CLEARY GOTTLIEB

ALERT MEMORANDUM

Slack's Direct Listing – Court Allows Securities Act Claims Without Requiring Tracing

April 30, 2020

Over the last two years, direct listings – in which companies list their stock on an exchange to enable insiders and early investors to sell their holdings to the public without issuing new shares – have received considerable attention as an alternative to traditional initial public offerings.[1] Until now it has been assumed that claims under Section 11 of the Securities Act, which generally require plaintiffs to "trace" their purchases to a registration statement, would be difficult to pursue because many shares in a direct listing may be sold without using a registration statement.

On April 21, 2020, however, in a decision of first impression, a judge in the Northern District of California declined to impose a tracing requirement for Section 11 claims concerning a direct listing, holding that there was a "good reason" for dispensing with the tracing requirement in that context in order to avoid "completely obviat[ing] the remedial penalties" of the Securities Act. *Dennee v. Slack Technologies Inc.*, No. 19-cv-05857-SI (N.D. Cal. Apr. 21, 2020). The *Slack* decision also rejected similar arguments that, as a matter of law, the plaintiff could not prove damages under Section 11, or satisfy the statutory seller requirement of Section 12(a)(2), in the context of a direct listing. If allowed to stand and followed by other courts, the *Slack* decision could therefore open the door to Securities Act liability for direct listings, which is a risk companies should consider in deciding whether to go public, particularly where they have no need for new equity capital.

If you have any questions concerning this memorandum, please reach out to your regular firm contact or the following authors.

NEW YORK

Nicolas Grabar
+1 212 225 2414
ngrabar@cgsh.com

David Lopez
+1 212 225 2632
dlopez@cgsh.com

Jared Gerber
+1 212 225 2507
jgerber@cgsh.com

Leslie N. Silverman
+1 212 225 2380
lsilverman@cgsh.com

[1] Cleary Gottlieb, "Spotify's Direct Listing – A Look Under the Hood" (Apr. 17, 2018).

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Background

Slack's Direct Listing. On June 21, 2019, common shares of the cloud-based computing company Slack began trading on the NYSE.[2] Rather than opting for a traditional Initial Public Offering ("IPO"), in which a company will offer a certain amount of new and/or existing shares to the public to help raise additional capital, Slack chose to use a direct listing, in which no new shares were issued, but insiders and early investors of the company were able to sell their preexisting shares to the public.[3]

Such direct listings gained attention beginning in 2018, when the SEC approved changes to exchange listing requirements to provide a means for certain companies with securities that have not previously been traded on a public market—and that are listing only upon effectiveness of a selling shareholder registration statement, without a related underwritten offering, and without recent trading in a Private Placement Market—to list on an exchange.[4] Significantly, because no new shares are issued in a direct listing, insiders holding preexisting shares are not subject to the typical lock-up period of 90 to 180 days where they cannot sell their shares.[5] Those insiders can sell their shares, which are exempt from registration under SEC Rule 144, at the same time as others whose shares must be sold under a Securities Act registration statement.

Thus, in Slack's direct listing, the registration statement applied to only 118,429,640 shares offered for resale to the public, and approximately 164,932,646 additional shares of common stock were available for resale and exempt from registration pursuant to SEC Rule 144.[6]

Plaintiff's Allegations. In September 2019, Plaintiff Fiyyaz Pirani, an investor who acquired Slack common stock on the first day of its public listing and subsequently, brought a securities class action against Slack and several of its directors, asserting claims under Sections 11, 12(a)(2), and 15 of the Securities Act.[7] That action alleged that the registration statement and prospectus for the listing contained misstatements and omissions regarding Slack's service outages, agreements in the case of such outages, competition from Microsoft Teams, scalability and purported key benefits, and growth and growth strategy.[8]

On January 6, 2020, Plaintiff filed an Amended Class Action Complaint ("ACAC").

Defendant's Motion to Dismiss. On January 21, 2020, Defendants moved to dismiss the ACAC, arguing, among other things, that (1) Plaintiff did not have standing because he could not allege facts showing that he bought registered shares; (2) Plaintiff could not recover damages under Section 11 because Slack's direct listing did not involve a public offering price; (3) Plaintiff could not plead standing under Section 12(a)(2) because Defendants were not statutory sellers; and (4) Plaintiff failed to plead that any statement was false or misleading.[9]

The District Court's Decision

In a decision issued on April 21, 2020, the District Court granted in part and denied in part Defendants' motion to dismiss. Notably, the court rejected all of Defendants' threshold legal arguments that Plaintiff could not establish required elements of his claims in the context of a direct listing, holding that: (1) there is no tracing requirement under Section 11 in cases involving a direct listing; (2) a plaintiff can establish Section 11 damages in a direct listing, notwithstanding the alleged lack of a determined offering price; and (3) signing the offering materials and soliciting sales at an Investor Day were sufficient to plead an active solicitation theory for the purposes of Section 12(a)(2)'s statutory seller requirement. However, the court dismissed certain alleged misstatements as inadequately pled.[10]

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[2] Slip Op. at 2.

[3] Slip Op. at 2.

[4] Slip Op. at 10-11.

[5] Slip Op. at 11.

[6] Slip Op. at 3.

[7] Slip Op. at 1.

[8] Slip Op. at 3.

[9] Slip Op. at 7.

[10] Slip Op. at 23-28.

Section 11

Tracing Requirement. The District Court first rejected Defendants' argument that Plaintiff could not plead statutory standing under Section 11 because he could not definitively trace his purchased shares to the defective registration statement.[11]

Under the text of Section 11, a claim for material misstatements and omissions in a registration statement for a security can only be brought by "any person acquiring such security."[12] In discussing this language, the court noted that the Second Circuit was the first to interpret the phrase "such security," and that Judge Henry Friendly, writing for the court, weighed two possible readings of the phrase: a narrower reading, "acquiring a security issued pursuant to the registration statement"; and a broader reading, "acquiring a security of the same nature as that issued pursuant to the registration statement."[13] In that decision, which was widely adopted by subsequent courts, the Second Circuit adopted the narrower reading based on its review of the statutory scheme, its legislative history, and an amicus brief from the SEC. Under this line of authority, plaintiffs must "trace their shares back to the relevant offering" in order to plead statutory standing under Section 11, meaning plaintiffs must either have "purchased shares in the offering made under the misleading registration statement," or purchased shares in the aftermarket "provided they can trace their shares back to the relevant offering."[14] However, in adopting this tracing requirement, Judge Friendly said that the broader reading, which would permit a person to bring a claim concerning a security "of the same nature as that issued pursuant to the registration statement," "would not be such a violent departure from the words that a court could not properly adopt it if there would good reason for doing so."[15]

Considering the issue as a matter of first impression, the District Court held that the broader reading was warranted in the context of a direct listing.[16] In reaching this conclusion, the court noted that the cited case law imposing a tracing requirement involved successive stock offerings, not simultaneous offerings as in a direct listing. The court further held that, in the "unique circumstance" of "a direct listing in which shares registered under the Securities Act become available on the first day simultaneously with shares exempted from registration," "the phrase 'such security' in Section 11 warrants the broader reading" because imposing a narrow tracing requirement would "completely obviate the remedial penalties" of the Securities Act, which the court concluded would "lead to absurd or futile results plainly at variance with the policy of the legislation as a whole."[17]

Damages. The District Court also rejected Defendants' second argument that Plaintiff could not establish damages under Section 11 because there is no offering price in a direct listing.

Under Section 11(e), the measure of damages for Section 11 claims considers "the amount paid for the security (not exceeding the price at which the security was offered to the public)." Defendants therefore argued that a necessary predicate for establishing damages under Section 11 is the existence of a price at which a "security was offered to the public."[18] Defendants further argued that, unlike an IPO in which the initial offering price is established by the company and the underwriters, Slack's direct listing did not involve a public offering price because the NYSE established a reference price for Slack's shares one day prior to the commencement of trading and a designated market maker set the opening trading price without coordination from Slack.[19]

The court, however, rejected Defendants' argument, concluding that they had "not met their burden at the pleading stage to show that plaintiff cannot recover damages as a matter of law."[20] In reaching this result,

[11] Slip Op. at 13-14.

[12] Slip Op. at 8.

[13] Slip Op. at 8; *see Barnes v. Osofsky*, 373 F.2d 269 (2d Cir. 1967).

[14] Slip Op. at 9; *see also In re Century Aluminum Co. Sec. Litig.*, 729 F.3d 1104, 1106 (9th Cir. 2013).

[15] Slip Op. at 8-9.

[16] Slip Op. at 13-14.

[17] Slip Op. at 12-13.

[18] Slip Op. at 14; *see* 15 U.S.C. § 77k(g).

[19] Slip Op. at 14.

[20] Slip Op. at 15.

the court noted that "[d]amages are not an element of a Section 11 claim," and instead are "an affirmative defense." The court therefore concluded that Plaintiff had satisfied his burden by "alleg[ing] that he purchased the relevant securities" and "facts creating the reasonable inference that the value of the securities on the presumptive damages date . . . is *less* than the purchase price."[21] The court also noted that the registration statement stated that the opening public price was determined "similar to how a security being offered in an underwritten initial public offering would open on the first day of trading," and that Plaintiff may pursue a "value-based theory of damages," which is a fact-intensive inquiry and not appropriate for resolution at the pleadings stage.[22]

Section 12(a)(2)

The District Court also rejected Defendants' argument that Plaintiff could not plead that Defendants were statutory sellers within the scope of Section 12(a)(2) because of their limited activities in connection with the direct listing.

Section 12(a)(2) provides that any person who "offers or sells a security . . . by means of a prospectus or oral communication" that includes a misstatement or omission may be liable "to the person purchasing such security from him."[23] Under the "purchasing . . . from him" language, courts have imposed a privity requirement on Section 12(a)(2) claims, and have limited liability to statutory sellers who either directly pass title or actively solicit a sale.[24] Relying on this case law, and subsequent district court cases holding that merely signing a registration statement or participating in a roadshow is insufficient to establish solicitation, Defendants argued that plaintiff did not adequately plead that they had actively solicited the sale to him in the direct listing.[25]

The District Court, however, rejected these arguments and found that "plaintiff ha[d] alleged enough facts to support an active solicitation theory against the Individual Defendants."[26] In particular, the court concluded that Plaintiff's allegations that "all of the Individual Defendants signed the offering materials, that certain defendants solicited sales at the Investor Day, and that all of the Individual Defendants were financially motivated to solicit sales" were sufficient to plead solicitation.[27] In reaching this conclusion, the court stated that "the solicitation question is a factual question which should generally be left to the jury."[28]

Key Takeaways

The *Slack* decision is significant because it is the first case to address the potential application of the civil liability provisions of the Securities Act to direct listings. While commentators had expected the risk of such liability to be limited in light of Section 11's tracing requirement and Section 12(a)(2)'s statutory seller requirement, *Slack* shows that courts may be willing to relax those requirements in order to prevent insulating direct listings from liability under the Securities Act. Accordingly, if the *Slack* decision stands and is followed by other courts, it raises a risk companies should consider in deciding whether to go public, particularly where they have no need for new equity capital.

At the same time, it is worth noting that the plaintiff in *Slack* did not seek to bring claims against the financial institutions that acted as advisors in the direct listing. The decision therefore does not call into question the view that financial institutions that participate in direct listings should not be subject to Securities Act liability as underwriters.

Finally, given that *Slack* considered an issue of first impression, departed from the well-established traceability requirement under Section 11, and recognized that district courts have reached differing conclusions regarding the activities that constitute

[21] Slip Op. at 15-16.

[22] Slip Op. at 16.

[23] Slip Op. at 16.

[24] Slip Op. at 17.

[25] Slip Op. at 18; *see In re Infonet Servs. Corp. Sec. Litig.*, 310 F. Supp. 2d 1080, 1101 (C.D. Cal. 2003); *In re Harmonic, Inc., Sec. Litig.*, 2006 WL 3591148 at *13 (N.D. Cal. Dec. 11, 2006); *Welgus v. TriNet Grp., Inc.*, Case 2017 WL 167708, at *19 (N.D. Cal. Jan. 17, 2017).

[26] Slip Op. at 18-19.

[27] Slip Op. at 19.

[28] Slip Op. at 19.

active solicitation under Section 12(a)(2), it is possible that the decision will receive appellate review or that other courts will disagree with its holdings.[29] In this respect, it is notable that many of the concerns expressed by the District Court are similar to other situations where courts have uniformly declined to dispense with the existing standing requirements of the Securities Act, including secondary offerings.

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[29] For example, with respect to Section 11, although the District Court acknowledged that only if a statute is "ambiguous" may the court use "canons of construction, legislative history and the statute's overall purpose to illuminate Congress's intent," and it cited the dicta in Judge Friendly's opinion in *Barnes* in finding the requisite ambiguity, other courts may hue more closely to the holding in *Barnes* as to the correct interpretation of the statutory language and reject there being any ambiguity. This is especially true because while registration statements under the Securities Exchange Act register a class of securities, it is settled law that registration statements under the Securities Act register specific securities and not a class of securities.

And with respect to the Section 12(a)(2) claim, not only could another court interpret "such security" in this context in the same limiting way as described above with respect to Section 11, but even the District Court questioned whether Slack itself could be a seller under Section 12(a)(2) because it sold no shares, *see* Slip Op., n.12 at 19.