Corporate Finance Alert

Skadden

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Second Circuit Upholds District Court's Facebook Lock-Up Ruling: Underwriters Not Subject to Group Ownership, Short-Swing Profit Rules

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On November 3, 2016, in *Lowinger v. Morgan Stanley & Co. LLC*, the U.S. Court of Appeals for the 2nd Circuit upheld a district court finding that customary initial public offering (IPO) lock-up agreements do not render parties to those agreements a "group" of shareholders for purposes of applying "short swing" profit rules. The decision protects underwriters entering into industry standard lock-up agreements in connection with securities distributions from potential short-swing profit liability when engaging in ordinary course stabilization activities following such distributions.

Background

In connection with the IPO of Facebook, Inc. in May 2012, the lead underwriters of the offering entered into lock-up agreements with certain pre-IPO shareholders, restricting those shareholders from selling shares into the market for a specified period of time. The lead underwriters also engaged in standard stabilization trading activities following the offering designed to maintain the market price of Facebook's shares and profited from these trades.

The appellant, a Facebook shareholder, argued that these underwriters, together with certain pre-IPO shareholders, constituted a "group" of beneficial owners of more than 10 percent of the company's shares, thereby subjecting them to rules under Section 16(b) of the Securities Exchange Act of 1934 (Exchange Act) requiring the disgorgement of profits realized in connection with trading activity within a six-month period. Under these rules, a beneficial owner may include "groups" of shareholders acting together under a common purpose to acquire, hold or dispose of securities. The appellant argued that the "group" was formed by virtue of entering into the lock-up agreements, which they contended were executed as part of the common purpose of controlling the market of Facebook stock.

Decision

The 2nd Circuit rejected this argument on the grounds that lock-up agreements, rather than being agreements to "act together" for a common purpose, are instead entered into for the legitimate goal of keeping certain shareholders out of the market for a period of time in order to facilitate an orderly trading market. The court also found that applying Section 16(b) to underwriters' lock-up agreements would impair the heavily regulated market for public offerings "by complicating the role of underwriters — adding tens of millions of dollars in legal exposure to the underwriters' costs." The court was careful to note that its decision applies only to "standard" lock-up agreements, which may still "bear upon" the question of whether a group exists if other facts or circumstances exist outside of the agreements.

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SEC Position

In rendering its decision, the court solicited the views of the Securities and Exchange Commission (SEC). The SEC advised the court of its view that "ordinary course" lock-ups do not implicate the definition of a "group" under the Exchange Act. The SEC also voiced a policy concern over applying the "group" definition in this context, noting that standard lock-up agreements can be an essential element of facilitating an offering, designed to assuage investor concern that the market may be flooded by large sales of preowned shares before newly offered shares have settled in the market.

Key Takeaway

The court's decision should provide a significant level of comfort to underwriters who enter into industry standard lock-up agreements that they will be protected from short-swing profit liability in connection with stabilization activities following an offering, absent a showing of other non-standard arrangements outside the lock-up agreements.

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