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Securities Law Alert

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October 2021

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Ninth Circuit: Plaintiff Who Purchased Shares in a Direct Listing Has Standing Under Section 11 and Section 12(a)(2) Regardless of Whether Shares Were Registered or Unregistered

On September 20, 2021, the Ninth Circuit affirmed a ruling that a stockholder who purchased shares of a company that went public through a direct listing had standing under Section 11 and Section 12(a)(2) of the Securities Act even though he could not determine if he had purchased registered or unregistered shares in the direct listing. *Pirani v. Slack Techs.*, 2021 WL 4258835 (9th Cir. 2021) (Restani, J.). The court held that plaintiff had standing because his shares "could not be purchased without the issuance of [the company's] registration statement, thus demarking these shares, whether registered or unregistered, as 'such security' under Sections 11 and 12 of the Securities Act."

Background and Plaintiff's Allegations

In 2019, plaintiff purchased shares on the day the company went public through a direct listing. Following a stock price drop related to service disruptions, plaintiff brought a class action against the company, its officers and directors, and venture capital fund investors, based on the company's registration statement and prospectus issued in the direct listing. Plaintiff brought claims for violations of Section 11 and Section 12(a)(2) of the Securities Act alleging the company's registration statement was inaccurate and misleading. The company challenged whether plaintiff had statutory standing to sue under Section 11 and Section 12(a)(2) because he could not prove that his shares were registered under the allegedly misleading registration statement.

Standing Exists Under Section 11 Because a Direct Listing Registration Statement Simultaneously Allows Sales of Both Registered and Unregistered Shares

Noting that this is a case of first impression, the court framed the issue as "what does 'such security' mean under Section 11 in the context of a direct listing, where only one registration statement exists, and where registered and unregistered securities are offered to the public at the same time, based on the existence of that one registration statement[.]"[1] The court explained that under the NYSE's direct listing rule[2] a company must file a registration statement in order to engage in a direct listing. The court continued that the SEC "interprets this reference to a registration statement in the rule as an effective registration statement filed pursuant to the Securities Act of 1933." The court then noted that a direct listing—as opposed to an IPO—has no bank-imposed lock-up period during which unregistered shares are kept out of the market, both registered and unregistered shares are immediately sold to the public at the time of the effectiveness of the registration statement, and the same registration statement makes it possible to sell both types of shares.

The court determined that the company'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." As there was only one registration statement here, the court stated that all of the stock sold in this direct listing, whether labeled as registered or unregistered, was traceable to that one registration. The court determined that plaintiff pled facts sufficient to establish standing under Section 11 and affirmed the denial of dismissal. Separately, the court stated that "Section 12 liability (resulting from a false prospectus) is consistent with Section 11 liability (resulting from a false registration statement)." Accordingly, statutory standing exists under Section 12(a)(2) to the extent it parallels Section 11.

Circuit Judge Miller Dissents

Circuit Judge Miller dissented stating that he would have reversed and remanded with instructions to dismiss in full. Judge Miller explained that plaintiff lacked standing under Section 11 because he could not show that the shares he purchased "were issued under the allegedly false or misleading registration statement[.]" If "such security" meant that a plaintiff must have purchased shares "issued under the allegedly false or misleading registration statement" in successive-registration cases, then that is what it should also mean in direct-listing cases. He cited similar reasons for concluding that plaintiff also lacked standing under Section 12.

Delaware Supreme Court: In Overruling *Gentile v. Rossette* the Court Throws Out the Exception to *Tooley*'s "Simple" Test to Distinguish Between Direct and Derivative Claims

On September 20, 2021, in a unanimous decision, the Delaware Supreme Court overruled *Gentile v. Rossette*, reversing a Court of Chancery decision holding that plaintiffs had direct standing to challenge a green energy company's private placement of common stock for allegedly inadequate consideration. [*Brookfield Asset Management v. Rosson*, 2021 WL 4260639 (Del. 2021) (Valihura, J.)]. The court agreed with

1. Section 11 of the Securities Act 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 mis-leading, 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).

2. NYSE Listed Company Manual, Section 102.01B, Footnote E.

defendants that there was a clear conflict between *Tooley v. Donaldson, Lufkin & Jennette, Inc.*, establishing the test to distinguish direct claims from derivative claims, and *Gentile* which served as an exception to *Tooley*. In support of its decision, the court noted the difficulty that courts have had in applying *Gentile* in a logically consistent way and *Gentile*'s erosion of *Tooley*'s simple analysis.

Background and Procedural History

The consolidated class action complaint alleged three counts of breach of fiduciary duty[3] arising from the controlling stockholders of a green energy company causing it to issue its stock in a private placement for inadequate value, allegedly diluting both the financial and voting interest of the minority stockholders. The counts were putatively brought both derivatively and directly. Defendants moved to dismiss plaintiffs' direct claims on the basis that they were entirely derivative.

Subsequently, a merger involving the energy company occurred and the energy company's public stockholders ceased to have any interest in the energy company, and all of its assets, liabilities, rights and causes of action became the acquirer's property. In light of the merger, the trial court dismissed the derivative counts of the complaint. The Court of Chancery later denied defendants' motion to dismiss holding that while plaintiffs failed to state direct claims under *Tooley*, they did state direct claims to challenge the private placement under *Gentile*, noting that the claims were predicated on similar facts. The Delaware Supreme Court accepted an interlocutory appeal from the Court of Chancery's opinion.

The Alleged Overpayment Falls "Neatly" Into *Tooley*'s Derivative Category

The court identified the central issue on appeal as whether plaintiffs had direct standing to pursue their claims or whether their claims were entirely derivative. The court explained that if their claims were only derivative, then the merger extinguished them and they lacked standing to pursue them. The court stated that *Tooley* created a "simple" test to distinguish direct claims from derivative claims.[4] The court then held that the "claim is derivative because [plaintiffs] allege an overpayment (or over-issuance) of shares to the controlling stockholder constituting harm to the corporation for which it has a claim to compel the restoration of the value of the overpayment." The court stated that "[c]learly, the gravamen of the Complaint is that the Private Placement was unfair and that [the energy company] suffered harm."

In discussing *Gentile*'s analytical tension with *Tooley*, the court summarized the complaint's allegations as follows: the private placement allegedly harmed the energy company by issuing shares for an unfairly low price and harmed the stockholders indirectly through economic and voting power dilution. The court then concluded that "the harm to the stockholders was not independent of the harm to the Company, but rather flowed indirectly to them in proportion to, and via their shares in, [the company]." The court stated that this alleged corporate overpayment falls "neatly" into *Tooley*'s derivative category. The court also stated that it saw "no practical need for the *Gentile* carve-out."

As to *stare decisis*, the court pointed out that 15 years was enough time to pass since *Gentile* was decided for the court to "properly say that the practical and analytical difficulties courts have encountered in applying it reflect fundamental unworkability and not growing pains[.]"

3. Count I was against an alternative asset manager, and two of its affiliates as controlling stockholders. Count II was against certain directors of the energy company and Count III was against the energy company's CEO.

4. Under *Tooley*, "whether a stockholder's claim is direct or derivative must turn *solely* on the following questions: (1) who suffered the alleged harm (the corporation or the stockholders, individually); and (2) who would receive the benefit of any recovery or other remedy (the corporation or the stockholders, individually)?" (emphasis in original).

Delaware Supreme Court: Adopts Three-Part Demand Futility Test; Agrees That Exculpated Claims Do Not Excuse Demand as They Do Not Expose Directors to a Substantial Likelihood of Liability

On September 23, 2021, the Delaware Supreme Court affirmed a decision dismissing a derivative complaint for failing to make a demand on the board of a social media company under Court of Chancery Rule 23.1. *UFCW Union & Participating Food Indus. Emps. Tri-State Pension Fund v. Zuckerberg*, 2021 WL 4344361 (Del. 2021) (Montgomery-Reeves, J.). Notably, the court adopted the Court of Chancery's three-part test for demand futility blending the tests from *Aronson v. Lewis*[5] and *Rales v. Blasband*.[6] Agreeing with the lower court, the court held that exculpated care claims do not excuse demand under *Aronson*'s second prong because they do not expose directors to a substantial likelihood of liability. The court also determined that plaintiff did not plead with particularity that a majority of the demand board lacked independence.

Background

Plaintiff stockholder filed a derivative complaint in the Court of Chancery seeking compensation for the money the defendant social media company had spent in a prior class action. Plaintiff alleged that the company's directors breached their duty of care by negotiating and approving a purportedly one-sided stock reclassification that had been proposed by the company's CEO/controller/chairman. In this case, plaintiff did not make a litigation demand, pleading that demand was futile because the board's negotiation and approval of the stock reclassification was not a valid exercise of its business judgment and because a majority of the directors lacked independence from the company's CEO. The company and the other defendants moved to dismiss the complaint under Court of Chancery Rule 23.1 arguing that plaintiff did not make demand or prove that demand was futile. Plaintiff appealed the Court of Chancery's judgment dismissing the complaint under Rule 23.1.

Exculpated Care Violations Do Not Satisfy *Aronson*'s Second Prong

The court pointed out that the company's charter contained a Section 102(b)(7)[7] clause, therefore, the directors faced no risk of personal liability from plaintiff's allegations. Under these circumstances the issue was whether a derivative plaintiff can rely on exculpated care violations to establish that demand was futile under *Aronson*'s second prong. The court affirmed the Court of Chancery's holding that exculpated care claims do not satisfy *Aronson*'s second prong. The court explained that when *Aronson* was decided, rebutting the business judgment rule through allegations of duty of care violations exposed directors to a substantial likelihood of liability and raised doubt as to whether they could impartially consider demand. However, due to the enactment of Section 102(b)(7) and other corporate law developments since *Aronson*, exculpated breach of care claims no longer pose a threat that neutralizes director discretion.

The Court Adopts the Court of Chancery's Three-Part Test as the Universal Test for Demand Futility

In support of its adoption of the Court of Chancery's test, the court explained that "[b]lending the *Aronson* test with the *Rales* test is appropriate because both address the same question of whether the board can exercise its business judgment on the corporation's behalf in considering demand; and the refined test does not change the result of demand-futility analysis." The court clarified that the purpose of the demand-futility analysis is "to assess whether the board should be deprived of its

5. "Under *Aronson*, demand is excused as futile if the complaint alleges particularized facts that raise a reasonable doubt that (1) the directors are disinterested and independent, or (2) the challenged transaction was otherwise the product of a valid business judgment."

6. "Under *Rales*, demand is excused as futile if the complaint alleges particularized facts creating a reasonable doubt that, as of the time the complaint is filed, a majority of the demand board could have properly exercised its independent and disinterested business judgment in responding to a demand."

7. Section 102(b)(7) of the Delaware General Corporation Law "authorizes corporations to adopt a charter provision insulating directors from liability for breaching their duty of care."

decision-making authority because there is reason to doubt that the directors would be able to bring their impartial business judgment to bear on a litigation demand." The court observed that this is a different consideration than whether the challenged transaction is likely to pass or fail the applicable standard of review.

Going forward, under the refined test, "courts should ask the following three questions on a director-by-director basis when evaluating allegations of demand futility: (i) whether the director received a material personal benefit from the alleged misconduct that is the subject of the litigation demand; (ii) whether the director faces a substantial likelihood of liability on any of the claims that would be the subject of the litigation demand; and (iii) whether the director lacks independence from someone who received a material personal benefit from the alleged misconduct that would be the subject of the litigation demand or who would face a substantial likelihood of liability on any of the claims that are the subject of the litigation demand." "If the answer to any of the questions is 'yes' for at least half of the members of the demand board, then demand is excused as futile."

As to the impact of the test, the court stated that "because the three-part test is consistent with and enhances *Aronson*, *Rales*, and their progeny, the Court need not overrule *Aronson* to adopt this refined test, and cases properly construing *Aronson*, *Rales*, and their progeny remain good law."

Southern District of New York: Misleading "Comforting Statements" Not Alleged Even Where Defendants Speculated About a Potential Positive Impact on Demand

On September 7, 2021, the Southern District of New York dismissed a putative securities fraud class action alleging that a holding company and certain of its executives made misstatements and omissions concerning potential risks facing its subsidiary, a liquid commodity storage and handling business, and concealed the company's exposure to an impending environmental regulation seeking to largely ban its subsidiary's single largest product (No. 6 fuel oil). *City of Riviera Beach Gen. Emps. Ret. Sys. v. Macquarie Infrastructure*, 2021 WL 4084572 (S.D.N.Y. 2021) (Broderick, J.). The court determined that plaintiff did not plausibly allege false statements or omissions. The court held that plaintiff did not allege that defendants made "comforting statements" while they already knew that the company's business storing No. 6 fuel oil was waning, even though one investor relations email, among other things, speculated on a potential positive impact on storage demand if producers started selling No. 6 fuel oil where it was not banned.

The court summarized plaintiff's position on defendants' affirmative statements to be that "securities fraud defendants must be forthright about the present facts, risks,

and threats facing their company when affirmatively disclosing its business and environment." The court explained that this statement "misse[d] the mark" because merely speaking on one's business did not trigger a duty to disclose all facts an investor may want to know. The court distinguished plaintiff's cases stating that they actually "show[ed] that the duty to be forthright is triggered when a defendant speaks with sufficient 'specificity' while omitting information that one would normally expect the defendant to have included had the defendant known it."

For example, in *Meyer v. Jinkosolar Holdings*, 761 F.3d 245 (2d Cir. 2014), the Second Circuit held that it was "misleading for a company to make detailed, comforting statements about how it handled environmental compliance . . . while at the same time withholding that, at the very moment it spoke, the company had known, ongoing issues preventing substantial violations of particular environmental regulations[.]"

The court stated that, by contrast, plaintiff did "not allege that Defendants made comforting statements while they already knew that [their] business storing No. 6 fuel oil was waning." The court noted that plaintiff had asked how the new regulations, banning ships from using heavy oils unless improved scrubbers were installed, would impact demand. The company's head of investor relations replied that plaintiff's information was consistent with their understanding of the regulatory changes. The head also speculated on the potential positive impact on storage demand if producers started selling No. 6 fuel oil where it was not banned and stated that the producing industry would try to find other uses for it.

The court determined that nothing in that response amounted to a specific comforting statement about the subsidiary's ability to withstand the new regulation, "much less a comforting statement made while [the head of investor relations] knew or should have known that [the subsidiary's] business had already been negatively impacted[.]" The court continued that "[f]ar from comforting Plaintiff, [the head of investor relations] confirmed that Plaintiff, 'a sophisticated institutional investor,' correctly understood that [the regulation] could prevent the shipping industry from burning No. 6 fuel oil."

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