishi's involvement with BP—does not place an undue burden on Gotham. While
10 Gotham could produce this information by deposition, it could also agree with Plaintiffs to
11 produce it in another less burdensome format and the parties are ordered to meet and confer and
12 agree by Friday, June 10, 2016 on the method and timing of the production of the information.

13 **II. Defendants' Motion to Compel**

14 Defendants propounded a broad subpoena seeking documents and a deposition.
15 Defendants seek all documents relating to Gotham's Report, all documents relating to Tile Shop,
16 Rucker, and several other identified individuals, all of Gotham's communications with Plaintiffs,
17 Plaintiffs' counsel and several others, and all trading records related to Tile Shop.² (No. 16-
18 80076, Dkt. No. 2-5 at 16-34.) Gotham asserts that it is not withholding any responsive
19 documents other than its trading records, but it refuses to produce those records or sit for a
20 deposition.

21 The Court declines to compel compliance with Defendants' subpoenas because they seek
22 irrelevant information. Defendants contend that Gotham intentionally misrepresented the facts in
23 its Report to drive down the Tile Shop share price and profit from its short position. They argue:

24 If the Tile Shop Defendants can demonstrate that the Gotham Report
25 was an untrue, unfounded attempt to manipulate the market, it can
26 rebut plaintiffs' claimed damages and causation in the
27 Minnesota action. The Tile Shop Defendants believe that the stock-

28 ² Defendants also seek deposition testimony regarding these and other topics including any posts
Gotham has made on any public websites relating to investing, the basis for Gotham's invocation
of the journalist privilege, and any public or non-public statements Gotham may have made
regarding the Tile Shop or anyone affiliated with the Tile Shop. (No. 16-80076, Dkt. No. 2-6 at
28-32.)

1 price drop that plaintiffs rely upon for their damages was caused by
2 something other than dissemination of relevant, true facts
3 uncovering a fraud; instead, it was really a reaction to the false
4 information and speculations included in the Gotham Report. This
5 evidence would refute plaintiffs' damages theory.

6 (Dkt. No. 16 at 3:11-16.) But Defendants do not require information from Gotham to prove that
7 the statements in the Report were wrong; Defendants possess that information. For example,
8 Defendants contend that the Report inaccurately stated that Tile Shop's fraud would require Tile
9 Shop to restate several years' historical results. (Id. at 3:1-2.) Defendants themselves possess all
10 the information needed to disprove that assertion.

11 Gotham's Tile Shop trading reports are likewise irrelevant. Defendants insist they need
12 the trading reports to show Gotham's financial interest in Tile Shop's share decline and thus assail
13 Gotham's credibility. But Gotham's credibility is not at issue; Defendants' credibility and the
14 alleged falsity of its statements to the market is what is at issue. To the extent they need evidence
15 of Gotham's financial interest as case background, Plaintiffs' motion to compel asserts that fact as
16 a given; thus, the parties should have no difficulty stipulating to that fact. And, in any event,
17 Gotham has now submitted a declaration in which it states that it takes a short position in a
18 company before it publishes its reports. The specific amount of profit Gotham made from its
19 trades is not at issue in the securities fraud action. Accordingly, Tile Shop's motion to compel is
20 denied.

21 CONCLUSION

22 The federal common law journalist privilege does not apply to Gotham. Accordingly,
23 Gotham must identify its sources (that is, the potential witnesses) of its report regarding Nishi's
24 involvement with BP. Plaintiffs and Gotham shall meet and confer and agree by Friday, June 10,
25 2016 on the timing and method of Gotham's disclosure. Although the privilege does not apply,
26 Defendants have not met their burden of showing that the information they seek is relevant to the
27 issues in the underlying securities fraud action. Accordingly, Defendants' motion to compel is
28 denied.

IT IS SO ORDERED.

Dated: June 7, 2016


JACQUELINE SCOTT CORLEY
United States Magistrate Judge