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Underwriter Not a Fiduciary of a Security Issuer

The New York state appellate court recently ruled that the lead underwriter in an initial public offering does not owe a fiduciary duty to the issuer of securities to disclose conflicts of interest in connection with the pricing of the securities, unless the two parties have a distinct relationship of higher trust that arises apart from the underwriting agreement.

Background

On December 8, 2011, the New York State Appellate Division, First Department, held in *EBC I, Inc. v Goldman Sachs & Co.* that Goldman Sachs & Co. ("Goldman Sachs"), the lead underwriter for the initial public offering of common stock (the "IPO") by EBC I, Inc., formerly known as eToys, Inc. ("eToys"), was not eToys' fiduciary.

According to the amended complaint, in January 1999, eToys, an internet start-up company that specialized in children's products, retained Goldman Sachs to act as lead underwriter of the IPO, which launched on May 20, 1999. Goldman Sachs entered into a firm commitment underwriting agreement with eToys to purchase 8,320,000 shares of eToys common stock for $18.65 per share and to offer such shares for sale to the public at $20 per share. On the first day of trading, eToys' stock opened at $79 per share. It peaked at $85 per share and ultimately closed on the first day of trading at $76.56 per share. By December 1999, the price of eToys' stock in the secondary market had declined to about $25 per share. In March 2001, eToys filed for Chapter 11 bankruptcy. In 2002, the Official Unsecured Creditors' Committee of eToys ("Creditors' Committee") sued Goldman Sachs on behalf of eToys.

On June 7, 2005, the Court of Appeals, New York's highest state court, ruled that the claim asserting breach of fiduciary duty on the part of Goldman Sachs should survive summary judgment and move to a trial. The case was then sent back to the New York Supreme Court, and, on November 8, 2010, the Supreme Court granted Goldman Sach's motion for summary judgment and dismissed the case. The Creditors' Committee appealed, and, on December 8, 2011, the New York State Appellate Division affirmed the Supreme Court's ruling that the lead underwriter in a firm commitment underwriting does not owe a fiduciary duty to the issuer with respect to the pricing of an initial public offering absent a distinct relationship of higher trust that arose apart from the underwriting agreement.

Discussion

The Creditors' Committee alleged that Goldman Sachs was eToys' fiduciary because eToys had relied on Goldman Sachs' expert advice in pricing its IPO and had placed trust and confidence in Goldman Sachs in doing so. It further alleged that Goldman Sachs breached its fiduciary duty to eToys by offering advice to eToys without disclosing an alleged profit-sharing arrangement with certain favored Goldman Sachs clients. The Creditors'

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Committee further argued that Goldman Sachs had an undisclosed incentive to underprice the IPO shares because an initial lower price per share would result in higher profits to its favored clients, which would lead to a higher "kickback" payment to Goldman Sachs under the alleged profit-sharing scheme.

In its recent opinion, however, the New York appellate court concluded:

- the underwriting agreement was the result of an arm's length negotiation between sophisticated parties, each represented by counsel;
- the pricing of the IPO was a negotiated term of the underwriting agreement;
- the underwriting agreement did not create a distinct relationship of higher trust from which fiduciary duties could be imposed; and
- firm commitment underwriting relationships are inherently adversarial because the underwriter has an incentive to set a lower price (which makes it easier to sell shares in the offering), while an issuer seeks a higher price to maximize its proceeds from the offering. Such an adversarial relationship, the court held, cannot give rise to a fiduciary relationship.

Whether or not the lead underwriter of a public securities offering is an issuer's fiduciary is a crucial determination because it affects the standard of care owed by an underwriter to an issuer. As a fiduciary, an underwriter would be obligated to act in the issuer's best interest and would owe a heightened level of care and loyalty. Alternatively, if, as the New York appellate court held, an underwriter is merely the issuer's advisor, then the obligations of the underwriter are purely contractual, resulting in a higher threshold for potential liability in the event of a dispute.

The New York Court of Appeals' 2005 ruling caused a great deal of uncertainty regarding the role and obligations of underwriters in a public securities offering. Previously, New York courts had refrained from imposing fiduciary duties on sophisticated parties in arm's length transactions. This uncertainty prompted a majority of underwriters to revise their forms of underwriting agreements to include protective provisions to minimize the risk of being deemed a fiduciary in the context of an underwriting relationship.

The appellate court's December 2011 decision suggests that, in New York, whose state law governs almost all underwriting agreements, claims against underwriters for breach of fiduciary duty will generally fail. However, some degree of uncertainty remains, and underwriters should bear in mind that this decision merely represents one state's interpretation as to the nature of the underwriter-issuer relationship. There is no guarantee that other courts and other states will follow suit or apply New York law on the question.

To minimize the risk of being labeled a fiduciary, underwriters should continue to include provisions in their underwriting agreements whereby all parties to the agreement expressly acknowledge and agree that the underwriter is not acting as the issuer's financial advisor and does not owe any duties, including fiduciary duties, to the issuer, except as specifically provided in the underwriting agreement. In addition, the parties should expressly acknowledge and accept the possibility of a conflict of interest due to the underwriter's existing arrangements with third parties. Underwriters should also adhere to the bounds of the relationship as set forth in the underwriting agreement to avoid creating an extra-contractual relationship of higher trust, which could potentially lead to the imposition by the courts of a fiduciary relationship between the issuer and underwriter.

Practice group contacts

If you have questions regarding the information in this legal update, please contact the Dechert attorney with whom you regularly work, or any of the attorneys listed.

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