LEGAL POST

New York high court ruling leaves underwriters exposed to litigation from both sides on IPOs

Duty chills underwriters

BY SANDRA RUBIN
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A lead underwriter may have a fiduciary duty to an issuer when pricing an initial public offering if it talks about using its expertise when pitching for the engagement, New York's highest court has held in a benchmark ruling the securities industry calls of "great concern."

EBC I Inc. v. Goldman Sachs & Co. cuts to the very heart of dealings between underwriters and their clients.

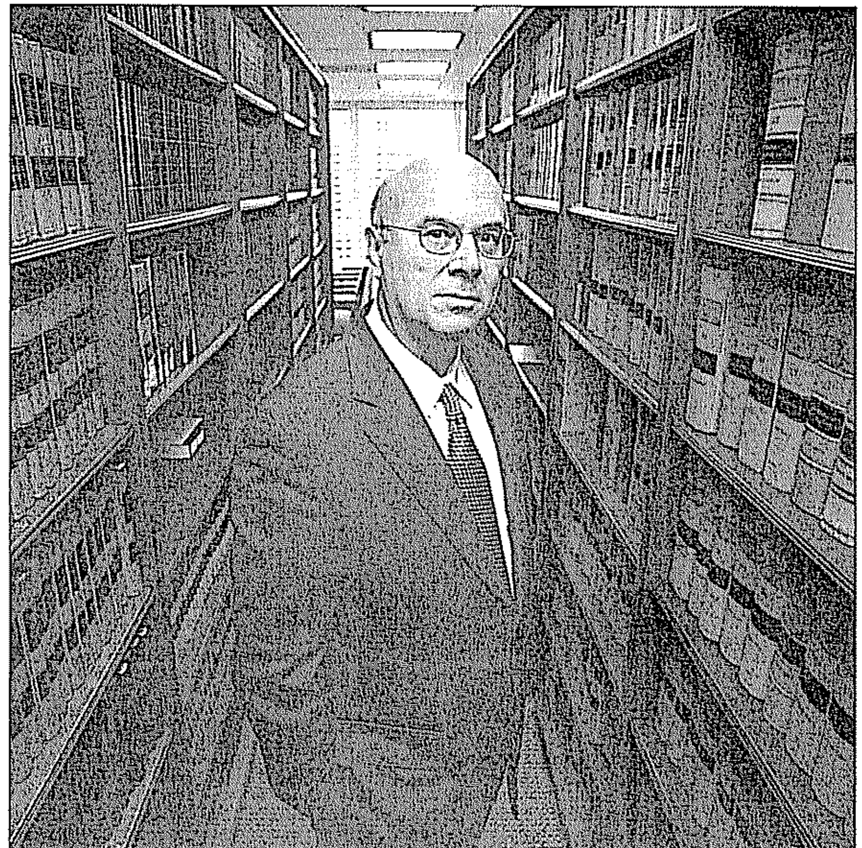
While the New York Court of Appeals decision is narrow, the possibility an advisory relationship could be created by a lead underwriter pledging to use its market knowledge to achieve a successful public offering — long considered an arm's-length commercial transaction — has sent a jolt through Wall Street.

"My view, the Street's view, at least the underwriting side of the Street, is that the Court of Appeals has misconceived how these relationships work," says Leslie Silverman, a corporate partner at Cleary Gottlieb Steen & Hamilton. The New York firm prepared an *amicus* brief for the Securities Industry Association in a vain attempt to convince the appeals court to overturn the lower-court decision.

'Saying 'we're going to work with you to help you achieve a successful offering' is what everyone says. Underwriters are always trying to sell themselves to some degree because there's competition and, if you want to be the lead underwriter, you need to shine in a beauty contest.

"The court said this is different from a standard underwriting — and unfortunately it's not. This is what happens all the time and I don't think it creates this kind of relationship. I think it's sales talk that ought to properly be distinguished from an advisory relationship."

The association, which represents nearly 600 U.S. investment banks, broker dealers and mutual funds, said in its brief that the objectives of underwriter



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designed to safeguard investors."

And the decision reaches across the border. It's common for underwriters such as Goldman Sachs, Merrill Lynch and Morgan Stanley to stipulate that agreements on cross-border deals be subject to New York law. And it's not unheard of when they lead all-Canadian deals.

Bill Horton, a senior litigator at Blake Cassels & Graydon in Toronto, says precedent suggests a Canadian court could find the same way. He said the Ontario Court of Appeal held in *Standard Investments Ltd. et al. v. Canadian Imperial bank of Commerce*, that a financial institution can have a fiduciary duty to a client to disclose another transaction with respect to the same securities.

He also pointed to *Drabinsky v. KPMG et al.*, in which Ontario's Superior Court found the fiduciary duty of an advisor goes "beyond the duty not to disclose confidential information."

"I think on the basis of these cases, a Canadian court would have no difficulty in finding that a broker who advises a client on the price at which a security should be offered may have a duty — depending on all the facts that are proven at trial — to disclose any other transactions in which the broker is involved for its own account relating to the same securities," he says.

"I am not sure that the basis for liability in Canada would necessarily be breach of fiduciary duty. I don't think that the Canadian court would so easily dismiss the other possible causes of action such as misrepresentation, unjust enrichment and breach of contract."

John Savarese, a litigator at Wachtell Lipton Rosen & Katz — which was not involved in eToys — says it's disturbing that a simple allegation the relationship went beyond underwriting is enough to sustain a lawsuit in the absence of any formal advisory agreement.

In fact, Wachtell is telling its clients the eToys decision is a reminder of the "increasingly unforgiving nature of the current legal and regulatory landscape, regardless of whether any specific law or market knowledge to achieve a successful public offering — long considered an arm's-length commercial transaction — has sent a jolt through Wall Street.

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The association, which represents nearly 600 U.S. investment banks, broker dealers and mutual funds, said in its brief that the objectives of underwriter and issuer "inherently diverge" when it comes to pricing.

Underwriters want a lower IPO price, because they are going to resell the shares and want to ensure demand and make the maximum profit. The company wants the highest price possible. That's why pricing is negotiated between the two sides, each with its own legal counsel.

The association said the imposition of a fiduciary duty is "of great concern due to the harm it could cause." It said it would expose investment banks to "simultaneous liability from parties on opposite sides of the buy-sell relationship with inherently contradictory interests."

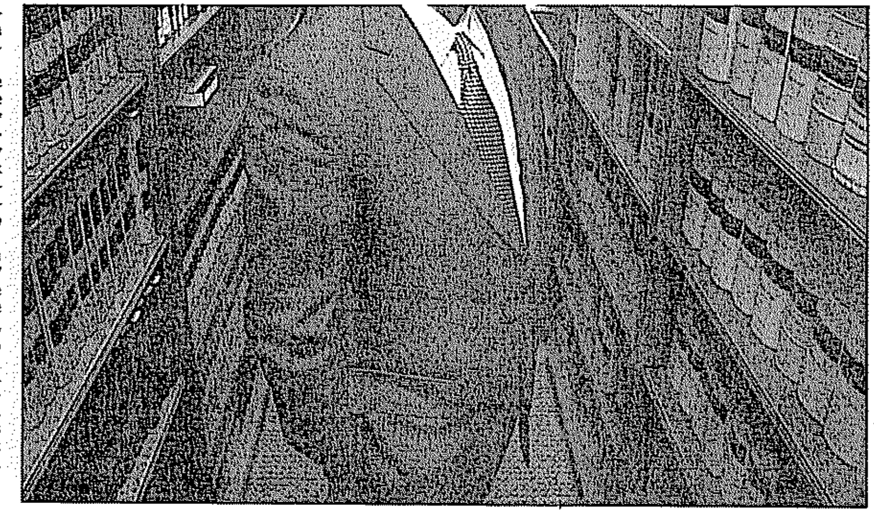
But the majority of judges on the New York Court of Appeals, over a strongly worded dissent, called such warnings "overstated" and said the decision is limited to actions such as providing advice on market timing — although most issuers would expect that from their lead underwriter.

"To the extent underwriters function, among other things, as expert advisers to their clients on market conditions, a fiduciary duty may exist," the panel said in the June 7 decision. "We stress, however, that the fiduciary duty we recognize is limited to an underwriter's role as adviser.

"We do not suggest that underwriters are fiduciaries when they are engaged in activities other than rendering advice."

The court allowed the claim for breach of fiduciary duty to proceed based on allegations that Goldman acted as an "expert adviser" in helping a now-defunct Internet company price its IPO. The company's creditors are alleging Goldman underpriced the issue to benefit from arrangements with buy-side clients to receive 20%-40% of any profit from the sale of their allotment.

The New York Stock Exchange and the National Association of Securities Dealers both have rules pending that will prohibit laddering, the practice of giving favoured clients a piece of an IPO to turn



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a quick profit. But the possible creation of a fiduciary duty in law from that type of transaction is an entirely different legacy, and reaction has been swift.

Investment banks are already looking at amending their standard form firm underwriting agreements to expressly disclaim a fiduciary relationship — although it's not clear that would be enough to keep them off the hook.

"I think you can expect to see revisions to negate this decision," concedes a senior litigator at a tier-one Wall Street firm. "People are already looking at it. They'd be crazy not to."

CREDITORS BRING SUIT

The case dates back to 1999, when ECB I Inc., which was then called eToys, retained Goldman Sachs as lead managing underwriter to take the company public.

It was a firm-commitment underwriting, in which the lead underwriter guarantees the issuer will raise a fixed amount of capital by buying the entire offering. The two sides negotiate the IPO price and the underwriter buys the shares at a discount. It then sells the shares to the public and makes its money on the spread.

With eToys, Goldman paid US\$18.65 a share and the IPO price was fixed at US\$20. That put its profit at US\$1.35 a share, or 6.75% of the offering proceeds.

When eToys started trading May 20, 1999, it opened at US\$79 but the inevitable euphoria was short-lived. Less than a year later, the Internet bubble had burst and the shares were trading below US\$20. In 2001, the company filed for bankruptcy protection in Delaware.

The U.S. Bankruptcy Court appointed a creditors' committee and authorized it to bring suit against Goldman Sachs on behalf of the company.

The complaint said eToys hired Goldman to give it advice on a fair IPO price and that, unbeknownst to the company, the investment bank had deliberately underpriced the issue in order to generate higher profits for favoured clients — and for itself — once the shares started trading.

The committee alleged Goldman had an advisory relationship with eToys that was separate from the underwriting relationship and which gave rise to fiduciary obligations.

It argued eToys had hired Goldman to give it advice for the benefit of the company, therefore the investment firm had a duty to disclose any conflict of interest concerning the pricing of the IPO. The causes of action were breach of fiduciary duty, breach of contract, fraud, professional malpractice and unjust enrichment.

The New York Supreme Court dismissed all but the fiduciary duty claim, saying "although the contract did not establish a formal fiduciary relationship ... the pleading sufficiently raises an issue as to the existence of an informal one."

'We do not suggest underwriters are fiduciaries'

The decision ended up before the New York Court of Appeals, which upheld the ruling. Because it was a motion to dismiss, the appeals court was required to treat all the allegations as true.

Goldman has denied the allegations and argued at every level the relationship between issuer and underwriter is an arm's length commercial one which can't give rise to fiduciary duties.

Justice Carmen Beauchamp Ciparick, who wrote for the majority, called that view "unavailing."

"Generally, a buyer purchases a seller's goods at a wholesale price and attempts to resell those goods at the highest possible profit," she wrote. "Such a transaction would negate any fiduciary duty concerning pricing advice as no rational seller would place trust in a buyer's pricing given the parties' opposing interests.

"Here, in contrast, Goldman Sachs and eToys agreed to a fixed profit from the selling of the securities — Goldman Sachs was to receive about 7% of the offering proceeds. Thus eToys allegedly believed its interests and those of Goldman Sachs were aligned: the higher the price the higher Goldman Sachs 7% profit."

JUDGE STRONGLY DISSENTS

Justice Susan Phillips Read, writing a vigorous nine-page dissent, said in allowing the claim to go forward "the majority disregards that eToys was a sophisticated, well-counselled business entity."

She also sided with the underwriting industry and against the majority view that Goldman may have had a duty to give eToys the highest price as part of its commitment to the company.

"How may a buyer ever owe a duty of the highest trust and confidence to a seller regarding a negotiated purchase price?" she asked. "The interests of buyer and seller are invariably not the same."

Justice Read disputed the view that Goldman "set" the price. She said it was negotiated between sophisticated parties, each with legal representation and based on not just anticipated demand for the shares but on eToys' historical performance, its business potential and earnings prospects.

She said she is "less sanguine than the majority about the consequences" of the decision, which "wars against our precedent and potentially conflicts with a highly complex regulatory framework

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In fact, Wachtell is telling its clients the eToys decision is a reminder of the "increasingly unforgiving nature of the current legal and regulatory landscape, regardless of whether any specific law or regulation is applicable."

"Not only have the regulators become tougher — but so have the judges in New York and the judges in Delaware who are involved in shaping the duties for directors and financial institutions," says Mr. Savarese. "That's one of the lessons of the case.

"I think the other is it will prove, in time, to be a difficult principle to cabin. You can be sure plaintiffs' lawyers will take maximum advantage of this decision and see if they can widen the scope of duties financial institutions have in other contexts.

"We'll have to see what judges do with this, but certainly I think it's a worry that everybody should have that the expanding scope of fiduciary duties is going to be applied in other contexts."

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