J. Account. Public Policy 28 (2009) 1–15

Contents lists available at ScienceDirect

J. Account. Public Policy

journal homepage: www.elsevier.com/locate/jaccpubpol

Shareholder litigation, management forecasts, and productive decisions during the initial public offerings

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A R T I C L E   I N F O

JEL classification:
G14
M41
M48

Keywords:
Voluntary disclosure
Disclosure regulation
Initial public offering
Investment decisions

A B S T R A C T

This paper develops a model to analyze the impact of shareholder litigation on managers' voluntary disclosure strategies in equity offerings. The major findings are as follows. First, under different economic parameters, the entrepreneur has two possible equilibrium disclosure strategies: full and partial disclosure. Of particular interest is the latter equilibrium, in which shareholder litigation can give the entrepreneur incentives to partially disclose her private information. Second, production decisions might be distorted by the entrepreneur's disclosure incentives. The full disclosure equilibrium is associated with underinvestment, while overinvestment exists in the partial disclosure equilibrium.

The model is then used to examine the effect of regulatory polices on firms' disclosure incentives. It shows that relaxing the legal liability can result in more information flow to the public. However, it also leads to a higher rate of lawsuits and an increase in deadweight litigation costs.

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1. Introduction

One stylized fact about the initial public offerings (IPOs) in the United States is that equity-issuing firms rarely disclose any numerical forward-looking information (such as earnings or sales forecasts) (Clarkson and Simunic, 1994; Lee et al., 2003). Two frequently cited reasons are the ‘‘quiet period'' regulation and the threat of shareholder litigation. On one hand, the ‘‘quiet period'' regulation forbids any disclosure of quantitative prospective information outside a statutory prospectus. Violation of the

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doi:10.1016/j.jaccpubpol.2008.11.004

regulation is called "gun jumping" and could result in an order from the SEC to delay the effective date of the registration. On the other hand, the highly litigious legal environment inhibits the issuing firms from including forecasts in the prospectus (Mak, 1996; Lee et al., 2003). That is, if a firm included a forecast in its prospectus and ultimately failed to meet it after the IPO, there could be a high risk of litigation. Due to these two factors, investors have very limited access to forward-looking information when they are making investment decisions.

The policymakers have long been concerned with the insufficient communication in the equity offerings. In a securities offering reform proposal issued on November 3, 2004 (SEC Release 33-8501), the SEC requested public comments on several issues, including whether a safe harbor should be granted to IPO firms' disclosure of forward-looking information, and whether the issuers should be required to provide projections in the registration statements.[1]

Motivated by these questions, this paper investigates the potential impact of shareholder litigation on the voluntary disclosure of forward-looking information in initial public offerings. It also analyzes the implications of disclosure legal liabilities for firms' production decisions. Specifically, I introduce a potential cost of a lawsuit for the "failure to meet the forecast". I assume that shareholders could hire a lawyer to file lawsuits against the equity-issuing firm if the subsequent actual performance falls below the management forecast disclosed during the offering. With an exogenous positive probability, the firm will end up settling the case and paying the shareholders for their damages. This positive probability is used to capture the litigiousness of the legal environment.[2]

The paper has the following major findings. First, under different sets of economic parameters, the entrepreneur has two possible equilibrium disclosure strategies: full disclosure and partial disclosure. Specifically, in a full disclosure equilibrium, the informed entrepreneur will always disclose her private signal when she issues equity; in a partial disclosure equilibrium, the entrepreneur will disclose only if her signal is above a certain threshold. Of particular interest is the latter equilibrium, in which shareholder litigation plays a significant role. The litigation threat can give the entrepreneur incentives to partially disclose her private prospective information. When the legal environment is sufficiently litigious, the entrepreneur rarely discloses forecasts in the offering, which is consistent with the situation in the United States.

Second, the entrepreneur's production decisions might be distorted by her disclosure incentives. In the full disclosure equilibrium, the entrepreneur, if informed, could give up some positive NPV projects if the expected litigation cost outweighs the expected investment profit. On the other hand, if she is uninformed and unable to issue a forecast, she has to forgo the investment opportunity even though the project is positive NPV, since the investors severely underprice the firm's stock when they observe no disclosure.[3] In contrast, in the partial disclosure equilibrium, the entrepreneur could invest in negative NPV projects. This is because when the investors have uncertainty about the entrepreneur's information endowment, in equilibrium they overpay for the firm's shares when the privately informed entrepreneur issues equity.[4] Such overvaluation induces the entrepreneur to take on unprofitable projects and incur an efficiency loss.

The model is then used to examine the effect of regulatory polices on firms' disclosure incentives. The analysis shows that relaxing the legal liability (for example, by providing a safe harbor for forward-looking information disseminated by IPO firms) can result in more information flow to the public and facilitate the capital formation process. On the cost side, however, such a safe harbor could lead to a higher rate of lawsuits and an increase in deadweight litigation costs. As to the issue on whether

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[1] In the final rule of the securities offering reform (effective December 1, 2005), the SEC granted reporting issuers (i.e., firms that file reports pursuant to the 1934 Securities Exchange Act) safe harbor protection for their continued release of forward-looking information. However, it did not extend the same safe harbor to non-reporting issuers (usually IPO firms).

[2] For example, it is commonly acknowledged that US firms are susceptible to a higher level of litigation risk than firms in other countries. Critics complained that plaintiffs' lawyers were filing frivolous lawsuits, often based on a company's prior optimistic statements that had not been fulfilled. Even when a lawsuit has no merit, it can still have a "blackmail effect" and force firms to settle to avoid a costly and lengthy litigation process and reputation loss.

[3] It is assumed that if the entrepreneur is uninformed, she cannot issue a "null" forecast which does not change investors' prior beliefs about the firm value. Alternatively, I can assume a "null" forecast and a "no disclosure" are treated as equivalent by the investors.

[4] The investors on average break even, since they also underpay for the firm's shares when the entrepreneur is uninformed.

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