Frontiers of Entrepreneurship Research

Volume 28 | Issue 3
CHAPTER III. VENTURE CAPITAL

Article 7

6-7-2008

THE PRICE OF LUST: THE CASE OF IPO LAWSUITS AGAINST VC-BACKED FIRMS (SUMMARY)

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Recommended Citation

Griffiths, Mark; Kickul, Jill; and Post, Colleen (2008) "THE PRICE OF LUST: THE CASE OF IPO LAWSUITS AGAINST VC-BACKED FIRMS (SUMMARY)," *Frontiers of Entrepreneurship Research*: Vol. 28: Iss. 3, Article 7.
Available at: http://digitalknowledge.babson.edu/fer/vol28/iss3/7

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SUMMARY

THE PRICE OF LUST: THE CASE OF IPO LAWSUITS AGAINST VC-BACKED FIRMS

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Principal Topic

Loughran and Ritter (2004) introduce the analyst lust hypothesis to describe IPO underpricing where influential analysts are engaged to take the firm public. Their spinning hypothesis describes the 1990s practice of providing side payments to individuals charged with finding an underwriter to manage the IPO process. Both hypotheses create incentives to seek underwriters with a reputation for severe underpricing. We verified the Loughran and Ritter hypotheses and tested both the importance of analyst coverage (Cliff & Denis, 2004) and the influence of VC versus non-VC-backed structures on control issues, whether the lawsuits were dismissed in whole or in part as well as the size of the settlements. We examined both the VC-backed success hypothesis (Jain & Kini, 2000) and the common wisdom of "sue the party with the deepest pockets."

Method

We examined 246 IPOs (111 venture backed and 135 non-venture backed) sued for material mis-statements in the issuing prospectus that resulted in over-pricing. Our sample of IPOs was taken from Thomson Financial's SDC New Issues database. Segment and accounting data were retrieved from Compustat's segment files.

Results and Implications

We find that VC-backed firms have more prestigious lead underwriters, were younger, and smaller in size. They had a higher price revision and offer size, were more underpriced, and a higher Tobin's Q than non-VC-backed firms.

We conducted a two-stage least squares regression (OLS) analysis on underpricing where the underwriter rank is operationalized using the predicted rank from a first-stage OLS regression. Our first-stage OLS regression for underwriter rank has these explanatory variables: the logarithm of assets, share overhang, age, logarithm of sales, filing width, a VC dummy, and the logarithm of the offer size. In our second stage with underpricing as the dependent variable, we included the same explanatory variables and the predicted value of the top-tier underwriter dummy.

Here, we find additional support for the Loughran and Ritter hypothesis. The presence of VC-backed firms predicts the severity of underpricing and, in a hierarchical discriminant analyses, we find that VC-backed firms are charged with more SEC offences, have more charges dismissed, and have smaller settlements, all consistent with both the VC-backed success and the deep pockets hypotheses.

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