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Federal Court Limits Section 11 Class Definition by Imposing Strict Share Tracing Requirement

On May 1, 2023, a federal court in California certified an investor class in a Section 11 lawsuit but restricted class membership to investors who purchased shares within 180 days of the IPO. *In re The Honest Company Securities Litigation*, 21-cv-7405 (C.D. Cal.). The court explained that, following that date, unregistered shares previously subject to an IPO "lock-up" entered the market and commingled with registered IPO shares, at which point it became "impossible" for any investor to prove that her shares were traceable to the allegedly misleading registration statement. The decision provides a strong argument for Section 11 defendants to limit the putative class size and substantially reduce their exposure and increase settlement leverage.

The Supreme Court is currently considering a related issue in *Slack Technologies, LLC* v. *Pirani*, where it agreed to review whether Section 11 "require[s] plaintiffs to plead and prove that they bought shares registered under the registration statement they claim is misleading." A decision in *Slack* is expected this summer and could impact Section 11 tracing arguments going forward.

Section 11 Traceability

Plaintiffs suing under Section 11 of the Securities Act of 1933 must plead and prove that they purchased shares that were issued pursuant to the allegedly false or misleading registration statement. This is not a difficult task immediately following a traditional IPO when all of a public company's shares trading on the open market are traceable to a single registration statement. This can, however, pose an issue for plaintiffs when shares from multiple offerings, or both registered and unregistered shares, are commingled on the open markets. Given the operation of modern markets, where investors' shares are typically deposited with a clearing house where they all bear the name of the clearing house's nominee and are held in fungible bulk, it can be extremely difficult for a shareholder to trace her shares back to a particular registration statement or offering.

Case Background

The Honest Company, a houseware and wellness company, sold 25.8 million shares in a traditional IPO on May 5, 2021. As is common, pre-IPO investors who held unregistered, non-IPO shares were subject to a 180-day "lock-up" period, during which they were prohibited from selling their shares. On August 19, 2021, 6,740 shares of unregistered common stock were released from the "lock-up" condition and entered the public markets.

After the company's share price declined, a putative class of shareholders asserted Section 11 claims alleging material misstatements and omissions in the offering documents. Plaintiffs' claims survived a motion to dismiss and plaintiffs moved to certify a class of investors whose shares were "traceable" to the registration statement. Defendants argued that any class should not include investors who traded after the end of the lock-up period.

The District Court's Decision

The court agreed with defendants. Although it certified a class, it modified the class definition by limiting it to investors who purchased or acquired shares "pursuant and traceable to the Offering Documents . . . *prior to August 19, 2021*." The court described the "realities of modern securities trading" in detail and explained that, "once shares that did not originate from an IPO are commingled with IPO shares it is effectively impossible to determine the origin of any individual stock."

Lead plaintiff argued that a class definition cut-off date was inappropriate because the proposed class definition was limited to investors whose shares were "traceable" to the registration statement, and because lead plaintiff herself purchased shares before the expiration of the lock-up period. The court rejected these arguments, explaining that without a properly limited class, individual class members would be required to prove that their shares were traceable to the IPO such that individual issues would predominate over common, class-wide issues. The court also rejected the argument that this issue could be resolved through the claims process because traceability is a matter of statutory standing, not claims analysis. Finally, the court noted its "concern" that its opinion could help inoculate corporations from Section 11 liability, but explained that its decision rested on statutory interpretation and that the court would not subvert the reasoned decisions of the legislative branch.

Implications

The reasoning in this decision provides a powerful argument for narrowing a proposed class in Section 11 lawsuits. Defendants opposing class certification in Section 11 cases may deploy this decision to argue that any class must exclude investors who transacted in the issuer's stock after the date on which unregistered shares first entered the secondary market—even if the number of unregistered shares were dwarfed by registered IPO shares. This decision and the arguments that flow from it may decrease defendants' exposure—and commensurately increase their settlement leverage—in Section 11 lawsuits. It remains to be seen what impact, if any, the Supreme Court's decision in *Slack* will have on these arguments.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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