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# S.D.N.Y. Dismisses Claim Seeking Short-Swing Profit Disgorgement from IPO Underwriters

In *In re Facebook, Inc., IPO Securities & Derivative Litigation*, 2014 WL 1760332 (S.D.N.Y. May 2, 2014), the U.S. District Court for the Southern District of New York rejected the argument that underwriters and selling stockholders in an IPO should be treated as a "group" for the purposes of the short-swing profit rule as a result of "lock-up" agreements temporarily prohibiting shareholders from selling their shares without underwriter permission. The court rejected plaintiff's theory that the lock-up agreements required the underwriters and shareholders to be treated as a group—which would subject underwriters to short-swing profit liability—because plaintiff did not plead that the parties agreed to "acquire, hold or dispose of securities" together.

## Background

This case arises from the May 18, 2012 Facebook IPO. The plaintiff—a Facebook shareholder—sought disgorgement of short-swing profits under Section 16(b) of the Securities Exchange Act of 1934 from three financial institutions, which served as the lead underwriters in the IPO. Section 16(b)—the "short-swing profit rule"—creates a strict liability regime that requires directors and officers of an issuer of equity securities, and stockholders who beneficially own more than ten percent of the issuer's securities, to disgorge profits made from a purchase and subsequent sale (or sale and subsequent purchase) of those securities within a six-month period. Section 13(d) further provides that when two or more persons agree to act together "for the purpose of acquiring, holding, or disposing of securities of an issuer," they form a "group" in which each member is deemed to beneficially own all equity securities owned by other group members.

The plaintiff alleged that defendants violated the short-swing profit rule when they sold Facebook stock short on the day of the Facebook IPO, and then within six months purchased shares on the open market below the short-sale price. Defendants did not deny that they profited from these transactions; rather, defendants argued they did not beneficially own more than ten percent of Facebook's shares, and therefore were not subject to Section 16(b) liability. The plaintiff argued in response that two of the underwriter defendants formed a "group" with the selling shareholders—who did own more than ten percent of Facebook stock—because they entered into "lock-up" agreements that prohibited the shareholders from selling Facebook stock without the underwriters' permission. According to the plaintiff, under these agreements the "Lead Underwriters 'combined' with the Selling Shareholders in 'furtherance of a common objective' to hold the securities." The plaintiff also argued that the third underwriter defendant was required to disgorge trading profit under the short-swing profit rule because it

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owned more than a ten percent interest in Facebook stock when it sold its shares, although there was no evidence it still held a ten percent interest when it subsequently purchased shares at a lower price. Defendants moved to dismiss all of plaintiff's claims.

## District Court Opinion

On May 2, 2014, the district court granted defendants' motions to dismiss the complaint. The court rejected plaintiff's argument that the underwriters and selling shareholders formed a "group" under Section 13(d), explaining that a "group" only exists if there is an agreement between alleged group members "for the purpose of acquiring, holding, or disposing of securities." Judge Sweet wrote that, although the lock-up agreements suggested that defendants shared the intent to protect the stability of Facebook stock and the investing public, they did not "bind the two groups as to either their roles and interests during the IPO, or with respect to their conduct in relation to the Facebook shares." Further, although the agreements restricted the shareholders' ability to sell their shares, "the Lead Underwriters were under no reciprocal agreement."

The court acknowledged that lock-up agreements may support a "group" inference if supported by specific factual allegations. For example, in *Morales* v. *New Valley Corp.*, 999 F. Supp. 470 (S.D.N.Y. 1998), a lock-up agreement supported a "group" inference when it was accompanied by an agreement giving lead underwriters the right of first refusal to purchase the selling shareholders' securities. Here, however, the court concluded that "[t]he Selling Shareholders were sellers and holders of Facebook stock, whereas the Lead Underwriters functioned as distributors, and the two groups acted entirely independently in relation to [] acquiring or selling the Facebook stock prior to, during and following the IPO."

Judge Sweet also rejected plaintiff's argument that the third underwriter defendant had to disgorge profits under Section 16(b) when it was a ten percent Facebook owner at the time of its initial sale, but not at the time of its subsequent purchase. Citing *Foremost-McKesson, Inc.* v. *Provident Securities Co.*, 423 U.S. 232 (1976), the court explained that the short-swing profit rule only applies where the defendant was a principal stockholder "both at the time of the purchase and sale, or the sale and purchase, of the security involved." Accordingly, the district court dismissed the complaint in its entirety.

## Analysis

This opinion reinforces the principle that the "strict liability" application of the short-swing profit rule will be "confined within narrowly drawn limits." The district court refused to allow a plaintiff to transform IPO underwriters into participants in a beneficial ownership group (subject to the short-swing profit rule) simply because they entered into standard lock-up agreements with selling shareholders. This opinion may provide some comfort to underwriters by protecting them from short-swing profit liability absent factual allegations showing that the underwriters and selling shareholders acted with a common purpose.

The court's ruling is consistent with both industry practice and the spirit and text of Section 13(d). The purpose of the lock-up agreement is to protect an underwriter engaged in a distribution of securities from the adverse impact of further sales by insiders in the period immediately following the offering—the purpose is not to form a coordinated group of stockholders. Moreover, underwriters commonly engage in stabilizing activities that involve purchases and sales of securities in the period immediately following an offering. A finding that such activities could give rise to short-swing profit liability merely because of the existence of a standard lock-up agreement would have a widespread adverse impact on standard underwriting practices.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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