November 8, 2016

Second Circuit Holds That Parties to Standard Lock-Up Agreements in IPOs Do Not Form a "Group" for Section 13(d) and Section 16(b) Purposes

On November 3, 2016, in an appeal arising out of the 2012 initial public offering ("IPO") of Facebook, Inc. ("Facebook"), the Second Circuit ruled that standard lock-up agreements between lead underwriters and pre-IPO shareholders in advance of an IPO do not, without more, render those parties a "group" within the meaning of Section 13(d) of the Securities Exchange Act of 1934. *Lowinger* v. *Morgan Stanley*, No. 14-3800-cv (2d Cir. Nov. 3, 2016). As a result, a standard lock-up agreement will not be independently sufficient to trigger liability under Section 16(b) for short-swing profits.

Factual Background

In May 2012, Facebook went public in an IPO underwritten by a syndicate of investment banks (collectively, "Underwriters"), led by Goldman Sachs & Co., Morgan Stanley & Co., LLC, and J.P. Morgan Securities LLC (collectively, "Lead Underwriters"). In connection with the IPO, the Lead Underwriters entered into conventional lock-up agreements with the pre-IPO Facebook shareholders. These lock-up agreements barred the pre-IPO shareholders from selling or otherwise disposing of their Facebook shares for a specified period of time after the IPO without first obtaining the Lead Underwriters' consent. As the court observed, such lock-up agreements are common in IPOs because they allow potential investors "to expect an orderly market free of the danger of large sales of pre-owned shares depressing the share price before the pricing of the newly offered shares has settled in the market."

As is also common in IPOs, the underwriting agreement permitted the Underwriters to "over-allot" by selling more shares in Facebook than they were obligated to purchase under the underwriting agreement. This arrangement was disclosed in Facebook's registration statement. Those overallotment shares left the Underwriters with a short position, which they were permitted to cover in two ways. The Underwriters could cover by purchasing additional shares from Facebook and the pre-IPO shareholders at an agreed-upon price, or by purchasing shares in the secondary market after trading commenced. In the days following the IPO, Facebook's stock price declined significantly. The Underwriters covered their overallotments by purchasing shares on the secondary market rather than from Facebook at the higher agreed-upon price. By so doing, the Underwriters realized a profit of roughly $100 million.

In September 2012, the plaintiff, a Facebook shareholder, made a demand on Facebook that it compel the Lead Underwriters to disgorge the profits they realized in the days following the IPO. After Facebook

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declined to bring suit, the plaintiff filed suit in the Southern District of New York in June 2013. The Southern District dismissed the plaintiff's claim.

Legal Background

The Complaint sought to compel the Lead Underwriters to disgorge profits pursuant to Section 16(b) of the Exchange Act. In relevant part, Section 16(b), subject to certain exceptions, creates a private right of action permitting shareholders of the issuer to recover on behalf of the issuer profits from "short-swing" transactions in the company's stock from any "beneficial owner" of 10% or more of the company's equity securities, if the issuer fails or refuses to do so. A "short-swing" transaction occurs when an insider (including a 10% beneficial owner) of an issuer either buys and then sells, or sells and then buys, issuer stock within a six-month period. A "beneficial owner" for purposes of Section 16(b) includes not only individual shareholders, but also any "group" of "two or more persons act[ing] as a partnership, limited partnership, syndicate, or other group for the purpose of acquiring, holding, or disposing of securities of an issuer."

Prior to the IPO, although certain subsidiaries of the Lead Underwriters owned Facebook stock, the Lead Underwriters collectively owned less than 10% of Facebook shares. For that reason, the Lead Underwriters did not fall within the ambit of Section 16(b). The Complaint, however, alleged that when the Lead Underwriters and the pre-IPO shareholders entered into the lock-up agreements, the Lead Underwriters and the pre-IPO shareholders formed a "group" that did fall under Section 16(b)'s scope by virtue of counting the shares beneficially owned by the Lead Underwriters and by the pre-IPO shareholders. Under the plaintiff's theory, because this purported "group" owned more than 10% of Facebook shares, the Lead Underwriters, as members of the "group," were barred from profiting from the short-swing transactions that occurred in the days immediately following the IPO.

According to the Complaint, the "group" was formed solely through the lock-up agreements between the Lead Underwriters and the pre-IPO shareholders. The question before the Second Circuit was "whether standard lock-up agreements in an IPO between lead underwriters and certain pre-IPO shareholders are alone sufficient to render those parties a 'group' under Section 13(d) and subject to Section 16(b) disgorgement."

The Second Circuit's Decision

The Second Circuit held that a standard lock-up agreement between lead underwriters and pre-IPO shareholders is insufficient, without more, to establish a "group" between the underwriters and the pre-IPO shareholders under the Exchange Act. The court was careful, however, to limit its holding "only to standard lock-up agreements." Adopting certain language verbatim from the Securities and Exchange Commission's ("SEC") *amicus* brief, the Second Circuit noted that " 'atypical language in the lock-up agreement, or other facts and circumstances outside of the lock-up agreement,' may trigger a Section

13(d) 'group' finding." For example, "coordination between underwriters and the other parties to a lock-up agreement with implications for control changes beyond those inherent in an IPO might trigger" a finding that that the two entities formed a "group." To maintain a claim that underwriters and shareholders formed a "group," a plaintiff must allege some facts beyond the mere existence of a standard lock-up agreement.

In reaching this decision, the Second Circuit first acknowledged that the plain language of the applicable regulations suggested that signing a lock-up agreement could make the signatories the members of a "group" for Section 13(d) and 16(b) purposes. It nevertheless concluded that literal application of this language overlooked important distinctions between transactions intended to be covered and the transactions contemplated by standard lock-up agreements, as well as policy considerations. In the court's view, "lock-up agreements, rather than being agreements 'to act together,' are generally one-way streets keeping certain shareholders out of the IPO market for a specified period of time or without compliance with other restrictions."

The Second Circuit's opinion is also heavily influenced by statutory interpretation provided by, and policy considerations raised by, the SEC in its *amicus* brief, which the court of appeals solicited. The court agreed with the SEC that "ordinary lock-up agreements do not implicate the purposes of Section 13(d)," because "typical lock-up agreements between shareholders and underwriters have nothing to do with potential control, long-term ownership, or evading disclosure rules." Section 13(d), instead, "is intended to 'alert investors in securities markets to potential changes in corporate control and . . . provide them with an opportunity to evaluate the effect of these potential changes.' "

The Second Circuit also expressed concern that extending the definition of "group" to underwriters and shareholders who enter into standard lock-up agreements would have a chilling effect on IPOs. As the court stated, "[u]sing Section 13(d) to create a 'group' subject to Section 16(b) would impose large damages on transitory conduits of a public offering of shares. This imposition of damages would have nothing to do with the allaying of concerns about changes in control but would greatly raise the costs, and reduce the number, of IPOs."

Analysis

The court's decision rejected a theory that would have exposed the Lead Underwriters to strict liability and impeded a normal, salutary process by which the trading of newly issued IPO shares is stabilized, to the benefit of both issuers and investors. In so doing, the court avoided a ruling that would have interfered with conventional arrangements for structuring IPOs. To do so, it departed from the canon of statutory interpretation that relies on statutory and regulatory language above all else. Instead, it took into account the public benefit of the conduct in question, as well as the strong support of the SEC, which oversees offerings.

The court reached its decision cautiously, declining to extend its ruling beyond the standard lock-up agreement and holding out the possibility that variations could lead to a different result. Nevertheless, even lock-up agreements that contain specifically negotiated language typically remain substantively very close to standard lock-up provisions. It is likely that only a substantial variance from current practice would render a lock-up agreement "atypical."

By rejecting the plaintiff's argument that the lock-up agreements formed a group between the Lead Underwriters and the pre-IPO shareholders, the court obviated any need to address whether, even if the Lead Underwriters and pre-IPO shareholders had formed a group, the Lead Underwriters' trading activity would have been protected by the exception provided by Rules 16a-7 and 16a-10. Rule 16a-7 states that "[a] security purchased in good faith by or for the account of the person effecting the transaction for the purpose of stabilizing the market price of securities of the class being distributed or to cover an over-allotment or other short position created in connection with such distribution" is exempt from Section 16(a)'s coverage. Although the court did not address whether the Lead Underwriters would have been protected by this exception, the SEC, in its *amicus* brief, indicated that in its view they would have been.

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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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