Westlaw Today
powered by Reuters

Supreme Court: Section 11 requires purchasers of shares in a direct listing to plead and prove that they purchased traceable shares

By Jonathan Youngwood, Esq., Stephen Blake, Esq., Peter Kazanoff, Esq., and Craig Waldman, Esq., Simpson Thacher*

JUNE 28, 2023

On June 1, the Supreme Court issued a unanimous opinion settling a circuit split concerning whether Section 11 of the Securities Act requires a plaintiff who purchased shares through a direct listing to trace his shares to a false or misleading registration statement.[1] The Court held that to state a claim under Section 11 "requires a plaintiff to plead and prove that he purchased shares traceable to the allegedly defective registration statement[.]"

In recent years, certain companies seeking to become publicly listed have utilized direct listings as an alternative to a traditional IPO.

The Court remanded the case to the Ninth Circuit to consider whether plaintiff's pleadings could satisfy Section 11 in light of its decision.

The Court also vacated the Ninth Circuit's judgment determining that plaintiff had standing under Section 12 for reconsideration in light of the Court's interpretation of Section 11. The Ninth Circuit had concluded that standing existed under Section 12 because it paralleled Section 11.

The Court declined to express a view as to the proper interpretation of Section 12 or its application to this case, even though a fair amount of the discussion during oral argument focused on this topic. However, the Court cautioned "that the two provisions contain distinct language that warrants careful consideration."

The Court's decision may increase the likelihood that a company going public pursues a direct listing rather than a traditional IPO in light of the limitations on potential liability under Section 11.

Background

Traditionally, IPOs have been an effective way for companies to access capital markets and become publicly listed, but they involve payment of significant fees to the underwriters hired to effectuate the transaction.

In recent years, certain companies seeking to become publicly listed have utilized direct listings as an alternative to a traditional IPO, particularly when the listed company is not looking to raise additional capital in the transaction. Rather than engaging underwriters and paying the related fees, in a direct listing the selected securities exchange and its designees are responsible for facilitating an orderly market for the trading of shares on the listing date, with pre-IPO stockholders electing to sell their shares as desired pursuant to ordinary brokerage transactions.

Critically, only a portion of the shares traded on the date of the IPO and thereafter are sold under a Securities Act registration statement relating to pre-IPO shares held by affiliates of the issuer and others that hold "restricted securities," while unrestricted shares held by non-affiliates are freely tradeable and sold without utilizing a registration statement.

Also in contrast to IPOs, direct listings do not involve lockup agreements,[2] meaning that both registered and unregistered shares are available for sale immediately from the IPO date.

Plaintiff purchased shares of Slack on the day the company went public through a direct listing, having filed a registration statement relating to a certain number, but not all, of the shares sold into the market on that date. Following a stock price drop, plaintiff filed a putative class action alleging that the company had violated Sections 11 and 12 of the Securities Act by filing a materially misleading registration statement.

The company moved to dismiss for failure to state a claim, arguing that Sections 11 and 12 authorized suit only for those who held shares issued pursuant to a false or misleading registration statement and plaintiff did not allege that he purchased shares traceable to the allegedly misleading registration statement. The district court denied the motion to dismiss but certified its ruling for interlocutory appeal and a divided panel of the Ninth Circuit affirmed. On December 13, 2022, the Supreme Court granted certiorari in the case.[3]

The Court looks to other Securities Act provisions to interpret the "such security" language in Section 11

The Court began its analysis by examining the text of Section 11:

> "In case any part of the registration statement, when such part became effective, contained an untrue statement of a

Thomson Reuters is a commercial publisher of content that is general and educational in nature, may not reflect all recent legal developments and may not apply to the specific facts and circumstances of individual transactions and cases. Users should consult with qualified legal counsel before acting on any information published by Thomson Reuters online or in print. Thomson Reuters, its affiliates and their editorial staff are not a law firm, do not represent or advise clients in any matter and are not bound by the professional responsibilities and duties of a legal practitioner. Nothing in this publication should be construed as legal advice or creating an attorney-client relationship. The views expressed in this publication by any contributor are not necessarily those of the publisher.

THOMSON REUTERS®

> 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 [certain enumerated parties]."[4]

The Court explained that the statute authorizes an individual to sue for a material misstatement or omission in a registration statement when he has acquired "such security." Viewing this as a matter of statutory interpretation, the Court focused its analysis on the meaning of the term "such security" in Section 11.

Plaintiff contended that "such security" could include a security that was not issued pursuant to the allegedly misleading registration statement, while the company argued that "such security" must refer to a security issued pursuant to the allegedly misleading registration statement.

Noting that there is no clear referent in Section 11 to indicate what "such" means in the phrase "such security" the Court looked to other sections of the Securities Act for context. In particular, the Court observed that "the statute repeatedly uses the word 'such' to narrow the law's focus." The Court reasoned that as to '"such security,' the statute is limited to a security registered under the particular registration statement alleged to contain a falsehood or misleading omission."

The Court also noted that Section 11(e) caps damages against an underwriter at the total price at which the securities were offered to the public, thereby tying the maximum available recovery to the value of the registered shares alone.

The Court observed that this provision would make "little sense" under plaintiff's interpretation because if Section 11 liability "extended beyond registered shares then presumably available damages would too." The Court concluded that "[c]ollectively, these contextual clues persuade us that [the company's] reading of the law is the better one."

The Court also expressly rejected plaintiff's expansive reading of "such security," stating that plaintiff failed to "explain what the limits of his rule would be, how we might derive them from §11, or how any of this can be squared with the various contextual clues we have encountered suggesting that liability runs with registered shares alone."

The Court was also unpersuaded by plaintiff's policy argument — that expanding liability for falsehoods and misleading omissions would better accomplish the purpose of the Securities Act — explaining that plaintiff's view of the statute's purpose was not "altogether obvious." Finally, the Court observed that Congress is "free to revise the securities laws at any time, whether to address the rise of direct listings or any other development."

Notes

[1] *Slack Technologies, LLC v. Pirani*, 143 S.Ct. 1433, 1437 (U.S., 2023). https://bit.ly/3Jujut2

[2] In an IPO, to prevent downward pressure on the stock price once public trading begins, underwriters typically require insiders and other large pre-IPO shareholders to execute a lockup agreement committing them to hold their shares for a period of time (up to 180 days) before being able to sell them on the public market.

[3] Please see https://bit.ly/46op9e1 to read our discussion of the Supreme Court's grant of certiorari in this case.

[4] 15 U. S. C. § 77k(a). (emphasis added.)

About the authors

(L-R) **Jonathan Youngwood** is global co-chair of **Simpson Thacher**'s litigation department and is based in New York, where he leads the civil securities litigation practice. He represents corporations, boards of directors and other clients in complex commercial litigation, arbitration, investigations and regulatory matters. His practice also focuses on disputes and other matters concerning corporate control, ERISA and antitrust. He can be reached at jyoungwood@stblaw.com. **Stephen Blake** is a partner in the firm's litigation department and is based in Palo Alto, California. He resolves high-stakes shareholder litigation and securities regulatory matters and advises corporations, financial institutions, funds and their advisers in connection with mergers and acquisitions, initial public offerings, legal compliance and commercial disputes. He can be reached at sblake@stblaw.com. **Peter Kazanoff** is a New York-based partner in the firm's litigation department. He represents private equity and corporate clients in transaction-related disputes and issuers, individuals and underwriters in securities litigation. He also defends clients against claims arising out of financial fraud. He can be reached at pkazanoff@stblaw.com. **Craig Waldman** is a partner in the firm's litigation department and is based in New York. He represents clients in securities litigation, including class and derivative actions, and private equity and corporate clients in transaction-related litigation, corporate governance matters and corporate control litigation. He can be reached at cwaldman@stblaw.com. This article was originally published June 5, 2023, on the firm's website. Republished with permission.

This article was published on Westlaw Today on June 28, 2023.

*** © 2023 Jonathan Youngwood, Esq., Stephen Blake, Esq., Peter Kazanoff, Esq., and Craig Waldman, Esq., Simpson Thacher**

This publication was created to provide you with accurate and authoritative information concerning the subject matter covered, however it may not necessarily have been prepared by persons licensed to practice law in a particular jurisdiction. The publisher is not engaged in rendering legal or other professional advice, and this publication is not a substitute for the advice of an attorney. If you require legal or other expert advice, you should seek the services of a competent attorney or other professional. For subscription information, please visit legalsolutions.thomsonreuters.com.