A Modest Strategy for Combatting Frivolous IPO Lawsuits

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With a minor change to the customary lock-up agreement, issuers and underwriters may be better able to fight frivolous IPO lawsuits. By allowing non-registration statement shares to enter the market, underwriters may prevent Section 11 strike-suiters from "tracing" their shares to the IPO. This could enable '33 Act defendants to knock out the lawsuits against them.

Basics of Section 11 Standing and Tracing

Section 11 of the Securities Act of 1933, 15 U.S. Code § 77k, provides a private remedy for those who purchase shares issued pursuant to a registration statement that is materially false or misleading. The remedy applies to "any person acquiring such security." Section 11(a). That is, a person may assert a claim with respect to shares issued pursuant to the particular registration statement.

What does that mean?

In the simplest case, a shareholder buys a company's shares, in the course of its public offering, from one of the underwriters of the offering. This purchaser has standing to bring a Section 11 claim against the company, the signatories of the registration statement, and the underwriters of the offering.

In the real world, Section 11 plaintiffs usually have not purchased in the offering. They typically have purchased the shares on the open market. Do they have standing to sue for misstatements in the prospectus?

The conventional wisdom answers "yes," provided they can "trace" their shares back to the allegedly actionable registration statement. Tracing has been the subject of many judicial decisions. Some courts are content, at the pleading stage, to accept conclusory assertions that the shares are traceable back to the offering documents. Other courts place a burden on plaintiffs to plead traceability in detail. It seems clear that, after the pleading stage, plaintiffs bear the burden of proving that their shares are traceable to the registration statement.

Lock-Up Agreements

A standard feature of most IPO's is a lock-up agreement. The underwriters require management and other shareholders to agree not to sell any of their shares on the public market for a specified period—usually, until 180 days after the IPO. The primary purpose of the lock-up is to promote stable trading with a finite pool of stock. The lock-up can prevent large volumes of stock from flooding the market and impairing trading during the company's inaugural period as a public company.

The lock-up usually applies to all employees of the company as well. Absent the lock-up, an employee could sell her shares, pursuant to Rule 144, into the market as soon as the IPO had gone effective (provided she had held those shares for one year.) Those shares would not have been issued pursuant to the registration statement. A person who purchased those shares would not have standing to bring a Section 11 claim against the signatories of the registration statement or the underwriters of the IPO.

Impact of the Lock-Up on Section 11 Standing

An unintended consequence of the lock-up agreements is to help Section 11 plaintiffs establish their standing by facilitating tracing. By definition, no shares entered the market prior to the IPO. At the time of the IPO, a large number of shares enter the market, all issued pursuant to the registration statement that forms the basis of the lawsuit. If a person buys stock on the open market a month or two later, she normally will have no problem tracing those shares to the registration statement, because the only shares that are trading were those issued in the IPO. No other shares have entered the market.

In many cases, this means that every person who bought the company's shares on the open market, for 180 days after the IPO, can assert a Section 11 claim and be part of a Section 11 class. This increases the plaintiff class (and the pool of potential class representatives) far beyond the number of purchasers in the IPO itself. Moreover, the actual IPO purchasers tend to be large institutions that will be reluctant to support a non-meritorious securities fraud class action. By contrast, individual purchasers in the aftermarket tend to be more willing to sue simply because the stock price subsequently declined.

Now, imagine that, as soon as public trading began in the company's stock, employees who held pre-IPO shares were permitted to sell them pursuant to Rule 144. A substantial number of "non-registration statement shares" would likely enter the market. Employees who had been waiting years for liquidity would likely want to sell some shares right away.

Along comes Plaintiff Alpha, two months after the IPO. She buys 100 shares on NASDAQ. The stock price later drops, and she asks a plaintiffs' lawyer to sue for misrepresentations in the prospectus. It would be virtually impossible for her to establish Section 11 standing, because she could not trace the particular shares she bought on the stock exchange to the shares issued in the IPO. The presence of non-registration statement shares can defeat a Section 11 claim except for those particular individuals who actually bought their stock in the IPO itself, from an underwriter or member of the syndicate. (This is why one sees far fewer Section 11 suits based on secondary public offerings: there are already so many shares in the market from the IPO as to make tracing to the later registration statement nearly impossible.)

Contours of a Modified Approach to Lock-Up Agreements

In my opinion, underwriters would be well-advised to think about easing lock-up requirements in order to enhance the potency of the standing defense to Section 11 claims. They need not adopt a one-size-fits-all approach. Among the questions they will want to consider are the following:

- Who should be allowed to sell Rule 144 shares into the market? In all likelihood, underwriters will continue to restrict sales by officers, directors, key executives, affiliates such as venture firms. Should all other employees be allowed to sell, or only those below a certain level on the org chart?
- How many shares should they be allowed to sell? Should the restrictions be aggregate (no more than *x* shares in total) or based on each employee's holdings (no more than *y* percent of their stock)?
- How soon after public trading begins should they be allowed to sell? From a defensive perspective, the sooner after the IPO goes effective, the stronger the standing defense. On the other hand, some underwriters may want a longer period to elapse before the presence of additional shares can affect the trading price of shares issued in the IPO.
- Companies often file a registration statement after the IPO to allow employees to sell their shares. Such statements, on Form S-8, often incorporate the disclosures in the S-1. Companies may need to revisit that practice in order to reduce exposure for the employee-sold stock.

Those options can be sorted out over time. The key point, in my view, is that by taking a fresh look at the scope and operation of lock-up agreements, regular players in the IPO process can reduce the risk from Section 11 claims that so often follow a decline in the stock price.

The greatest challenge to implementing the proposal set forth here will be the historical preference by underwriters for strict lock-up agreements. Underwriters will need to conclude that the modest degree of control they will cede is worth it in terms of reduced Section 11 risk.