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Recommended Citation

Noam Sher, *Negligence Versus Strict Liability: The Case of Underwriter Liability in IPO's*, 4 DePaul Bus. & Com. L.J. 451 (2006)

Available at: <https://via.library.depaul.edu/bclj/vol4/iss3/5>

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Negligence Versus Strict Liability: The Case of Underwriter Liability in IPO's

Noam Sher*

ABSTRACT:

[The present article focuses on the following question: What degree of liability should be imposed on the leader of the consortium of underwriters (leader) and on the other underwriters of initial public offerings (IPO's) for misleading details in the offering prospectus - negligence or strict liability? The article explores new justifications for imposing liability in terms of negligence rather than strict liability.]

In a model representing the problem of hidden actions by the firm and the leader, leading to a moral hazard problem, the present article demonstrates that the negligence rule has advantages over the strict liability rule. The justifications derived from this model focus on the fact that a negligence rule serves the law's function in serving the moral hazard problem optimally, since the rule only obliges the court to ask whether the leader has indeed carried out an optimal due diligence. Moreover, a negligence rule also assists the law optimally in reducing costs due to the effect of the due diligence procedure on third parties, contributes to the creation of a standard due diligence procedure, and has an external positive effect on the private capital raising market.

In an additional model presenting IPO pricing using the book-building method, the leader manages to reach an equilibrium in which she convinces an optimal number of permanent investors to invest in collecting information about the offered security's value. This model shows that the negligence rule is preferable to the strict liability rule, as it helps convince various investors that the leader indeed made the optimal effort in executing due diligence, and therefore allows them to reduce the costs of maintaining the testing and verification system, while at the same time increasing certainty as to the accurateness of the market demand curve presented by the leader. In addition, a negligence rule better serves the post-IPO market in dealing with strategic actions by the leader intended to maximize the latter's profits in that market.

A further justification focuses on the leader's insurance role, and on her ability to be the IPO's "least expensive insurer." Arguably, hold-

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ing the leader liable for negligence can add to the efficiency of the market risk distribution system.

Finally, the above justifications for holding underwriters liable for negligence also apply, at least in part, to the firm and its directors. Additionally, they may have certain implications on laws regarding IPO's, and their proper scope should also be examined in other areas where legal scholars argue for either negligence or strict liability as the optimal basis for liability.]

I. INTRODUCTION

The present article focuses on finding answers to the following questions: Based on an economic analysis of law, what degree of liability should be imposed on the leader of the consortium of underwriters ("leader") and on the other underwriters of initial public offerings (IPO's) for misleading details in the offering prospectus: negligence or strict liability? Further, what can be learned, generally, from the choice between negligence and strict liability?

A significant part of the discussion pertaining to the economic analysis of tort law focuses on the liability regimes that should be applied in various circumstances. The main question concerns how a regime of no liability, negligence (together with a contributory negligence rule, or without it), or absolute liability (together or without contributory negligence) can affect, in the same case, the precaution and activity levels of potential offenders, and those of potential injurers.¹ This article also examines whether a negligence standard used to determine underwriter liability, in the present American legal system, is preferable to a strict liability standard, assuming that underwriter liability is preferable to no underwriter liability at all.²

1. See RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* 179 - 235 (5th ed., Aspen Law 1998); WILLIAM M. LANDES & RICHARD A. POSNER *THE ECONOMIC STRUCTURE OF TORT LAW* (Harvard Univ. Press 1987); Richard A. Posner, *A Theory of Negligence*, 1 J. OF LEGAL STUD. 29 (1972); Richard A. Posner, *Strict Liability: A Comment*, 2 J. OF LEG. STUD. 205(1973); STEVEN SHAVELL, *ECONOMIC ANALYSIS OF ACCIDENT LAW* 5-45 (Harvard Univ. Press 1987); Steven Shavell, *Strict Liability versus Negligence*, 9 J. OF LEGAL STUD. 1 (1980); R. COOTER & T. ULEN, *LAW AND ECONOMICS* 287-371 (Reading & Others, 3d ed., 2000). For a list of several dozens of articles on the distinction between strict liability and negligence, based on economic analysis of the law, see H. B. SCHÄFER & A. SCHÖNENBERGER, *Strict Liability Versus Negligence*, *ENCYCLOPEDIA OF LAW AND ECONOMICS* (B. Bouckaert & G. De-Geest eds. 1999) available at <http://allserv.rug.ac.be/~gdegeest/3100book.pdf> (last visited Mar. 9, 2006).

2. Elsewhere, we have presented the justifications for holding the leader and other IPO underwriters liable. See Noam Sher, *Underwriter Civil Liability for IPO's: Deterrence in a Double Moral Hazard Model* (Working Paper 2005); Noam Sher, *Underwriter Civil Liability for IPO's: An Economic Analysis* (forthcoming in 27 U. PA. J. INT'L ECON. L. (2006)). For more on recent studies in the area, see *infra* Section III.

Recent studies argue that strict liability should be applied to gatekeepers in the IPO market, including underwriters.³ According to author F. Partnoy,⁴ the appropriate underwriter liability regime is strict liability with a rule-changing option. According to his suggestion, underwriters should be required to compensate for each damage for which it is determined, whether by judicial decision or way of compromise, that the issuing company should indemnify the investors. The underwriters would be allowed to change this rule through an agreement with the firm that limits their share of liability, so long as this change is mentioned in the prospectus (up to a certain legal minimum, for example, the rate of commissions collected or any standard rate between one and five percent). In Partnoy's opinion, the existing arrangement, which allows underwriters the due diligence defense, entails high costs due to the law's reliance on the underwriter reputation mechanism. Therefore, in Partnoy's opinion, a different solution should be found which does not rely on this mechanism. Author J.C. Coffee⁵ also suggested that the IPO gatekeeper should be subject to strict liability, with a limitation on claim size. Coffee's suggestions, however, are based on regulation rather than a contractual arrangement, and in determining the damages ceiling in a different manner.⁶

In many studies that discuss the aspects of underwriter liability, various justifications for the existing rules are suggested. Some studies

3. Gatekeepers in the securities primary market are entities who provide monitoring to the supply of securities to investors. For other definitions, see Reinier H. Kraakman *Gatekeepers: The Anatomy of a Third-Party Enforcement Strategy*, 2 J. OF L. ECON. & ORG. 53 (1986); Assaf Hamdani, *Gatekeeper Liability*, 77 S. CAL. L. REV. 53, 58 (2003); John C. Coffee, *Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reform*, 84 B.U. L. REV. 301, 308-311 (2004); and Peter B. Oh, *Gatekeeping*, 29 IOWA J. CORP. L. 735 (2004). As Coffee has pointed out:

[T]wo core elements underlie the concept of gatekeeper, and it is important to distinguish between them. First, the gatekeeper is a person who has significant reputational capital, acquired over many years and many clients, which it pledges to assure the accuracy of statements or representations that it either makes or verifies. Second, the gatekeeper receives a far smaller benefit or payoff for its role, as an agent, in approving, certifying, or verifying information than does the principal from the transaction that the gatekeeper facilitates or enables.

John C. Coffee, *Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reform*, 84 B.U. L. REV. 301, 308 (2004).

4. Frank Partnoy, *Barbarians at the Gatekeepers?: A Proposal for a Modified Strict Liability Regime*, 79 Wash. U. L. Q. 491, 546-47 (2001). For a more detailed discussion in his claims, see *infra* Section III.

5. Coffee, *supra* note 3 at 306-307. For a more detailed discussion in his claims, see *infra* at Section III.

6. See Frank Partnoy, *Strict Liability for Gatekeepers: A Reply to Professor Coffee*, 84 B.U. L. REV. 365, 368-73 (2004) (explaining why, in his opinion, his suggestion for applying strict liability, allowing contractual conditioning, is superior to Coffee's). For a more detailed discussion in his claims, see *infra* at Section III.

have found disclosure of information through underwriter due diligence to be highly beneficial, for various reasons, usually without asking the material question of the present discussion: whether liability should be strict or negligence-based. Other studies, however, suggest doing away with underwriter liability under the present system.⁷

This article argues that the director general of an underwriter consortium (leader), together with other underwriters, should be held liable for negligence (and also required to shoulder the burden of proving that they have not been negligent in their due diligence), and not strictly liable, for the presence of misleading details in the IPO prospectus. The justifications for this approach are presented in two models. In the first model,⁸ capital markets suffer from the problem of hidden actions by company managers and the leader, in turn creating a moral hazard problem. The second model⁹ focuses on the IPO pricing process and the way securities are distributed to investors using the bookbuilding method.

Section II provides a background regarding the role of the Leader of the Consortium of Underwriters. Section III presents studies discussing, either directly or indirectly, the level of liability that should be imposed on a director general of an underwriter consortium and the other underwriters for misleading details in the IPO prospectus. It will focus on justifications for holding the leader liable based on a negligence standard, or for justifications for strict liability and on differences between their thesis and that presented herein. Furthermore, we will refer to studies which suggested not holding underwriters liable. Section IV details the justifications supporting a negligence rather than strict liability rule. Section V reviews possible counterarguments for the justifications supporting a negligence standard. Section VI examines the first insight derived from the thesis concerning the design of various sections of the appropriate law by asking, what is the appropriate standard of care that should be imposed on other participants in the issue's process. Finally, section VII summarizes the discussion and inquires whether the thesis presented herein has further implications in terms of designing other elements of the appropriate law in the area of holding IPO participants liable for misleading details in the prospectus and in other areas beyond the scope of liability for misleading

7. For more on arguments presented in the legal literature discussing negligence versus strict liability of IPO underwriters, see *infra* in Section III.

8. For a comprehensive presentation of the model, see Sher, *Underwriter Civil Liability for IPO's: Deterrence in a Double Moral Hazard Model*, *supra* note 2. See also *infra* Section IV-A1.

9. For a comprehensive presentation of the model, see Sher, *Underwriter Civil Liability for IPO's: Deterrence in a see also infra* Section IV-B1.

details in IPO's for which using either the negligence or the strict liability standard is being considered.

II. BACKGROUND

In the IPO market, *underwriters* are financial intermediates whose main roles are to distribute the offered securities, give quasi-insurance to the issue, and bridge information gaps between sellers and buyers in the primary market.¹⁰ Usually, underwriters act in a group, or consortium, which assigns to its members their said commitment to distribute the securities, to insure the issue, and to bridge information gaps.¹¹ The crucial work of the consortium, which includes bridging information gaps, is being done by *the leader*. Before the IPO, the issuing firm usually contacts an underwriter who undertakes to manage the IPO. This underwriter, usually an investment bank or a big investment company, is called a leader. As IPO manager, the leader's duties include: (1) advising the issuer, (2) providing investment-banking services, including management and financial support for company activities, (3) assistance in formulating the prospective, (4) carrying out due diligence, (5) assessing the value of securities to be sold, (6) determining the IPO's structure and terms, and (7) creating and managing the securities' underwriting and distribution networks. The leader's crucial role in the IPO allows her to affect its structure and terms, including the price of the securities offered and disclosure to the public of information relevant to an investment decision.

Under prevailing American law, the underwriters¹² of a public offering of securities bear civil liability for damages suffered by inves-

10. See Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 613-621 (1984) (discussing the role of the investment banker). According to the common IPO American system, the underwriters's role is to purchase securities from the issuer in order to distribute them to the public. *Id.*

11. "Underwriting" is an insurance term. In insurance transactions, it means joining, by means of signing an insurance policy, an insurance obligation by a consortium of insurers. See Webster's Collegiate Dictionary 1287 (9th ed. 1990). In the case of securities underwriting, this consortium purchases the securities offered in order to sell them to the public (according to the common IPO American system). *Id.*

12. Section 2(a)(11) of the Securities Act of 1933, 15 USC § 77b(11), defines the term "underwriter" as follows:

The term "underwriter" means any person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security, or participates or has a direct or indirect participation in any such undertaking, or participates or has a participation in the direct or indirect underwriting of any such undertaking; but such term shall not include a person whose interest is limited to a commission from an underwriter or dealer not in excess of the usual and customary distributors' or sellers' commission. As used in this paragraph the term "issuer" shall include, in addition to an issuer, any person directly or indirectly controlling or con-

tors resulting from misleading details in the offering prospectus. The underwriters are subject to a negligence standard and bear the burden of proof in showing that the misleading details in the prospectus did not result from their negligence.¹³ Moreover, potential defendants can deny liability by arguing that, at the time of the transaction, the investor was aware of the untruth or omission claimed to constitute the misleading detail.¹⁴

III. A REVIEW OF THE LITERATURE

The literature on underwriter liability is based, methodically, on management oversight and mandatory disclosure duties.¹⁵ Most re-

trolled by the issuer, or any person under direct or indirect common control with the issuer.

Id. For a detailed examination of the definition's components, see Louis Loss & Joel Seligman, *FUNDAMENTALS OF SECURITIES REGULATION* 246-61 (Aspen Publishers 3d ed., 1995); Louis Loss & Joel Seligman 2 *SECURITIES REGULATION* 1108-1134 (Little Brown & Co. Law & Bus. 3d ed., 1993); Louis Loss & Joel Seligman *SECURITIES REGULATION* 193-95 (Little Brown & Co. Law & Bus. 3d ed., 1998 Supp.); Thomas L. Hazen *ON THE LAW OF SECURITIES REGULATION* 244-256 (West 3d ed. 1996); and Jennifer O'Hare, *Institutional Investors, Registration Rights, and the Specter of Liability Under Section 11 of the Securities Act of 1933*, 1996 *Wis. L. Rev.* (1996) 217.

13. 15 U.S.C. § 77k (2006). Section 11(a) of the Securities Act holds the undersigned on registration statements, the issuing firm, its directors, the experts undersigned on opinions attached to the prospectus and the underwriters themselves all liable under civil law. *Id.* at § 77k(a)(1-5). According to § 11(a), they are liable "in case any part of the registration statement, when such part becomes effective, contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading." *Id.* at § 77(k)(a) (hereinafter and above "misleading detail"). Any buyer of securities in an IPO or in the secondary market may thus sue for damages due to such a misleading detail. In § 11 suits, the plaintiff need not show reliance on the misleading detail and the existence of a causal relation or an element of damage. In case the registration statement contains a misleading detail, the underwriters will be exempt from § 11(a) liability only if they can rely on one of the defenses outlined in § 11(b). 15 U.S.C. § 77(k)(b) (2006). The most important among those will apply if they show that they have carried out a reasonable investigation and had a reason to believe, and indeed believed, that no misleading detail was included in the registration statement. *Id.* This means that the liability standard applied to the underwriters is *negligence*, and that they carry the *burden of proof* to show that they have not been negligent.

14. Securities Act of 1933, § 11(a) (codified at 15 U.S.C. § 77k (2006)). See also Loss & Seligman, *SECURITIES REGULATION*, SUPRA note 12, at Vol. IX, 4255.

15. In the literature on mandatory disclosure duties and their enforcement we can identify a variety of approaches. See Frank H. Easterbrook & Daniel R. Fischel, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 276-314 (Harvard Univ. Press 1991). For example, Easterbrook and Fischel believe, that in a world with anti-deception laws, the disclosure system should be based on self-disclosure by the issuing companies. *Id.* Some argue that it is improper to implement a mandatory disclosure regime. This approach is based on claims that market mechanisms would operate optimally without legal intervention, or alternatively, on the various specific costs of such an intervention. See also Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation*, 107 *YALE L. J.* 2359, 2368 (1998); Stephen J. Choi & Andrew Guzman, *The Dangerous Extraterritoriality of American Securities Law*, 17 *NW. J. INT'L L. & BUS.* 207 (1996); Stephen J. Choi & Andrew Guzman, *Portable Reciprocity: Rethinking the International Reach of Securities Regulation*, 71 *S. CAL. L. REV.* 903 (1998); Merritt B. Fox, *Retaining*

search follows Gilson and Kraakman's assertions that, in the IPO market, *underwriters* have three main functions: to distribute the offered securities, give quasi-insurance to the issue, and to bridge information gaps between sellers and buyers.¹⁶ The discussion focuses mainly on whether underwriters should be liable under civil law for the presence of misleading details in the prospectus and not the degree of liability that should be imposed. It also focuses on the underwriters' role of bridging information gaps between sellers and buyers and not on other roles. On the one hand, many writers (for example, Fox,¹⁷ Kraakman¹⁸ and Coffee¹⁹) find great benefits in holding underwriters legally liable for reasons such as the positive effect of underwriters, as

Mandatory Securities Disclosure: Why Issuer Choice is Not Investor Empowerment, 85 VA. L. REV. 1335(1999); Alan R. Palmiter, *Toward Disclosure Choice in Securities Offerings*, COLUM. BUS. L. REV. 1 (1999); Stephen J. Choi, *Regulating Investors Not Issuers: A Market-Based Proposal*, 88 CAL. L. REV. 279 (1999); Stephen J. Choi, *Law, Finance, and Path Dependence: Developing Strong Securities Markets*, 80 TEXAS L. REV. 1657 (2002); Paul G. Mahoney, *The Allocation of Government Authority: The Exchange as Regulator*, 83 VA. L. REV. 1453 (1997). For arguments stressing self-disclosure as an exclusively efficient system, see Douglas W. Diamond, *Optimal Release of Information by Firms*, 40 J. OF FIN. 1071 (1985); Jonathan R. Macey, *Administrative Agency Obsolescence and Interest Group Formation: A Case Study of the SEC at Sixty*, 15 CARDOZO L. REV. 909 (1994); Marcel Kahan, *Games, Lies, and Securities Fraud*, 67 N.Y.U.L. REV. 750 (1992). Others have found several justifications for such duties. There are many reasons for mandatory disclosure duties. Even Easterbrook and Fischel, who've supported the revocation of the mandatory disclosure rules regime, have found such reasons. In their view, disclosure duties can resolve under-disclosure problems due to three potential causes: (1) Information provided by the firm also serves investors and other firms; (2) The impossibility of charging a price for the production of comparative information; and (3) The lack of incentive to create the most inexpensive disclosure format. Frank H. Easterbrook & Daniel R. Fischel, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 290-92, 300-302 (Harvard Univ. Press 1991). For arguments in favor of mandatory disclosure duties, see John C. Coffee, *Market Failure and the Economic Case for a Mandatory Disclosure System*, 70 VA. L. REV. 717 (1984); Joel Seligman, *The Historical Need for a Mandatory Corporate Disclosure System*, 9 J. OF CORP. L. 1 (1983); Paul G. Mahoney, *Mandatory Disclosure as a Solution to Agency Problems*, 62 U. CHI. L. REV. 1047 (1995); Edward Rock, *Securities Regulation as Lobster Trap: A Credible Commitment Theory of Mandatory Disclosure*, 23 CARDOZO L. REV. 675 (2002). For justifications for imposing mandatory disclosure duties in view of the ability of those held liable to insure the legal "accident" under discussion, see Joshua Ronen, *Post Enron-Reform, Financial Statement Insurance, and GAAP Revisited*, 8 STAN. J. L. BUS. & FIN. 39 (2002) (concluding that a market based solution realigning auditors' incentives is necessary in any securities reform provision). For further conclusions based on Ronen's analysis, see Lawrence A. Cunningham, *Choosing Gatekeepers: The Financial Statement Insurance Alternative to Auditor Liability*, 52 UCLA L. REV. 413, 439-42(2004). For a discussion of the various approaches and cost-benefit considerations involved in a mandatory disclosure system, see also Merritt B. Fox, *Securities Disclosure in a Globalizing Market: Who Should Regulate Whom*, 95 MICH. L. REV. 2498 (1997).

16. Gilson and Kraakman, *supra* note 10 at 616-617.

17. Merritt B. Fox, *Shelf Registration, Integrated Disclosure, and Underwriter Due-Diligence: An Economic Analysis*, 70 VA. L. REV. 1005, 1128-32 (1984).

18. Kraakman, *supra* note 3.

19. John C. Coffee, *Re-Engineering Corporate Disclosure: The Coming Debate Over Company Registration*, 52 WASH. & LEE L. REV. 1143, 1168-69 (1995).

reputable intermediates, on the precise pricing of securities, on the conduct of the managements of issuing firms and in preventing entry of low-quality firms who present themselves as high-quality firms in order to mislead investors.²⁰

On the other hand, some claim that it is inefficient to hold underwriters liable. For example, Choi²¹ claims that it is inefficient and costly to the IPO market to intervene in the market and hold financial intermediates liable.²² According to his view, the benefit of barring entry to misleading, low-quality firms might be overshadowed by the costs, such as those involved in unnecessary defense required of all market participants where the market already provides effective defense, for example, through the investors' ability to identify product quality.²³ Choi,²⁴ therefore, suggests that financial intermediates not be held liable in the traditional legal sense, but a system of self-tailored liability should be implemented, where underwriters are able to select their applicable duties out of several alternatives, including the effective period of their binding contractual commitments to the investors.²⁵

Further arguments (for and against imposition of underwriters' liability) focus on underwriters' quasi-insurance role. On the one hand, as Partnoy²⁶ stated: "A second conception of the function of securities regulation as applied to underwriters assumes that the underwriter

20. Kraakman, *supra* note 3, at 94. (noting that key affiliates, like underwriters, serve as "reputational intermediaries"). As mentioned above, we have presented elsewhere the reasons we believe require holding the leader and the other IPO underwriters liable. See Sher, *Underwriter Civil Liability for IPO's: Deterrence in a Double Moral Hazard Model*, *supra* note 2; Sher, *Underwriter Civil Liability for IPO's: An Economic Analysis*, *supra* note 2. For the necessity of gatekeeper liability, see also John C. Coffee, *The Acquiescent Gatekeeper: Reputational Intermediaries, Auditor Independence and the Governance of Accounting* (Working Paper No. 191 2001), available at <http://ssrn.com/abstract=270944> (last visited Mar. 9, 2006); Coffee, *supra* note 3.

21. Stephen J. Choi, *Market Lessons for Gatekeepers*, 92 Nw. U.L. REV. 916 (1998).

22. *Id.* at 962-965.

23. *Id.* at 947.

24. *Id.* at 949-966.

25. *Id.* For more research that points to the need of reducing legal intervention in the area of IPO and gatekeepers' liability, see Donald C. Langevoort, *Information Technology and the Structure of Securities Regulation*, 98 HARV. L. REV. 747 (1985); Donald C. Langevoort, *Toward More Effective Risk Disclosure for Technology-Enhanced Investing*, 75 WASH. U. L. Q. 753 (1997); Donald C. Langevoort, *Deconstructing Section 11: Public Offering Liability in a Continuous Disclosure Environment*, 63 L. & CONTEMP. PROBS. 45 (2000); Howell E. Jackson, *Reflections on Kaye, Scholer: Enlisting Lawyers to Improve the Regulating of Financial Institutions*, 66 S. CAL. L. REV. 1019 (1993); Howell E. Jackson, *The Expanding Obligations of Financial Holding Companies*, 107 HARV. L. REV. 507 (1994); Victor P. Goldberg, *Accountable Accountants: Is Third-Party Liability Necessary?*, 17 J. LEGAL STUD. 295 (1988).

26. Partnoy, *supra* note 4, at 517.

can serve a risk-bearing function". Partnoy accepted Dooley's²⁷ observation that underwriters do not provide insurance, but believes that it "does not mean that they could not in the future" (assuming a proper liability regime). On the other hand, Banoff²⁸ claims that when issuing securities in an efficient market, the cost of due diligence that is required under an underwriter liability regime, outweighs its benefits. In her opinion, holding underwriters liable provides additional insurance to investors without increasing their welfare, apart perhaps from cases when new securities are issued.²⁹ The reason for this is that investors diversify their portfolios, thus reducing the specific risk involved in holding securities, including the specific risk that underwriters should neglect to find misleading details in the prospectus. This argument has also been advanced by Romano³⁰ in the context of IPO's.

As mentioned above, Partnoy suggested³¹ that the underwriter liability regime would be strict liability with an option for change. The rule would be that underwriters will be held liable for any damage that a legal decision or settlement would determine that the issuing company should compensate investors for. The underwriters will have the option of changing the rule by agreeing with the company on limiting the percentages of their involvement in its liability. This will be subject to the proviso that such a change be stated in the prospectus (up to a certain legal minimum, for example, the rate of commissions collected or any standard rate between one and five percent).

As for the underwriters' role of bridging information gaps between sellers and buyers, Partnoy³² claimed, that the costs of lawsuits against underwriters are forbiddingly high (also *ex ante*), and that, in many cases, the underwriters fail the examination. Partnoy pointed to the fact that underwriters, acting as gatekeepers, may prefer to jeopardize their reputation in order to secure higher short-term profits.³³ Furthermore, beside high litigation costs with poor benefits, the existing legal solution, offering underwriters the defense of due diligence, entails high costs as a result of legal uncertainty, and other costs resulting from the fact that the law grants underwriters excessive property

27. Michael P. Dooley, *The Effects of Civil Liability on Investment Banking and the New Issue Market*, 58 VA. L. REV. 776, 788 (1972).

28. Barbara A. Banoff, *Regulatory Subsidies, Efficient Markets, and Shelf Registration: An Analysis of Rule 415*, 70 VA. L. REV. 135, 183 (1984).

29. *Id.*

30. Romano, *supra* note 15.

31. Partnoy, *supra* note 4, at 491-493, 540-546.

32. *Id.* at 513.

33. *Id.* at 497. "On one hand, gatekeepers may achieve short-term gains by providing inaccurate certification or by overstating the value of securities." *Id.*

rights, due to the centralization it imposes on underwriters. Partnoy claimed,³⁴ that “[t]he more vigorously the securities laws are enforced in court, particularly against lower quality gatekeepers, the higher the barrier to entry in those areas”. Therefore, Partnoy reasons that a different solution should be found, one not relying on underwriter reputation.

In Partnoy’s opinion, regulation holding underwriters liable can also have indirect effects.³⁵ Among the two most important are: (1) the high costs entailed in holding underwriters liable may deter them from preferring to raise capital in private issues; and (2) holding underwriters liable can be seen as an indirect bestowal of superfluous property rights, in areas only indirectly relevant to the public offering. In *Smith v. Van Gorkom*³⁶, for example, the court decided that the directors could have served their duties for the firm had they contacted an investment bank for its opinion on the appropriateness of the transaction in question.³⁷ Since firm managers are usually risk averse, it is reasonable to believe that they tend to over-invest in the opinion’s quality. The same holds for the underwriters’ quality. Hence, the underwriting market becomes a “winner takes all” market, in which the big investment banks are able to ask for and receive higher commissions than in a non-regulated market.

According to Partnoy, a regime of strict gatekeeper liability with an option to change offers several advantages:³⁸ First, it reduces the costs of negotiations between the issuing firm and its underwriters.³⁹ Second, it permits dividing the benefits of such cost reduction between the underwriters and the investors.⁴⁰ Third, it promotes a more decentralized market “by encouraging competition based on the willingness of the gatekeeper to assume the expected liability of the issuer and by reducing direct and indirect regulatory costs and regulatory licenses, which tend to benefit only top-tier firms and to encourage market concentration.”⁴¹

As for the underwriters’ quasi-insurance role, Partnoy⁴² believes a strict liability regime applied according to his suggestion offers an ad-

34. *Id.* at 520.

35. *Id.* at 505.

36. See *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985). The example is in Partnoy, *supra* note 4, at 523.

37. See Partnoy, *supra* note 4, at 522.

38. *Id.*

39. *Id.* at 542-544.

40. *Id.* at 542.

41. See Partnoy *supra* note 4, at 542.

42. *Id.* at 542-545.

ditional advantage: risks will still be distributed as they are today – major underwriters signing indemnity contracts with firms and effecting insurance arrangements. However, the suggested regime will allow them to do so in a less costly insurance environment, since there will be no need to distinguish, for the purpose of establishing liability, between intentional acts of commission or omission, those attributable to negligence and others. Essentially, Partnoy suggests shifting the focus of the gatekeepers' role to more of an insurance role and less of a policing role.⁴³

In an analysis of the reasons for gatekeepers' failure to oversee company reports (focusing mainly on accountants, analysts – who are usually employed by investment banks – and lawyers, for whom he believes there's a need for a special arrangement), Coffee⁴⁴ suggested that the central arrangement in the area of gatekeeper liability be strict liability combined with a limitation on the amount claimed. The limitation should be determined as follows: "Under this approach, for example, if the corporate client were found liable for \$100 million, then the auditor would have to contribute toward that liability up to the amount of its policy. The one mandatory element in this proposal would be a minimum floor on the gatekeeper's insurance policy that would have to equal some adequate multiple of the highest annual revenues received by the gatekeeper from its client over the last several years. For purposes only of illustration, let us assume a multiplier of ten. Now, on the facts of the Enron case, where it has been widely reported that Arthur Andersen received roughly \$52 million from Enron in its final year, Andersen's liability would be not less than \$520 million (i.e., \$ 52 million times ten)".

In Coffee's opinion, the advantages of strict liability over negligence liability are:⁴⁵

- (1) strict liability gives the gatekeeper greater incentive to take precautions and exercise due diligence;
- (2) strict liability induces the gatekeeper to limit its level of activity, for example, by rejecting overly risky corporations as clients; and
- (3) strict liability spares both courts and regulators the need to descend into the Serbonian bog of defining precise standards of care, thereby reducing transaction costs and increasing predictability.

43. See Partnoy *supra* note 4, at 542.

44. Coffee, *supra* note 3, at 353-363. In Coffee's opinion, the legal regime should be made compatible with each type of gatekeeper. *Id.* He believes lawyers should be subjected to special rules. *Id.*

45. *Id.* at 346-347. Coffee suggests that these advantages, discussed in economic analysis of the law literature are agreed upon by both those who support a strict liability role and those who oppose it. *Id.* See Partnoy, *supra* note 4, at 514 (supporting liability); see Hamdani, *supra* note 3, at 59 (opposing liability).

He suggests that a negligence rule does not meet the need for deterring gatekeepers and entails high judicial costs. A strict liability rule, although meeting the need for deterrence, is not without its own shortcomings:⁴⁶ First, in the new market equilibrium, gatekeepers will demand fees so as to reflect the risk they may have to shoulder in the case of a “fraudulent” firm. Given the higher fees they can be expected to demand, and assuming gatekeepers would not be able to distinguish, completely and in advance, between “fraudulent” and “honest” customers, the resultant high fees can push even “honest” customers out of the market. Second, a strict liability regime might push “quality” gatekeepers out of the market, to be replaced by “lower quality” gatekeepers who wouldn’t be able to prevent “fraudulent” issuing firms from entering the IPO market. Finally, a strict liability regime might increase the number of claims. In Coffee’s opinion,⁴⁷ his suggested regime will meet the need for deterring gatekeepers, on the one hand, without imposing forbiddingly high costs on the market or compromising the stability of market players, on the other.

Coffee⁴⁸ suggests that his view differs from Partnoy’s on several grounds.⁴⁹ First, Coffee’s suggested rule “is essentially regulatory” while Partnoy’s “is essentially contractual.”⁵⁰ The gatekeeper market is highly centralistic, so that gatekeepers will tend not to undertake any commitment which exceeds minimal requirement. Moreover, in a bubble period, should Partnoy’s rule be adopted, investors may desist in view of the fact that the leaders have accepted only part of the liability, even though it is reflected in the IPO prospectus. In addition, potential clients do not have strong incentives to bargain for a high level of liability. Second, Partnoy “uses a percentage of the total damages as his minimum floor,” while Coffee “uses a multiple of the gatekeeper’s highest annual revenues from the client.”⁵¹ Finally, as opposed to Partnoy’s rule, he believes his suggestion will lead to gatekeeper bankruptcy only in extremely rare cases. Although Coffee thinks the two suggestions do not stem from a tort standpoint – that of internalizing damages – which is inapplicable, but from the need to ensure optimal deterrence. The difference between the two consists in his regime’s ability to achieve optimal deterrence (the sanction expected

46. Coffee, *supra* note 3, at 347-349.

47. *Id.* at 349-350.

48. *Id.* at 350-353.

49. *Id.* at 350-353.

50. *Id.* at 350.

51. See Coffee, *supra* note 3, at 350 (outlining the differences between Coffee’s approach and Partnoy’s approach).

tancy being higher than the profit expectancy), while Partnoy's will not be able to achieve such equilibrium (the parameters for determining the compensation rate can lead to compensation that is too high).

Partnoy's counterarguments are as follows:⁵² First, in reference to Coffee's⁵³ claims that his own system is advantageous in being based on regulation,⁵⁴ unlike Partnoy's mainly contractual system. First, he believes that the contractual stipulation option will add another parameter to the market game (determining liability level) which will *increase* competition.⁵⁵ Moreover, even in a bubble period, he expects investors not to ignore information about the scope of liability accepted by leaders. Finally, in response to the argument that prospectives do not have strong incentives to bargain for a high level of liability, he believes the requirement of specifying the gatekeeper liability ratio in the proepectus will lead to choosing an optimal liability level.⁵⁶

Second, in reference to Coffee's⁵⁷ claims (even though his system is preferable as it is based on a damages ceiling which is a multiple of the high annual revenue) and as opposed to Partnoy's ceiling, which is based on a percentage of the damages: (1) "[D]amages based on revenues would measure only private costs to gatekeepers, not social costs, and therefore would either under-deter or over-deter, depending on the relationship between gatekeeper revenues and overall shareholder damages;"⁵⁸ (2) "Calculating a revenues multiple is fraught with technical difficulties;"⁵⁹ (3) "Professor Coffee's assertions as to the scope of gatekeeper liability under a percentage measure are not supported by available facts".⁶⁰ According to Partnoy, his own suggestion will not lead to frequent gatekeeper bankruptcies since the average settlement in class-action security-related suits in 2000-2002, in the United States, ranged between 15 and 25 million dollars (excluding one large settlement of \$3.19 billion in 2000); and (4) "Having a regulator dictate a minimum liability cap would exacerbate the adverse selection

52. Partnoy, *supra* note 6.

53. *Id.* at 368-370.

54. *Id.* at 368-370.

55. *Id.* at 369.

56. *Id.* "Moreover, because the minimum percentage would be disclosed in public documents, it would more likely be the subject of competition than other variables (such as hourly rates, number of professionals assigned, or scope of the project) that are not disclosed." *Id.*

57. *Id.* at 370-374.

58. See Partnoy, *supra* note 6, at 370.

59. *Id.*

60. *Id.*

problem gatekeepers face by preventing them from engaging in price discrimination as to liability.⁶¹

Hamdani⁶² presented the considerations to be taken into account when determining the gatekeepers' scope of liability. He argued⁶³ that, in principle, as suggested by the economic analysis of the law literature,⁶⁴ and not unlike Coffee's position,⁶⁵ strict liability: (1) provides wrongdoers with optimal incentives to exercise precaution (as in negligence schemes); (2) makes defendants adopt optimal activity levels; and (3) relieves courts from entering the thicket of determining what constitutes "reasonable care" in a given set of circumstances.⁶⁶ However, the second insight does not extend to gatekeeper liability. As Coffee claimed, strict liability will increase gatekeeper fees.⁶⁷ In a market where gatekeepers cannot distinguish among prospective clients based on wrongful intentions and therefore cannot charge each one of them according to its risk - this will result in three plausible outcomes: Gatekeeper liability may drive out only law-abiding clients and leave intact the number of wrongdoers.⁶⁸ Alternatively, it may lead to the unraveling of the relevant market. Finally, it may have no impact on the number and quality of clients entering the market.⁶⁹

In Hamdani's⁷⁰ opinion, adopting a strict liability rule can offer certain benefits also in terms of improved deterrence of misconduct by issuing companies. However, he states, "Whether the benefits of strict liability outweigh its costs is an empirical matter. Other things being equal, however, moving in the direction of strict liability will become more appealing when (1) the government does a poor job in implementing a negligence-based regime, and (2) gatekeepers become more effective in preventing client wrongdoing".⁷¹

The idea that imposing strict reliability on gatekeepers might be undesirable has also been suggested by Kraakman.⁷² He claimed that holding underwriters strictly liable may result in their being punished "for a much wider range of misconduct than they can actually detect."

61. *Id.* at 373.

62. Hamdani, *supra* note 3.

63. *Id.* at 59, 63-82.

64. See *supra* note 1 and accompanying text.

65. See *supra* note 44 and the accompanying text (discussing Coffee's approach).

66. Hamdani, *supra* note 3, at 84-85.

67. See Coffee, *supra* note 3, at 347.

68. *Id.* at 348.

69. *Id.*

70. Hamdani, *supra* note 3, at 61, 82-98.

71. *Id.* at 103.

72. Kraakman, *supra* note 3, at 76.

The dispute over the question of underwriter liability has to do, on the one hand, with a description of the way markets behave and the definition of underwriter responsibilities. On the other hand, it also touches on determining the proper function of the law. Coffee and Partnoy's approach is based on an interpretation of the cost structure that identifies primary market failures as caused by, among other things, the fact that the leader's reputation is insufficient to solve the adverse selection problem. These failures justify, in their view, holding gatekeepers liable.

The present thesis differs from their approach not only in its description of how the IPO market operates but also in terms of the roles the law plays, or could play, in the existing market structure. In our opinion, a negligence-based liability arrangement can better serve the existing primary market issuing mechanism and reduce its existing costs better than a strict liability arrangement.

The justifications presented here for a negligence standard also argue against relieving underwriters of any liability for misleading details in the offering prospectus. Thus, Choi⁷³ described the primary market as a market with both high and low quality companies, financial intermediates, and uninformed investors.⁷⁴ At the first stage, the investment state, the companies select whether to be high-, or low-quality.⁷⁵ At the second stage, the IPO stage, the market comprises a constant amount of firms of both kinds, and they present themselves as high- or low-quality in order to sell their stock.⁷⁶ Since investors cannot distinguish between high- and low-quality firms, a market equilibrium is reached where, at the second stage, all firms present themselves as high-quality and the investors respond by devaluating the securities, while at the first stage, the firms prefer to be low-quality. In this market, financial intermediates have the important role of verifying the company's quality. The higher the verification quality, the greater the companies' incentive to invest in higher quality. On the other hand, a higher verification standard involves greater expense (higher commissions).

Choi claimed that intervening in the market by holding the financial intermediates liable can be inefficient and costly for the IPO market.⁷⁷ In his view, the benefit of barring entry to misleading, low-quality

73. Choi, *supra* note 21. For more research that had pointed to the need of reducing legal intervention in the area of IPO's and gatekeepers' liability, see *supra* note 23 and accompanying text.

74. Choi, *supra* note 21.

75. *Id.* at 922.

76. *Id.*

77. *Id.* at 946-949.

firms might be overshadowed by the costs, such as those involved in unnecessary defense required of all market participants where the market already provides effective defense, for example, through the investors' ability to identify product quality.⁷⁸ The government can also intervene in determining the verification's level of precision and the intermediates' verification costs, limitations that might be inefficient and weaken the investigation incentives or cause some of the intermediates to exit the market, respectively.⁷⁹ Government intervention can also hamper the dynamic development of market mechanism, which may deal effectively with deception.⁸⁰ Furthermore, it may lead to a wave of unjustified claims intended to blackmail the financial intermediates, which may cause some of them to exit the market and reduce competition.⁸¹ Choi⁸² therefore suggested not to hold the financial intermediates liable in the traditional legal sense, and instead implement a system of self-tailored liability, where underwriters will be able to select their applicable duties out of several alternatives, including the effective period of their binding contractual commitments to the investors.⁸³

The present thesis counters such arguments by showing that a negligence standard can offer a good solution for the costs entailed in the current market mechanism, without interventions seeking to change market structure. Among other things, it emphasizes the role of the leader's reputation in the primary-market issuing mechanisms, and her ability to behave strategically in this market.

The importance of leader reputation in the issuing mechanism is clear and supported by empirical findings. These findings point to the relation between the main leader's reputation and the approach adopted by players in the market to the results of IPO's. Among others, Nanda and Yumfound⁸⁴ that up to a certain rate, substantial underpricing of IPO's is followed by a significant increase in the leader's market value. A similar effect was not found concerning the market value of run-of-the-mill underwriters or of other consortium executives. It was also found that underpricing that is higher than a certain rate is followed by a smaller increase in the leader's market

78. *Id.*

79. See Choi, *supra* note 21, at 947.

80. *Id.* at 948.

81. *Id.*

82. *Id.* at 949-966.

83. *Id.*

84. V. Nanda & Y. Yun, *Reputation and Financial Intermediation: An Empirical Investigation of the Impact of IPO Mispricing on Underwriter Market Value*, 6 J. FIN. INTERMEDIATION 39 (1997).

value. A loss in the leader's market value was found in a case where offerings were overpriced.

An important study on the evaluation of securities issued by investment banks was recently conducted by Deloof, De Maeseneire and Inghelbrecht.⁸⁵ Based on data from the Brussels Stock Exchange (BXS) for the years 1939-2000, these researchers found that evaluations of IPO's by the underwriting consortium managers are based, in each issue, on a variety of value assessment methods. Some of those are precise (such as the method based on the predicted net cash flow) while others are systematically biased. This finding suggests that leaders deliberately bias the offering price, or at least, that underpricing takes place despite the fact that the leader knows the expected post-IPO market price. These results support the approach which stresses the leader's strategic behavior in each stage of the issuing process.

IV. THE APPROPRIATE ARRANGEMENT: NEGLIGENCE OR STRICT LIABILITY?

A. *The Question of Directing Behavior: Efficiency Aspects in a Double Moral Hazard Model*

1. A Double Moral Hazard Model

The first model⁸⁶ to be presented considers the fact that the existing capital market structure creates a problem of hidden actions by both the firm executives and the leader, which leads to a moral hazard problem. As such, it differs from standard models presenting the capital markets partial information problem as an adverse selection problem.⁸⁷

85. Marc Deloof, Wouter De Maeseneire & Koen Inghelbrecht, *The Valuation of IPO's by Investment Banks and the Stock Market: Empirical Evidence*, (Working Paper 2002) available at <http://ssrn.com/abstract=298602> (last visited Mar. 9, 2006).

86. See Sher, *Underwriter Civil Liability for IPO's: Deterrence in a Double Moral Hazard Model*, *supra* note 2, for a comprehensive discussion of the model, See also Sher, *Underwriter Civil Liability for IPO's: An Economic Analysis*, *supra* note 2.

87. DAVID M. KREPS, *A COURSE IN MICROECONOMIC THEORY* 577 (Princeton Univ. Press 1990). Kreps clarifies the distinction between the problems, as follows: *Moral hazard* - "... , where one party to a transaction may undertake a certain action that (a) affects the other party's valuation of a transaction but where (b) the second party cannot monitor/enforce perfectly." *Id.* *Adverse selection* - "... , where one party to a transaction knows things pertaining to the transaction that are relevant but unknown to the second party." *Id.* For more discussion on the differences between the problems, see Sher, *Underwriter Civil Liability for IPO's: Deterrence in a Double Moral Hazard Model*, *supra* note 2. See also Sher, *Underwriter Civil Liability for IPO's: An Economic Analysis*, *supra* note 2. Note that in many situations, there are mixed problems of adverse selection and moral hazard. In those papers we argued that the existing primary-market problem can also be presented as a moral hazard problem, and not only as an adverse selection problem.

According to this model, the central players in the market act strategically: the *issuing companies* can choose how to portray themselves; *leaders* can choose the effort they exert in carrying out due diligence requirements; and *investors* can choose the degree of trust they have in the presentations of each issuing company and leader and tailor their demands for the securities offered to the appropriate level of trust.

The model does not involve firms of varying quality, but various levels of misleading descriptions of offered securities. The investors, who estimate that each firm might report inadequate information at a certain distribution of deception levels, weigh this information into the price that ought to be paid, in their opinion, for the offered securities. The main problem in the primary market is that the firm cannot convince the investors of having provided adequate disclosure (without substantial transaction costs). Consequently, the equilibrium stock-market price will be lower than the price resulting from a situation in which all parties have complete information (or where the firm can convince the investors of having provided adequate disclosure without substantial transaction costs).

The problem described here is that of hidden action by company executives, resulting in a moral hazard problem. The company hires a leader to market, distribute and insure the IPO, and to bridge the information gaps conducive to the moral hazard problem, which does not allow it to raise capital at an optimal price. The leader is in a situation where hiring her distribution and risk-reduction services also includes hiring her reputation for reducing information asymmetric's costs. This is because she cannot separate reputation from the other services provided. The investors know that the leader collects and analyzes all information required for the transaction, with a view to maximize the utility from collecting the information and assessing it minus the collection and assessments costs. The investors realize that this means the leader carries out a comprehensive check of information relevant to evaluating the transaction. Information about the securities' value and the risk they represent is important to the leader in order to estimate the deal and determine its various terms. Should a leader make a mistake, for instance, overestimate the securities' value, she might find herself in a situation where the stock offered does not sell and the underwriters are stuck with overpriced securities. In this

For a presentation of the capital market partial information problem as an incentive collapse problem, see, e.g., Easterbrook & Fischel, *supra* note 15 (discussing the general area of imposing mandatory disclosure); Choi, *supra* note 21 (noting justifications for underwriter liability); Partnoy, *supra* note 4; Hamdani, *supra* note 3, Coffee, *supra* note 3; Partnoy, *supra* note 6 (discussing negligence versus strict liability).

case, when it is realized that the share price is falling (following information processing by the secondary market), the leader's reputation inevitably suffers. Even in a case where investors realize that the prospectus contains a misleading detail and the share price is dropping, loss of reputation naturally ensues.

Underwriters know that their ability to transact with companies in the future depends on their past successes. Their reputation is highly sensitive to failure in selling issued stock and to mistakes in collecting and assessing information. In addition to closing the deal (profitably), the underwriters wish mainly to create a good reputation, as good as possible. In the model, underwriters select the price of securities offered to the public. Their selection is based on data provided by the firm and double-checked by them, data later conveyed to investors through the draft prospectus; the investors' response in evaluating the real price of the offered securities is then the final basis for the leader's estimate of the expected real price.

In the model, two fundamental questions arise: (1) Why hiring the leader's reputation services is not enough to solve the asymmetric information problem; and (2) How a law holding the leader liable solves this problem.

The answer to the first question is that without a law holding leaders liable, investors cannot know how much effort the leader has exerted in implementing due diligence. They cannot review the raw data provided by the firm to the leader, have no record of the leader's activities and are in no place to judge, based on the securities' performance alone, whether any drop in share value is due to natural causes (a business failure by the firm) or to inadequate disclosure.

Since investors do not know the causes of share-price changes, they have no reason to believe a leader's reputation will change in proportion to the effort exerted. Since reputation's evolution is dependent on the conduct of the various participants to a given IPO is not known, the investors cannot be convinced that it would always be profitable for the leader to exert an optimal effort. The leader's effort in carrying out due diligence is also hidden and therefore, this creates a leader moral hazard problem, resulting in several potential market equilibria.

The answer to the second question is that a law requiring optimal leader effort may facilitate a new, more efficient equilibrium by creating a convention regarding the leader's chosen strategy. Having no incentive to mislead the investors, the leader prefers the optimal-effort equilibrium and the investors believe her. The problem is that the leader cannot convince the investors that among all possible equilibria

ria, that in which she exerts an optimal effort and they believe her will actually obtain. However, a social convention regarding the leader's strategy may contribute substantially to preferring a game play leading to the desired equilibrium and for recognizing such a desired equilibrium should it, in fact, obtain.

The role played by the law in resolving the hidden action problem is that it provides a credible threat of revealing a leader's actions to the investors. When the share price drops and the investors suspect their leader of not having exerted an optimal effort, they may turn to the courts where the leader's actual behavior can be reviewed. Such a judicial review will begin already in the early procedural stages of the legal process; through various disclosure requirements, such as document disclosure, the latter's *modus operandi* can be exposed. Additional tools that can increase the investors' certainty in their assessment of the leader's true actions are the litigation process and the legal decisions in later stages of the legal procedure.

An additional conclusion from the model is, *inter alia*, that when the leader is held legally liable, it is much easier and cheaper to convince company executives to opt for the proper disclosure strategy. The reason for that is that the law causes the leader to opt for a strategy of exerting optimal effort in due diligence. Therefore, it becomes unprofitable for the executives to opt for a different strategy.

2. Why a Negligence Rule Contributes to Optimal Equilibrium in the IPO Market, While a Strict Liability Rule Might Threaten It

As previously mentioned, from the efficiency maximization perspective, the leader is hired, among other things, in order to "compromise" her own reputation. It allows investors to trust that she will exert optimal effort in order to prevent the inclusion of misleading details in the IPO prospectus. The law supports this mechanism by threatening to expose the leader's *modus operandi* in court. According to the consensus in the area of economic analysis of torts, the two liability regimes under discussion, negligence and strict liability, will cause a potential offender to take optimal precautions. However, in the present case, a negligence rule supports the mechanism described, while a strict liability rule does not, even to the point of undermining it.

First, when it is feared that a misleading detail has been included in the prospectus, investors cannot know this for certain. On the other hand, we may assume that investors can estimate the probability that the detail is misleading. Given some level of certainty that the detail is

misleading, both factually and legally, investors estimate that it's possible the leader has not exerted an optimal effort in preventing its inclusion in the prospectus. However, there is also the possibility that she *has*, albeit unsuccessfully. When the applicable rule is strict liability, the uncertainty inherent in this situation will be only partially removed by a lawsuit, since the court will enquire whether a misleading detail has been included in the prospectus, but not whether the leader's due diligence effort has been optimal. Under a strict liability regime, the threat to the leader's reputation has to do with the court's ability to remove the uncertainty only from the facts and legal decisions related to the question of the actual presence of a misleading detail. It has nothing to do with the level of effort actually exerted in due diligence. Therefore, investors will not be able to rely, *ex ante*, on the leader's presentation that he has harnessed her reputation to the task. The leader will not be able to convince investors that their having hired her reputation means that he risks her reputation for conducting optimal due diligence. This is because, given a strict liability rule, it will not be reviewed *ex post*.

On the other hand, a negligence rule will make the court deal with the other concern, missing in the case of strict liability. Under a negligence regime, the court will also inquire whether the leader has in fact acted optimally, exposing both her usual *modus operandi* and her conduct in the relevant case. In that, it will convey invaluable information to the market allotment mechanism, allowing the market to rely *ex ante* on the leader's presentation of having harnessed her reputation to the task.

Second, when the applicable rule is strict liability, the leader has no incentive for disclosing misleading details chances are will not be revealed, or being interpreted as indicating unprofessional conduct on her part. In addition, there could be situations in which certain events may be interpreted by the investors as highly likely to stem from lack of professionalism by the leader, even if she *had* carried out optimal due diligence. In these cases, too, the leader has no incentive to exert optimal effort to prevent the inclusion of misleading details in the IPO prospectus. A negligence rule solves that problem.

Third, a strict liability rule does not offer good support for the law's function of reducing costs resulting from the effect of the due diligence procedure on third parties. Easterbrook and Fischel,⁸⁸ who support revoking the mandatory disclosure rules regime, believe, among other things, that had the investors been able to contract with all the

88. Easterbrook & Fischel, *supra* note 15, at 290 - 292, 300 - 302.

firms at a negligible cost, they would have demanded that the firms maintain a standard reporting format, allowing them to minimize the costs of learning the “prospectus lingo” and to conduct optimal comparison between the firms. Their argument is that a possible justification for a mandatory disclosure rules is the law’s inability to impose a standard format; this is required since the firms themselves do not have any harmonization incentives, and sometimes even have harmonization *disincentives*.⁸⁹ In this context, our argument is that holding the leader liable for negligence will serve this purpose of ensuring a standard reporting format better than a strict liability regime.

Standardization arguments also figure in Rock’s⁹⁰ study, suggesting that the U.S. mandatory disclosure laws are preferable to contractual solutions in dealing with the issuing company’s various problems, in terms of the disclosure’s content, credibility and enforceability.⁹¹ In his view, these laws act as an efficient mechanism on several levels: First, through standardization.⁹² Second, by allowing for compatible disclosure requirements over time.⁹³ Third, by constituting a reliable and professional enforcement mechanism promoting complete and accurate disclosure.⁹⁴ And finally, Rock suggests that it is easy for a private firm to go public and enter the capital market, but not as easy to reacquire the securities traded in the market so as to exit (go private).⁹⁵ In his opinion, these facts suggest another important function of the U.S. mandatory disclosure laws - making it possible for issuing companies to reliably guarantee their disclosure level and their degree of consistency in providing complete and accurate disclosure over time.⁹⁶ Rock believes that such a commitment is reliable in view of the heavy sanctions attached, the fact that it can be adjusted to SEC requirements (the SEC changes those in response to changes in the market), and the ability to enforce the law against issuers trying to avoid the strict requirements for exiting the capital market (tender offers rules, and so on).

The present thesis is consistent with Rock’s argument, suggesting that the U.S. mandatory disclosure laws provide a reliable and professional enforcement mechanism promoting complete and accurate dis-

89. *Id.*

90. Rock, *supra* note 15.

91. *Id.*

92. *Id.*

93. *Id.*

94. See Rock, *supra* 15, at 686.

95. *Id.* at 687.

96. *Id.*

closure.⁹⁷ However, according to the present thesis, imposing mandatory, as opposed to contractual, liability on underwriters is not enough; a negligence standard must be determined in order to ensure a more effective market mechanism (in terms of efficiency and division of welfare). Descriptions of the primary market cost structure and its operation, on the one hand, and of the law's function, on the other, suggest that the market mechanism's high costs will be *minimized* under a negligence-based regime.

Fourth, creating a standard process of due diligence is also important. Holding the leader liable for negligence will serve this purpose better than strict liability. The argument first focuses on the fact that the leader plays an almost exclusive role in creating a standard test format: she is the individual carrying them out in practice; she is knowledgeable and experienced in the area; she has access to various experts required for creating an efficient format; she is a repeated player in the primary market and will be required to run the tests on many other issues; compared to all other private, repeated players in the primary market (such as accountants), only her own expertise covers all the areas relevant to creating that format; and, last but not least, she has partially independent incentives for creating the standard format and enforcing it on the issuing firms. The law holds the leader liable and thus enables her to make the most of those advantages.

The law must step in and require the leader to create the standard format because the leader also faces certain disincentives. First, a free-rider problem is created when the major leaders consider whether to make the required investments in creating an optimal due diligence format. Each would prefer another leader to make the adjustments required by market or legal changes, since she's bound to learn about it eventually and be able to judge for herself whether such adjustments are worthwhile. Such learning is possible when several leaders co-manage a consortium or from reports provided by leaders to ordinary underwriters about each offering (the so-called "comfort letters").

A second problem involves the hidden nature of the leader's actions, which creates a moral hazard problem. The leader has no way to prove to the market that she has the optimal due diligence format. Even a very detailed report published alongside the prospectus would not have enabled the market to scrutinize her actions. Moreover, such

97. As Rock stated, "Here, the public and private enforcement machinery of the securities laws and the combination of criminal and civil liability makes securities disclosure far more credible than purely contractual representations." *Id.* at 686.

a report would have exposed her to competition and also to various claims by her clients, both legal and commercial. Clearly, the issuing companies would have opposed any publication with a potential to reveal commercial secrets or provide their competitors with important advantages – even assuming, which cannot at all be taken for granted, that such a disclosure would have contributed to exposing the leader's *modus operandi* and the level of effort she exerted in that specific offering.

A third problem is how to ensure standardization in a liability-free regime. Holding the leader liable prevents the development of several competing due diligence formats. The existence of several such formats will impair investors' abilities to compare the issuing companies based on date published during the offering.

Finally, the issuing companies may pressure the leader to create a due diligence format made to measure. They may refuse to accept special tests required by the leader without any external dictation. For example, issuing firms will oppose the appointment of an external tax-law expert or of a professional real-estate assessor.

The argument next details the manner in which a negligence rule better serves the cause of creating a uniform, optimal format of due diligence. The main reason for that is that such a rule will require the court to inquire what the optimal format is and whether it has been implemented in the case under litigation. Thus, through judicial oversight, and in fact, through the *ex ante* threat of oversight, a negligence rule will contribute to solving the problems described herein. First, a negligence rule will force each leader to develop an optimal format independently. A strict liability rule will not have the same effect since it allows the leader to decide that developing the efficient format independently is not economically worthwhile. Second, a negligence rule deals with the fact that developing an optimal format is a hidden action, creating a moral hazard problem, by threatening a judicial inquiry as to the leader's due diligence format and its compatibility with existing market conditions. Third, the same holds for the fear that several due diligence formats may be created, and the fear that the companies may pressure the leader to create a format made to their measure. Fourth, a negligence rule will require the court to discuss the issue, without allowing the leader to escape the fact that her own format is completely different from primary market current practice. A negligence rule will not allow the leader to create a format that is not the optimal one. Conversely, a strict liability rule does not allow the court to discuss this question and therefore poses no threat enforcing such a standard format on the leader and the issuing firms.

Fifth, in the same context, a strict liability rule does not support the law's ability to provide a mechanism allowing the adjustment of due diligence over time. As mentioned above, one of the justifications for imposing mandatory disclosure is the fact that it provides a mechanism permitting such adjustment.⁹⁸ In an analogy to this argument, it is also important to adjust the due diligence format over time. A negligence rule permits the court to examine whether such an adjustment is indeed taking place. One of the applicable legal requirements, when a court examines whether a professional meets the required precaution standard, is that professional's consideration of changing market conditions and diligence in staying updated about professional innovations (such as changes in the rules of accounting presentations, changes in tax tools, or changes in the risk levels in a certain market). A strict liability rule, on the other hand, does not allow the court to look into this issue and therefore creates no external threat to the leader in this area.

Sixth, enabling courts to determine criteria for optimal leader action will have a positive external effect on the market of private capital raisings. In this market, the normal operational model is contractual, and leaders who act as intermediaries in such transactions apply their methods and ways of presenting information to investors in the IPO's market also to private capital raising agreements. Therefore, creating an optimal action structure in a regulated market will have a positive external effect on a market in which significant regulations seems, on the face of it, inefficient. A negligence rule will allow the application of a standard due diligence format, at very low costs, to the contractual market as well, and allow the latter to operate using an optimal testing format developing in a regulated market and optimally changing over time.

Seventh, a negligence rule has a certain advantage over a strict liability rule in that it encourages leaders to act with a certain degree of transparency regarding the way they have conducted their due diligence. A negligence rule requires leaders to observe the market, in order to make sure they are acting in a way acceptable to other leaders. Since actual coordination is illegal, the least costly way of "coordinating" leaders is providing market players with information about the way due diligence is conducted (in the road show process,⁹⁹ and

98. See *supra* note 91 and the accompanying text.

99. "Road show" is the name given to the marketing campaign conducted after the submission of the first draft prospectus to the SEC. In a road show, representatives of the consortium director general, together with senior managers in the offering firm, present the firm to prospective investors and analysts, and receive informal bids for securities offered in the IPO. This

during the establishment of the underwriter consortium). Nevertheless, in both cases, the consortium's establishment requires financial bodies joining in, whether as additional leaders or as ordinary underwriters, to receive copies of the comfort letters from the firm, its directors and the various IPO consultants, with a (partial) description of the due diligence procedure – copies that are to be provided by the leader, after having carried out the due diligence.

In summary, a negligence rule creates an equilibrium wherein both parties know, *ex ante*, that the court will try to expose the leader's *modus operandi*. In doing so, the court will inquire whether the leader operates according to an optimal due diligence format – one that is adjusted to changing market conditions – and whether the leader has indeed implemented that format in that specific offering. Moreover, the court will provide information pertinent to these issues to both parties, and to the capital market as well. This oversight and coordination mechanism requires the leader, and in fact even makes it possible for her, to invest in developing and implementing the optimal format. Furthermore, the leader is required to introduce appropriate changes in her format, in accordance with her interpretation of changing market conditions and by reviewing comfort letters distributed by other leaders, learning from procedures undertaken in collaboration with other leaders and learning from court decisions. A strict liability regime, on the other hand, cannot function as such a mechanism and does not provide the market with valuable information regarding the appropriate due diligence format.

B. *The Question of Directing Behavior: Efficiency Aspects in an Underpricing Model*

1. An Underpricing Model

The second model¹⁰⁰ presented focuses on the IPO pricing process and the manner in which securities are allotted to investors. In this model, the leader's strategic actions play a major role in determining the allotment mechanism's efficiency. Even during the process of interfacing companies' securities supply and investor demand, the leader plays an important role generating enough costs to justify liability. Unlike previous studies, the present model focuses on the central players' strategic actions, and the gamut of the leader's functions –

method of a two-way information flow required to complete the IPO – on the one hand, information about the firm for prospectives, and on the other, pricing information for the leader, is common practice all around the world.

100. See Sher, *Underwriter Civil Liability for IPO's: An Economic Analysis*, *supra* note 2, for a comprehensive discussion of this model.

insurance, bridging information gaps, marketing and distribution, and post-IPO market support – which also have an effect on underwriter actions.¹⁰¹ The model also takes into account the fact that the issuing process comprises information flows from the firm to the leader and the investors, and also the other way around.

The model is based on a single system of selling securities in the primary market, called the bookbuilding method.¹⁰² In primary markets around the world, there are two main groups of security selling mechanisms. The first includes offerings complying with rules of equality, to a certain degree, in receiving bids from the public and distributing them among the various bidders.¹⁰³ This group also includes the auction method. The second group includes a mechanism or working method of a single kind, allowing the leader discretion (subject to various legal and conventional rules) in selecting the investors participating in the offering. This is the bookbuilding method which is the basis of our model. In the U.S., most IPO's are conducted in this method, and it is being increasingly used in exchanges all over the world.¹⁰⁴

In the bookbuilding method, the leader interacts with prospective clients during the marketing phase. In the road show, she presents the company to prospective investors and receives indications, or informal bids, for the amount and price of securities they expect to order. These indications inform her about the way investors analyze the in-

101. See *supra* notes 10-11 and accompanying text (discussing underwriters' roles).

102. For a description of the method and its implications, see Lawrence M. Benveniste & Paul A. Spindt, *How Investment Bankers Determine the Offer Price and Allocation of New Issues*, 24 J. OF FIN. ECON. 343 (1989); Lawrence M. Benveniste & Walid Y. Busaba, *Bookbuilding vs. Fixed Price: An Analysis of Competing Strategies for Marketing IPO's*, 32 J. OF FIN. & QUANTITATIVE ANALYSIS 383 (1997); Francesca Cornelli & David Goldreich, *Bookbuilding and Strategic Allocation*, 56 J. OF FIN. 2337 (2001), Hsuan-Chi Chen & Jay R. Ritter, *The Seven Percent Solution*, 55 J. OF FIN. 1105 (2000); Ann E. Sherman & Sheridan Titman, *Building the IPO Order Book: Underpricing and Participation Limits with Costly Information*, 65 J. OF FIN. ECON. 3 (2002).

103. For a description of the various methods included in this group and their implications, see Bhagwan Chowdhry & Ann E. Sherman, *International Differences in Oversubscription and Underpricing in Initial Public Offerings*, 2 J. OF CORP. FIN. 359 (1996); Bhagwan Chowdhry & Ann E. Sherman, *The Winner's Curse and International Methods of Allocating Initial Public Offerings*, 4 PACIFIC-BASIN FIN. J. 15 (1996); Benveniste & Busaba, *supra* note 102.

104. For a description of the global trend of increased use of the bookbuilding method, a comparison of this method with others which include egalitarian rules (concerning the receipt of bids from the public and their distribution among the bidders), such as the fixed price method, and for a review of the first method's advantages, see, e.g., Tim Loughran, Jay R. Ritter & Krystian Rydqvist, *Initial Public Offering: International Insights*, 2 PACIFIC-BASIN FIN. J. 165 (1994); Ann E. Sherman, *Global Trends in IPO Methods: Book Building vs. Auctions with Endogenous Entry*, (Working Paper, December 2004) available at <http://www.ssrn.com/abstract=276124> (last visited Mar. 9, 2006); Benveniste & Busaba, *supra* note 102.

formation provided in the road show, as well as their own private information. The information thus gleaned is used to determine the offered securities' price and the way they are to be allotted to investors. The investors giving those indications are usually sophisticated, regular clients. An unwritten agreement between the two parties states that once the prospectus becomes effective and can be used to order securities on offer, they do not retract their informal bid, while she in turn rewards them in the allotment. Henceforth, these investors will be called *regular investors*.

In discussing the bookbuilding method, the financing literature examines it mainly from the point of view of the IPO underpricing phenomenon.¹⁰⁵ This phenomenon consists in an increase in share value in the first trading session, after having registered for trading in the exchange, compared to their IPO evaluation. In developed economies, the mean IPO underpricing rate is higher than 15%, with more than 60% in developing economies.

Of all the explanations suggested for the phenomenon, the present model deals with asymmetric information costs, focusing on the type of explanations related to the way the offering is marketed by the underwriters and to structural limitations,¹⁰⁶ not unlike the models designed by Benveniste and Spindt,¹⁰⁷ and Sherman and Titman.¹⁰⁸ Benveniste and Spindt's model simulates the offering process in the bookbuilding method, which relies on a two-way relationship between the leader and the investors. According to Benveniste and Spindt, this relationship allows the first to provide investors with proprietary information about the company's value; receive their "good" and "bad" private information, required for an "accurate" IPO pricing; and to reward them by underpricing the offering and allotting a relatively higher percentage of the securities offered. The

105. For an overview of the underpricing as a global phenomenon, and for a review of the various models suggested to explain it, within the extensive literature on the subject, see TIM JENKINSON & ALEXANDER LJUNGVIST, *GOING PUBLIC*, 64-138 (Oxford 2d ed. 2001). Jenkinson and Ljungqvist divide those models into three main categories: (1) asymmetric information models; (2) models focusing on institutional explanations; and (3) models taking into account considerations of ownership and control over the issuing companies. *Id.* For a review of the possible reasons for that phenomenon. See also R. A. BREALEY & S. C. MYERS, *PRINCIPLES OF CORPORATE FINANCE* 414-416 (McGraw-Hill 6th ed. 2000); Steven A. Ross, ET AL., *CORPORATE FINANCE* 503-509 (McGraw-Hill 5th ed., 1999); Sher, *Underwriter Civil Liability for IPO's: An Economic Analysis*, *supra* note 2.

106. For the various models based on partial information costs and focusing on the type of explanations related to the way the offering is marketed by underwriters and to structural limitations, see JENKINSON & LJUNGVIST, *supra* note 105, at 88-107.

107. Benveniste & Spindt, *supra* note 102.

108. Sherman & Titman, *supra* note 102.

bookbuilding mechanism operates as a truth-telling verification mechanism: if it is revealed that the investors have not been cooperative, opting for a strategic behavior of non-disclosure of real information, the leader will erase them from her regular investors list.

Also worthy of note are models dealing with institutional explanations for the underpricing phenomenon and focusing on the underwriter's role of supporting the post-IPO price. In this context, the leader can use various tools to reduce the risk entailed in the offering, such as: (1) stabilization activities¹⁰⁹(2) overselling of offered securities (being in a short position) and covering the difference by exercising her right to over-allot or by buying securities in the secondary market,¹¹⁰and (3) penalty bid.¹¹¹ In addition, the leader also acts as a market maker in the offerings she manages.¹¹²One of the main explanations for underpricing according to these models, is that the leader uses those tools to increase her own profits.¹¹³

In the current model, *regular investors* differ from ordinary ones in that they are constantly in touch with potential leaders who allow them to take part in the bookbuilding process. Not any investor enjoys the privilege of being included in the leader's contact list during the bookbuilding process. To become regular, the investor must be (1) a financial intermediary of some sort (such as a trust fund) or one of the

109. The leader can flow bids, at a price not higher than the offering price, for a certain period after trade begins, so long as the securities are still being distributed, in order to support the offering price (and so long as that option has been made explicit in the IPO prospectus).

110. The leader usually has the so-called "green shoe option" to purchase securities from the issuing firm – up to 15% of the amount issued and at the offering price, within thirty days after the offering date. Price-supporting actions are very common, and according to Asquith, Jones and Kieschnick, they were carried out in about half of the offerings in the years 1982-1983. See Daniel Asquith, ET AL., *Evidence on Price Stabilization and Underpricing in Early IPO Returns*, 53 J. OF FIN. 1759, 1765 (1998).

111. The leader can deny a selling group member's right to receive a commission in case his customers rush to resell their recently acquired securities (these investors are dubbed "flippers"), or even avoid using that member's services in the future.

112. Based on NASDAQ data, in the post-offering days, the leader acts as a market maker for about half the trade volume, and accumulates an average of 8% of the shares. See Katrina Ellis, R.oni Michaely & Maureen O'Hara, 55 J. of Fin. 1039 (2000).

113. The following are some of the explanations suggested: Reena Aggarwal, *Stabilization Activities by Underwriters after Initial Public Offerings*, 55 J. OF FIN. 1075 (2000); Ellis, Michaely & O'Hara, *supra* note 112; R. Raymond P. H. Fische, *How Stock Flippers Affect IPO Pricing and Stabilization?*, 37 J. of Fin. and Quantitative Analysis 319 (2002); Ekkehart Boehmer & Raymond P. H. Fische, *Do Underwriters Encourage Stock Flipping? A New Explanation for the Underpricing of IPOs*, (Working Paper, 2000) available at <http://ssrn.com/abstract=228434> (last visited Mar. 9, 2006); Ekkehart Boehmer & Raymond P. H. Fische, *Underwriter Short Covering in the IPO Aftermarket: A Clinical Study*, (Working Paper, 2003) available at <http://ssrn.com/abstract=278945> (last visited Mar. 9, 2006); Royce de R. Barondes, *Adequacy of Disclosure of Restrictions on Flipping IPO Securities*, (Working Paper, 1999) available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=173248 (last visted Mar. 9, 2006).

leader's important customers, (2) financially sound, and (3) able to evaluate companies for the purpose of issuing their stocks. Candidates who meet those requirements will offer themselves for the job, if it is included in their investment policies. Importantly, all regular investors can become *informed investors* if they invest in collecting and evaluating the information. In the bookbuilding process, the leader contacts her regulars, or to a substantial part of them, and presents the company to them (using the draft prospectus and road show). These in turn assess the information and place their bids, which is part of their demand curve.

The leader assesses public demand based on bids by regular investors stating their maximum price for securities ordered. According to Cornelli and Goldreich, there are three types of bids,¹¹⁴ including two types meeting this condition (stating maximum price): *step bids* and *limit bids*. The maximum price informs the leader about the expected pricing of the securities offered. The maximum price is the most important data gleaned by the leader from those two bid types. Therefore, from the leader's perspective, these bids have a similar value, which is higher than that of less informative bids. We further assume that the third type – *strike bids* – informs the leader about the regular investors' demand curve (without price data).

In fact, the leader selects her regular investors in such quantity and quality so as to include, in each offering, a certain number of investors that will conduct analysis allowing them to inform her about pricing. On the one hand, this number should be high enough to allow accurate evaluation. On the other hand, the number of those conducting analysis in a certain offering shouldn't be too high, because of the costs involved. Too many informed investors will limit the leader's maneuverability in allotting the stocks, because she would have to "re-pay" them for their investment in collecting and evaluating the information.

The model answers two important questions: How does the leader's strategic behavior affect the IPO price and the security allotment? How does a law holding the leader liable affect this mechanism?

The answer to the first question is that in equilibrium, only some of the regular investors evaluate the securities offered, to a degree allowing for efficiency in plotting the market demand curve. In equilibrium, the regular investors, both informed and non-informed, present the leader with their real demand data (the price data according to their evaluation or the demand data, respectively). Informed investors

114. Cornelli & Goldreich, *supra* note 102.

(regular investors who have invested in evaluating the information) will not present demand data without price data (that is, will not pretend to be uninformed). This is because in this case, the compensation received from the leader will not cover their costs. Informed investors will also not mislead the leader about their evaluations. If they report a lower price, the effect on the IPO pricing will be negligible, while reducing their chances to take part in the offering. They will also not report a higher price because, independently of their chances to participate, it will not be worth their while to buy offered stock at a price higher than their true value.

The uninformed regular investors will present the leader with market data (strike bids) without price data. This is because a strategy of not investing in analysis and participating in the IPO as informed investors is very costly. Moreover, uninformed investors will present real demand data, for reasons similar to those of their informed counterparts.

In equilibrium, the leader's strategic action achieves ample efficiency in accurately plotting the demand curve, on the one hand, while preventing forbiddingly high costs of information analysis and verification by the regular investors, on the other. The leader's ability to create an efficient equilibrium depends on her ability to reward the regulars by underpricing and overallotment. This is done by means of differential rewards to regulars who evaluate the company and inform it of their evaluation, who receive a greater allotment than those who do not (whose allotment is still higher than that of regular investors).

The answer to the second question is that holding the leader liable can increase the allotment mechanism's efficiency when using the bookbuilding method. Given the legal rule holding the leader liable, regular investors can rely on the company's presentations during the road show and reduce the costs of maintaining their due diligence and information verification system.

Another conclusion derived from the model is that when the leader is held liable, regular investors will match their demands to the highest degree of certainty, ensured by the application of the legal rule in question. Therefore, the leader, who plots the market demand curve by means of extrapolation (*i.e.*, using a forecast based on the regulars' demand data), will be able to calculate a higher level of demand, due to both increased demand by informed investors and the fact that the extrapolation coefficients (the multipliers used to forecast the market demand curve based on that of the regulars) will be higher. All these contribute to an equilibrium in which a higher price is systematically ensured for the offered securities, reflecting more accurately their full

estimated value, while efficiency losses in the primary market security allotment mechanisms are concomitantly reduced.

Moreover, although the effect of a law holding the leader liable for misleading prospectus details is felt mainly in terms of regulating her conduct in the IPO stage, it can also have a mitigating effect on her strategic behavior in the post-IPO market. In other words, the law can reduce efficiency costs resulting from the leader's strategic behavior, since it limits her ability to profit by further increasing the underpricing ratio.

2. Why a Negligence Rule Optimally Supports the Security Allotment Mechanism

The second model's conclusions suggest two further advantages of applying a negligence versus a strict liability rule. First, a negligence rule can optimally restrain the leader's strategic behavior. According to the previous description of the primary market's structure and the way the leader operates within it, the leader takes a variety of strategic actions in order to maximize her profits. These actions affect certain parameters which are crucial to the allotment mechanism's efficiency. Among other things, the leader selects the regular investors who will maintain a system analyzing information about issuing firms and report demand data. In equilibrium, the leader manages to optimize the investment in checking the information. Holding her liable will reduce the costs of maintaining an information analysis and verification system and also increase the certainty as to the accuracy of the market demand curve plotted by the leader. The efficiency of the bookbuilding mechanism depends on the credibility of the leader's claim to have exerted optimal effort, as perceived by the regular investors. A negligence rule will serve that purpose optimally, for the reasons enumerated above. It poses a more credible threat to the leader when it comes to carrying out due diligence, as it allows the investors to scrutinize her activity. Thus, a negligence rule makes it possible for the regular investors to reduce the costs of maintaining an information analysis and verification system, as well as increasing their certainty as to the accuracy of the market demand curve plotted by the leader. Compared to a strict liability rule, it can significantly reduce the primary market's indirect costs. A strict liability rule does not support the bookbuilding mechanism to the same degree, since it (1) does not allow institutional investors to increase their reliance on the leader's presentations, (2) does not permit a similar reduction of the costs of maintaining the information analysis and verification sys-

tem, and (3) does not increase the credibility of the leader's demand curve to the same extent.

Second, a negligence rule can better serve the post-IPO market in dealing with the leader's strategic, profit-maximizing activities. This liability imposition effect is indirect. One example is the possible use of disclosure rules by the leader in order to influence the investors' identity (for example, preferring flippers), in order to ensure higher personal profits in the secondary market. As already mentioned, the law can reduce the efficiency losses resulting from the leader's strategic behavior, since it reduces her ability to profit by further increasing the underpricing ratio. Since it seems that a negligence rule can reduce the primary market underpricing ratio better than a strict liability rule, the former will make it difficult to deviate from equilibrium in the pre-IPO market and will therefore better limit the leader's ability to profit from strategic behavior in the post-IPO market.

C. *Damage Distribution and Insurance: Efficiency Aspects*

1. The Leader Is the Least Expensive Insurer

A law holding underwriters liable can help the leader exercise her function as an IPO insurer.¹¹⁵ The leader has an advantage relative to the other participants in the offering, as she can obtain the best insurance policy. Her substantial economy of size, and the fact that she is a repeated player in the market, ensure her ability to reduce insurance premiums. She has the knowledge and the ability to formulate the best insurance agreement with potential insurers. The leader's risk aversion is lower than most participants due to her own large capital and the considerable number of offerings in which she takes part. Moreover, she is better able to bargain with potential insurers and has a reputation that can be relied upon as a tool to reduce premiums. Thus, it is obvious that the leader is the least expensive insurer of the risk of misleading details being found in the IPO prospectus.

Creating an efficient insurance system in the primary market requires combined agreements between the issuing firms and its directors, the leader and the other underwriters, and it is the leader who's in the best position to implement them. Holding her liable also solves the under-insurance problem, which can result from the risk of omissions by the firm and its directors in terms of insurance cover. When the policy is not effective for any reason, it is possible for the leader to bear the responsibility. Importantly, the leader is also a "deep pocket"

115. For a comprehensive discussion of that subject, see Sher, *Underwriter Civil Liability for IPO's: An Economic Analysis*, *supra* note 2.

so that holding her liable increases the investors' chances of being completely compensated for their damages. A leader's collapse is not very likely since the law imposes the liability on the underwriter consortium as a whole and thus distributes the risk.

The leader's advantage in terms of risk distribution in public offerings is especially apparent in *systematic* risks.¹¹⁶ It seems that in practice, systematic and specific risks in IPO prospectuses cannot be completely separated from one another. In this situation, only the leader has the professional knowledge, the information, and the economies of size required in order to do so efficiently, and thus distribute risks optimally. Holding the leader liable may add to the efficiency of the market risk distribution mechanism. Should she not be held liable, she will have no incentive to insure the risk of misleading details in the IPO prospectus. Without liability, the advantages stemming from insuring the risks involved will diminish, since the insurance will be in far less skillful hands. For similar reasons, from the insurer's point of view, the risk management procedure is much less costly when it is the leader who is being supervised, rather than the issuing firm and its directors.

2. Why a Negligence Rule Optimally Supports Leader Insurance

In reference to the law's objective in terms of *risk distribution and insurance*, holding the leader liable for negligence can improve the efficiency of the market risk distribution mechanism. The present analysis has provided several justifications for leader liability and imposing a negligence rule will increase those advantages in comparison with a strict liability rule. Nevertheless, this effect is not as significant as the effects in the area of directing behavior. On the one hand, a negligence rule allows for better oversight of leader actions by potential insurers. The mechanism of exposing her actions (through litigation) also gives potential insurers a better idea about the leader's actions. Thus, a potential insurer will be able to rely on the leader's

116. The question how risks become distributed in capital markets received several answers in the financing theory literature. A basic answer was given in the form of the capital asset pricing model, or CAPM. For a presentation of the model and its various extensions, see, e.g., ROBERT A. HAUGEN, *MODERN INVESTMENT THEORY* 201-235 (Prentice Hall 5th ed. 2001) 201-235; WILLIAM SHARPE, ET. AL., *INVESTMENTS*, 227-55 (Prentice Hall 6th ed. 1999). The model was heavily criticized, but its basic insight, that adding a stock to the market portfolio permits distribution of the specific risk entailed in the new asset but does not permit distribution of the systematic risk, is widely accepted. According to that understanding, when we are talking about a specific risk inherent in the new stock, it will be better distributed by the investors. A risk of this kind is, for example, the difficulty of assessing the managers' skillfulness and reliability. But when the issue is an inherent systematic risk, this cannot be distributed by diversifying the investors' portfolios.

presentations concerning the quality of her due diligence with a higher degree of certainty. This will enable him to harness the leader's reputation to the insurance premium pricing mechanism. A higher degree leader reliability is also good for the leader herself. As already mentioned, it allows her to insure at a lower premium.

The mechanism of exposing leader actions (through litigation) also gives other consortium managers and ordinary underwriters a better idea about her actions. Since there is no practical means of revealing raw company data to a large number of interested parties, litigation allows the various members of the consortium to indirectly scrutinize her actions. Furthermore, the custom of reports by the leader to ordinary underwriters, in the road show and through the so-called comfort letters, has developed thanks to the liability for negligence imposed on both parties. It may be that a strict liability standard does not make those reports unnecessary. Be that as it may, a negligence standard gives both parties an incentive to show that they have conducted themselves properly: the leader – in testing for adequacy; and the other underwriters – in scrutinizing the leader's testing procedure and verifying that it has indeed been implemented according to accepted standards. Imposing strict liability undermines a defense based on both parties' examinations, thus considerably weakening the leader's and other underwriters' incentives to conduct themselves in the above-mentioned manner.

D. *Division of Welfare*

As for the division of welfare, both in reference to the law's objective of directing the leader's behavior and from the point of view of insurance and risk distribution, if the conclusions of the models and analysis presented are accepted, it is reasonable to assume that the company, the leader and the various investors each benefit from part of the added efficiency resulting from holding the leader liable for negligence. It is therefore expected that a negligence rule will also have a better effect on the division of welfare among the IPO participants.

V. DISCUSSION OF POSSIBLE COUNTERCLAIMS

A. *Responding to Questions Raised in Literature Supporting Strict Liability*

The first counterclaims focus on arguments raised in the legal literature supporting the imposition of strict liability on underwriters for

the presence of misleading details in IPO prospectuses. Partnoy¹¹⁷ suggested that profit-maximizing gatekeepers may prefer risking their reputation for higher short-term profits. The present thesis describes the offerings market such that a situation is created whereby leaders are unable to harness their reputation to the task of convincing investors that they have indeed carried out the due diligence to an optimal degree and that, therefore, the issuing company's prospectus includes the optimal information for them. It is not short-term profits which cause leaders to risk their reputation but their inability to substantiate their actions during the IPO.

Partnoy believes that the very imposition of liability offers efficiency advantages, only that the negligence rule entails high costs, both direct and indirect. The first stem from the uncertainty of legal decisions and high litigation expenses, resulting from the fact that underwriters must take into consideration criteria determined by the court. In our view, these criteria constitute an efficient mechanism for reducing the direct costs.

As for indirect costs, Partnoy holds that a negligence rule creates a preference for capital-raising in private offerings. However, the negligence rule, together with the adoption of several legal adjustments that will prevent the leader from liability avoidance, will arguably *promote* public offerings. Moreover, there is a trend of applying the leaders' due diligence methods to private capital raisings as well. Leaders who have acted as intermediaries in transactions of the former kind tend to use the same methods and presentations also in private placement memorandums. This suggests a *positive* external effect of court-determined criteria in the IPO market (on the private offerings' market).

Moreover, the selection of leaders by company executives is also not biased so as to prefer too high-quality leaders. Quality leaders are being selected in terms of various parameters, such as their relative expertise in the issuing company's areas of business activity. However, the claim that company executives ostensibly buy services that are "too good" because of their risk aversion is incorrect. In fact, company executives try to contract with the optimal service provider (sometimes by means of an auction); only the latter cannot "deliver" due to IPO market failures.¹¹⁸

117. For detailed presentation of Partnoy's arguments, see *supra* notes 31-42 and 52-57 and accompanying text.

118. For a comprehensive, recent empirical study about the way issuing firms and leaders select one another in initial and seasonal public offerings, see C. S. Fernando, V. Gatchev & P. A. Spindt, *Wanna Dance? How Firms and Underwriters Choose Each Other*, (Working Paper,

As for the manner in which the law solves the primary market problems, Partnoy believes that his suggested strict liability regime would reduce the costs of litigation between the firm and its underwriters and allow them to divide the resulting profits between them. However, these costs are relatively low, while the costs of misleading details in the IPO prospectus are the most significant ones. Accordingly, imposing liability for negligence will ensure efficient cost reduction not least because it will deal better with the major cost in the market—reduced demand for newly offered securities. It will thus allow for a division of profits among all IPO market participants. Even the primary market division of risk will be optimized following a negligence rule, with adjustments preventing leader “shirking”, as opposed to Partnoy’s strict liability regime.

B. *A High Rate of Settlements in Suits Involving Underwriters, and Low Underwriter Participation in the Suits and Settlements*

A second set of counterclaims focuses on whether a high rate of settlements or low participation by underwriters as co-defendants in lawsuits related to misleading details in IPO prospectuses can undermine the present thesis. One of the main reasons for applying the negligence rule is that it promotes exposure of the leader’s working methods and actions concerning the IPO, thus optimally contributing to solving the major problem in the market, which is the investors’ lack of information about the leader’s actions. A possible refutation of the present thesis is that the rate of settlements in lawsuits related to misleading details in IPO prospectuses is high, while the rate of leader participation as co-defendants in such suits is low, so that in practice, the leader’s working methods and actions remain hidden.

The counterargument involves the presentation of several data. Empirical findings show that in the U.S., the rate of settlements in class-action suits of this kind is high. Based on IPO data for the period 1990-1999, Choi¹¹⁹ found that following the 1995 Private Securities Litigation Reform Act (“PSLRA”),¹²⁰ the rate of settlements reached in such lawsuits fell from 83% to 75%. This change, however, does not reflect increased exposure of leaders to judicial review, but rather le-

2004) available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=586964 (last visited Mar. 9, 2006).

119. Stephen J. Choi, *Do the Merits Matter Less After the Private Securities Litigation Reform Act?*, (Working Paper, 2004) available at <http://ssrn.com/abstract=558285> (last visited Mar. 9, 2006).

120. Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (1995) (codified as amended in sections of 15 U.S.C.)

gal limitations on filing suits.¹²¹ Empirical data are available also on the rate of settlement. Based on the same data set, Choi, Bajaj, Mazumdar, and Sarin¹²² found that following the enactment of the PSLRA, the rate of settled lawsuits declined from 58% to 26% out of all class-action suits. The PSLRA thus ensures a relatively long exposure of defendants to the threat of legal claims and reviews. However, this change can also be interpreted as resulting from the reduced threat to potential defendants in any case of suspected presence of misleading details in the IPO prospectus.

Another important phenomenon is the relatively low rate of class-action suits related to misleading details in IPO prospectuses in which the suit is filed also against leaders. According to Bajaj, Mazumdar, and Sarin,¹²³ based on the same data set, the post-PSLRA rate of class-action suits with leaders as co-defendants (together with the issuing firm and its directors) is 6%.¹²⁴ However, though their data seem to support the existence of the phenomenon in question, they fail to reflect the true rate of lawsuits of this kind. One indication for that is found in Tinic's 1988 study:¹²⁵ according to IPO prospectuses of two investment banks – Alex Brown & Sons, Inc. and L.F. Rothschild, Unterberg & Towbin, Inc. – in 1986, they were defendants in 60 and 73 suits, respectively, involving public offerings they had underwritten. An additional indication comes from searching the American legal cases database. In a random sampling of Lexis.com data, we found that in some 44% of the class-action suits of this kind, leaders were co-defendants.¹²⁶ We therefore believe that the rate of lawsuits with leaders as co-defendants is higher than as stated by Bajaj, Mazumdar and Sarin (6%), but lower than 50%.

Another significant phenomenon is that when a suit is filed against leaders as co-defendants, their rate of participation in the settlement is

121. For lawsuits of this kind, where leaders have been sued as co-defendants, *see, e.g.*, *Kapps v. Torch Offshore, Inc.*, 379 F.3d 207 (5th Cir. 2004); *Cohen v. USEC, Inc.*, 70 Fed. Appx. 679 (4th Cir. 2003); *Demaria McKowan Lowe & Co. v. Jasmine, Ltd.*, 295 F.3d 380 (3d Cir. 2002); *Lilley v. Charren*, 17 Fed. Appx. 603 (9th Cir. 2001); *In re Flag Telecom Holdings, Ltd.*, 308 F. Supp.2d 249 (S.D.N.Y. 2004); *In re WRT Energy Sec. Litig.*, 96 CIV 3610, 1997 U.S. Dist. LEXIS 14009 (S.D.N.Y. 1997).

122. Mukesh Bajaj et al., *Empirical Analysis: Securities Class Action Settlements*, 43 SANTA CLARA L. REV. 1001, 1009-1010 (2003).

123. *Id.* at 1007-1008.

124. *Id.*

125. Seha. M. Tinic, *Anatomy of Initial Public Offerings of Common Stock*, 43 J. OF FIN 798-799 (1988).

Id. at 799 n.11.

126. We have found no significant difference between the 2000-2004 and the 1996-2000 samples in terms of the rate of leader participation as co-defendants in class-action suits for misleading details in IPO prospectuses.

usually low.¹²⁷ In order to achieve that objective, the leaders pressure the firm and its directors to forego their participation and show no willingness to pay. Using this strategy, they manage to create a situation whereby, when a settlement is eventually reached between the plaintiffs and the firm and its directors, the leaders join it at the last minute, at low participation rates. Moreover, the leaders then demand to implement the underwriting contract's indemnification clause.

Why do class-action plaintiffs agree to such low leader participation in settlement payments, and why do they not attach the leader as a co-defendant in all lawsuits? The answer is that the firm's liability for misleading details in the IPO prospectus is at a higher level than that of the leader's (strict liability), and is also more obvious and relatively easy to prove. Moreover, the firm and its directors almost always have professional liability insurance, making the "deep pocket" question irrelevant. The indemnification clause is also a disincentive.¹²⁸ Furthermore, under certain circumstances it may be that the law imposes limits on the leader's participation rate. It seems that from the plaintiffs' point of view, attaching the leader to their suit might make its management more difficult, without offering substantial benefits.

Why does the firm, its directors, and their professional liability insurer agree to the leader's low participation, and why do *they* not attach them as co-defendants in all lawsuits? The answer is that the firm and its directors, on the one hand, and the insurance company, on the other, face the same facts as the class action plaintiffs. They too realize that the company's liability is at a higher level than the leader's and also easier to prove. They too are deterred by the indemnification clause and the legal limitations imposed under certain circumstances on the leader's participation rate. Additionally, they are under enormous business pressure applied by the leader and the insurance companies, in particular, do not wish to seem as though they damage the insured's business.

Nevertheless, for the reasons mentioned above, it should not be concluded that it is inappropriate to hold the leader and the other underwriters liable for misleading details in IPO prospectuses. It may still be concluded, however, that underwriters are very skilled in reducing their exposure to the risks involved in lawsuits, including reputation risks. It is the law's responsibility to deal with the phenomena described herein, which create a situation whereby the objective of increasing social utility by holding leaders liable, in general, and liable

127. Janet C. Alexander, *The Lawsuit Avoidance Theory of Why Initial Public Offerings are Underpriced*, 41 UCLA L. REV. 17, 48-49 (1993).

128. *Id.* at 46-47.

for negligence, in particular, is attained only partially, if at all. This is a major justification for not allowing indemnification for leaders; for the inappropriateness of deviating from the normal tort participation arrangements (jointly and severally); that special settlement rules must be applied to the case where leaders are co-defendants; and that other *escape routes* developed by the latter in order to reduce their exposure to litigation risks, including risks to their reputation, must be blocked. Each of these deserves a separate research.

C. *Escape Routes*

A *third group of questions* concerns why leaders create the escape routes described, and why they settle in a high rate of the lawsuits filed against them as co-defendants. If exposing the leader's actions contributes to social welfare, it must be in the leader's interest to use this exposure in order to prove her quality and improve her reputation. The *answer to these questions* is related to many fundamental issues regarding the behavior of individuals, in general, and of businesses, in particular. Professionals have a tendency to effect legislation and to create mechanisms which will reduce their exposure to legal claims. Physicians' and bankers' associations act this way. It seems that sometimes they believe that reducing their exposure serves not only their own good, but the social good; sometimes they believe it only serves their own good, while sometimes they act this way although their own private welfare is reduced, together with social welfare (for example, due to union interests or to an overall strategy of continuous action to reduce exposure). These aspects, however, are outside the scope of the present article.

Furthermore, after the IPO, when a leader fears she may be sued for missing details in the prospectus, she will try to reduce exposure, and not increase it, even if she believes herself to be innocent. Apart for the abovementioned behavioral reasons, the reason for that is the uncertainty inherent in each lawsuit. Exposure may result in high costs for the leader, including damage to her reputation. It is the extent of those potential reputation costs, used in the models presented here to leverage the desirable equilibrium, which causes the leader to open up the legislative and market escape routes. The cost of the risk that the court would be mistaken or that the market will misinterpret the results of the lawsuit is so high, that the leader will forego any benefit of proving her quality. Moreover, the probability that the leader would be able to prove her quality is very low, since in most cases a settlement is reached in which the plaintiffs are compensated for all their

damages. Therefore, the leader will not be able to attain a decision buttressing her reputation.

Since the leader knows in advance that should a lawsuit be filed, her strategy will be reduced exposure, she prepares all possible escape routes in advance, by effecting legislation and developing market mechanism (in addition to the abovementioned behavioral aspects, which propel professionals and their associations to adopt this strategy).

D. *The Cogent Nature of Liability*

Other important questions have to do with the cogent nature of liability. If it is indeed in the leader's interest that investors be informed about her *modus operandi*, why is it necessary to hold her liable at all, in general, and liable for negligence, in particular? Why not leave it to the leader's discretion to state in the prospectus that she is liable for the existence of misleading details therein, and willing to compensate the investors for their damages if it is found that she has been negligent? Conversely, why not let the leader condition her liability for negligence, in terms of such misleading details? Moreover, if transparency is in the leader's own interest, why do they tend *not* to reveal their *modus operandi* in their prospectuses?

Some of the discussion of these important questions is beyond the scope of this article. However, and without exhausting the discussion of the need for cogent liability in the stock market, whether to hold leaders liable and whether to hold them liable for negligence, some of the principles and ideas underlying the justifications suggested by several authors for the imposition and enforcement of mandatory disclosure, and some of the above justifications for imposing liability for negligence are also relevant in the present context. According to Easterbrook and Fischel,¹²⁹ a cogent rule of imposing and enforcing disclosure duties can reduce under-disclosure problems, for which there may be three reasons. First, because a firm estimates that the information in question may serve other competing firms directly, or may help investors considering to invest in competing firms. Second, the unfeasibility of charging a price for the production of comparative information. And third, the lack of appropriate incentives for creating the least expensive disclosure format. As already mentioned, an unconditional negligence rule will contribute optimally to the creation of a standard reporting format in prospectuses, which will allow inter-firm comparison and will also be the least expensive. Furthermore, such a

129. Easterbrook & Fischel, *supra* note 15, at 290–292, 300–302.

rule will optimally assist the law in cutting costs resulting from the effect of the due diligence process on third parties.

The same applies to Rock's argument:¹³⁰ U.S. mandatory disclosure laws are preferable to contractual solutions in resolving the various problems faced by the issuing firm, in terms of disclosure content, credibility, and enforceability. As previously mentioned, Rock believes these laws represent an efficient mechanism, both in terms of standardization and by allowing adjustment of disclosure requirements over time. Should the leader be held unconditionally liable for negligence, a similar adjustment mechanism could be created for the level of due diligence.

The answers to the above questions focus on the claim that, without a cogent law, the negligence rule's objective will not be served. The same mechanism of "shirking," both by promoting legislation and by various activities before and during the IPO, will operate in the same way in each of the cases. This mechanism, in the form of contractual conditioning of the type of liability so that strict liability, with an indemnification ceiling (instead of conditioned negligence), will apply. For instance, it will have the following indirect results: the costs of the effects of the due diligence procedure on third parties and the costs of lack of adjustment of the testing format over time.

The same applies for the question of why the leader does not tend to disclose her *modus operandi* in the prospectus. Although doing so will serve the objective of exposing her activity, the same problems concerning hidden action and the investors' inability to verify her working methods and her conduct in the context of the specific IPO, mean that such disclosure will not be very effective. The same applies to the possibility that the leader hire an independent party to evaluate her functioning. Even the activity of a financial body, the effectiveness of whose scrutiny is low in any case, suffers from the hidden action problem. On the other hand, the risk entailed by exposing the leader's *modus operandi* in the prospectus or to an independent body is considerable. Such exposure might increase the risk involved in lawsuits filed against her for a missing detail or for inaccurate portrayal of the due diligence procedure. When such a lawsuit is filed, the leader's reputation will suffer considerably.

130. See Rock *supra* note 91 and accompanying text.

VI. THE APPROPRIATE STANDARD OF CARE FOR OTHER PARTICIPANTS IN THE ISSUING PROCESS

In the U.S., the scope of Section 11 liability varies among the various potential defendants:¹³¹ all the undersigned in the registration statement, including the issuing firm, its directors and underwriters, are liable for all presentations in the registration statement.¹³²

Authors of expert opinions (lawyers, accountants, assessors, etc. and hereinafter "experts") are liable for the presentations included in their own opinions. The level of Section 11 liability further varies within the first group. While the issuing firm is held strictly liable, its directors, the underwriters, and the experts, and anyone undersigning the registration statement apart for the firm, will be held liable unless entitled to one of the defences enumerated in Section 11(b). The latter's main available defence is that stipulated in Section 11(b)(3), according to which those seeking to be relieved of their liability have to show that following reasonable investigation, they have had reason to believe, and indeed believed, that no misleading detailed had been included in the registration statement. In sum, the liability standard imposed on the issuing firm's underwriters and directors is negligence, while that imposed on the firm itself is strict liability.

The present thesis supports the appropriateness of holding the issuing firm and its directors liable for negligence, as well, for the following two reasons: *First*, the justifications for imposing a negligence rule on the leader are also partially applicable to the firm and its directors. They too are exposed to the same problem: their inability to convince the investors that they have taken the optimal steps to ensure provision of all relevant information. Although the firm and its directors are not well-known players in the stock market, they have an interest in acquiring a reputation that will enable them to raise capital efficiently in the future. A law holding the firm and its directors liable for

131. For a brief review of the issue of liability according to § 11, see *supra* note 5 and the accompanying text. For a legislative history of § 11, see references in LOUIS LOSS & JOEL SELIGMAN, *SECURITIES REGULATION*, *SUPRA* note 12, Vol. IX, at 4247-4248 & n. 135; LOSS & SELIGMAN, *SECURITIES REGULATION* *supra* note 12 at 911 (1998 Supp.). For an analysis of the section's components, the development of legal decisions and various problems related to the imposition of liability based on this section, including the indemnification arrangements problem, see & SELIGMAN, *FUNDAMENTALS OF SECURITIES REGULATION*, *supra* note 12, at 1002-1013, 1159-1154; LOSS & SELIGMAN, *SECURITIES REGULATION*, Vol. IX, at 4246-4278, Vol. X, at 4685-4701; LOSS & SELIGMAN, *SECURITIES REGULATION* at 911-916, 984-985 (1998 Supp.); COX, ET. AL. *SECURITIES REGULATION*, 228-29, 589-621 (Aspen 1997); and HAZEN, *THE LAW OF SECURITIES REGULATION*, *supra* note 12 at 328-349.

132. See *Harden v. Raffensperger, Hughes & Co.*, 65 F.3d 1392 (7th Cir. 1995) (finding underwriter liable under § 11).

negligence can play a major role in exposing their own *modus operandi* as well. In this case, too, a strict liability rule will prevent judicial review of their activity.

Second, a strict liability rule imposed on those liable for all prospectus presentation (under U.S. law, it is the issuing firm) is one of the reasons for the reduced effectiveness of holding leaders liable for negligence. This is because, as already mentioned, it is one of the factors enabling leaders to develop escape routes. Strict liability is one of the reasons for plaintiffs' tendency not to press charges against leaders. It is also one of the reasons for the effectiveness of the indemnification threat. Furthermore, strict liability is one of the explanations for the relative ease in which issuing firms and their liability insurance companies can be persuaded to settle. It is also one explanation for the situation whereby the court is not required to look into the part played by the leader in causing the missing detail to be included in the prospectus. Only a rule imposing a *uniform* standard of negligence on all parties liable for all misleading details in the IPO prospectus will require the court and the parties to the litigation, when bargaining for a settlement, to examine each party's conduct and contribution to the existence of the misleading detail in the prospectus.

VII. CONCLUSION

The thesis presented offers several justifications for the appropriateness of imposing a negligence rather than a strict liability rule on the leader and other underwriters of initial public offerings (IPO's) when misleading details are found in the IPO prospectus. As for applying the thesis to the firm and its directors, there are justifications for holding them liable for negligence as well.

Can the thesis, that the leader should be held accountable for negligence in view of the need to use the court to expose his *modus operandi* and his specific actions concerning the IPO, be applied to other areas as well? Can the implications of extending the thesis to the first group of potential defendants – the issuing firm and its directors – be relevant in additional areas? These questions require further research.

One example is the issue of the liability of medical institutions for acts of commission and omission by medical staffs hired to carry out operations. Facially, it seems justified to extend the thesis under these circumstances. Thus, in an analogy to one of the justifications for holding leaders liable, the common denominator between the cases is that medical staffs are incapable of convincing their potential customers, the patients, that they implement optimal working methods, and that they have done so in a specific case. Holding the medical institu-

tion liable for their actions (rather than only for issues under its contractual control, such as the quality of the surgical equipment) may solve the problem. The institution's reputation is not enough to deal with the problem, since the quality of its oversight is also impossible to assess. Holding it liable for negligence will compel the court to inquire whether it has carried out the (medical) "due diligence" in an optimal manner. A strict liability rule forgoes such judicial inquiry.

The justifications for a negligence rule may weaken should the rationale of liability in general be weakened. In this context, Langevoort¹³³ claimed that, now that technological allow IPO's to be implemented in new ways, the investment bank's gatekeeper function becomes less significant. In his view, it would not be advisable, in such cases, to hold them legally liable and require that they carry out adequacy tests.¹³⁴ But, should significant changes occur in the way that IPO's are conducted, the justifications for liability will also have to be re-examined. Thus, the leader has an advantage in terms of developing financial devices designed to circumvent financial intermediaries in the primary market. Should such devices be developed, it would require reexamining the legal situation.

In sum, both underwriters and the firm, as well as its directors, should be held liable for negligence when misleading details are found in the IPO prospectus. The following questions require further studies. The first involves the leader's escape routes. What are the implications of the present thesis and what is the appropriate law it advocates in ancillary areas: indemnification arrangements, participation arrangements, settlements and appropriate rules of managing the procedure and reaching a court decision in claims against leaders.

Note that regarding settlements involving the leader, the thesis presented above suggests that, *prima facie*, it is not at all obvious that settlements with the leader should be encouraged. Despite the legal system's interest in reducing its costs, the utility loss, resulting from the inability to achieve the objectives of applying the negligence rule, should also be taken into account. The reason is the escape routes described above. The common case where settlements are reached in which the leader's participation is relatively meager, and the large

133. Langevoort, *Information Technology and the Structure of Securities Regulation*, *supra* note 25. See also Langevoort, *Markets and Information Gathering in an Electronic Age: Securities Regulation in the 21st Century: Toward More Effective Risk Disclosure for Technology-Enhanced Investing*, *supra* note 25.

134. Elsewhere, Langevoort suggested that § 11 liability be reformulated with alleviated requirements of underwriters in shelf offerings, but without any change in the liability imposed on IPO underwriters. Langevoort, *Deconstructing Section 11: Public Offering Liability in a Continuous Disclosure Environment*, *supra* note 25, at 67.

number of cases where they are not co-defendants (among other reasons, because they are expected to participate insignificantly), suggest that encouraging settlements may exacerbate the problem.

On the other hand, the thesis presented does not suggest that settlements are to be avoided at any cost. Should the law be redesigned so as to block escape routes which erode the efficiency of imposing a higher degree of liability, it will be of interest to discuss the question of reaching *efficient* settlements. Assuming leader "shirking" can be avoided in this manner, the compensation rates imposed on leaders are expected to increase, as well as the rate of lawsuits in which they are co-defendants. In this case, it will certainly make sense to ask, what is the rate of lawsuits in which it is efficient for a settlement to be reached with the leader as well (in view of the judicial system's interest, etc.).

If the leader's *modus operandi* is judicially reviewed in a large enough portion of the cases, the question of efficient settlements will thus become relevant. In this case, the question will be how to design the law so as to prevent evasion of the discussion concerning division of liability, and what mechanisms must be added in order to ensure that the utility in terms of the legal discussion is not outweighed by the negative utility of forgoing complete disclosure of the leader's *modus operandi* and particular actions. One of the pertinent questions in this case will be, what oversight should the court apply to the parties to the suggested settlement. Another question is whether the parties should deliver a detailed report to the investors concerning the existence of misleading details in the prospectus, as a condition for the court's acquiescence to the suggested settlement.

Importantly, on the face of it, preventing the leader from taking part in settlements seems inefficient. This is because it might entail high costs, as it might prevent any lawsuits from being filed against him. It is also worthy to note, as the thesis suggests, that the court should consider using its insights to design procedure management rules and the manner in which decisions are formulated. At first glance, it seems desirable that the court devote a special effort to expose the leader's *modus operandi* as part of the legal procedure, and also make sure that its findings in that matter be fully articulated in its decision.