Securities Regulation Daily Wrap Up, TOP STORY—2d Cir.: A standard lock-up agreement does not make a 'group', (Nov. 3, 2016)

Securities Regulation Daily Wrap Up

Click to open document in a browser

By Rodney F. Tonkovic, J.D.

A standard lock-up agreement between lead underwriters and pre-IPO shareholders is not sufficient by itself to render those parties a "group" subject to Section 16(b) disgorgement. A Second Circuit panel affirmed that the lock-up agreements in this case did not establish a "group," where there were no allegations of coordination between parties to the agreement with implications for changes in control beyond what is inherent in an IPO (*Lowinger v. Morgan Stanley & Co. LLC*, November 3, 2016, Winter, R.).

Lock-up agreements. This action arose out of Facebook's May 18, 2012 IPO, which was underwritten by a syndicate of 33 financial firms, including lead underwriters Goldman Sachs & Co., Morgan Stanley & Co., LLC, and J.P. Morgan Securities LLC. Prior to the IPO, the lead underwriters entered into lock-up agreements with the selling shareholders, committing the selling shareholders not to sell Facebook shares for set periods of time after the IPO without Morgan Stanley's consent.

On May 9, 2012, Facebook disclosed that the increased use of mobile devices, which at the time did not display advertisements, could impact revenue. Facebook also allegedly informed "select investment bankers and their securities analysts" about the revised lower projected revenue, after which analysts for the underwriters then revised their revenue estimates downward in response, but allegedly told only a few "major clients" of the changes. Retail investors purchased Facebook stock while being unaware of these facts until trading closed on the first day of the IPO; over the next few days the stock price declined to nearly 19 percent below the IPO price. During this period, the underwriters allegedly secured $100 million by selling short Facebook stock and then buying it back after the price fell.

Facebook shareholders then sued the underwriters, arguing that they were liable under Section 16(b) for disgorgement of short-swing profits received in connection with their sales and purchases of shares in the course of the IPO. While the lead underwriters alone did not meet the ten-percent beneficial ownership threshold under Section 16(b), the shareholders argued that the lead underwriters plus certain pre-IPO shareholders formed a "group" under Section 13(d). The district court rejected the shareholders' contention, stating that lock-up agreements are a standard industry practice and, without more, do not suffice to establish a "group" for the purposes of Section 16(b).

Not a group. On appeal, the shareholder appellant urged that the lead underwriters were members of a group that in aggregate held ten percent of Facebook's shares. This group was allegedly formed as a result of the lock-up agreements.

The panel stated at the outset that this has in the past only stated that a lock-up agreement may "bear upon" whether a group exists. The touchstone of finding a "group," the Second Circuit has held, is "the members combined in furtherance of a common objective" to acquire, hold, vote or dispose of securities. The court remarked that lock-up agreements, instead of being agreements to act together, are usually "one-way streets," keeping certain shareholders out of the IPO market for a period of time.

The panel also pointed out that the SEC's amicus brief in this matter cautioned against applying Section 13(d) literally in the context of standard lock-up agreements. The brief noted that lock-up agreements are common to typical IPOs and assure potential buyers that large sales of pre-owned shares will not depress the share price before the pricing of the newly offered shares has settled in the market. Ordinary lock-up agreements do not implicate the purposes of Section 13(d) and its definition of a "group," the Commission advised.

As parties to lock-up agreements, the panel said, underwriters are not investors seeking to buy low and sell high, but rather are "conduits for the distribution of securities in an offering to the public in which their participation begins and ends with the offering." Lock-up agreements serve to limit the investment decisions of large shareholders and ensure an orderly and successful offering, the panel added, and are essential to the regulation of public offerings. The panel then stated that the use of Section 13(d) to create a "group" subject to Section 16(b) in this context would impose large damages on "transitory conduits of a public offering of shares" and would significantly raise the costs, while reducing the number, of IPOs.

In conclusion, the panel said that its analysis only applied to standard lock-up agreements like the ones at issue in this case. If there is coordination between the underwriters and other parties to a lock-up agreement with implications for changes in control beyond what is inherent in an IPO, a Section 13(d) "group" might be found. There were no allegations in this case, however, that would persuade the panel that any such coordination existed.

The case is No. 14-3800-cv.

Attorneys: Jeffrey S. Abraham (Abraham, Frutcher & Twersky, LLP) for Robert Lowinger. Andrew Brian Clubok (Kirkland & Ellis LLP) for Morgan Stanley & Co. LLC and Facebook, Inc. James P. Rouhandeh (Davis Polk & Wardwell LLP) for J.P. Morgan Securities LLC and Goldman, Sachs & Co.

Companies: Morgan Stanley & Co. LLC; and Facebook, Inc.; J.P. Morgan Securities LLC; Goldman, Sachs & Co.

MainStory: TopStory BeneficialOwnership IPOs ConnecticutNews NewYorkNews VermontNews