Cooley

US Supreme Court to Hear Direct Listing Appeal

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On December 13, 2022, the US Supreme Court granted Slack's petition for a writ of certiorari, which urged the Court to review the Ninth Circuit's ruling that shareholders in a direct listing have standing to sue under Sections 11 and 12 of the Securities Act of 1933. The Court's opinion in this closely-watched case is expected to have important implications for whether investors can bring suit against companies that go public by way of direct listing. Catch up on the Ninth Circuit's 2-1 decision – and Judge Miller's dissent – in the post below.

Ninth Circuit Rejects 'Direct Listing' Carve-Out from Securities Act Liability

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On September 20, 2021, the United States Court of Appeals for the Ninth Circuit issued its much anticipated decision in *Pirani v. Slack Technologies, Inc.*, which raised the novel question (a question of first impression, according to the panel) of whether shareholders lack standing to sue under Sections 11 and 12(a)(2) of the Securities Act of 1933 ("Securities Act") when an issuer goes public via a "direct listing," as opposed to the traditional firm commitment underwritten initial public offering. In a split 2-1 decision, the panel of the Ninth Circuit held that shareholders in a direct listing have standing to sue under Sections 11 and 12 because the public sale of shares (whether registered or unregistered) "cannot occur without the only operative registration in existence," noting that a contrary interpretation "in a direct listing context would essentially eliminate liability for misleading or false statements made in a registration statement in a direct listing *for both registered and unregistered shares.*" (emphasis added).

In a direct listing, both registered and unregistered shares are immediately available for sale to the public, whereas in a traditional underwritten IPO only registered shares are sold, and the underwriters typically require company employees and early investors with unregistered shares to agree to a six-month "lock-up" period. Thus, following a traditional underwritten IPO, during the lock-up period, and absent an intervening secondary offering, the only publicly traded shares are those issued pursuant to the offering materials (registration statement and prospectus). However, because brokers do not keep track of which shares were issued to whom and when, once the lock-up expires it becomes impossible to distinguish the previously registered shares from the unregistered shares that start to get sold into the market by company insiders who were previously subject to lock-up agreements. In contrast, the shares made available through a direct listing are sold directly to the public and not through a bank, so there is no lock-up agreement restricting the sale of unregistered shares. Thus, from the first day of a direct listing, both registered and unregistered shares may be sold to the public and, consequently, the tracing problems which exist in a traditional underwritten IPO after the expiration of the lock-up exist from day one in a direct listing.

The distinction in offering forms has potentially serious ramifications for shareholders who wish to sue under Sections 11 and 12(a) of the Securities Act. While both sections of the Securities Act impose strict liability for any "untrue statement of a material fact or a material fact," in a registration statement (15 U.S.C. §77k(a)) or "prospectus" (*id.* at §77l(a)(2)), the Securities Act limits the class of plaintiffs who can sue: Section 11 provides standing only to "any person acquiring such security" (*id.* at §77k(a)), while Section 12 provides standing only "to the person purchasing such security" (*id.* at § 77l(a)). Prior to the Ninth Circuit's decision in *Slack*, every Court of Appeal to consider the issue had interpreted the statutory language "such security" to mean that, in order to have standing, a shareholder needed to prove that its shares were issued under the allegedly false or misleading registration statement at-issue. However, unlike in a direct listing, each of those cases (as both the majority and dissent note in *Slack*) involved successive registrations "whereby a company issues a secondary offering to the public such that there are multiple registration statements under which a share may be registered, and other tracing challenges stemming from an IPO." If interpreted narrowly to direct listings, as Slack argued at both the district court and on appeal, these precedents could have the effect of eliminating Section 11 and 12 liability for plaintiffs who, like Pirani in *Slack*, cannot prove that their shares (because they don't know whether they bought registered or unregistered shares) were issued under the registration statement that is claimed to be false and misleading.

Concerned that adoption of Slack's argument would "obviate" Securities Act liability in the context of direct listings, the

district court denied Slack's motion to dismiss and adopted a broad interpretation of "such security" that had initially been contemplated, but was rejected, in the seminal tracing case *Barnes v. Osofsky*, 373 F.2d 269 (2d Cir. 1967). Specifically, the district court interpreted "such security" to mean all securities "of the same nature as that issued pursuant to the registration statement." This interpretation applied to a direct listing meant that any holder of "a security of the same nature as that issued pursuant to the registration statement" had standing to sue under Section 11. On June 5, 2020, the district court certified its decision for interlocutory review, and, on July 23, 2021, the Ninth Circuit granted Slack's petition under 28 U.S.C. § 1292(b).

In its published 2-1 decision, the panel of the Ninth Circuit affirmed the decision of the district court, although on a different legal basis, finding that "Pirani had standing to bring a claim under Section 11 and Section 12(a)(2) because Pirani's shares could not be purchased without the issuance of Slack's registration statement, thus demarking these shares, whether registered or unregistered, as 'such security' under Sections 11 and 12 of the Securities Act." In reaching that conclusion, the panel made clear that it was not adopting the district court's "broad meaning" of "such security:" rather, it looked "directly to the text of Section 11 and the words 'such security'" to determine "what does 'such security' mean under Section 11 in the context of a direct listing." However, as the dissent correctly notes, "the Court never analyzes the text," of the statute focusing instead on the NYSE rule that requires a company "to file a registration statement in order to engage in a direct listing." Because there is no lock-up with underwriters in a direct listing, "at the time of the effectiveness of the registration statement, both registered and unregistered shares are immediately sold to the public on the exchange . . . Thus, in a direct listing, the same registration statement makes it possible to sell both registered and unregistered shares to the public. Slack's unregistered shares sold in a direct listing are 'such securities' within the meaning of Section 11 because their public sale cannot occur without the only operative registration in existence. Any person who acquired shares through its direct listing could do so only because of the effectiveness of its registration statement." In other words, *but for* the registration statement, none of the listed shares could have been sold on the exchange, whether they were registered or unregistered.

It was on this basis that the majority distinguished the Ninth Circuit's (and other court's) prior rulings involving "successive registrations" holding that "ecause this case involves only one registration statement, it does not present the traceability problem identified by this court in cases with successive registrations . . . All of Slack's shares sold in this direct listing, whether labeled as registered or unregistered, can be traced to that one registration." In response to Slack's argument that the Ninth Circuit should apply "Section 11 to direct listings in the same way it has in cases with successive registration statements,"—specifically, Slack "argue that past cases in this circuit and others limit the meaning of 'such security' in Section 11 to only registered shares"—the Court countered on public policy grounds, asserting that Slack's interpretation "would undermine this section of the securities law" by "essentially eliminat Section 11 liability" in this context: specifically, "from a liability standpoint it is unclear why any company, even one acting in good faith, would choose to go public through a traditional IPO if it could avoid any risk of Section 11 liability by choosing a direct listing. Moreover, companies would be incentivized to file overly optimistic registration statements accompanying their direct listings in order to increase their share price, knowing that they would face no shareholder liability under Section 11 for any arguably false or misleading statements. This interpretation of Section 11 would create a loophole large enough to undermine the purpose of Section 11 as it has been understood since its inception."

With respect to Section 12, the panel noted that "Section 12 liability . . . is consistent with Section 11 liability," so "t follows from the analysis of 'such security' in Section 11, that the shares at issue in Slack's direct listing, registered and unregistered, were sold 'by means of a prospectus' because the prospectus was a part of the offering materials . . . that permitted the shares to be sold to the public." Thus, the panel held, "neither the registered nor unregistered shares would be available on the exchange without the filing of the offering materials."

In a sharply worded dissent, Circuit Judge Eric D. Miller took the majority to task for what he perceived were "concern that it would be bad policy for a section 11 action to be unavailable when a company goes public through a direct listing." Specifically, Judge Miller noted that "while the factual setting of the case may be novel, the legal issues it presents are not," he would have applied the long line of precedent from Section 11 cases that involved successive registrations statements, stating that "nothing in the reasoning of the cases suggests that the distinction should matter. In cases involving successive registrations, we did not invent a requirement that a plaintiff's shares must have been issued under the registration statement because we thought it seemed like a good idea; we interpreted the statutory text to impose that requirement.…If 'such security' means that plaintiffs must have purchased shares 'issued under the allegedly false or misleading registration statement' in successive-registration cases,…then that is also what it means in direct-listing cases." Acknowledging that the implications of applying that case law to a direct listing would mean that all shareholders would lack standing to sue under Section 11, Judge Miller stated that "whatever the merit of the policy considerations, they are no basis for changing the settled interpretation of the statutory text"; rather, "he place to make new legislation, or address unwanted consequences of old legislation, lies with Congress."

It remains to be seen how Slack will respond to the Ninth Circuit's decision, but given the current composition of the

United States Supreme Court, and absent the full Ninth Circuit overturning the panel's decision on a rehearing en banc, it's highly likely that Slack will submit a petition for a writ of certiorari based on the statutory interpretation arguments set forth in Judge Miller's dissent. In the interim, it is the law of the Ninth Circuit that plaintiffs—regardless of whether they can prove they bought registered or unregistered shares—have standing to sue under Sections 11 and 12(a)(2) of the Securities Act when an issuer goes public through a direct listing. However, because the panel was also clear that the Ninth Circuit's decisions involving successive, or multiple, registration statements, remain good law, outside of the direct listing context, to have standing under Sections 11 and 12(a)(2), plaintiffs still must be able show that they bought shares that were issued under the allegedly false and misleading registration statement.

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