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Client Alert

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New York State Court of Appeals Recognizes a Fiduciary Duty of Lead Underwriter

In a recent decision, the New York State Court of Appeals found that there exists a fiduciary relationship between the managing underwriter of an underwritten initial public offering (IPO) and the issuer, when the managing underwriter renders advice, such as when it advises the issuer on the initial offering price of the securities to be sold.

The Complaint and Decision

The case, *EBC 1, Inc. vs. Goldman, Sachs & Co.*, decided by the Court of Appeals on June 7, 2005, arose out of the initial public offering of eToys, Inc. for which Goldman, Sachs & Co. acted as lead managing underwriter. Goldman Sachs and eToys entered into a customary underwriting agreement and the initial offering price was fixed at $20.00 per share. On the first day of trading, May 20, 1999, the stock opened at $79.00 per share, but, by the end of the year, the stock closed at $25.00 per share and thereafter fell below $20.00 per share and never rose above the initial offering price. In March 2001, eToys filed a petition for reorganization under Chapter 11 of the U.S. Bankruptcy Code.

The complaint, filed by the unsecured creditors committee of eToys, alleged that eToys had relied on Goldman Sachs's expertise in pricing the initial public offering and that Goldman Sachs, in giving that advice, did not disclose that it had a conflict of interest. The complaint specifically alleged that Goldman Sachs entered into an arrangement whereby certain of its customers "were obligated to kick back to Goldman a portion of any profits that they made from the sale of eToys stock subsequent to the initial public offering." Because a lower IPO price would result in a higher profit to these clients upon the resale of eToys stock and thus a higher payment to Goldman Sachs, the complaint further alleged that Goldman Sachs had an incentive to advise eToys to underprice its stock. Based on these allegations, eToys brought five causes of action against Goldman Sachs: breach of fiduciary duty, breach of contract, fraud, professional malpractice and unjust enrichment.

The Court of Appeals found the existence of a fiduciary duty claim and permitted the plaintiff to replead the fraud claim, while dismissing the other causes of action. Notwithstanding Goldman Sachs's argument that the relationship between an issuer and underwriter is an arm's-length relationship, the court found that a cause of action for breach of fiduciary duty may exist where the complaining party alleges that "the underwriter and issuer created a relationship of higher trust than would arise from the underwriting agreement alone."

In this case, the complaint alleged the existence of an advisory relationship that was independent of the underwriting agreement. Plaintiff alleged that:
(1) eToys was induced to rely upon Goldman Sachs's expertise to advise it as to a fair IPO price,
(2) Goldman Sachs thereby had a fiduciary obligation to disclose any conflict of interest concerning the pricing of the IPO and (3) Goldman Sachs breached this duty by allegedly concealing from eToys its divided loyalty arising from its alleged profit-sharing arrangements with clients.

In holding that the plaintiff had sufficiently stated a claim for breach of fiduciary duty, the court stated that a fiduciary duty may exist to the extent that an underwriter functions as an expert advisor to its client on market conditions and that when an underwriter does render such advice, it must disclose any conflicts of interest.

The Dissent

In reaching its decision, the majority disregarded the dissenting views of Judge Read that the initial offering price was not set by Goldman Sachs but was negotiated by the parties (based, in part, on market conditions); that the interests of a buyer (Goldman Sachs) and seller (eToys) are inevitably not the same and should not be subject to fiduciary duties; and, therefore, to impose a new fiduciary obligation on underwriters unnecessarily interferes with sophisticated, counseled parties' arm's-length commercial dealings. Judge Read expressed the view that any changes in this area would be better dealt with by specialized regulators than by the evolving common law.

Conclusion

In order to create a clear record that an issuer does not believe it has a fiduciary relationship with the underwriters, underwriters may wish to include a specific agreement to that effect in their underwriting agreements. Underwriters may further wish to add a provision to their underwriting agreements acknowledging that the offering price was arrived at through arm's-length negotiations between the underwriters and the issuer and that such price was not set or otherwise determined as a result of expert advice rendered by the underwriter to the issuer.

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