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June 2005 / Special Alert

A legal update from Dechert's Financial Services and Securities Litigation Group

NY Court of Appeals: Lead Underwriter Owes a Fiduciary Duty to Issuer for Pricing of IPO

The lead underwriter in an initial public offering owes a fiduciary duty to the issuer to disclose conflicts of interest in connection with the pricing of securities, according to a decision by the New York Court of Appeals on June 7, 2005.

In a case of first impression in New York, the New York Court of Appeals held on June 7, 2005, in *EBC I, Inc. v. Goldman Sachs & Co.*, that the lead managing underwriter in a firm commitment underwriting may owe a fiduciary duty to the issuer with respect to alleged expert advisory services in connection with the pricing of an initial public offering. The Court of Appeals, New York's highest state court, found that the plaintiffs' allegations that the defendant failed to disclose an alleged profit-sharing "kickback" scheme with the underwriter's favored clients stated a claim for breach of that fiduciary duty.

According to the complaint, in January 1999 eToys, Inc. ("eToys"), an internet-retailer specializing in the sale of products for children, retained Goldman Sachs & Co. ("Goldman Sachs") as lead managing underwriter of its initial public offering. After meeting with potential investors, responding to inquiries concerning eToys' business, and gauging investors' indications of interests in eToys' shares, Goldman Sachs entered into a firm commitment underwriting agreement with eToys to purchase at least 8,320,000 shares of eToys shares for $18.65 per share, and offer such shares to the public at $20 per share, thus potentially providing the underwriters with a profit of $1.35 per share or 6.75% of the offering proceeds.[1]

On the first day of trading, eToys shares opened at $79 per share, rose as high as $85 per share and closed at $76.56. By the end of the year, the shares had declined to $25, and in March 2001 eToys filed for Chapter 11 protection in the Bankruptcy Court for the District of Delaware. The Bankruptcy Court authorized the Official Unsecured Creditors ("Committee") to sue Goldman Sachs on behalf of eToys, now known as EBC I, Inc.

The complaint alleged that eToys relied on Goldman Sachs for its expertise as to pricing the IPO, and that Goldman Sachs gave advice to eToys without disclosing that it had a "conflict of interest" consisting of an arrangement with Goldman Sachs' customers to receive a kickback of a portion of any profits they made from the sale of eToys shares subsequent to the IPO. The complaint further alleged that Goldman Sachs had an incentive to underprice the IPO because an initial lower price would result in higher profits to its customers and thus a higher payment to Goldman Sachs from such an undisclosed scheme.

Based upon these allegations, the Committee sued Goldman Sachs alleging breach of fiduciary duty, breach of contract, fraud, professional malpractice and unjust enrichment. Goldman Sachs moved to dismiss. Upon appeal to the Court of Appeals, the state's high court dismissed the Committee's claims for breach of contract, professional malpractice and unjust enrichment. The Court found no error in the intermediate appellate court's ruling allowing the Committee to

[1] In addition to Goldman Sachs, there were three other co-managing underwriters who formed an underwriting syndicate, later joined by other firms.

replead its claim for fraud in connection with the alleged kickback scheme in order to attempt to meet New York's more stringent fraud pleading requirements. However, in a decision of first impression in New York, the Court upheld on a pleading basis the Committee's cause of action for breach of fiduciary duty.[2]

In reaching this result, the Court of Appeals recognized that the firm commitment underwriting agreement between Goldman Sachs and eToys was negotiated at arm's length between parties represented by sophisticated counsel, and that the agreement itself did not create a relationship of trust that would give rise to a relationship of higher trust from which fiduciary duties could be imposed. In fact, a firm commitment underwriting relationship has traditionally been viewed as adversarial in that it is in the underwriter's interest to set a price that minimizes its exposure for unsold shares, while the issuer wants to maximize what it will receive from the offering, as well as accomplishing such other objectives as gaining access to the capital markets and increasing its visibility in the marketplace. If either party believes the price the other wishes to set is too high or too low, it can withdraw from the offering before the underwriting agreement is signed.[3]

The Court of Appeals found, however, that the Committee had alleged an extra-contractual advisory relationship between the issuer and the underwriter with respect to the pricing of the IPO independent of the underwriting agreement, and that eToys had reason to believe that its interests and those of Goldman Sachs were aligned via their fixed profit underwriting spread agreement. Such facts, the Court found, converted the alleged relationship from a mere arm's length, commercial one to a relationship "of higher trust." Such allegations, the Court found, were sufficient to sustain a claim for breach of fiduciary duty, although the Court of Appeals took pains to state that its holding was limited to where underwriters are alleged to act as "expert advisors to their clients on market conditions."[4] The Court of Appeals also rejected the notion that recognition of such a fiduciary duty with respect to pricing the security to be offered would put the underwriter in conflict with its securities law duties to potential investors in the securities being offered, or to its agency duties to fellow syndicate members, if it also owed fiduciary duties to the issuer.

As pointed out by the dissent, until the *EBC I, Inc*. decision, New York was particularly strict in refraining "from injecting fiduciary obligations into sophisticated, counseled parties' arms-length commercial dealings." By finding that a buyer might "owe a duty of the highest trust and confidence to a seller regarding a negotiated purchase price," the Court of Appeals, despite its cautionary language as to the limits of its decision, has seemingly departed from longstanding principles of contract law governing the relationship between sophisticated parties. This result is of potential concern for a number of reasons.

First, as the Securities Industry Association argued in its amicus brief, "New York law is overwhelmingly chosen to govern the contracts that enable securities to be offered to the public. In short, just as New York is critical to the capital formation process, the participants in that marketplace have long relied upon New York law as the basis upon which the risks and rewards of that enterprise are conferred and protected."[5] Recognition of new fiduciary obligations of uncertain dimension could lead to new claims not contemplated when underwriting arrangements were originally negotiated. Underwriters may also reconsider their choice of New York law to avoid such uncertainty. It remains unclear after *EBCI I, Inc.* whether changes to underwriting agreements could effectively preclude claims of a relationship giving rise to broader, unstated obligations.

Second, the Court of Appeals' recognition of a new fiduciary duty claim in the underwriting context comes at a time when the New York Stock Exchange and the NASD have proposed new rules governing the entire IPO process. [6] As the dissent cautioned, "how our new

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2 In *Breakaway Solutions, Inc. v. Morgan Stanley & Co.*, Inc, 2004 WL 1949300 (Del.Ch.), the Court found that such a duty existed under New York law but grounded its decision on the Appellate Division decision in the EBC I, Inc. case. Id. at *13. In MDCM *Holdings, Inv. v. Credit Suisse First Boston Corp.*, 216 F. Supp. 2d 251, 260 (S.D.N.Y. 2002) and *Xpedior Creditor Trust v. Credit Suisse First Boston (USA) Inc.*, 2004 WL 435058 (S.D.N.Y.), such claims survived motions to dismiss under the simple fair notice pleading standard of the Federal Rules without discussion of the factual basis under which such an extra contractual breach of fiduciary duty claim could arise.

3 See Brief Amicus Curiae of the Securities Industry Association ("SIA Brief") located at 2004 WL 3327880 at *5-9.

4 Notably, the Court of Appeals left for another day the question of whether an underwriter could face liability for professional malpractice in the providing of such advice.

5 SIA Brief at *4.

6 See pending proposed NYSE Rule 470 and NASD Rule 2712 (see 69 Federal Register 77,8004 [Dec. 28, 2004]; see also 70 Federal Register 19,672 [April 13, 2005]), which, if adopted, will govern allocations and distributions of share in IPOs.

fiduciary duty for underwriters may fit into or conflict with the developing regulatory scheme [for initial public offerings] is impossible to predict." Again, by recognizing a new common law duty in the face of the efforts by two major self-regulating organizations to come up with comprehensive and universal rule-making to address the problems caused by the "internet high tech mania" that gave rise to the *EBC I, Inc*. case—and the spate of federal and state enforcement actions that followed thereon—the Court of Appeals may have, as the SIA and the dissent argued, injected "uncertainty into a complex subject of enormous importance to investors."

The practical options open to underwriters to avoid imposition of unexpected fiduciary obligations in the wake of *EBC I, Inc.* are unclear as is the protective effect of such steps. Designating another state's law to govern may be one consideration, although it is premature to assume that such a choice would avoid application of New York fiduciary duty law. Careful drafting to narrow the lead underwriter's role, with close monitoring to ensure adherence to such limits, may be useful. Avoidance of collateral relationships with the issuer client could also play a role. Risk analysis when undertaking underwriting roles, particularly for long-term clients, will be important since the breadth and depth of relationships may provide issuers additional arguments that their dealings with underwriters were closer than arm's length. And the fundamental question of how underwriters are compensated has become relevant, since the Court of Appeals found that the unity of interest resulting from the industry-standard fixed profit-based compensation arrangement could have given the client issuer additional reason to repose trust in the underwriter.

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