Litigation risk and IPO underpricing

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Abstract

We examine the relation between risk and IPO underpricing and test two aspects of the litigation-risk hypothesis: (1) firms with higher litigation risk underprice their IPOs by a greater amount as a form of insurance (insurance effect) and (2) higher underpricing lowers expected litigation costs (deterrence effect). To adjust for the endogeneity bias in previous studies, we use a simultaneous equation framework. Evidence provides support for both aspects of the litigation-risk hypothesis. © 2002 Elsevier Science Ltd. All rights reserved.

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1. Introduction

Firms conducting Initial Public Offerings (IPOs) typically earn a return of approximately 15% on their first day of trading. While the magnitude of this initial return varies over time and as a function of firm characteristics, it shows no signs of dissipating. The persistent and systematic underpricing of IPO issues is puzzling, and this apparent violation of market efficiency has received considerable attention from researchers. There currently exist three main theories for these high initial returns: signaling, information asymmetry, and litigation risk (Ibbotson et al., 1994). A

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substantial body of literature empirically tests the first two potential explanations, and evidence indicates that information asymmetry is an important determinant of IPO initial returns. However, much of the magnitude of and variation in initial returns remains unexplained. Interestingly, litigation risk, the third potential explanation for underpricing, has received relatively little attention in the empirical literature. The idea that IPO firms and underwriters intentionally underprice their shares to insure against future liability is intuitively appealing, yet the existing evidence on this is at best mixed and inconclusive.

Skeptics of the litigation-risk hypothesis (e.g., Alexander, 1993) often point to the high costs of underpricing relative to the average lawsuit settlement costs and the low historical lawsuit frequency (around 6% for our sample) as anecdotal evidence against this hypothesis. However, this ‘back-of-the-envelope’ reasoning ignores many important factors. First, it is possible that the lawsuit frequency and settlement payments are low precisely because most firms have used underpricing as a form of insurance. Further, as discussed in more detail below, this argument omits many of the costs associated with lawsuits.

For a firm planning to go public, the potential costs of litigation are substantial. One of the most highly publicized costs of litigation is the settlement payment, which averages $3.3 million in our sample and represents 11% of the total proceeds raised. Notably, some of the cases settle for considerably larger amounts. For example, in four cases the settlement amount exceeds 35% of proceeds raised, and in one case the settlement amount is nearly 50% of proceeds. Further, these settlement amounts are only one portion of the total costs associated with a lawsuit. There are other, potentially more important, costs of litigation that are often overlooked because they are not directly observable. Examples of such costs include reputation costs to both the IPO firm and its managers, legal fees, and the opportunity cost of management time dedicated to the lawsuit. As discussed later, several companies in our sample cite such costs in their decisions to settle their lawsuits.

Because litigation is costly, managers have incentives to insure against such costs. One way to effectively insure against these costs is to lower the probability of being sued. For this reason, all firms and their underwriters conduct due diligence prior to the IPO, i.e., they investigate all aspects of the firm’s business, finances, management, and projections and discuss their findings in the IPO prospectus. However, it is not feasible to foresee every possible future event, and there are obvious limits to what can be incorporated into a prospectus. A second way to lower the probability of being sued is to decrease the potential damages that plaintiffs can recover. Alexander (1993) emphasizes that the amount of the expected settlement reward is a major determinant of the probability of being sued. For this reason, underpricing is a particularly attractive form of insurance. Unlike other forms of insurance that firms can purchase, underpricing lowers the potential damages that plaintiffs can recover, and thus reduces plaintiffs’ incentives to bring a lawsuit against the firm.

To understand why underpricing potentially lowers the probability of being sued, we briefly discuss some specifics of the securities laws. The Securities Acts of 1933 and 1934 give investors the right to bring a lawsuit against an IPO firm for material untruths or omissions in the prospectus and provide guidelines for the calculation of
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