SHAREHOLDERS GET SOME SLACK ON SECTION 11, DIRECT LISTING PLEADING STANDARD

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This past September, the United States Court of Appeals for the Ninth Circuit held that shareholders who purchased securities in Slack's direct listing have standing under Section 11[1] of the Securities Act of 1933 (Securities Act) to sue the company for misrepresentations in its registration statement, even if they cannot prove that their shares were issued under the challenged registration.[2] To rule otherwise, the split-panel majority wrote, would leave buyers of both registered and unregistered shares in a direct listing without any avenue for relief under Section 11.[3] *Pirani v. Slack Technologies, Inc.* is the first case to address Section 11 liability in a direct listing, a new method of going public approved by the SEC in 2018.[4] And the case has controversially eliminated the tracing requirement – the need for plaintiffs to "trace" the shares they purchased to the challenged registration statement[5] – to effect Section 11 liability for a direct listing, counter to precedent in cases concerning successive registration statements[6] in traditional underwritten initial public offerings (IPOs).[7]

Significant differences exist between an underwritten IPO and a direct listing. In the former, a company may sell only registered shares to the public for the first six-months if the underwriting bank requires—and it generally does—owners of unregistered shares to agree to this "lock up" period.[8] This restriction postpones the tracing issue; although it is impossible to differentiate registered from unregistered shares, buyers can still trace their registered shares to the registration statement during the lock-up period because only registered shares can be purchased.[9] Once the lock-up period expires, however, both types of shares are released for sale, creating tracing problems that, for the past few decades, have barred plaintiffs from asserting Section 11 standing.[10]

In contrast, tracing issues manifest from the onset of a direct listing because both registered and unregistered shares can be immediately and directly sold to the public.[11] This is because a direct

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[1] 15 U.S.C. § 77k(a). Plaintiff also sued under Section 12(a)(2), which imposes liability on a person who "offers or sells a security" to the public by a false or misleading prospectus or oral communication. 15 U.S.C. 77l(a)(2). For the sake of brevity, this article focuses on the Court's Section 11 analysis, but the Court applied the same reasoning in analyzing whether plaintiff had standing under the Section 12(a)(2) claim. *Pirani*, 13 F.4th 940, 949 (9th Cir. 2021) ("For the purposes of our analysis, Section 12 liability . . . is consistent with Section 11 liability.").

[2] *Pirani*, 13 F.4th at 949.

[3] *Id.* at 948.

[4] *Id.* at 944 (citing SEC Approval 2018, 83 Fed. Reg. at 5653–54).

[5] *See* 15 U.S.C. §77k(a); Pirani, 13 F.4th at 946.

[6] Successive registration cases involve companies issuing stock in multiple public offerings, creating multiple registration statements under which a share may be registered. *Pirani*, 13 F.4th at 946.

[7] *Pirani*, 13 F.4th at 946 (citing *Hertzberg v. Dignity Partners, Inc.*, 191 F.3d, 1076, 1080 (9th Cir. 1999)).

[8] Pirani, 13 F.4th at 943 (noting that the lock-up period is not required by law).

[9] *Id.*

[10] *Id.* at 947 ("Because this case involves only one registration statement, it does not present the traceability problem identified by this court in cases with successive registrations."); *see, e.g., Barnes v. Osofsky*, 373 F.2d 269, 273 (2d Cir. 1967).

[11] *Pirani*, 13 F.4th at 948.

listing eliminates the underwriter, and therefore the underwriter's mandated lock-up period.[12] A company need only file a registration statement to sell registered shares; unregistered shares can be sold if they fall into one of the exceptions of SEC Rule 144.[13] As such, plaintiff Fiyyaz Pirani, who purchased shares offered on the New York Stock Exchange (NYSE) after Slack filed its registration statement, could not show that the shares he bought related to the allegedly misleading registration statement.[14]

This distinction is important because Pirani sued under Section 11, which states:

> In case any part of the registration statement, when such part became effective, contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading, any person acquiring *such security* . . . may, either at law or in equity, in any court of competent jurisdiction, sue– (1) every person who signed the registration statement.[15]

In the past, the Ninth Circuit and other appellate courts have interpreted "such security" as one that is directly traceable to the specific registration statement at issue, not some later or earlier statement.[16] But, as the *Pirani* majority noted, past cases have dealt only with tracing challenges from traditional IPOs involving successive registrations, where a company issues a secondary offering to the public such that there are multiple registration statements under which a share may be registered.[17] It is under those circumstances that courts have rejected Section 11 claims by subsequent purchasers for failure to prove that their shares could be traced to the specifically challenged registration statement.[18]

Unlike previous cases, *Pirani* required interpretation of "such security" under Section 11 in what the Court deemed a novel situation: "in . . . a direct listing, where only one registration statement exists, and where registered and unregistered securities are offered to the public based on existence of that one registration statement."[19] In that context, the Court declined to adopt the broad meaning of Section 11 that was rejected in the seminal tracing case, *Barnes v. Osofsky*.[20] Instead, the Court purported to look to the text of Section 11.[21] But as the dissent noted, the majority's reasoning actually focused on the NYSE rule that a company must issue an effective registration statement to engage in a direct listing on its forum.[22] Under the NYSE rule, Slack could only issue both registered and unregistered shares to the public once its registration became effective.[23] It

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[12] *See Pirani*, 13 F.4th at 943.
[13] *Pirani*, 13 F.4th at 944; 17 C.F.R. § 230.144.
[14] *Pirani*, 13 F.4th at 945.
[15] 15 U.S.C. § 77k(a) (emphasis added).
[16] *See e.g., Hertzberg*, 191 F.3d at 1080.
[17] *See e.g., Barnes*, 373 F.2d at 273.
[18] *See, e.g., id.*
[19] *Pirani*, 13 F.4th at 946.
[20] *Barnes*, 373 F.2d at 273; Pirani, 13 F.4th at 946 ("[W]e do not adopt, as the district court did, the broad meaning of Section 11 that Judge Friendly rejected in *Barnes*.").
[21] *Pirani*, 13 F.4th at 949.
[22] *Pirani*, 13 F.4th at 952 (Miller, J., dissenting).
[23] *Pirani*, 13 F.4th at 944 (citing NYSE, Section 102.01B, Footnote E).

followed that, where a single operative registration made it possible to sell both types of shares, all purchases made after its issuance were traceable to the challenged statement.[24]

But this reasoning raises some questions. For one, it is unclear why the NYSE rule affects interpretation of "such security" within the meaning of Section 11 of the Securities Act, which applies regardless of the exchange listing.[25] The majority in fact noted that the SEC allows unregistered shares in a direct listing to be sold if they fall within one of the registration exceptions in SEC Rule 144.[26] Rule 144 disrupts the premise that Slack's registration statement is a but-for cause of the sale of unregistered shares, an argument that the majority did not address.[27]

Discrepancies such as the above led the dissent to interpret the majority's reliance on the NYSE rule as a means to advance its policy concern that a contrary holding would leave plaintiffs in direct listings without any relief under section 11.[28] Judge Miller argued that this push for policy stood in contrast to decades of precedent requiring plaintiffs to trace their shares to the challenged registration statement in successive-registration cases.[29] Further, he argued, "nothing in the reasoning of the cases suggests that the distinction should matter" because "while the factual setting of the case may be novel, the legal issues it presents are not."[30] And given that the proper mechanism for effecting change to legislation lies with Congress, Judge Miller found that these policy arguments, however valid, should not have disrupted established interpretation of the statutory text.[31]

What could be driving the Ninth Circuit's concern for a lack relief for plaintiffs in a direct listing under Section 11? Even if plaintiffs in a direct listing are unable to sue under Section 11, they can pursue a securities fraud claim under Section 10(b) of the Securities Act.[32] The answer may relate to Section 11's evidentiary threshold; it holds an issuer *strictly liable* for any misrepresentation or material omission in its registration statement to any person acquiring "such security."[33] As Section 11 does not require that a plaintiff show scienter,[34] it creates a significantly lighter burden.

While the Ninth Circuit denied Slack's petition for an *en banc* rehearing of its panel decision this past May,[35] it remains to be seen whether the *Pirani* will merit Supreme Court review.

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[24] *Pirani*, 13 F.4th at 947.
[25] *Id.* at 954 (Miller, J., dissenting).
[26] *Id.* at 944.
[27] Boris Feldman et al., *Roadmap to Cert: Ninth Circuit Splits from Other Circuits, Itself, and History on Strict Liability for Direct Listings*, FRESHFIELDS (Sept. 22, 2021), https://blog.freshfields.us/post/102h6u4/roadmap-to-cert-ninth-circuit-splits-from-other-circuits-itself-and-history-on.
[28] *Pirani*, 13 F.4th at 953 (Miller, J., dissenting).
[29] *Id.*
[30] *Id.* at 952, 950.
[31] *Id.* at 953.
[32] *Id.* (citing *Herman & MacLean v. Huddleston*, 459 U.S. 375, 382 (1983)). Section 10(b) of the Securities Exchange Act of 1934 bans fraud in the purchase or sale of securities. 15 U.S.C. § 78j(b).
[33] 15 U.S.C. § 77k(a).
[34] *See, e.g.*, *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 201 (1976).
[35] *Pirani*, No. 20-16419, 2022 U.S. App. LEXIS 11846 (9th Cir. May 02, 2022).]