Journal of Corporate Finance 17 (2011) 438–456

Contents lists available at ScienceDirect

Journal of Corporate Finance

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

Securities litigation, withdrawal risk and initial public offerings☆

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ARTICLE INFO

Article history:
Received 1 November 2007
Received in revised form 13 December 2010
Accepted 23 December 2010
Available online 14 January 2011

JEL classification:
G24
K22

Keywords:
IPO
Litigation risk
Withdrawal risk
IPO failure
Underpricing
Underwriter gross spread

ABSTRACT

I examine the relations between litigation risk, withdrawal risk, and the costs of going public using a sample of withdrawn and completed initial public offerings (IPOs) filed during 1996–2005. Firms with a higher probability of offer withdrawal face higher litigation risk if they complete these offers. Firms with higher litigation risk pay slightly higher gross spreads, but do not underprice their IPOs by a greater amount. Withdrawal probability is strongly and positively associated with underwriter gross spreads, consistent with underwriters charging fees that reflect the probability of not getting paid. When the pre-market demand for an IPO is weak, a higher withdrawal probability raises underpricing on completed deals.

1. Introduction

Litigation risk poses a significant threat to firms going public in the United States. Once issuers are sued, regardless of the eventual outcome of the lawsuits, just the indirect costs due to lost management time and damaged reputation represent an enormous burden, not to mention the potentially huge legal liabilities for a young firm with limited resources. How does the legal threat affect the initial public offering (IPO) process? This paper tries to shed light on several open questions in the literature.

First, is the IPO withdrawal decision affected by an issuer's legal liability concerns? How is the probability of IPO withdrawal related to litigation risk? For firms with high litigation risk, the expected costs of completing an IPO should be high for both underwriters and issuers. Therefore, I expect firms with high litigation risk to have a high probability of IPO withdrawal. However, the literature lacks empirical evidence on this question.

Second, do litigation risk and withdrawal risk affect IPO underpricing? The litigation risk hypothesis for IPO underpricing argues that firms with higher litigation risk underprice their IPOs by a greater amount as a form of insurance. While many researchers have contributed to the debate (see, e.g., Ibbotson, 1975; Tinic, 1988; Hughes and Thakor, 1992; Drake and Vetsuypens, 1993; Hensler, 1995; Lowry and Shu, 2002; Zhu, 2009; Pukthuanthong et al., 2009), one important issue has been

☆ This paper is substantially revised from one chapter of my Ph.D. dissertation at the University of Florida. I owe special thanks to an anonymous referee and David Denis (the editor), who have provided many constructive suggestions, and to Jay Ritter (my dissertation committee chair), for his IPO data, valuable comments, and continued support. I sincerely thank Chunrong Ai, Kathleen Hanley, John Howe, Christopher James, Kevin M. LaCroix, James Leigh-Pemberton, Jeffrey Wooldridge, Yun Zhu, and seminar participants at the 2007 European Financial Management Symposium on IPOs at Oxford University for helpful comments. I thank Matt Crook and Anamaria Calincan for providing excellent research assistance. I acknowledge financial support from the Robert J. Trulaske, Sr. College of Business at the University of Missouri.

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0929-1199/$ – see front matter
doi:10.1016/j.jcorpfin.2010.12.005

ignored. If IPOs with greater litigation risk are more likely to be withdrawn, then the effect of withdrawal risk also needs to be considered when examining how litigation risk affects underpricing of completed IPOs.

Third, do litigation risk and withdrawal risk affect underwriter gross spreads? Firms with fundamentally higher underwriting risks and requiring more extensive underwriter marketing efforts should pay higher underwriting fees. If litigation risk and withdrawal risk are part of the overall underwriting risk, I expect them to positively affect gross spreads. However, this issue has received no attention in the literature.

Using a sample of withdrawn and completed IPO filings during the 1996–2005 period, I uncover several key findings. First, firms that are more likely to withdraw their IPOs, are more vulnerable to lawsuits if they complete their offers. At least one in every five IPOs filed with the SEC is withdrawn. The withdrawal decision is significantly affected by the information learned during the registration period. For issuers completing their IPOs, the estimated probability of withdrawal turns out to be a significant predictor of litigation that is brought against the issuers later. A one standard deviation increase in the probability of withdrawal raises the probability of being sued by 1%. Compared with the 4.2% unconditional probability of an IPO firm being sued, the probability of being sued increases by approximately 25%. The result suggests that the withdrawal decision is strongly influenced by litigation risk.

Second, I find that firms with higher litigation risk do not underprice their IPOs by a greater amount. The results are robust to controls for withdrawal risk and the potential endogeneity of litigation risk in the underpricing regression. Given the empirical support found for the litigation risk hypothesis during the 1988–1995 sample period by Lowry and Shu (2002), I explore what may cause the lack of support for the hypothesis in the 1996–2005 sample period. Several institutional changes may contribute to the declining use of underpricing as litigation insurance. First, the increasing use of directors and officers (D&O) insurance and errors and omissions (E&O) insurance may reduce the need to insure through underpricing, and these insurance fees are likely to be substantially lower than the cost of additional IPO underpricing. Second, the passage of the Private Securities Litigation Reform Act of 1995 (PSLRA) has increased the hurdles to successful private litigation for securities fraud, thus reducing expected litigation costs faced by issuers and underwriters.[1] This reduced legal threat can also reduce the incentives to leave money on the table as an indirect form of litigation insurance.

When IPO market conditions are weak, firms with higher withdrawal risk underprice their offers by a greater amount to increase the probability of completing the offer. Specifically, a one standard deviation increase in the predicted probability of withdrawal is associated with an increase of 4.94% in underpricing. This relation is not present when IPO market conditions are strong.

Third, firms with higher litigation risk and withdrawal risk pay higher gross spreads to underwriters. Withdrawal risk affects gross spreads more strongly than litigation risk does. The effect of withdrawal risk on gross spreads is not only statistically, but also economically significant, more specifically, a one standard deviation increase in the probability of withdrawal increases the expected gross spread by 9.1 basis points (or 1.3% of the average gross spread). Based on the average proceeds of $104 million (2005 purchasing power), this suggests that a one standard deviation increase in the probability of withdrawal increases the dollar amount of underwriter revenue by $94,640 on completed deals. The findings suggest that underwriters are charging fees that reflect the probability of not getting paid.

The remainder of this article is as follows. In Section 2, I develop the hypotheses. In Section 3, I describe the data and report the empirical results. Section 4 concludes the paper.

2. Hypothesis development

Litigation risk can be a significant concern in the process of going public. Lowry and Shu (2002) report that 5.8% of the firms that went public during 1988–1995 were sued in class actions and the average settlement-to-IPO proceeds ratio was 10% for those sued. The indirect costs of being sued, such as lost management time and damaged reputation, can be much larger. In this section, I discuss how legal concerns can affect several decisions in the IPO process. I also discuss how withdrawal risk can affect IPO pricing and gross spreads.

2.1. Litigation risk and IPO withdrawal

When an IPO is withdrawn, issuers most often refer to “current market conditions” as the reason. Unfavorable market movements not only can reduce the proceeds raised in an IPO, but also can affect the after-market stock performance. Given that a necessary condition for litigation against the issuers is poor after-market stock performance, deciding whether to complete or withdraw an offer when negative information arrives during the registration period is critical in reducing future legal liabilities for issuers and underwriters alike.

However, withdrawing an IPO also has associated costs. First, withdrawing an IPO can delay a profitable investment project due to the inability to immediately tap alternative sources of financing. This opportunity cost could be substantial for firms in nascent industries whose early entrants can enjoy significant first-mover advantages.

Second, withdrawing an IPO can put cash-strapped firms in financial distress. Guo (1998) finds the survival rate for firms that withdraw to be lower than that of firms that complete their issues. A withdrawn issuer not only loses the chance to raise

[1] The PSLRA stimulated heated debate on whether it would benefit or harm shareholders, as this legislation not only may reduce frivolous lawsuits; it also may deter meritorious lawsuits (see, e.g., Spiess and Tkac, 1997; Johnson et al., 2000; Ali and Kallapur, 2001). Nevertheless, litigation risk for issuing firms and underwriters would be reduced by the passage of the PSLRA regardless of its net effect on shareholder wealth.