September 2021

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Ninth Circuit Broadens Shareholder Standing to Bring Securities Act Claims

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On September 20, 2021, the Court of Appeals for the Ninth Circuit issued its decision in *Pirani v. Slack Techs., Inc.*, finding that a shareholder who purchased shares through a direct listing had standing to sue under Section 11 and Section 12 of the Securities Act of 1933, even if he could not ascertain that the shares he had purchased in a direct listing were registered shares.[1] While the Court characterized this as a case of first impression, the decision arguably departs from established precedent, as noted by the dissent, and provides a warning to issuers in assessing potential disclosure liability in connection with direct listings.

Background

In a traditional IPO, an issuer files a registration statement and then sells the new shares issued under that registration statement. Investment banks that underwrite the IPO typically include a "lock-up period," where any unregistered shares issued under an exemption to the registration requirement, such as to a company's employees, may not be sold. In this way, "[a]nyone purchasing shares on the stock exchange during the lock-up period can therefore be certain that the shares were issued under the registration statement."[2] A direct listing differs in that no new shares are issued; instead, in a direct listing the registration statement is "solely for the purpose of allowing existing shareholders to sell their shares" on the exchange, such that both registered and unregistered shares can be sold.[3]

In *Pirani*, the issuer was a communications platform company that went public through a direct listing on June 20, 2019, releasing 118 million registered shares and 165 million unregistered shares into the public market for purchase. The plaintiff purchased 250,000 such shares, but was unable to determine if he had purchased registered or unregistered shares in the direct listing. Subsequently, the issuer allegedly experienced service disruptions and its share price dropped. Plaintiff filed a class action suit against the issuer, its officers, directors, and certain investors, alleging failures to make relevant disclosures in its registration statement in violation of Sections 11, 12(a)(2), and 15(a) of the Securities Act of 1933.[4]

To have standing to sue under Section 11 of the Securities Act, shareholders must be able to "trace the lineage of their shares" to the offering of the challenged registration statement.[5] The District Court ruling adopted a broad reading of "such security" under Section 11, holding that plaintiff had standing, even if his shares were unregistered, because his shares were "of the same nature" as the shares issued pursuant to the registration statement and were sold simultaneously in the same listing.[6]

Analysis

On interlocutory appeal, the appeals court affirmed the district court's holding because the unregistered securities in question could not have been sold without the challenged registration statement:

> [I]n contrast to an IPO, in a direct listing there is no bank-imposed lockup period during which unregistered shares are kept out of the market. Instead, at the time of the effectiveness of the registration statement, both registered and unregistered shares are immediately sold to the public on the exchange. *See* NYSE, Section 102.01B, Footnote E. Thus, in a direct listing, the same registration statement makes it possible to sell both registered and unregistered shares to the public. [The issuer'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 [the issuer's] shares through its direct listing could do so only because of the effectiveness of its registration statement.[7]

The majority of the panel also stated that public policy counseled in favor of its holding, as the opposite result would unfairly allow companies to escape liability, creating a loophole "large enough to undermine the purpose of Section 11."[8] For similar reasons, the appeals court held that plaintiff had satisfied the statutory standing analysis under Section 12(a)(2), because "neither the registered nor unregistered shares would be available on the exchange without the filing of the offering materials."[9]

The dissent criticized the ruling as overturning over 50 years of settled jurisprudence. Observing that the statutory standing requirement was designed to "temper" the "strong medicine" of strict liability, Judge Miller criticized the majority opinion for ignoring the statutory prerequisite that the acquired shares be "issued under the allegedly false or misleading registration statement."[10] Because the plaintiff could not show that the shares he purchased were issued under the allegedly false or misleading registration statement, the shareholder lacked statutory standing, and the Section 11 claim should have been dismissed. The dissent further explained that any policy concerns about potentially evading Section 11 liability were mitigated by the fact that the registration statement would remain subject to Section 10(b) liability under the Securities Exchange Act for materially false statements made with scienter.[11]

Ramifications

The exact impact of the *Pirani* decision is not yet clear. It remains to be seen whether a subsequent court, such as an *en banc* panel of the Ninth Circuit or the Supreme Court, may overturn this decision, or whether other courts outside of the Ninth Circuit will follow the reasoning of *Pirani* and expand issuer liability across jurisdictions. For now, shareholders may perceive the Ninth Circuit as a more favorable forum for securities class actions that involve direct listings. The ruling also impacts corporate planning. For years, the tracing rule has defined the class of shareholders who can bring Section 11 claims. Companies and underwriters have relied on the tracing rule to assess the timing, size, components, policies, and risks associated with an initial public offering and any subsequent Section 11 case. The Ninth Circuit decision injects uncertainty into that process and may subject companies and underwriters to increased costs and liability. Accordingly, companies and underwriters should work closely with counsel to ensure that proper disclosures are made in connection with such issuances and that appropriate risk management measures are taken.

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[1] No. 20-16419, 2021 WL 4258835 (9th Cir. Sept. 20, 2021).

[2] *Pirani*, 2021 WL 4258835, at *8.

[3] *Id.* at *2 (quoting Order Granting Accelerated Approval of NYSE Proposed Rule Change Relating to Listing of Companies, Exchange Act Release No. 34-82627, 83 Fed. Reg. 5650, 5651 (Feb. 2 2018); *NYSE, Section 102.01B, Footnote E*).

[4] *Id.* at *2.

[5] *See* 15 U.S.C. §§ 77k(a), 77l(a)(2). ("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 ....") (emphasis added). *Barnes v. Osofsky*, 373 F.2d 269, 271–73 (2d Cir. 1967) (citation omitted).

[6] *Pirani*, 2021 WL 4258835, at *3. The Court did not reach the issues of whether the Section 12 claims were sufficiently pled.

[7] *Id.* at *5.

[8] *Id.* at *6.

[9] *Id.* at *7. The appeals court declined to address the express privity requirement between the seller and the purchaser found in Section 12(a)(2) claims because it did not "motivate" the district court's certification for interlocutory appeal and did not otherwise satisfy the interlocutory appeal requirements. *Id.*

[10] *Id.* at *9.

[11] *Id.* at *10 (citing *Herman & Maclean v. Huddleston*, 459 U.S. 375, 382 (1983)).