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Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

9th Circ. Case Could Gut Section 11 Shareholder Protections

By **John Browne and Lauren Ormsbee** (May 26, 2021, 3:55 PM EDT)

John Browne

Lauren Ormsbee

The U.S. Court of Appeals for the Ninth Circuit is on the verge of deciding whether a new initial public offering mechanism will strip shareholders of any way to enforce liability under the Securities Act of 1933.

This case — Pirani v. Slack Technologies Inc. — was first decided in the shareholders' favor last year by U.S. District Judge Susan Illston of the U.S. District Court for the Northern District of California.

But the defendants sought, and were granted, immediate appeal to the Ninth Circuit, where the defendants seek to avoid all strict liability under the Securities Act by commingling both registered and unregistered shares in initial public offerings.

If the defendants prevail in the Ninth Circuit, that decision would erode nearly 100 years of protections, all made possible by a dramatic and rapid rule change approved by the U.S. Securities and Exchange Commission at the end of 2020.

Will Courts Strip Section 11 Liability From Direct Listings?

Wall Street's love affair with special purpose acquisition companies, or SPACs, has dominated the financial press in recent months. But with all eyes focused on SPACs, another fundamental change sweeping the IPO markets has flown under the radar.

Between 2018 and 2020, the SEC revolutionized the way companies are permitted to go public, allowing them to avoid the traditional IPO format by issuing securities through a direct listing on one of the major stock exchanges.[1]

While the new regulations have garnered praise from the world of corporate finance, they raise a significant question with far-reaching implications: Were the SEC's rule changes intended to entirely overturn traditional notions of civil liability under the Securities Act?

The Pirani v. Slack case will answer that question and likely determine whether companies and their executives who conduct direct listings can face any liability under the Securities Act for false and misleading statements made in the publicly filed registration statements associated with the direct listing.

Although the case has received surprisingly little focus, the upcoming decision in this case could have grave consequences for shareholders.

At issue in Slack is a legal technicality called tracing, a requirement that an investor seeking to recover under the Securities Act for a material misstatement or omission in a registration statement show that the purchased securities were "issued pursuant or traceable to" the deficient registration statement.[2]

If the Ninth Circuit holds that the tracing requirement must be strictly applied in the context of direct listing IPOs, it will usher in a frightening new world where, for the first time since 1933, investors will have no ability to sue companies under the Securities Act for false and misleading statements.

The Looming Boom in Direct Listings

The evolutionary cycle of direct listings was exceedingly rapid.

In February 2018, the SEC approved a rule change permitting early investors or insiders of certain private corporations to directly list their shares for resale on the New York Stock Exchange, thus bypassing the traditional IPO process.

In December 2020, the SEC approved another rule change permitting private companies with a valuation of at least $250 million to issue new shares from the corporation and sell them directly to the public in direct listing IPOs.

In April 2018, audio streaming company Spotify Technology SA completed the first direct listing under these new rules, and in June 2019, software company Slack completed the second major direct listing under this new regime.

While there were only six IPO direct listings in the three years between 2018 and 2020, this year from March 10 to May 5, five companies valued collectively at over $150 billion, including Roblox Corp. and Coinbase Inc., entered the market through IPO direct listings.

Wall Street's rapid adoption of direct listings, coupled with the December 2020 rule change allowing corporations themselves to raise capital through direct listings, suggests that the heightened activity over the past few months is just the tip of the iceberg and multiple companies will be conducting direct listing IPOs in the coming years.

Unintended Legal Consequences of Direct Listings?

The public discussion surrounding direct listings initially focused on allowing early investors to monetize their shareholdings and, later, on paving an easier route to the public markets for supposedly well-capitalized companies.

But savvy corporate law firms noticed another advantage of direct listings — they could eliminate shareholder lawsuits under the Securities Act.

The Securities Act, passed in the wake of the stock market crash of 1929, requires companies issuing new securities to register the shares pursuant to a registration statement disclosing specified and truthful information about the company and its finances.

Importantly, the Securities Act also provides shareholders with powerful civil claims for misrepresentations or omissions in those registration statements. It imposes strict liability against corporations even for innocent misstatements, reflecting the legal principle described in a 1988 Ohio State Law Journal article on the Securities Act, which states that "if one of two innocent persons must bear the loss, that person should bear it who has the opportunity to learn the truth and has allowed the untruths to be published and relied upon."[3]

In December 2019, attorneys from Latham & Watkins LLP, the firm that represented Spotify and advised Slack in their direct listing IPOs, published an article noting that an "important advantage of the direct listing" was that it could prevent shareholder litigation under Section 11 of the Securities Act because it is "difficult (if not impossible)" to meet Section 11's tracing requirement in the context of a direct listing.[4]

A Case of First Impression

That article proved prescient. The applicability of tracing to direct listings was put to the test when a Section 11 action was filed in September 2019 on behalf of investors who acquired Slack common stock "pursuant to or traceable to the Offering Materials issued in connection with the listing."

The defendants moved to dismiss on the grounds that neither the plaintiff nor any other Slack investor had Section 11 standing, arguing that case law requires "that a plaintiff's purchased shares must be traced to the defective registration statement, which is impossible to do here."[5]

The plaintiff agreed that it would be impossible to satisfy a strict application of the tracing requirement in a direct listing. This is because of a fundamental difference between a traditional IPO and a direct listing.

In a traditional IPO, all of the shares in circulation following the IPO are registered pursuant to a registration statement filed by the company and approved by the SEC. The Wall Street banks acting as underwriters then impose a lockup period on insiders, which prevents them from selling their (unregistered) shares into the market for several months.

Thus, any investor purchasing a company's shares during the lockup period knows with certainty that the shares were issued pursuant to the registration statement — those are the only shares in circulation.

By contrast, in a direct listing there are no underwriters and no lockup period, so both registered shares sold pursuant to the direct listing registration statement and unregistered shares held by insiders become available for trading on public exchanges on the same day.

Because registered and unregistered shares are indistinguishable from one another the moment they begin trading, it is impossible to know whether any given share was issued pursuant to the registration statement or began life as an unregistered share sold by an insider.[6]

Faced with this as an issue of first impression, the district court noted that the traceability requirement developed out of a line of case law interpreting ambiguous language in the Securities Act.

Section 11 provides that in the event of a defective registration statement, "any person acquiring such security" may bring suit to recover damages. The term "such security" was first interpreted in 1967 by the U.S. Court of Appeals for the Second Circuit in Barnes v. Osofsky.

U.S. Circuit Judge Henry Friendly noted that the term could be read narrowly to mean that the security must be "issued pursuant to the registration statement," or more broadly to mean a security "of the same nature as that issued pursuant to the registration statement."[7]

While Judge Friendly adopted the narrow reading, he stated that it "would not be such a violent departure from the words that a court could not properly adopt [the broader meaning] if there would be good reason for doing so."

Of course, in Barnes, Judge Friendly was not interpreting the Securities Act in the context of a direct listing — the very concept was more than 50 years in the future. Nonetheless, a strict application of the tracing requirement announced in Barnes and adopted in subsequent case law would, in the words of the district court in Slack, "cause the elimination of civil liability under the Securities Act," a result that is at odds with the "central purposes" of the statute.[8]

The district court in Slack reviewed the legislative history of the Securities Act and found it to be remedial in nature. It then noted that adopting the narrow reading of the term "such security" would lead to an absurd result plainly at odds with the intent and purpose of Section 11.

For these reasons, the court denied the defendants' motion to dismiss and held that tracing could be established by purchasers of "a security of the same nature as that issued pursuant to the registration statement" — i.e., purchasers of either registered or unregistered securities.

What's Next?

The district court certified this issue for appeal to the Ninth Circuit, which held oral argument on May 13.[9] An opinion is likely to be issued this year.

While the SEC did not file an amicus in the appellate briefing, it is notable that, in approving the August 2020 rule change, the SEC assuaged investor concerns over the nullification of Section 11 by pointing to the Slack opinion and noting that the "court ruled in favor of allowing the plaintiffs to pursue Section 11 claims."

If the Ninth Circuit overrules the district court and adheres to an overly rigid interpretation of prior precedent, the result could be catastrophic to shareholder rights in all direct offerings going forward.

As the plaintiffs in Slack argued, to demand that investors satisfy the standard tracing analysis here would eviscerate the rights afforded by Section 11 and allow companies to eliminate Section 11 liability by releasing nonregistered shares into the market at the same time as registered shares.

If companies planning direct listings are given the green light by the Ninth Circuit to evade liability by commingling registered and unregistered shares in an initial offering, shareholders will lose one of the most important enforcement tools available to them, neutering the nearly century-old remedial powers of Section 11.

John C. Browne and Lauren Ormsbee are partners at Bernstein Litowitz Berger & Grossmann LLP.

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[1] See Exchange Act Release No. 90768 (Dec. 22, 2020).

[2] See 15 U.S.C. § 77k(a); see also In re Century Aluminum Co. Secs. Litig., 729 F.3d 1104, 1107-08 (9th Cir. 2013).

[3] Elisabeth Keller, "Introductory Comment: Historical Introduction to the Securities Act of 1933 and the Securities Exchange Act of 1934," Ohio State Law Journal 49 (1988) at 345.

[4] See Complex and Novel Section 11 Liability Issues of Direct Listings, Corporate Counsel (December 20, 2019), at 1.

[5] Pirani v. Slack Tech., Inc., 445 F. Supp. 3d 367, 376 (N.D. Cal. 2020).

[6] Insiders can sell their unregistered shares after a company becomes public pursuant to an exemption from registration under SEC Rule 144. 17 C.F.R. § 230.144.

[7] 373 F.2d 269, 271 (2d Cir. 1967).

[8] 445 F. Supp. 3d at 381.

[9] An audio recording of the oral argument can be found here: https://www.ca9.uscourts.gov/media/view.php?pk_id=0000036797.

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