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Litigation risk, strategic disclosure and the underpricing of initial public offerings ☆

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ABSTRACT

Using word content analysis on the time-series of IPO prospectuses, we show that issuers tradeoff underpricing and strategic disclosure as potential hedges against litigation risk. This tradeoff explains a significant fraction of the variation in prospectus revision patterns, IPO underpricing, the partial adjustment phenomenon, and litigation outcomes. We find that strong disclosure is an effective hedge against all types of lawsuits. Underpricing, however, is an effective hedge only against Section 11 lawsuits, those lawsuits which are most damaging to the underwriter. Underwriters who fail to adequately hedge litigation risk experience economically large penalties, including loss of market share.

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1. Introduction

When proposed by Tinic (1988) and Hughes and Thakor (1992) as a potential explanation for underpricing in initial public offerings (IPOs), litigation risk seemed both intuitively plausible and economically relevant. Section 11 of the Securities Act of 1933 gives investors the right to sue issuers and underwriters for declines in value below the offer price due to material omissions in the prospectus.[1] Given the inherent uncertainty of an IPO, and the potential reputational losses associated with litigation, issuers and underwriters concerned about lawsuits can attempt to hedge litigation risk by underpricing.

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[1] Section 11 states, " In case any part of the registration statement …omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading, any person acquiring such security … may, either at law or in equity, in any court of competent jurisdiction, sue every person who signed the registration statement" including the underwriter. Further, "the suit… may be to recover such damages as shall represent the difference between the amount paid for the security (not exceeding the price at which the security was offered to the public) and (1) the value thereof as of the time such suit was brought, or (2) the price at which such security shall have been disposed of in the market before suit, …."

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Drake and Vetsuypens (1993), in the first empirical paper to study the effect of litigation risk, examine differences in initial returns between IPOs that are sued and those that are not. The authors find no evidence that underpricing reduces the incidence of a lawsuit. Lowry and Shu (2002), however, take into account the endogeneity of initial returns and lawsuit incidence and find support for both an insurance and a deterrence effect as predicted by litigation risk theories. Despite this recent support, some researchers remain skeptical. Ritter and Welch (2002), in their review article state, ''In our opinion, leaving money on the table appears to be a cost-ineffective way of avoiding lawsuits.'' This paper proposes an enriched litigation risk framework that can reconcile these disparate views.

The underlying assumption in existing studies of litigation risk is that stock market losses alone are sufficient to extract legal penalties. In reality, two conditions must be met. First, investors must have suffered damages in the form of investment losses. Second, investors must be able to produce evidence of a material omission in the firm's disclosure that existed at the time of their initial investment. Importantly, in our enriched litigation framework, plaintiffs must establish evidence of *both* losses and poor disclosure (an ''and'' not an ''or'' condition). To reduce litigation risk, therefore, issuers need to hedge only one of these conditions. Hedging can be done by either underpricing (to reduce damages) or by enhancing disclosure (to reduce the probability of a material omission).

Our approach differs from prior studies of litigation risk in IPOs in that we examine both the firm's disclosure and pricing strategy. We hypothesize that disclosure and underpricing are substitute hedges against liability risk. In our enriched litigation framework, underpricing should be high only when a firm has a potential material omission (and vice versa). In other words, not all issuing firms will choose to use underpricing as a hedge. Therefore, the effect of underpricing in reducing incidences of litigation will be concentrated only in firms with a high probability of a material omission.

One reason why this enriched litigation risk framework has not yet been tested is that a ''material omission'' in a firm's prospectus is difficult to measure. With the advent of textual analysis, determining a firm's disclosure strategy is now feasible. We determine the likelihood of a material omission by examining how the issuing firm reacts to the arrival of new information during the offering period. In particular, we examine the intensity of revisions to the issuer's prospectus text over the same time interval as information-gathering activities, such as bookbuilding and road shows, are being conducted. These activities often result in information material enough to generate large price revisions from the initial filing range to the final IPO price. The typical issuer files an initial prospectus and two to three revisions during the roughly three-month period between the initial filing and the IPO date, giving us considerable power to assess any changes in disclosure over time.

We construct a proxy for the likelihood of a material omission in the prospectus using two conditions: (A) the extent to which the IPO price is revised since the initial filing estimate, and (B) whether the initial prospectus *is not* substantially revised during the offering period. Condition (A) reveals the potential materiality of the new price-relevant information that arrived during the bookbuilding process. If condition (A) is sufficiently large, condition (B) reveals that this new information was not disclosed in the prospectus, resulting in a potential material omission.

Specifically, we predict that the substitution effect of pricing for disclosure is increasing in the probability of a material omission. In this context, larger price revisions indicate that the new information is particularly relevant in determining the firm's offer price, and we consider it more ''material.'' As a result, an issuer who chooses not to revise their disclosure following a large price revision is particularly prone to successful litigation should the stock price decline ex post.

We find strong support for a substitution of pricing for disclosure as a hedge against litigation risk. The strongest substitution effect occurs when the proprietary value of the revealed information is likely to be high, i.e., in IPOs with positive price-relevant information generated during the offering period. The economic magnitude of these initial returns is substantial and is even larger still for issuers with high ex ante litigation risk. Ex ante litigation risk is determined by how similar the issuer's prospectus is to IPOs that were sued prior to the issuer's filing date. Thus, litigation risk plays an important role in the partial adjustment phenomenon and can explain why the underpricing of IPOs with positive information ''seems too large to be explained as equilibrium compensation for revealing favorable information'' (Ritter and Welch, 2002).

The traditional interpretation of the litigation risk theory is that high underpricing can deter all lawsuits by reducing damages. But underpricing applies only to IPO purchasers and therefore, cannot deter lawsuits brought by aftermarket purchasers. In our enriched litigation framework, we propose and test an alternative view of the deterrence effect of initial returns. We show that the deterrence effect of underpricing is in reducing the probability that IPO investors will bring a lawsuit under Section 11.

We find that the primary benefit of deterring a Section 11 lawsuit is to reduce the likelihood of the underwriter being named in the suit and suffering reputational damage along with subsequent market share losses.[2] The risk of being named in a lawsuit and losing market share can explain why underwriters are willing to substantially underprice even when positive information is revealed.

Unlike initial returns, we show that enhanced disclosure can deter all types of lawsuits because it applies equally to

[2] Section 11 limits damages to underwriters, ''In no event shall any underwriter … be liable in any suit or as a consequence of suits authorized under subsection (a) of this section for damages in excess of the total price at which the securities underwritten by him and distributed to the public were offered to the public.'' Lawsuits against underwriters claiming fraudulent behavior can still be brought by aftermarket investors under Section 10b-5 but the threshold is higher because it requires a proof of intent.

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