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Re: Breakaway Solutions, Inc. v.
Morgan Stanley & Co., et al.
C.A. No. 19522-NC
Date Submitted: August 31, 2005

Dear Counsel:

This case involves a dispute between an issuer, Plaintiff Breakaway Solutions, Inc., and its underwriters, Defendants Morgan Stanley & Co., Inc., Lehman Brothers Inc., and Deutsche Bank Securities Inc. The Complaint focuses

on the opportunity allegedly taken by underwriters to profit from sharp increases in share price following initial public offerings.

I.

The Defendants have moved "for revision" of the Court's letter opinion and order of August 27, 2004 (the "Order"),[1] which denied their motions to dismiss. The Order addressed the Defendants' two separate attacks on Breakaway's Amended Class Action Complaint (the "Complaint"). The Defendants first challenged Breakaway's efforts under the Securities Litigation Uniform Standards Act of 1998 ("SLUSA")[2] and second contended that the Complaint—if construed in a fashion to avoid the consequences of SLUSA—failed to state a claim under New York law.[3] The motion "for revision" focuses on the second prong. This Court, in its Order, relied upon a decision by the Appellate Division, *EBC I, Inc. v. Goldman Sachs & Co.*[4] The Court of Appeals, however, subsequently reversed that decision in part.[5] Because this Court's conclusions under New York law were based upon the Appellate Division's opinion, it is appropriate to revisit these issues

[1] 2004 WL 1949300 (Del. Ch. Aug. 27, 2004). The Court, for present purposes, assumes familiarity with the Order. The factual context developed there will not be repeated here.
[2] 15 U.S.C. §§ 77p, 78bb.
[3] The underwriting agreement's choice of law provision designated New York law.
[4] 777 N.Y.S.2d 440 (N.Y. App. Div. 2004).
[5] *EBC I, Inc. v. Goldman Sachs & Co.*, 832 N.E.2d 26 (N.Y. 2005) ("*EBC I*").

to determine if the Complaint survives in light of the opinion of the Court of Appeals.[6]

Following the Order, Breakaway had four remaining claims: breach of contract (Count I),[7] breach of the covenant of good faith and fair dealing (Count II), unjust enrichment (Count V), and breach of fiduciary duty (Count III). As set forth below, all of Breakaway's claims, except for its fiduciary duty claim, must be dismissed.

II.

The Court, in revisiting a motion to dismiss, remains governed by the familiar standard guiding that function: The Court must accept all well-pleaded facts in the Complaint as true and must draw all reasonable inferences from those facts in the light most favorable to Breakaway. Moreover, dismissal may be granted only if the Court can determine with "reasonable certainty" that

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[6] This Court is also guided by the opinion of the United States District Court for the Southern District of New York in *LaSala v. Needham & Co., Inc.*, 2005 WL 2547986 (S.D.N.Y. Oct. 11, 2005) ("*LaSala II*"), which addresses claims similar to those asserted by Breakaway here.

[7] The Order dismissed a relatively minor aspect of Breakaway's breach of contract claim.

Breakaway would not be "entitled to relief under any set of facts that could be proven."[8]

III.

Breakaway concedes that its claim for breach of contract fails under the principles set forth in *EBC I*. The Court of Appeals observed that the underwriter had "fulfilled its commitments as set forth in the parties' contract, purchasing all of the available shares at a total of $178.4 million paid to eToys and reselling them to the public at the initial offering price of $20 per share."[9] Here, there is no dispute: the Defendants purchased the necessary shares for the agreed-upon amount and sold them to the public at the price set forth in the underwriting agreement. Thus, Breakaway's breach of contract claim must be dismissed.

The Court of Appeals also concluded that, under the facts alleged in *EBC I*, no action could be brought for breach of the covenant of good faith and fail dealing. Specifically, it determined that the complaint in *ECB I* did "not adequately allege that Goldman Sachs injured eToys' right to receive the benefits

[8] *Orman v. Cullman*, 794 A.2d 5, 15 (Del. Ch. 2002).
[9] *EBC I*, 832 N.E.2d at 33.

of their agreement."[10] Under New York law, every contract contains an implied covenant of good faith and fair dealing, which "embraces a pledge that 'neither party shall do anything which will have the effect of destroying or injuring the right of the other party to receive the fruits of the contract.'"[11] Breakaway asserts that the Defendants benefited from "allocating Breakaway's undervalued shares to favored clients, and by directly or indirectly requiring and receiving compensation therefrom . . . ."[12] These grounds, however, fail to demonstrate injury to its right to receive the "fruits of the contract" sufficient to permit a claim for breach of the implied covenant of good faith and fair dealing cognizable under New York law. As in *EBC I*, the contractual objectives, as set forth in the controlling underwriting agreement, were achieved by the Defendants as underwriters and conferred upon Breakaway as issuer. Thus, in accordance with *EBC I*, no viable claim for breach of the implied covenant of good faith and fair dealing has been pled.

In addition, the Court of Appeals dismissed the claim in *EBC I* for unjust enrichment. Under New York law, "[a] plaintiff fails to state a cause of action for unjust enrichment as the existence of a valid contract governing the subject matter

[10] *Id.* (citing *511* W. *232nd Owners Corp. v. Jennifer Realty Co.*, 773 N.E.2d 496, 500-01 (N.Y. 2002); *Dalton v. Educational Testing Serv.*, 663 N.E.2d 289, 291-92 (N.Y. 1995)).
[11] *511 W. 232nd Owners Corp.*, 773 N.E.2d at 500.
[12] Compl. ¶ 45.

generally precludes recovery in quasi contract for events arising out of the same subject matter."[13] The circumstances described by the Court of Appeals as requiring dismissal are also those presented by Breakaway's Complaint: there is a valid contract governing the subject matter and the challenged conduct arises out of the same subject matter. It follows that Breakaway's claim for unjust enrichment fails as a matter of law.[14]

Accordingly, Breakaway's claims for breach of contract, breach of the covenant of good faith and fair dealing, and unjust enrichment must be dismissed.

IV.

Analysis of Breakaway's fiduciary duty claim is somewhat more complicated. As the Defendants concede, the Court of Appeals in *EBC I* did not reverse the lower court's conclusion that the *EBC I* complaint could survive a motion to dismiss the fiduciary duty claim. The starting point for my analysis is the Court of Appeals' opinion:

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[13] *EBC I*, 832 N.E.2d at 33-34.

[14] *See also LaSala II*, 2005 WL 2547986, at *4 - *5 (rejecting unjust enrichment claim on grounds that enrichment was pled to be at expense of underwriters' customers and not issuer). In the Order, because of the Appellate Division's opinion in *EBC I*, I declined to follow this line of reasoning; however, in light of the decision of the Court of Appeals, I am persuaded that Breakaway's claim for unjust enrichment fails on these grounds, as well.

It may well be true that the underwriting contract, in which Goldman Sachs agreed to buy shares and resell them, did not in itself create any fiduciary duty. However, a cause of action for breach of fiduciary duty may survive, for pleading purposes, where the complaining party sets forth allegations that, apart from the terms of the contract, the underwriter and issuer created a relationship of higher trust than would arise from the underwriting agreement alone.

Here, the complaint alleges an advisory relationship that was independent of the underwriting agreement. Specifically, plaintiff alleges eToys was induced to and did repose confidence in Goldman Sachs' knowledge and expertise to advise it as to a fair IPO price and engage in honest dealings with eToys' best interests in mind. Essentially, according to the complaint, eToys hired Goldman Sachs to give it advice for the benefit of the company, and Goldman Sachs thereby had a fiduciary obligation to disclose any conflict of interest concerning the pricing of the IPO.

. . .

To the extent that underwriters function, among other things, as expert advisors to their clients on market conditions, a fiduciary duty may exist. We stress, however, that the fiduciary duty we recognize is limited to the underwriter's role as advisor. We do not suggest that underwriters are fiduciaries when they are engaged in activities other than rendering expert advice. When they do render such advice, the requirement to disclose to the issuers any material conflicts of interests that render the advice suspect should not burden them unduly.

. . .

Under the complaint here, however, the parties are alleged to have created their own relationship of higher trust beyond that which arises from the underwriting agreement alone, which required Goldman Sachs to *deal honestly* with eToys and *disclose its conflict of*

> *interest*—the alleged profit-sharing arrangement with prospective investors in the IPO.[15]

The Defendants read *EBC I* to allow fiduciary duty claims in this context only if the underwriter has failed to disclose "material conflicts of interest that render advice suspect." The Defendants then proceed to seek to hold Breakaway to its frequently offered position that it is not alleging any material omission by the Defendants (a point asserted in response to the Defendants' challenges under SLUSA): (1) "The Complaint does not allege that Defendants made any misrepresentation or omissions."[16] (2) "Nowhere does [the Complaint] allege any untrue statement, misrepresentation, omission or manipulative or deceptive device."[17] Indeed, the Court wrote in its Order that "Breakaway has not alleged that the Defendants were under any obligation to make such a disclosure [of additional compensation from the 'favored' clients participating in the IPO]. Thus, by reference to the allegations advanced by Breakaway, there is no basis for concluding that Breakaway has alleged a material omission."[18] If the Court of Appeals had limited the range of viable fiduciary duty claims to instances where

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[15] *Id.* at 31-33 (emphasis added).
[16] Breakaway's Memorandum of Law in Opp'n to Defs.' Mot. to Dismiss at 8.
[17] *Id*. at 4.
[18] *Breakaway*, 2004 WL 1949300, at *6.

the underwriters fail to disclose conflicts of interest, the Defendants' argument might well prevail. The Court of Appeals, however, did not limit the scope of such claims to only disclosure. Even though the scope of potential fiduciary claims against underwriters is limited, the Court of Appeals acknowledged the existence of a second prong: a requirement to "deal honestly," a notion that encompasses more than a duty to disclose.[19]

The Complaint alleges a fiduciary relationship: e.g., that Breakaway relied upon the Defendants' expertise;[20] that Defendants were entrusted with "confidential and . . . proprietary information;" and that the Defendants had "superior knowledge, information and experience concerning the underwriting and IPO process."[21] The Defendants' alleged employment of that status to advance their financial self-interest in the manner set forth in the Complaint meets the notion of "honest dealing" in *EBC I* as a method for sufficiently alleging a breach of fiduciary duty in this context.[22]

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[19] One can wonder, of course, whether full disclosure would have precluded a "deal honestly" claim under these circumstances.
[20] Compl. ¶ 22.
[21] Compl. ¶ 48.
[22] The Defendants, in their pending application, have not argued that the "deal honestly" concept would run afoul of SLUSA.

Significantly, the Court in *LaSala II*, although in *dictum* because the fiduciary duty claim asserted there was time barred, concluded that allegations similar to those asserted by Breakaway would have stated a claim under New York law:

> Although the parties did not brief the merits of LaSala's breach of fiduciary duty claim, such a claim is properly alleged under New York law "where the complaining party set forth allegations that, apart from the terms of the contract, the underwriter and issuer created a relationship of higher trust than would arise from the underwriting agreement alone." *EBC I*, [832 N.E.2d at 31]. *Cf. Xpedior Creditor Trust v. Credit Suisse First Boston (USA), Inc.*, 2005 WL 1837960, at *6 (S.D.N.Y. Aug. 2, 2005) (denying defendant underwriter's summary judgment motion on breach of fiduciary duty claim, when "[issuer plaintiff Xpedior] has produced substantial evidence that Xpedior's management relied on [its underwriter] to advise Xpedior and act in Xpedior's best interests in underwriting its IPO and setting the IPO price."). LaSala's Complaint contains similar allegations. *See* Complaint ¶ 29 ("Fatbrain relied on [defendants'] superior knowledge and expertise in connection with the IPO, and provided them with highly sensitive confidential and proprietary information."). Thus, if the claim was not time-barred it could survive.[23]

In sum, the Court cannot conclude with "reasonable certainty" that Breakaway could not prevail, under any set of facts that could be proven, on a fiduciary duty claim asserted under New York law. The scope of that claim—hemmed in, perhaps, by Breakaway's prior pleadings and advocacy, SLUSA, and

[23] *LaSala II*, 2005 WL 2547986, at *5 n.68.

the *EBC I* decision—may be narrow; indeed, it may not survive subsequent scrutiny. It does, however, survive for present purposes under Court of Chancery Rule 12(b)(6).

V.

Accordingly, Counts I, II, and V of the Complaint are dismissed and to that extent the Defendants' Motion for Revision of August 27, 2004 Order is granted. Otherwise, the motion is denied.

IT IS SO ORDERED.

Very truly yours,

/s/ John W. Noble

JWN/cap
cc: Register in Chancery-NC