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Legal opportunism, litigation risk, and IPO underpricing☆

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ABSTRACT

We consider the importance of legal opportunism as an explanation for observed litigation following a large sample of initial public offerings (IPOs). We characterize legal opportunism as litigation based on the potential to recover losses after negative stock price developments rather than the legal merits. We find the most important predictors of post-IPO litigation activity (both likelihood and settlement amounts) to be ex post legal stakes (i.e., monetary damages plaintiffs could claim), and the remaining wealth available in the firm. Our results suggest a disturbing role for legal activity and starkly contrast existing models of IPO underpricing that focus on ex ante risk factors.

1. Introduction

Few countries have securities laws as well developed as those in the United States. Both the 1933 Securities Act and the 1934 Securities Exchange Act provide valuable protection and legal recourse. U.S. investors who buy a company's debt, equity securities or related derivatives in either the primary or secondary markets can sue the issuer of those instruments if they feel misled in their investment decision because the issuer misrepresented or withheld important information. Corporations and their defense lawyers argue that such laws make it too easy for investors and their legal counsel to file suit in hopes of extracting a large settlement.

After a considerable increase in litigation activity during the early 1990s, corporate lobbyists raised concerns that legal burdens were too high and that U.S. security issuers were increasingly targeted by so-called "strike suits," i.e., largely unmerited lawsuits in which plaintiffs sought to recover investment losses from companies that would rather settle than face the large costs and risks associated with a court trial. Congress reacted by passing two securities law reforms, the 1995 Private Securities Litigation Reform Act (PSLRA) and the 1998 Securities Litigation Uniform Standards Act (SLUSA). These reforms attempted to decrease litigation burdens by 1) enforcing a discovery stay while motions to dismiss the case were pending, 2) assigning the lead plaintiff role to the party with the largest financial interest (not the first party to file suit, which had previously sparked "runs to the courthouse"), 3) raising scienter (i.e., the burden of proof for plaintiffs to show that defendants knowingly violated security laws), and 4) requiring all lawsuits to be filed in federal court (where they have to comply with the reform acts) rather than in State court. Debate about how to best protect investors while limiting non-meritorious lawsuits has not abated. In fact, concerns have increased due to scandals involving high-profile firms such as Enron, Worldcom, Adelphia Communications, and Healthsouth; investigations into Wall Street's practices spearheaded by New York State Attorney General Eliot Spitzer during his time in office; and reforms such as Regulation FD and the 2002 Sarbanes–Oxley Act.

Examining the motivation behind securities lawsuits provides important insight for regulators to evaluate the effectiveness of laws protecting investors from fraudulent issuers and shielding issuers

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against abusive litigants. Some literature in this area investigates lawsuits filed against seasoned companies under the 1934 Securities Exchange Act (e.g., Crutchley and Minnick (2012) link litigation likelihood to executive compensation in seasoned firms). We focus on firms following their initial public offering (IPO).

IPO firms provide a rich empirical setting for security lawsuit analysis. Founders or professional managers who decide to take their firm public confront a variety of pressures. They must fulfill the often high expectations of underwriters, venture capitalists, analysts, and outside shareholders. They are also likely to experience a substantial shift in personal wealth as their compensation may be closely tied to the firm's share price. Unfortunately, in response to these pressures managers may portray their firm in an overly positive light or engage in manipulative or fraudulent activities. If concerns exist regarding the long-term prospects for their firm or industry, managers may be particularly tempted to use an IPO as a wealth enhancing exit strategy. Not surprisingly, our litigation sample includes many of the once popular technology and internet IPOs. In addition to allegedly manipulating earnings, many of these firms were accused of overly optimistic forecasts and failing to disclose known problems in their prospectuses. Moreover, many lawsuits allege that managers of these firms continued to mislead investors well after the IPO — often while selling their own holdings.

There is little doubt that improper behavior sometimes occurs during the IPO process. However, risks inherent in IPO firms make them particularly susceptible to unmerited lawsuit filings. Ritter (p.91991) discusses the tendency for IPO firms to have larger average betas at the time of offering relative to other firms. Relatedly, Baker and Wurgler (2006) discuss how opaque, difficult to value, firms may offer additional rewards to investors related to market wide sentiment. Berger and Turtle (2012) extend this work and find economic conditions in which opaque portfolios offer superior marginal risk adjusted performance. Thus, even in the absence of management wrongdoing, IPO shares will be more susceptible to most measures of market risk, and perhaps to 'hype' among investors who overestimate the future prospects of a firm or industry. Subsequent stock price declines and resultant litigation may be the result of broader risk factors with no commensurate mismanagement.

We explore the determinants of a firm's litigation risk at the time of IPO and following the offering, when litigants file and potentially settle lawsuits. Because we focus on IPOs rather than seasoned firms, we have the unique opportunity to differentiate between ex ante firm and offer characteristics and ex post events to evaluate their relative impact on a firm's litigation risk. Existing legal and finance literature largely focuses on ex ante determinants (cf., Alexander, 1991; Drake & Vetsuypens, 1993; Lowry & Shu, 2002; Tiniç, 1988, and Zhu, 2009). In contrast, we suggest that a firm's litigation risk is largely determined by ex post events in the IPO aftermarket.

We hypothesize that a non-negligible proportion of firms become the target of legal opportunism, i.e., plaintiffs and their law firms make exploitative use of events such as concurrent industry or market downturns to file suits against IPO firms that otherwise show no signs of fraudulent behavior. We show that ex post events largely overshadow any pre-IPO litigation deterrents that a firm may put in place (e.g., hiring prestigious underwriters or substantially underpricing their shares). Our findings cast doubt on models such as the lawsuit avoidance theory and the assertion that issuers and their underwriters can effectively reduce litigation risk during the pre-IPO stage.

We present evidence that the most important predictors of litigation following an IPO are ex post legal stakes (i.e., monetary damages that plaintiffs could claim), and the wealth remaining in the firm. These results suggest a disturbing role for legal activity and starkly contrast with existing models focusing on the importance of ex ante IPO underpricing. Overall, we find that ex ante firm and offering characteristics only explain about two to 3% of the variation in observable litigation risk. In contrast, models that consider post-IPO developments capture over 65% of the variation in litigation likelihood.

Our study provides a number of additional insights. First, we find that industry factors outside the scope of a firm's control impact litigation risk. This suggests that IPO firms may be sued for reasons that are largely opportunistic. In our empirical estimation, we consider a series of control variables to proxy for the merit of a given case, e.g., the existence of parallel SEC investigations, the eventual outcome of a given case, and the presence of earnings restatements and secondary allegations. Although these variables show that merits matter, their explanatory power is comparatively much smaller than our proxies for legal opportunism. Second, the significance of aftermarket performance (at both the firm and industry level) suggests that IPO firms may face litigation due to information not available or foreseeable at the time of offering. Third, we find little evidence that underpricing is a rational response to, or an effective deterrent of, potential litigation risk. Finally, our study explores the determinants of out-of-court settlements paid by defendant firms. We examine whether and how firm and offer characteristics, as well as the occurrence of certain post-IPO events (e.g., parallel investigations by the Securities and Exchange Commission) influence the size of eventual settlement payments.

Our results are similar in spirit to the discussion in Alexander (1991, 1993) who finds that plaintiffs pursue legal actions for reasons determined almost entirely in the post-IPO market, based on information that was inherently unknowable at the time of offering. The importance of after-market wealth lost, equity remaining, and other counterparties' obligations are all determinants of legal risk. Notably, the ex post measurement of these risks determines lawsuit likelihood, not ex ante prediction of these values. Alexander argues that the 1933 Securities Act addresses disclosure requirements, not pricing decisions, and that underpricing is immaterial to the outcome of litigation. We quantify these relationships in our empirical analysis and provide strong support for many of Alexander's hypotheses.

Our investigation of IPO lawsuits offers new empirical evidence for regulators, managers and parties that aid corporations during the IPO process (including auditors, underwriters, and legal counsel).

2. Literature review and hypothesis development

We focus on legal opportunism as an alternative to the lawsuit avoidance hypothesis to explain the relationship between IPO underpricing and litigation risk. Under the lawsuit avoidance hypothesis, firms have an incentive to sell IPO shares at a discount to reduce the likelihood of future litigation brought against them by investors disappointed with the performance of their shares.

Empirical tests of the lawsuit avoidance hypothesis focus on two implications: (i) the *deterrence effect* and (ii) the *insurance effect*. The *deterrence effect* predicts that higher underpricing causes lower litigation risk, or that litigation risk is a decreasing function of underpricing. Further, an underpriced equilibrium offer reduces the available losses investors can claim in a lawsuit and thus mitigates any eventual settlement. Tiniç (1988) and Lowry and Shu (2002) provide empirical support for the deterrence effect of IPO underpricing in the U.S. In contrast, Drake and Vetsuypens (1993) find no support for the deterrence effect. They claim that underpricing does not reduce the probability of a lawsuit and document no significant differences in the level of underpricing between firms that face, or do not face, lawsuits. Lowry and Shu argue that the Drake and Vetsuypens ex post comparison is biased and suggest that ex ante litigation risk – not ex post litigation – causes greater underpricing. More recently, Zhu (2009) also finds little support for the deterrence effect of underpricing. We examine the deterrence effect of underpricing in both a simultaneous logistic regression analysis similar to that of Drake and Vetsuypens (1993), and a simultaneous regression setup similar to Lowry and Shu (2002) using multiple variations in model specifications, variable definitions, and controls for potential endogeneity biases.

The *insurance effect* predicts that higher litigation risk causes higher underpricing, or that underpricing is an increasing function of litigation