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Second Circuit: Facebook Shareholders Lack Standing for Derivative Suits Challenging Pre-IPO Statements

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Earlier this week, a U.S. Court of Appeals for the Second Circuit opinion reinforced that federal courts take standing in derivative actions quite seriously, particular when the alleged director misconduct predated the IPO. Corporate defense attorneys would be mindful to evaluate and bring standing challenges early in these cases to help save defense costs and protect their directors. The Second Circuit affirmed the Southern District of New York's dismissal of putative shareholder derivative actions brought against Facebook's directors. In three separately filed suits, the shareholders alleged that the directors breached their fiduciary duties because Facebook's Registration Statement—filed before Facebook's initial public offering (IPO)—failed to account for its projected mobile growth and decreasing revenue therefrom. Because the court concluded that the shareholders ultimately lacked derivative standing, the Second Circuit affirmed the lower court's dismissal. Facebook is the world's largest social media company. Its May 18, 2012, IPO was one of the largest in history and, accordingly, had to be underwritten by multiple institutions. Months before the IPO, Facebook filed its Form S-1 Registration Statement with the Securities and Exchange Commission. The S-1 details, among other things, a company's current business model, its competition, and information on the offering price and methodology for setting that price—including projected revenues. According to the complaint, before the IPO, Facebook provided its underwriters with revenue projections for the second quarter and full year of 2012. Also according to the complaint, on May 9, 2012, less than 10 days before the IPO, Facebook supplemented its Registration Statement with a one-page, standalone disclosure that identified a trend: The number of Facebook users was increasing at a higher rate than the amount of advertisements. This was due, in large part, to the increased use of Facebook on mobile devices, in which Facebook had less space and opportunity per page to display advertisements. As a result, Facebook advised its underwriters that revenue estimates for 2012 were actually 3–3.5 percent lower than Facebook's initial estimate. Because of the last-minute changes in Facebook's Registration Statement, the media seized upon the altered guidance and claimed that the underwriters priced the IPO based on the initial projections. Three lawsuits followed—in state court in California, state court in Delaware, and federal court in New York—all claiming that Facebook's directors breached their duties to shareholders because the IPO disclosures did not include a "sufficient description of the effect that increasing mobile usage was projected to have on the company's revenue growth." The state cases were removed and ultimately transferred to accompany the federal court action in New York. But, the complaint was a preface to nothing. The district court found, on a motion to dismiss, that none of the plaintiffs could ultimately establish that they had derivative standing to bring the suit under Rule 23.1. The Second Circuit affirmed. Under Rule 23.1, the plaintiff in a derivative action must "allege that the plaintiff was a shareholder or member *at the time of the transaction complained of* or that the plaintiff's share of the membership later devolved on it by operation of law." This has also been phrased as the "contemporaneous ownership rule." The rule ensures that the plaintiff is the proper party to assert claims on behalf of the corporation. Here, none of the plaintiffs could satisfy the requirement. In putting this rule into practice, the Second Circuit again held that to invoke derivative standing, a plaintiff is required to plead that they owned stock "throughout the course of the activities that constitute the primary basis of the complaint." Put another way, a plaintiff must have *acquired* the stock and acquired it *prior to* the allegedly wrongful conduct. In these cases, none of the plaintiffs could satisfy this requirement. As to two of the plaintiffs, the Second Circuit explained that they owned Facebook shares before the IPO through their units in an investment vehicle. However, their agreement with that investment vehicle specifically stated that they had "no direct interest in any Facebook Securities" and that the investment vehicle "in its sole discretion shall have the right, but not the obligation to distribute" the Facebook shares. Because these plaintiffs did not have any direct interest in the stock at the time the disclosures were made, they lacked standing to pursue their claims. As to the third plaintiff, the appellate court held that because she bought Facebook stock *during* the IPO, and because the challenged disclosures were made *before* her acquisition of that Facebook stock, she too lacked standing to pursue her claims. The proper place for a complaint about disclosures in an IPO for such a shareholder is in a direct suit under the securities laws—not in a derivative action against the directors. *In re Facebook IPO* displays the hurdles that any shareholders will face to challenge the actions of a company's directors taken before an IPO. Most shareholders will not have held any stock prior to the IPO and will have to look to the securities laws in a direct suit rather than pursuing a matter on behalf of the newly public company for violation of state-law fiduciary duties. This does not mean that no suit can be brought against directors on behalf of the company for the alleged misconduct, but that any derivative action in such a context will face an uphill battle. *In re: Facebook, Inc. Initial Public Offering Derivative Litigation*, Case No. 14-1445L (2d Cir. July 24, 2015).

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