



# CRA Insights: Finance

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## Section 11 Damages Computation for Direct Listings

In September 2021, the Ninth Circuit ruled in *Pirani v. Slack Technologies, Inc.*<sup>1</sup> (*Slack*) that Section 11 liability applies to direct listing shares. This decision came under scrutiny because it challenged previous decisions on Section 11, namely with respect to liability. While the *Slack* ruling dealt mainly with Section 11 liability requirements, we discuss four issues surrounding Section 11 damages arising from direct listings.

### Background

Direct listings are a relatively new method for companies to go public. Whereas in a traditional initial public offering (IPO) shares are sold to investors through an underwriter (i.e., the primary market), in a direct listing, shares are sold directly into secondary markets, such as an exchange like the NYSE or Nasdaq. Direct listings offer some advantages over a traditional IPO. One such benefit is the ability to provide forward-looking guidance to investors before trading (an advantage also held by companies that go public via merger with a special purpose acquisition corporation, or SPAC). Direct listings also provide savings to selling shareholders on underwriting fees (typically 3.5% to 7% in a traditional IPO).<sup>2</sup> Finally, direct listings often do not involve share lockup agreements that bind insiders and other pre-listing investors. Such lockup agreements are a common feature of traditional IPOs.

Although direct listings can be used to raise new capital, typically no new capital is raised at the time of the initial share listing.<sup>3</sup> As a result, direct listings are considered most suitable for more established, profitable firms that have less need for new capital. Indeed, all 12 of the direct listing companies we analyzed had either positive operating cash flow or significant cash and equivalents on hand as of the quarter ended before their direct listings.

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<sup>1</sup> 13 F.4th 940 (9th Cir. 2021).

<sup>2</sup> PwC reviewed the public filings of 829 companies and found that the average underwriting fee ranged from 3.5% to 7.0%, with an inverse relationship between deal value and underwriting fee. "Considering an IPO? First, understand the costs," pwc, <https://www.pwc.com/us/en/services/deals/library/cost-of-an-ipo.html>, accessed May 1, 2022.

<sup>3</sup> In the 12 direct listings between 2018 and 2021, none of the firms raised new capital at the time of the initial listing, though some later made secondary equity offerings.

## Section 11 liability issues

The *Slack* decision addressed Section 11's tracing requirements, holding that purchasers in a direct listing may bring Section 11 claims even if the investors cannot trace their securities purchased to a registration statement. This is important in a direct listing, where only a portion of the company's shares will typically be registered. The median direct listing registers only about a third of shares outstanding, though as few as 16% and as many as 87% of shares have been registered (see Table 1).<sup>4</sup>

**Table 1: Direct Listing Share Registration<sup>5</sup>**

Company name	Listing date	Market cap (\$ thousands, first day close)	% Shares registered	% of [d] Officers & Directors	Average daily trading volume/shares registered <sup>6</sup>
[a]	[b]	[c]	[d]	[e]	[f]
<b>Spotify Technologies</b>	04/03/2018	26,540,594	31.3%	72.3%	8.2%
<b>Watford Holdings</b>	03/28/2019	612,438	15.8%	3.3%	1.8%
<b>Slack</b>	06/20/2019	19,484,259	23.5%	15.3%	13.3%
<b>Palantir</b>	09/30/2020	15,673,100	16.2%	37.2%	17.6%
<b>Asana</b>	09/30/2020	4,451,965	19.8%	45.4%	13.5%
<b>Thryv Holdings</b>	10/01/2020	341,433	86.7%	69.2%	0.1%
<b>Roblox</b>	03/10/2021	38,262,561	36.9%	18.9%	7.4%
<b>Coinbase Global</b>	04/14/2021	65,393,376	61.8%	45.9%	11.4%
<b>SquareSpace</b>	05/19/2021	5,939,774	29.7%	17.9%	2.2%
<b>ZipRecruiter</b>	05/26/2021	2,207,060	80.7%	27.1%	2.4%
<b>Amplitude</b>	09/28/2021	5,627,960	34.6%	12.6%	4.1%
<b>Warby Parker</b>	09/29/2021	6,075,635	69.7%	39.9%	3.0%

Another Section 11 issue arises from the lack of any underwriting in the direct-listing process. Underwriters' due-diligence efforts not only provide a quality signal to potential investors but also bring potential Section 11 liability for the underwriter in connection with its due diligence. SEC Commissioners Lee and Crenshaw noted this lack of investor protection as a potential weakness of direct listings.<sup>7</sup>

<sup>4</sup> Direct listing issuers may also register additional shares after shares begin trading, covering, for example, shares to be issued in connection with employee equity compensation plans.

<sup>5</sup> Market capitalization and volume data from Eikon. Share registration data from each company's S-1A filing.

<sup>6</sup> Average daily trading volume in the first month following each company's direct listing.

<sup>7</sup> Allison Herren Lee & Caroline A. Crenshaw, "Statement on Primary Direct Listings," SEC (Dec. 23, 2020), <https://www.sec.gov/news/public-statement/lee-crenshaw-listings-2020-12-23>.

## Section 11 damages issues

Section 11 damages follow a statutory formula: damages are the difference between the purchase price of the security (not to exceed the public offer price) and the sale price of the security.<sup>8</sup> A direct listing of shares raises an important issue, namely, the lack of any public offering price.<sup>9</sup> There are several alternative ways plaintiffs and defendants might approach the public offer price limitation, which we describe below; we also raise notable questions related to each alternative.

**No public offer-price limitation:** The simplest approach, for which plaintiffs might advocate, is to ignore the offer-price damages limitation as irrelevant in the case of direct listings, as the registration statement contains no offer price.<sup>10</sup> Would this approach, though, be at odds with the intent behind the Section 11 public offer-price limitation? That might depend on what purpose is served by the offer-price damages limitation. One view is that the limitation caps the exposure of issuer and/or selling shareholder defendants so they are liable for no more than the amount of funds received in an offering.<sup>11</sup> Under this view, the lack of a public offer price is indicative of the fact that no funds were raised. An alternative view would hold that the public offer-price limitation relates to limits on the investors' ability to link their damages to a specific registration statement. That is, if an investor chooses to pay more than the offer price, they forfeit the ability to claim Section 11 damages for such overpayment.<sup>12</sup>

Research has shown that traditional IPOs often result in market prices exceeding the offer price shortly after trading begins (the so-called first day "pop"). Therefore, the offer-price limitation is often a binding damages limitation for investors who purchase shares in the secondary market.<sup>13</sup> Although not many firms have gone public via direct listing, their first-day price changes do not consistently result in the first-day "pop" seen in traditional IPOs, as demonstrated in Table 2 below. For Section 11 damage claims, not having an offer-price limitation provides a potential improvement to secondary market purchasers as compared to secondary market purchasers after traditional IPOs.

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<sup>8</sup> Section 11 statutory damages are limited by the securities price at the time of lawsuit and any post-lawsuit filings' price recovery, for shares sold after the lawsuit filing.

<sup>9</sup> Others have noted this issue. See, e.g., Andrew Clubock et al., "Complex and Novel Section 11 Liability Issues of Direct Listings," *Corporate Counsel* (Dec. 20, 2019), <https://www.lw.com/thoughtLeadership/section-eleven-liability-direct-listings>.

<sup>10</sup> The pre-public selling shareholders might argue that when they offer their shares to the secondary market through brokers, an "offer price" is represented by brokerage quotes. The prices that pre-public selling shareholders received in their transactions would reflect buyers' acceptance of these offers.

<sup>11</sup> In typical public offerings, the public offer price will be higher than the amount of funds received by the issuer in the amount of the underwriting discount.

<sup>12</sup> For example, in secondary market trading, the share may resell at a price higher than was paid to the issuer/selling shareholders when it was initially offered.

<sup>13</sup> Assuming such secondary market trades are able to establish Section 11's tracing requirements.

**Table 2: Direct Listing First-day Return: Open to Close<sup>14</sup>**

Company name	Reference price	First day open	First day close	Private transaction price(s) <sup>15</sup>	Max offer price per share <sup>16</sup>
[a]	[b]	[c]	[d]	[e]	[f]
<b>Spotify Technologies</b>	\$ 132.00	\$ 165.90	\$ 149.01	\$ 48.93 to \$ 131.88	\$ 17.94
<b>Watford Holdings</b>	\$ 25.26	\$ 25.26	\$ 27.00	n/a	\$ 39.22
<b>Slack</b>	\$ 26.00	\$ 38.50	\$ 38.62	\$ 26.38	\$ 1.68
<b>Palantir Technologies</b>	\$ 7.25	\$ 10.00	\$ 9.50	\$ 7.31	\$ .48
<b>Asana</b>	\$ 21.00	\$ 27.00	\$ 28.80	\$ 25.11	\$ .52
<b>Thryv Holdings</b>	\$ 12.40	\$ 14.00	\$ 11.08	\$ 10.17	\$ 1.18
<b>Roblox</b>	\$ 45.00	\$ 64.50	\$ 69.50	\$ 6.34	\$ .85
<b>Coinbase Global</b>	\$ 250.00	\$ 381.00	\$ 328.28	\$ 343.58	\$ 8.21
<b>SquareSpace</b>	\$ 50.00	\$ 48.00	\$ 43.65	\$ 68.42	\$ .00
<b>ZipRecruiter</b>	\$ 18.00	\$ 20.00	\$ 21.10	\$ 9.00	\$ 1.19
<b>Amplitude</b>	\$ 35.00	\$ 50.00	\$ 54.80	\$ 35.41	\$ 3.14
<b>Warby Parker</b>	\$ 40.00	\$ 54.05	\$ 54.49	\$ 24.53	\$ 2.45

**Maximum offering price in the registration statement:** For purposes of calculating registration statement fees, issuers provide a value of the maximum aggregate offering price. For direct listings of common stock, these are not based on public offer prices but rather on some other indications of value. Direct listing registration statements typically use book value of equity, which reflects the historical cost at which stock was issued plus any net retained earnings since issuance and is likely to be much lower than current market price. One issue with such an approach is that this is an estimate of value rather than an actual transaction price. Because courts have drawn distinctions between “value” and “price,” it is unclear whether the Section 11 offer-price limitation can be set using estimates of value rather than observable transaction prices.<sup>17</sup>

**Reference price:** The exchange publishes a reference price prior to trading of a direct listing stock. Both the NYSE and NASDAQ reportedly set reference prices using buy and sell orders received from broker dealers before the listing, as well as consultation with the issuer’s financial advisor.<sup>18</sup> These exchanges may also consider recent private placement transactions, where available, in their

<sup>14</sup> Reference prices published by stock exchange and other media outlets. Share price data from Eikon.

<sup>15</sup> Most recent private transaction price (range), as listed in each company’s S-1A filing.

<sup>16</sup> Based on book value of Class A common shares, as listed in each company’s S-1A filing.

<sup>17</sup> Melanie E. Walker, Nicholas K. Tygesson, and Aaron Dolgoff, “Section 11 Damages and Stock-for-Stock Acquisitions: Legal and Economic Considerations,” *Bloomberg Law*, 2019.

<sup>18</sup> “Choose Your Path to Public: Direct Listing, Now with a Capital Raise,” NYSE, <https://www.nyse.com/direct-listing> (accessed May 1, 2022); “NASDAQ Direct Listings Offer a Different Way to Go Public with Unrestricted Liquidity and No Lock-up Period,” Nasdaq, <https://www.nasdaq.com/solutions/direct-listings>.

determination of the reference price.<sup>19</sup> Contrary to the name, a reference price is really an estimate of value rather than an actual transaction price. Thus, similar to the maximum offering price in the registration statement, the reference price might not be accepted as a price limitation. As shown in Table 3 below, reference prices are typically lower than either the opening or closing first-day trading prices for direct listing securities.

**Table 3: Direct Listing First Day Return: Change from Reference Price to Open or Close**

Company name	First-day open price gain (loss) compared to reference price	First-day closing price gain (loss) compared to reference price
[a]	[b]	[c]
<b>Spotify Technologies</b>	25.7%	12.9%
<b>Watford Holdings</b>	0.0%	6.9%
<b>Slack</b>	48.1%	48.5%
<b>Palantir Technologies</b>	37.9%	31.0%
<b>Asana</b>	28.6%	37.1%
<b>Thryv Holdings</b>	12.9%	-10.6%
<b>Roblox</b>	43.3%	54.4%
<b>Coinbase Global</b>	52.4%	31.3%
<b>SquareSpace</b>	-4.0%	-12.7%
<b>ZipRecruiter</b>	11.1%	17.2%
<b>Amplitude</b>	42.9%	56.6%
<b>Warby Parker</b>	35.1%	36.2%

Another issue with using the reference price as an indicator of a public offering price is that it is set by a third party, not by the issuer, selling shareholders, or underwriter. That is, the reference price is set by an entity that plays no role in securities registration, and the reference price itself is generally not reported by the issuer in its registration statement filings. It is unclear that Section 11 damages limitations should be set by a price indication determined by third parties outside the registration filings themselves.

**First-day trading prices:** Prior to trading, the exchange conducts price discovery in its determination of the opening price. This discovery factors in buy and sell orders. The opening price is typically much higher than the reference price. As shown in Table 3 above, all but one direct listing company saw a positive gain in their opening prices when compared to reference prices, with a median increase of 32%. Although the opening price reflects an actual transaction based on buy and sell orders, it is set by an entity other than the company and is not reported in the registration statement. It is therefore

<sup>19</sup> Gibson Dunn, "A Current Guide to Direct Listings," Jan. 8, 2021, <https://www.gibsondunn.com/a-current-guide-to-direct-listings/>.

unclear whether it might be considered akin to an offer price under Section 11, mainly because it is not a price that investors rely on when submitting an order before listing. Investors might also consider secondary market prices after the initial opening price to be similar to an offer price. However, secondary market prices reflect transactions not only with shareholders' selling shares through the direct listing but also resales of secondary market purchases, and, thus, are further removed from the concept of an offering price.

**Recent transaction prices:** Closely related to the reference price are private transactions in the company's stock prior to the direct listing. Summaries of such transactions are typically included in the registration statement before a direct listing. Unlike the reference price, such prices have the advantage of being based on actual transactions, though in private placements. However, such transactions, again, do not represent an offer price for the securities sold through the direct listing. Moreover, such transactions may be of varying degrees of comparability to publicly traded shares bought after a direct listing due to differences in timing and terms associated with private placements. Because private-placement transactions may have discounts associated with illiquidity and/or lack of marketability, such transaction prices might be low relative to prices associated with public offerings.

## Conclusions

Direct listings raise many issues regarding the extent to which Section 11 liability applies to shares registered and ultimately traded via this form of public offering —namely issues arising from the lack of a public offer price in the registration statement and the comingling of registered and unregistered shares. This makes it difficult, if not impossible, to trace traded shares to a specific registration statement and, further, calculate damages under Section 11—two components typically needed to introduce such claims. Although the *Slack* ruling seems to have temporarily undermined these key features of Section 11 claims, similar claims and appeals will likely continue to challenge Section 11 claims brought against direct listing companies. Future Section 11 claims for direct listing securities are likely to face not only renewed scrutiny of traceability issues, but also, significant unresolved questions regarding the statutory offer-price limitation on damages.

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