Grabski v. Andreessen: Court of Chancery Addresses *Brophy* Claims Against Officers and Directors in a Direct Listing

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In *Grabski v. Andreessen*, C.A. No. 2023-0464-KSJM (Del. Ch. Feb. 1, 2024), the Delaware Court of Chancery declined to dismiss fiduciary claims against officers and directors of Coinbase Global, Inc. who sold shares in a going-public transaction. In the opinion, the court, which has in recent years decided a number of cases involving companies going public via de-SPAC mergers, addressed fiduciary principles in the context of another alternative to a traditional initial public offering: the direct listing.

Typically, companies go public via either an IPO, which generally involves a private company selling new shares to the public indirectly through an underwriter, or a de-SPAC merger, which generally involves a public shell company acquiring a private company and issuing new shares to the private company's stockholders as merger consideration. Rather than pursing either of these options, Coinbase decided to go public using a direct listing.

A direct listing involves the sale of shares held by the private company's existing stockholders directly to the public. In general, direct listings are considered to be less expensive than traditional IPOs because they do not require the use of underwriters. A direct listing can also be an attractive option for existing stockholders of a private company. For those who do not wish to sell, a direct listing may be preferable because it does not dilute existing holders. And for those who do want to sell, it can offer more immediate liquidity than other going-public alternatives because IPOs and de-SPACs are often structured to impose lock-ups on existing investors. A lock-up prevents pre-IPO stockholders from selling their shares for a period of time (typically 90 to 180 days) following the IPO. And while lock-ups are not required by the Securities and Exchange Commission or stock exchanges, they are often requested by underwriters in IPOs or implemented voluntarily by the company as a means to reduce the volatility in the post-IPO stock price that could result if all pre-existing stockholders were able to sell their shares immediately. As noted by the court, the lock-up period can also give the public more time to receive information about the company through required current and periodic reports before insiders are permitted to sell, which, in turn, can help to alleviate potential informational asymmetries among market participants.

As alleged by the plaintiff, Coinbase decided to pursue a direct listing because it would provide liquidity to employees and existing investors while minimizing dilution and the overall cost of going public. In preparation for the direct listing, the company ran a secondary trading program for non-insiders that was designed to help set a reference price for purposes of the direct listing. The average stock price that resulted from the trading program was $343.58 per share. In early 2021, the Coinbase board approved a direct listing, but, based in part on the recommendation of Coinbase management, decided not to impose lock-up periods on insider investors or employees. Around the same time, the board had reviewed and approved a Section 409A valuation prepared by the company's tax consultants that valued the common stock at $303.75 per share for purposes of issuing equity and options to employees.

Coinbase completed its direct listing in April 2021, setting the initial reference price for its shares in conjunction with Nasdaq at $250. The stock price opened on Nasdaq at $380 per share and rose as high as $429 per share on the first day of trading. In the first week following the direct listing, Coinbase's officers and directors sold $2.9 billion worth of stock to the public. Two years later, a stockholder who bought stock on that first day of trading brought a derivative suit against five directors and four officers of Coinbase who sold stock in the days following the direct listing, alleging that the defendants had breached their fiduciary duties by improperly selling their shares while in possession of material, non-public information regarding the company. At the time the lawsuit was filed in April 2023, Coinbase's stock was trading in the range of $50 to $60 per share. The defendants moved to dismiss the complaint under Court of Chancery Rules 23.1 and 12(b)(6).

In addressing the motion to dismiss, the court explained that under *Brophy v. Cities Service Co.* the plaintiff's claims were derivative because they involved the alleged misuse of corporate property (confidential information) by fiduciaries of the corporation for personal gain. Given that the claims were derivative and that the plaintiff had not made a pre-suit demand on the board, the court assessed whether demand was excused. The court concluded that it was because the plaintiff had adequately alleged that a majority of the members of the board had received "staggering amounts" in the direct listing while in possession of material, non-public information (namely, the 409A valuation) such that a majority of the board was incapable of impartially considering the demand and/or faced a substantial likelihood of liability. For similar reasons, the court also refused to dismiss the *Brophy* claims, finding that the plaintiff had adequately pled that the defendants had sold their shares while having access to the undisclosed 409A valuation and had acted with scienter by structuring the direct listing without a lock-up on corporate insiders such that they were free to sell into the market immediately.

While the court was required to draw plaintiff-friendly inferences in this case given that it was in the early stages of litigation, the court's opinion does suggest some factors to consider when engaging in a direct listing. First, disclosures in this context will be closely scrutinized after the fact. As a result, care should be taken to provide disclosure to the public of all material information bearing on the value of the shares to be sold in the direct listing. And in this context, recent valuation information (even if prepared for other purposes, such as a 409A valuation) will likely be considered material by the Delaware courts. Second, consideration should be given to requiring corporate insiders, such as officers and directors, to agree to some reasonable lock-up period that delays their ability to sell their shares to the public in or immediately after the direct listing. While doing so would eliminate one of the potential benefits to them of a direct listing, it would also lower the risk that they will be accused of improperly benefiting from potential information asymmetry in the days following the going public transaction.

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