NEW YORK COURT HOLDS THAT ALLEGATIONS SHOWING A PREEXISTING RELATIONSHIP BETWEEN A COMPANY AND THE LEADING UNDERWRITER OF ITS IPO SUSTAIN A CAUSE OF ACTION FOR BREACH OF FIDUCIARY DUTY

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On May 20, 2004, the New York Supreme Court, Appellate Division, First Department, in *EBC I, Inc. v. Goldman Sachs & Co.*, 2004 WL 1118313, slip op. 04091 (N.Y. App. Div., May 20, 2004), opined that a fiduciary duty may arise under New York law in the context of an underwriting relationship. Thus, it sustained a cause of action for breach of fiduciary duty against the lead underwriter of an initial public offering (IPO) upon allegations that showed "a preexisting relationship between plaintiff and defendant that justified the alleged trust the former placed in the latter in setting the price of its shares."

The case does not represent a final judgment on the merits, only a determination that the case can proceed to discovery and conceivably ultimately to trial. When discovery is taken and the plaintiff's allegations are subject to cross-examination at trial, the outcome may differ.

FACTS OF THE CASE

Plaintiff EBC I, Inc., is the remains of eToys, an Internet startup company that had a brief, parabolic existence, ultimately liquidating in Chapter 11. EToys went public on May 20, 1999 at $20.00 per share, up from an initially forecasted range of $10-$12. The offering raised gross proceeds of $166 million, and implied a valuation of just over $2 billion. In the first day of trading, its shares closed at $76.56 per share, implying an equity market capitalization of $7.78 billion. However, EToys's business model was not successful and by March 2001, EToys had to file chapter 11. Its assets were sold to KB Toys (itself now bankrupt) for $8.7 million in May 2001, just two years after the IPO at the center of the New York State litigation.

Subsequent to the liquidation, eToys filed a complaint against defendant Goldman Sachs, the lead managing underwriter of its IPO. The complaint alleged that the defendant under-priced plaintiff's shares in order to reap an additional profit, beyond the underwriting spread. Defendant filed a motion to dismiss for failure to state a cause of action.

PROCEDURAL HISTORY

On May 2, 2003, the Supreme Court of New York County (Moskowitz, J.) granted defendant's motion to dismiss with respect to the causes of action for breach of contract, fraud with leave to replead, malpractice, and unjust enrichment, but denied the motion with respect to the cause of action for breach of fiduciary duty. In an order entered May 13, 2003, the same court and justice dismissed the causes of action for breach of contract, fraud, malpractice, and unjust enrichment, and severed and continued the cause of action for breach of fiduciary duty. In its May 20, 2004 opinion, the New York Supreme Court, Appellate Division, unanimously reversed and vacated the Supreme Court of New York County's judgment, reinstating all dismissed claims, except for fraud, and sustaining the breach of fiduciary duty count.

THE APPELLATE DIVISION'S DECISION

The Appellate Division found that the cause of action for breach of fiduciary duty was sustained upon "allegations showing a preexisting relationship between plaintiff and defendant that justified the alleged trust the former placed in the latter in setting the price of its shares." In reaching this holding, the court did not explain what kinds of relationship would justify such a trust. The court, however, rejected two contentions made by defendant. First, the court rejected defendant's contention that New York law "articulated a bright-line test regarding the requisite length of the pre-existing relationship."[1] The court also rejected the defendant's contention that "the alleged fiduciary relationship is necessarily negated by the limited statement of defendant's agency status vis-à-vis other underwriters contained in the prospectus."

The Appellate Division then considered the other causes of action and held that the fraud cause of action was correctly dismissed on the ground that this cause of action alleged an affirmative misrepresentation that the share price was based on market conditions, and "[a]t the least, plaintiff should have identified the person(s) who made this misrepresentation." The Appellate Division also held, however, that the remaining causes of action — for breach of contract, malpractice, and unjust enrichment — should not have been dismissed. Regarding the breach of contract cause of action, the court noted that while "no express contractual provision" prohibited the defendant's conduct, plaintiffs also alleged that "defendant breached its implied obligation of good faith and fair dealing by frustrating the overarching purpose of the offering to obtain for plaintiff the true value of its shares." The court also sustained the malpractice cause of action, emphasizing, "investment bankers are professionals." As for the unjust

1 In *Apple Records v. Capitol Records*, 529 N.Y.S.2d 279, 283 (N.Y. App. Div. 1988), the court emphasized that business dealings between the parties "date[d] back to 1962" and that it could be said that "from such a *long enduring relation* was born a special relationship of trust and confidence, one which existed independent of the contractual duties" (emphasis added).

enrichment cause of action, the court held that "[i]t suffices that defendant received benefits to which it was not entitled that were effectively conferred by plaintiff in the form of a lower price for its shares."

PRIOR CASE LAW

The eToys case is not the first time that New York courts have evaluated allegations of a fiduciary duty on the part of investment bankers to their sophisticated business clients. The results of those litigations are mixed. Six years ago, in *Societe Nationale d'Exploitation Industrielle des Tabacs et Allumettees v. Salomon Bros. Int'l Ltd.*, 674 N.Y.S.2d 648 (N.Y. App. Div. 1998), the court stated that a confidential relationship may arise between the parties to a business relationship. In making this statement, the court negated the interpretation of New York law contained in the Southern District of Ohio decision in *Procter & Gamble Co. v. Bankers Trust Co.*, 925 F. Supp. 1270, 1289 (S.D. Ohio 1996), which had rejected the proposition that a fiduciary relationship can arise between the parties to a business transaction." The *Salomon* court, however, noted that, in order for a confidential relationship to arise, "the requisite high degree of dominance and reliance must have existed prior to the transaction giving rise to the alleged wrong, and not as a result of it." In part because a "high degree of dominance and reliance" did not pre-exist in that case, the *Salomon* court ruled in defendant's favor. The Appellate Division in *EBC I*, however, applied the same reasoning to reach a different conclusion by specifying that a "preexisting relationship" between plaintiff and defendant could justify "the alleged trust the former placed in the latter."

Some recent decisions have recognized a cause of action for breach of fiduciary obligation in a business context without a "preexisting relationship" between the parties. In *Frydman & Co. v. Credit Suisse First Boston Corp.*, 272 A.D.2d 236 (N.Y. App. Div. 2000), the court held that "the allegations of the complaint that CSFB provided Frydman with investment banking advice and other services, including conducting negotiations . . . on Frydman's behalf, *in connection with the attempted acquisition*, raised an issue of fact as to whether CSFB owed Frydman a fiduciary duty" (emphasis added). The *Frydman* court added that "it is not mandatory that a fiduciary relationship be formalized in writing" and that "the ongoing conduct between the parties may give rise to a fiduciary relationship that will be recognized by the courts." That court did not explicitly require that a preexisting relationship was necessary for a fiduciary duty to exist.

In *Bestolife Corp. v. Am. Amicable Life*, 774 N.Y.S.2d 18 (N.Y. App. Div. 2004), the court similarly held that the complaint raised a factual issue regarding the existence of a fiduciary duty because it "sufficiently allege[d] that CSI was obliged to provide investment and banking advice and other services, including negotiating upon request." The *Bestolife* court found this to be especially the case because, "knowing that the … transaction was overpriced, and that further negotiation would increase plaintiffs' transaction costs, CSI advanced the purchase anyway in order to secure fees for itself." Although the court mentioned that the business relationship between the parties was well established, it did not explicitly link that fact to its discussion of the fiduciary duty issue.

Courts have provided little information on what specific factors are required for a fiduciary duty to exist in a business transaction. For instance, the eToys opinion makes no mention of the sophistication of the officers, directors or major stockholders of the plaintiff,[2] the extent, if any, to which the selection of a lead underwriter was the result of a competitive process, or the extent to which the prospect of a short-term "bubble" in IPO aftermarket pricing was well-publicized at the time or specifically discussed between plaintiff and defendant.

Many cases support the proposition that disparity in knowledge is a relevant — but not necessarily determinative — factor that courts must consider in deciding whether there is a fiduciary relationship. *In* *Stuart Silver Assocs. v. Baco Dev. Corp.*, 245 A.D.2d 96 (N.Y. App. Div. 1997), the court stated that "[t]o claim that a business transaction gave rise to a fiduciary relationship, plaintiff must show that defendant had superior expertise or knowledge about some subject and misled plaintiff by false representations concerning that subject." The *Stuart* court held that there was no fiduciary relationship because plaintiffs "could easily have obtained background information about the anticipated state of the Harlem real estate market by consulting the legal and financial advisors who had guided their previous investment decisions." The court mentioned that "[w]hile this documentation may have been largely possessed by [defendant] initially, plaintiffs were not too inexperienced to know what type of information to request."

IMPLICATIONS

The *EBC I* decision serves as a reminder that even sophisticated businesses may be given significant leeway to pursue a cause of action for breach of fiduciary duty against their investment bankers with respect to a seemingly arm's-length transaction, if the transaction goes awry. Moreover, this theory can be asserted with respect to any investment banking relationship, not solely an underwriting role.

EBC I is more limited than some prior cases in that it appears to require, and at least emphasizes, that a relationship between the parties existed prior to the transaction giving rise to the alleged wrong. Under the Appellate Division's decision, there is no bright-line rule, however, regarding the requisite length or nature of such a relationship. To determine whether there is a fiduciary duty in any particular case, a court will also consider several other factors, including whether there is a disparity of knowledge and whether defendant used its superior knowledge to mislead the plaintiff.

[2] Two large, experienced venture capital investors held substantial equity stakes in eToys at the time of its IPO.

It should be noted that Goldman Sachs may seek appellate relief with respect to the decision in the New York Court of Appeals.

If you have further questions about the *EBC I* decision, please contact David Ichel (dichel@stblaw.com, 212 455-2563) or Mark Thompson (mthompson@stblaw.com; 212-455-7355).

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