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Recommended Citation

Royce de R. Barondes, Professionalism Consequences of Law Firm Investments in Clients: An Empirical Assessment, 39 *American Business Law Journal* 379 (2002).

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PROFESSIONALISM CONSEQUENCES OF LAW FIRM INVESTMENTS IN CLIENTS: AN EMPIRICAL ASSESSMENT

*Royce de R. Barondes**

Increasing attention has recently been focused on the financial interests in clients held by professionals participating in securities offerings. Much of the attention has addressed accountants. Recently, PricewaterhouseCoopers settled administrative charges brought by the Securities and Exchange Commission (SEC), which alleged widespread violations of rules limiting interests in firms being audited.¹ The big five accounting firms subsequently agreed with the SEC to study the extent of their compliance with then-existing rules.²

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¹ *PWC Settles SEC Charges It Violated Auditor Independence Rules*, 31 Sec. Reg. & L. Rep. (BNA) 119 (Jan. 22, 1999).

² Steve Burkholder & Phyllis Diamond, *Big Five Firms to Take Part in Voluntary Independence Program*, 32 Sec. Reg. & L. Rep. (BNA) 795 (June 12, 2000).

Most recently, the SEC adopted new rules regulating auditor independence.³

Similar questions have also, to a lesser extent, been raised concerning law firms. Although law firm interests in clients being taken public have historically been considered taboo,⁴ popular accounts indicate law firms are increasingly taking equity interests in their clients.⁵ These investments and relationships merit attention.⁶ Proper functioning of the securities markets depends in part on the reliable provision of services by professionals (lawyers, accountants, and investment banks) that assist companies in bringing to market

³ Revision of the Commission's Auditor Independence Requirements, Securities Act Release No. 7919, 65 Fed. Reg. 76,008 (Dec. 5, 2000). Recent evidence indicates the scope of non-audit services provided by accounting firms is greater than was previously recognized. Lawrence Abbott et al., *Audit, Non Audit and Information Technology Fees: Some Empirical Evidence* 12 (unpublished manuscript, on file with author), http://papers.ssrn.com/paper.taf?abstract_id=265951.

⁴ John C. Coffee, Jr., *The New Compensation*, N.Y.L.J., Mar. 16, 2000, at 5. *But see* Shawn Neidorf, *Silicon Valley Lawyers Embrace VC-Like Role*, VENTURE CAPITAL J., Oct. 1999, at 35 (stating that lawyers in the Silicon Valley area, and a few others, have invested in clients for decades).

⁵ E.g., Debra Baker, *Who Wants to Be a Millionaire?: Law Firms Investing in Hot High-Tech IPOs Are Making a Fortune, but Some Critics Worry the Stock Craze Is Clouding Ethics Matters*, A.B.A. J., Feb. 2000, at 36; Sheldon I. Banoff, *When Can Law Firms and Lawyers Accept Stock or Stock Options for Services?*, ACCT. FOR L. FIRMS, Sept. 2000, at 3; Coffee, *supra* note 4; Cornelia Wallis Honch, *Stock an Option to Attorney Fees, but Put It in Writing*, CHIL. DAILY L. BULL., Oct. 13, 2000, at 5; *see also* ABA Comm. on Ethics & Prof'l Responsibility, Formal Op. 00-418 (2000); Ass'n of the Bar of the City of N.Y. Comm. on Prof'l & Judicial Ethics, Formal Op. 2000-3 (2000), <http://www.abcnyc.org/eth2000.htm#20003>; Jason M. Klein, *No Fool For a Client: The Finance and Incentives Behind Stock-Based Compensation for Corporate Attorneys*, 1999 COLUM. BUS. L. REV. 330, 331.

Some malpractice insurance policies limit the amount of these investments. 2 RONALD E. MALLIN & JEFFREY M. SMITH, *LEGAL MALPRACTICE* 668 (5th ed. 2000).

⁶ Cf. JOSEPH S. O'FLAHERTY, *GOING PUBLIC* 59-60 (1984) ("[C]ompany counsels who own stock in ventures are placed in a confusing position. In one part of their minds they are concerned as shareholders about the value of their stock, and thus their financial involvement may distort their professional and dispassionate thinking on their clients problems."); JAMES B. ARKEBAUER & RON SCHULTZ, *GOING PUBLIC* 86 (1998) ("The strongest argument against stock as payment is the potential conflict of interest. Some company managers may question whether the advice they are receiving is in their interest or the adviser's interest These may seem extreme concerns but should not be ignored in a decision whether to offer stock for the services of legal counsel.").

their securities.⁷ Before securities are marketed, the issuer has private information. Attempts to sell a portion of the company suggest that the issuer has private, negative information,⁸ which will cause a downward adjustment in a third party's valuation of the firm.

One role played by professionals in the offering process is to certify the absence of undisclosed, negative information. This certification is, in some cases, explicit. In public offerings, an accounting firm will provide a letter, made available to the public, stating the accounting firm has performed certain procedures as part of assuring the company's financial statements have been compiled in accordance with generally accepted accounting principles.⁹ A lawyer will provide in a publicly available filing an opinion concerning the validity of the securities being sold.¹⁰ The legal environment makes these certifications valuable, by imposing potential legal liability where the

⁷ The U.S. Court of Appeals for the Second Circuit stated:

The legal profession plays a unique and pivotal role in the effective implementation of the securities laws. Questions of compliance with the intricate provisions of these statutes are ever present and the smooth functioning of the securities markets will be seriously disturbed if the public cannot rely on the expertise proffered by an attorney when he renders an opinion on such matters

. . . The public trust demands more of its legal advisers than "customary" activities which prove to be careless.

SEC v. Spectrum, Ltd., 489 F.2d 535, 541-42 (2d Cir. 1973); see also Emanuel Fields, Securities Act Release No. 5404, 1973 SEC LEXIS 2816, at *10 (June 18, 1973) ("Members of this Commission have pointed out time and time again that the task of enforcing the securities laws rests in overwhelming measure on the bar's shoulders [T]his Commission with its small staff, limited resources, and onerous tasks is peculiarly dependent on the probity and the diligence of the professionals who practice before it This is a field where unscrupulous lawyers can inflict irreparable harm on those who rely on the disclosure documents that they produce."); Marc I. Steinberg, *Corporate Counsel: Roles and Liabilities—An Essay for Professor Walter Steele*, 52 SMU L. REV. 707, 714 (1999) ("The success of our private and public capital markets is owed in large measure to the integrity and expertise of the corporate and securities bar."). See generally Robert A. Prentice, *The SEC and MDP: Implications of the Self-Serving Bias for Independent Auditing*, 61 OHIO ST. L.J. 1597, 1601 n.10 (2000) ("High-quality audits do seem to help keep management honest.").

⁸ Cf. Hayne E. Leland & David H. Pyle, *Informational Asymmetries, Financial Structure, and Financial Intermediation*, 32 J. FIN. 371, 372 (1977) ("We show that the entrepreneur's willingness to invest in his own project can serve as a signal of project quality The value of the firm increases with the share of the firm held by the entrepreneur.").

⁹ See 17 C.F.R. § 210.2-02 (2000).

¹⁰ See *id.* §§ 228.601, 229.601.

certification is not accurate.¹¹ The participation of these professionals also can provide an *implicit* certification that further mitigates potential investors' concerns with whether there is undisclosed, negative information. The professional standing of these professionals may be decreased by assisting issuers who are less than candid,¹² leading to decreased professional fees in the future. Given the importance of the professionals' services, developments in either the regulatory framework governing securities offerings or in professional practice that potentially jeopardize the fulfillment of these roles merit attention.

Certain aspects of the law firm investments have been detailed. Popular press reports law firms invest at the times investments are made by, and at the prices offered to, venture capitalists.¹³ One commentator notes:

These investments can occur in all stages of financing, but usually the lawyer purchases in the earlier financing stages when it is harder for the company to find sources of money because of the greater risk Later, when venture capitalists dominate the investor list, the lawyer purchases a smaller percentage of the financing round and eventually stops purchasing stock altogether.¹⁴

The law firm investments are, in some cases, substantial. For example, Deger notes that at the end of 1999, Wilson Sonsini Goodrich & Rosati, a California-based law firm, held stock worth \$230 million in newly-public clients, representing \$1.9 million per partner.¹⁵ The business plan of another prominent California-based

¹¹ 15 U.S.C. § 77k(a)(4) (1994); *see also infra* notes 76–91 and accompanying text.

¹² Bernard S. Black, *The Legal and Institutional Preconditions for Strong Securities Markets*, 48 UCLA L. REV. 781, 787 (2001).

¹³ Baker, *supra* note 5.

¹⁴ Gwyneth E. McAlpine, Comment, *Getting a Piece of the Action: Should Lawyers Be Allowed to Invest in Their Clients' Stock?*, 47 UCLA L. REV. 549, 552 (1999). *See generally* Kevin Miller, *Lawyers as Venture Capitalists: An Economic Analysis of Law Firms That Invest in Their Clients*, 13 HARV. J.L. & TECH. 435, 444–45 (2000) (describing as the “typical” circumstance one in which the law firm “defers its billing for the start up company, anticipating that this risk will be repaid by the profit opportunity provided by some amount of future investment in the client,” which that author distinguishes from the “stock-as-fees model”).

¹⁵ Renee Deger, *Taking Stock: Hitting the Jackpot*, RECORDER, Jan. 6, 2000, at 1.

law firm seeks greater revenue from these investments than from fee income.¹⁶

Reflecting the increased attention focused on these investments, the investments have been the subject of recent ethics opinions issued by a number of organizations. Those opinions include the American Bar Association's Committee on Ethics and Professional Responsibility,¹⁷ the Bar of the City of New York Committee on Professional and Judicial Ethics,¹⁸ the D.C. Bar Legal Ethics Committee,¹⁹ the Ethics Committee of the Mississippi Bar,²⁰ and the Utah Bar.²¹

In assessing whether these law firm investments are appropriate, it is crucial to determine whether these investments affect the legal services performed. It is therefore striking that, with the wealth of discussion these investments have received,²² the published literature has not quantitatively examined the relationship between these investments and performance of professional obligations. The law frequently has to be developed to regulate an activity where there is insufficient empirical evidence to reach a definitive conclusion. That is inherent in the nature of law.²³ Yet reliance on mere heuristic

¹⁶ *Id.* (discussing the Venture Law Group). Coffee reports one unidentified firm having investment earnings per partner of \$2 million—more than its earnings from fees. Coffee, *supra* note 4.

¹⁷ ABA Comm. on Ethics & Prof'l Responsibility, *supra* note 5 (finding no per se violation of applicable rules).

¹⁸ Ass'n of the Bar of the City of N.Y. Comm. on Prof'l & Judicial Ethics, *supra* note 5.

¹⁹ D.C. Bar Legal Ethics Comm., Op. 300 (2000), http://www.dcbar.org/attorney_resources/opin300.pdf (ownership interest as compensation for legal services not unethical per se).

²⁰ Ethics Comm. of the Miss. Bar, Mississippi Bar Op. 230 (1995), LEXIS, Ethics Library, Ethop File (finding that receipt of a fee in the form of stock does not necessarily create a conflict of interest in future representations).

²¹ Utah State Bar Ethics Advisory Comm., Op. 98-13 (1998), LEXIS, Ethics Library, Ethop File (finding the arrangement not per se unethical). Older ethics opinions include Va. State Bar Standing Comm. on Legal Ethics, Legal Ethics Op. 1593 (1994), <http://www.vacle.org/opinions/1593.TXT> (finding receipt of stock for legal services not improper per se).

²² See *supra* notes 4–5.

²³ See KARL N. LLEWELLYN, *THE BRAMBLE BUSH* 42–43 (1951) (“[A]ll our cases are decided, all our arguments are made, on certain . . . assumptions *The court must decide the dispute that is before it.* It cannot refuse because the job is hard, or dubious, or dangerous If the job is in the first instance to settle disputes which do not otherwise get settled, then the only way to do it is to do it. And it will not matter so much *how* it is done, in a baffling instance, so long as it is done at all.”).

assessments, for example, unsupported reference to the “professionalism” of lawyers,²⁴ is inappropriate, where more objective evidence can be brought to bear. This article provides, to the best of the author’s knowledge, the first empirical assessment of the consequences of these investments.

This article examines two principal hypotheses:

Hypothesis 1: Law firm investments in clients diminish the extent to which those law firms require issuers to disclose adverse information in IPO prospectuses.

Hypothesis 2: Those law firms that are willing to invest in their clients are generally less aggressive in requiring their clients, in their IPOs, to disclose adverse information in their IPO prospectuses.

To investigate these hypotheses, empirical models were prepared that examine, in a sample of recent IPOs, the change between the offer price estimated in the IPO preliminary prospectus and the actual price realized in the IPO.²⁵ The models then test whether this change in price is correlated with, among other things, the amount of equity interest the issuer’s law firm has in its client. Because this price change is, in part, a function of the due diligence performed by an issuer’s lawyer,²⁶ it provides a means for examining that due diligence and enables one to gather empirical evidence bearing on the effect of law firm investments in clients. The results suggest that law firm

²⁴ See generally Baker, *supra* note 5, at 36 (“[Edward H.] Cohen, whose [ABA] Business Law Section subcommittee plans to complete its report in coming months, says that the potential for conflicts is not a serious one.”).

²⁵ Pricing of an IPO proceeds in three phases. The first price is an estimate proposed when an investment banker is selected (commonly called the “beauty pageant” price). A second price appears in the preliminary prospectus published after some of the due diligence of the professionals involved. The actual IPO price is established on the date of issue. See *infra* notes 100–16 (detailing the pricing process). Beauty pageant prices are not systematically reported. See *infra* text preceding note 123. However the preliminary prospectus price has been used as a proxy for the beauty pageant price. See *infra* note 152 and accompanying text. Following that methodology, this article uses the prospectus price as a “proxy” for the beauty pageant price. See *infra* notes 125–32 (explaining why the prospectus price is likely to mirror the beauty pageant price). Hence, the study seeks to compare the price of the offering prior to due diligence with the price after disclosures are made.

²⁶ See *infra* notes 123–32.

investment in issuing clients may indeed reduce the amount of negative disclosure in IPO prospectuses.

The remainder of this article is structured as follows: Part I details the applicable rules of professional ethics that are implicated by these investments. In sum, those rules require the law firm be able to justify that the terms of the investment are reasonable to the client. In discussing those rules, Part I identifies certain latent concerns, not previously identified, which may materially inhibit the ability of a law firm to justify the reasonableness of the terms of its investment.

Part II examines the impact of these investments on that alignment of interests and, in particular, addresses the contours of applicable federal securities laws. Although the scholarly literature addressing these law firm investments is sparse,²⁷ one aspect that has been addressed is the extent to which these investments beneficially align the interests of a law firm and its client. Given the role fulfilled by law firms in securities offerings,²⁸ it is not clear that increasing the alignment of these interests is desirable. In particular, the incentive created by these investments can be in favor of less disclosure of negative information than is in the best interests of the client (as well as the public). The discussion in Part II demonstrates that one cannot reach a definitive conclusion of the consequences of these investments from a merely theoretical analysis. An empirical analysis can provide additional, relevant information.

The remainder of the article focuses on the empirical evidence. Part III describes the mechanics of an IPO relevant to developing an empirical assessment of the relationship between law firm investments and lawyers' performance of professional obligations. Part IV provides the details of the empirical models developed, presents the results, and considers the implications of those results, including the benefits of requiring increased disclosure of the terms of these investments. The article concludes with some reflections on the extent to which these investments can influence whether engaging a law firm that has a financial interest in its client can affect the extent to which due diligence obligations can be fulfilled by reliance on the services of that law firm.

²⁷ The relevant law review articles are Miller, *supra* note 14, Klein, *supra* note 5, and McAlpine, *supra* note 14.

²⁸ See *supra* notes 9–11 and accompanying text.

I. ETHICAL RESTRICTIONS ON LAW FIRM INVESTMENTS IN CLIENTS

Some law firm investments in clients arise from the law firm's participation in a pre-IPO round of equity financing.²⁹ Where the law firm purchases securities from its client, that transaction would be a "business transaction with a client," the propriety of which is governed by Model Rule of Professional Conduct 1.8.³⁰ Other investments by legal counsel in their clients arise from the law firm taking all or a portion of its fees in the form of securities of the client.³¹ This form of investment implicates two distinct ethical issues. First, as is the case with all fee arrangements, a fee arrangement taking this form is subject to the requirements of Model Rule of Professional Conduct 1.5 that "[a] lawyer's fee shall be reasonable."³² Second, the acquisition of a client's securities in payment of a fee also can be construed as consummating a "business transaction with a client" subject to the requirements of Rule 1.8.³³

The contours of the relevant rules are as follows:

A lawyer's fee shall be reasonable. The factors to be considered in determining the reasonableness of a fee include the following:

(1) the time and labor required, the novelty and difficulty of the questions involved, and the skill requisite to perform the legal service properly;

²⁹ See *supra* text accompanying note 14.

³⁰ MODEL RULES OF PROF'L CONDUCT R. 1.8 (1999).

³¹ *E.g.*, McAlpine, *supra* note 14, at 557. Taking securities is only one novel form of financial interest in an issuer that lawyers have sought for fees in lieu of cash. See, e.g., *Bauermeister v. McReynolds*, 571 N.W.2d 79, 83 (Neb. 1997) (fee in the form of a royalty on material delivered to a landfill), *modified*, 575 N.W.2d 354 (Neb. 1998); Ariz. Comm. on the Rules of Prof'l Conduct, Formal Op. 94-15 (1994), LEXIS, Ethics Library, Ethop File (approving the retention of a partial assignment of patent rights as a fee for prosecuting the patent); Ethics Comm. of the Miss. Bar, Mississippi Bar Op. 202 (1992), LEXIS, Ethics Library, Ethop File (allowing a contingency fee based on product sales in exchange for "use [of] the law firm to open doors to potential purchasers, and negotiate any deals and contracts regarding the sale of the new product," but strongly advising against this form of arrangement).

³² MODEL RULES OF PROF'L CONDUCT R. 1.5(a) (1999).

³³ See *infra* notes 55-56 and accompanying text. In addition, this form of arrangement might be considered a contingent fee. Ass'n of the Bar of the City of N.Y. Comm. on Prof'l & Judicial Ethics, *supra* note 5 (discussing the issue). Treating the arrangement as a contingent fee would also implicate disclosure requirements. *Id.*

- (2) the likelihood, if apparent to the client, that the acceptance of the particular employment will preclude other employment by the lawyer;
- (3) the fee customarily charged in the locality for similar legal services;
- (4) the amount involved and the result obtained;
- (5) the time limitations imposed by the client or by the circumstances;
- (6) the nature and length of the professional relationship with the client;
- (7) the experience, reputation, and ability of the lawyer or lawyers performing the services; and
- (8) whether the fee is fixed or contingent.³⁴

* * *

A lawyer shall not enter into a business transaction with a client or knowingly acquire an ownership, possessory, security or other pecuniary interest adverse to a client unless:

- (1) the transaction and terms on which the lawyer acquires the interest are fair and reasonable to the client and are fully disclosed and transmitted in writing to the client in a manner which can be reasonably understood by the client;
- (2) the client is given a reasonable opportunity to seek the advice of independent counsel in the transaction; and
- (3) the client consents in writing thereto.³⁵

As to the financial terms of the investment or fee, the burden of proving the reasonableness of the arrangement lies on the law firm.³⁶

³⁴ MODEL RULES OF PROF'L CONDUCT R. 1.5(a) (1999).

³⁵ *Id.* R. 1.8(a).

³⁶ *In re A. H. Robins Co.*, 86 F.3d 364, 374 (4th Cir. 1996) (fee agreement); *McKenzie Constr., Inc. v. Maynard*, 758 F.2d 97, 100 (3d Cir. 1985) (fee agreement); *Greene v. Greene*, 436 N.E.2d 496, 499 (N.Y. 1982) (addressing the propriety of a trust agreement under which the defendant-lawyer was a co-trustee); Ass'n of the Bar of the City of N.Y. Comm. on Prof'l & Judicial Ethics, *supra* note 5 (addressing the issue in the context of discussing the requirement that fees be reasonable); RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 42 (1998), LEXIS, 2ndary Library, Lawgv1 File; 2 MALLIN & SMITH, *supra* note 5, at 643-45, 661 (addressing investments in clients and other contracts between counsel and client). *Contra* *Jacobs v. Holston*, 434 N.E.2d 738, 741 (Ohio Ct. App. 1980) (not placing the burden on the attorney to demonstrate the reasonableness of a fee arrangement entered into before the representation begins).

Anderson and Steele assert that, in practice, meeting this burden is particularly difficult for lawyers, compared with the corresponding burden imposed at common law on other fiduciaries who contract with clients. Roy Ryden Anderson & Walter W. Steele, Jr., *Ethics and the Law of Contract Juxtaposed: A Jaundiced View of Professional Liability Considerations in the Attorney-Client Relationship*, 4 GEO. J. LEGAL ETHICS 791, 793, 800-04 (1991).

This article will not attempt to distinguish between the "reasonableness" test of Rule 1.5 and the "fair and reasonable" requirements of Rule 1.8.³⁷

Various circumstances may make it difficult, however, for a law firm to fulfill its burden of proving the reasonableness of the terms of its investment.³⁸ To confirm the reasonableness of the arrangement, a law firm would need to reference either a market price for the securities in question or some substitute for a market price. Where the client has not previously consummated an IPO, there almost invariably will not be a public market in the securities the law firm acquires.³⁹

Paying professional fees, in whole or in part, with securities has become increasingly common.⁴⁰ That increases the likelihood that this form of benchmark transaction will be available for purposes of valuing securities acquired by a law firm from its client. However, the value of the services provided by another professional may not be subject to easy determination. Where that is the case, those transactions do not assist in assessing the value of law firm investments.

³⁷ In addition to the referenced ethical principles, a transaction between a client and a lawyer could be subject to scrutiny under common law fiduciary principles. McAlpine, *supra* note 14, at 559–61. For purposes of this examination, no distinction will be drawn between the various applicable tests of fairness, although there might be one in practice. See *infra* note 47.

³⁸ See generally D.C. Bar Legal Ethics Comm., *supra* note 19, at 4 n.3 (2000) ("Where the stock received by the lawyer is not publicly traded, its value at the time it is transferred to the lawyer may be difficult to determine, a factor that may further complicate the Rule 1.5(a) analysis.").

³⁹ Occasionally, a public market could develop for such an issuer's securities. That trading would be in securities previously issued in a private placement that had been held for a sufficient time so that the initial investor no longer could be considered an underwriter under section 2 of the Securities Act of 1933, 15 U.S.C. § 77b(a)(11) (1994), on the resale of the securities. In the ordinary circumstance, however, there would be no public market for the securities acquired by a law firm from a client that had not previously consummated an IPO.

⁴⁰ Compare Cindy Krischer Goodman, *Stock Becoming Payment of Choice for Professionals Servicing Dot-coms*, MIAMI HERALD, May 16, 2000, available at LEXIS, News Library, Allnews File (stating that consultants, accountants, recruiters, public relations firms and advertising agencies are taking fees in the form of stock), and Jerry Useem, *New Ethics or No Ethics? Questionable Behavior Is Silicon Valley's Next Big Thing*, FORTUNE, Mar. 20, 2000, at 82 (stating that consulting firms are taking fees in the form of equity and executive search firms are taking interests in their clients), with Miller, *supra* note 6, at 445 (asserting "other service providers or suppliers" do not acquire equity interests).

Alternatively, one might look to sales of securities in prior rounds of pre-IPO equity financing.⁴¹ It would appear that, were recent sales made, they could provide an appropriate benchmark for valuing securities sold to a law firm.

Various factors, however, can make those sales not comparable. In particular, finance research indicates a venture capital investment provides a benefit over and above the money conveyed to the firm in which the investment is made. The investment by a venture capital firm conveys information about the firm in which the investment is made—a positive assessment of an investment in the firm. In sum, the investment represents an implicit certification. Disclosing this investment to other potential investors can decrease future costs of raising capital. Thus, for example, Megginson and Weiss find “underpricing” is reduced where a venture capitalist has an investment in the firm.⁴²

“Underpricing” refers to the difference between the price at which stock is sold to the public in an IPO and the market price shortly thereafter.⁴³ The well-documented average difference, on the order of fifteen percent,⁴⁴ represents a cost to a firm selling stock in an IPO. The findings of Megginson and Weiss—that venture capital backing reduces IPO underpricing—indicate venture capital firms provide benefits by investing over and above their capital contributions and any other networking (beneficial access to partners) or similar services they provide. The venture capital investment provides some certification to prospective investors who therefore need less compensation, in the form of purchasing below the market price, to make an investment.

⁴¹ See 2 MALLIN & SMITH, *supra* note 5, at 665 (suggesting that adjustment may be required where the benchmark transaction occurred more than three months before the law firm’s investment).

⁴² William L. Megginson & Kathleen A. Weiss, *Venture Capitalist Certification in Initial Public Offerings*, 46 J. FIN. 879, 880 (1991).

⁴³ E.g., Richard Carter & Steven Manaster, *Initial Public Offerings and Underwriter Reputation*, 45 J. FIN. 1045, 1045 (1990).

⁴⁴ See Roger G. Ibbotson, *Price Performance of Common Stock New Issues*, 2 J. FIN. ECON. 235 (1975) (11.4%); Robert E. Miller & Frank K. Reilly, *An Examination of Mispricing, Returns, and Uncertainty for Initial Public Offerings*, FIN. MGMT., Summer 1987, at 33, 34, 38 (9.9%); Jay R. Ritter, *The Long-Run Performance of Initial Public Offerings*, 46 J. FIN. 3 (1991) (16.4%). These price changes are occasionally much larger. E.g., Baker, *supra* note 5 (noting a 698% one-day return for one IPO).

A law firm does not necessarily provide the identical certification "service" when it takes an investment in a client, whether in exchange for legal services or for cash.⁴⁵ This fact affects the utility of the value of an investment by a venture capitalist as a benchmark for value of a law firm investment. If the law firm is purchasing securities for cash at the same time, and at the same price, as a venture capital firm, the law firm is providing only part of the consideration the venture capital firm provides. Therefore, one could argue the law firm is, by definition, acquiring a better-than-market price.

For example, if a venture capital firm pays \$10 per share in a pre-IPO round of equity financing, the value of the venture capitalist's certification indicates the issuer is receiving something more than \$10 per share in consideration. The transaction thus indicates the shares are worth *more* than \$10 each. One therefore cannot ascertain the value received by a *law firm*, in exchange for legal services or a cash investment, by multiplying the number of shares acquired by \$10. That calculation understates the value being received by the law firm.

For a variety of reasons, then, it may be difficult for a law firm to use terms of securities sales to other firms to form a basis for determining the reasonableness of the terms of their transactions in securities of a client. Assessing the reasonableness of a law firm's investment in its client is further complicated by two additional factors: the time-frame at which the reasonableness of the arrangement is assessed and the consequences of illiquidity of the securities acquired. The reasonableness of an investment in a client can be measured as of the time of the investment or as of some later time. At times, market prices of stock sold in an IPO have risen dramatically following the IPO.⁴⁶ Thus, an *ex post* valuation of the consideration received by the law firm may change whether one views the arrangement as fair to the client.

⁴⁵ One might argue that law firms provide the same type of certification as venture capital firms. See Miller, *supra* note 6, at 450 ("Venture capitalists then use these law firms as filters to establish a client's 'trustworthiness.'"). There is no basis, however, for concluding the magnitude of the effect—the value of the certification—is the same for law firms. Moreover, the size of a typical law firm investment is substantially smaller than that of a typical venture capital investment. McAlpine, *supra* note 14, at 590; see Miller, *supra* note 14, at 441 (noting that a prominent firm's investment is "typically less than 1% of the total equity"). It is not at all clear that any "certification" relationship would be linear. For example, an investment of \$20,000 might provide no certification, whereas an investment of \$2 million could.

⁴⁶ See *supra* note 44.

The ABA's Standing Committee on Ethics and Professional Responsibility and the Committee on Professional and Judicial Ethics of the New York City Bar have concluded the valuation is to be made as of the time of the investment.⁴⁷ Were increases in stock value predictable as of the time of the investment, however, those expected increases would have to be included in an ex ante assessment of the reasonableness of the arrangement to the client.

There is, however, modest authority in a related area in favor of the ex post approach, which would make the arrangement more difficult to justify. In assessing the propriety of conflicts of interest between a lawyer and his client, there is some authority that suggests unanticipated events can give rise to ethical violations.⁴⁸

Lastly, a law firm's investment frequently will take the form of restricted securities, securities that cannot be freely resold without registration under the Securities Act of 1933 (1933 Act) or the availability of an exemption from those registration requirements.⁴⁹

⁴⁷ ABA Comm. on Ethics & Prof'l Responsibility, *supra* note 5; Ass'n of the Bar of the City of N.Y. Comm. on Prof'l & Judicial Ethics, *supra* note 5 (concluding that spectacular increases in value could be justified on the basis of riskiness of the investment); *see also* D.C. Bar Legal Ethics Comm., *supra* note 19, at 6 n.5 (but expressly leaving open the possibility an ex post valuation would be proper in assessing compliance with common law fiduciary duties); Klein, *supra* note 5, at 336 (concluding that the valuation should be made as of the time the interest is acquired).

⁴⁸ *See* Ethics Comm., N.H. Bar Ass'n, Formal Ethics Op. 1992/93-12 (1993), LEXIS, Ethics Library, Ethop File ("The attorney should ask himself or herself whether, if a disinterested lawyer were to look back at the inception of this representation once something goes wrong, would that lawyer seriously question the wisdom of the first attorney's requesting the client's consent to this representation or question whether there had been full disclosure to the client prior to obtaining the consent.").

⁴⁹ Unless the securities had been acquired in a registered offering, they would be restricted. 17 C.F.R. § 230.144(a)(3)(i), (b) (2000) (providing that persons selling restricted securities in compliance with that rule will not be considered "underwriters" and including in the definition of restricted securities "[s]ecurities acquired directly or indirectly from the issuer, or from an affiliate of the issuer, in a transaction or chain of transactions not involving any public offering"). *See generally* Miller, *supra* note 14, at 457 (asserting that illiquidity of restricted securities, coupled with insider trading rules, will eliminate profit potential, a view that may have had more force under the former two-year holding period applicable to sales under Rule 144, 17 C.F.R. § 230.144, that Miller erroneously references, a period which was shortened to one year in 1997, by Revision of Holding Period Requirements in Rules 144 and 145, Securities Act Release No. 7390, 62 Fed. Reg. 9242, 9242 (Feb. 28, 1997)). A client ordinarily would not undertake registering the sale, and thereby become a public company, subject to the reporting requirements of the Securities Exchange Act of 1934, 15

Other restrictions may be imposed by contract. It is customary in an IPO for various shareholders to agree that, unless they receive the consent of the investment bank that manages the IPO, they will not resell the securities for some period of time following the IPO.⁵⁰

A security's value is affected by the liquidity of the security.⁵¹ Although attempts to quantify the effect produce widely varying results, the impact can be significant. For example, Bajaj et al. find a seven percent decrease in value attributable to shares being issued by a firm that is not public.⁵² They further collect estimates for liquidity discounts prepared by others that range up to forty-five percent or more, depending on the methodology used.⁵³

One could argue that, in assessing the value of the property received by the law firm, liquidity restrictions should be ignored,⁵⁴ which would increase the value of property received by the law firm. The question is one of perspective. Illiquidity adversely affects the holder—it prevents the holder from realizing on the value of the investment. But it does not to the same degree decrease the value of all the rights the issuer has relinquished. By delivering securities, an issuer delivers voting rights and rights to participate in declared

U.S.C. §§ 78a–78mm (1994 & Supp. V 1999), merely to provide unrestricted securities to its counsel.

⁵⁰ CHARLES J. JOHNSON, JR. & JOSEPH McLAUGHLIN, *CORPORATE FINANCE AND THE SECURITIES LAWS* 89 (2d ed. 1997) (stating that the typical period is between ninety and 180 days).

⁵¹ Accounting Series Release No. 113, Investment Company Act Release No. 5847, 35 Fed. Reg. 19,989, 19,990 (Dec. 31, 1970) (“[S]ecurities which cannot be readily sold in the public market place are less valuable than securities which can be sold”); Rockies Fund, Initial Decisions Release No. 181, 2001 SEC LEXIS 443, at *71 (Mar. 9, 2001) (finding that section 10(b), 15 U.S.C. § 78j(b), and Rule 10b-5, 17 C.F.R. § 240.10b-5, had been violated by misrepresentations that securities owned were unrestricted, and stating that “except for the most unusual situations, restricted securities and unrestricted securities have different values”); Mates Fin. Servs., Exchange Act Release No. 8836, 1970 SEC LEXIS 375, at *17 (Mar. 9, 1970) (“The valuation of restricted securities at the market quotations for unrestricted securities of the same class, or at slight discounts from such quotations, is improper except in most unusual circumstances”).

⁵² Mukesh Bajaj et al., *Firm Value and Marketability Discounts* 33 (Feb. 25, 2001) (unpublished manuscript, on file with author), http://papers.ssrn.com/paper.taf?abstract_id=262198.

⁵³ *Id.* at 8 tbl.1.

⁵⁴ *But see* Utah State Bar Ethics Advisory Comm., *supra* note 21 (stating that liquidity restrictions should be considered in determining whether a fee paid in the form of securities is reasonable).

dividends. The cost to the issuer of delivering these rights—the diminution of existing securityholders' voting rights and rights to participate in future dividends—is not affected by illiquidity of securities acquired by counsel. In sum, liquidity restrictions are “negative sum”—the cost imposed on the holder does not fully inure to the benefit of the issuer.

The perspective provided by the ethical rules is whether an arrangement is reasonable to the client—not whether the arrangement is reasonable to the law firm. Because some of the cost to an issuer of delivering securities does not depend on their liquidity, one can plausibly argue liquidity discounts should not be applied in valuing equity interests acquired by law firms for purposes of compliance with ethical mandates.

This part has shown there are various difficulties a law firm will have in meeting its burden of proving the reasonableness of the terms of its investment in a client. Those difficulties arise from the absence of comparable transactions and questions concerning whether a law firm can decrease the value it ascribes to securities it receives based on the illiquidity of the securities. In practice, then, law firms may have difficulty in complying with applicable ethical principles when they make these investments.

The applicable ethical principles also may require certain disclosure, which may either be difficult for a law firm to provide or may be easy to overlook. Rule 1.8 requires full disclosure of the terms of the transaction.⁵⁵ It is not clear whether the taking of a fee in the form of the client's securities is a “business transaction with a client” governed by Rule 1.8. The authority seems to confirm that it is.⁵⁶ If so, those investments would be subject to Rule 1.8, even when made as part of a fee arrangement.

An examination of the financial incentives arising from a law firm's investment in a client indicates these investments may foster divergent

⁵⁵ MODEL RULES OF PROF'L CONDUCT R. 1.8(a) (1999).

⁵⁶ See *Bauermeister v. McReynolds*, 571 N.W.2d 79, 89 (Neb. 1997), *modified*, 575 N.W.2d 351 (Neb. 1998); ABA Comm. on Ethics & Prof'l Responsibility, *supra* note 5; Ass'n of the Bar of the City of N.Y. Comm. on Prof'l & Judicial Ethics, *supra* note 5; D.C. Bar Legal Ethics Comm., *supra* note 19, at 4–5; Ethics Comm. of the Miss. Bar, *supra* note 20; Utah State Bar Ethics Advisory Comm., *supra* note 21; GEOFFREY C. HAZARD, JR. & W. WILLIAM HODES, *THE LAW OF LAWYERING* § 1.8:202 (2d ed. 1990 & Supp. 1998); 2 MALLIN & SMITH, *supra* note 5, at 664.

incentives. If so, a thorough disclosure required by Rule 1.8 could require disclosure of these potentially conflicting interests. Part II details those divergent incentives.

II. ALIGNMENT OF INCENTIVES

Although law firm investments in clients have received little attention in scholarly legal publications, one of the aspects that has been addressed is the effect of these investments on the alignment of a law firm's interests with those of its clients. It has been argued that permitting these investments may increasingly align the interests of counsel with those of their clients.⁵⁷

This argument is one example of the substantial literature addressing the desirability of aligning an agent's incentives with those of his principal.⁵⁸ Assessing the extent to which investments in clients

⁵⁷ Miller, *supra* note 14, at 442-43; Klein, *supra* note 5, at 355 ("Allowing a lawyer to hold equity or equity-related claims on their clients may actually improve the lawyer's economic incentives to fulfill these fiduciary duties."); McAlpine, *supra* note 14, at 575-77. It also has been argued these arrangements facilitate law firm provision of necessary, non legal services, for example, the provision of access to a network of other professionals. McAlpine, *supra* note 14, at 575; *see also* Miller, *supra* note 14, at 451 (discussing increased monitoring arising from lawyers who have financial interests acting as directors). Where the client has the ability to pay in cash, the same services could be provided by a law firm that billed on an hourly basis. There is always judgment exercised in assessing whether time spent can properly be billed to a client. By appropriately adjusting the hourly rate and the activities for which the client is billed, these services can be provided on a compensated basis without requiring that the law firm receive an equity interest in its client. In the case of services provided in the capacity as a director, that type of service is one that has been provided long before these equity stakes became common.

⁵⁸ For example, Elson argues in favor of payment of directors' fees in the form of restricted stock, to align the interests of corporate directors with those of the owners (the shareholders). Charles M. Elson, *Executive Overcompensation—A Board-Based Solution*, 34 B.C. L. REV. 937, 944 (1993). *See generally* Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976) (providing a seminal analysis of agency costs and the theory of the firm). Fox examines section 16 of the Securities Exchange Act of 1934, 15 U.S.C. § 78p, and argues that it reduces "the attractiveness of management share ownership and share-price-based compensation and detracts from their effectiveness as methods of reducing agency costs." Merritt B. Fox, *Insider Trading Deterrence Versus Managerial Incentives: A Unified Theory of Section 16(b)*, 92 MICH. L. REV. 2088, 2201 (1994). Curran and Schrag find a change in the law that increased the frequency in which selling real estate agents represented buyers was associated with a significant decline in the prices of expensive houses in one metropolitan area. Christopher Curran & Joel Schrag, *Does It Matter Whom an Agent Serves? Evidence from Recent Changes in Real Estate Agency Law*, 43 J.L. & ECON. 265, 265 (2000). Frierman and Viswanath address the extent to which the

properly align a law firm's incentives, however, is complex. Initially, one has to ascertain whose interests should be promoted. Formally, a law firm's principal is its client.⁵⁹ But that does not end the inquiry; one might view the lawyer's role as requiring the interests of the investing public also be considered.⁶⁰

use of convertible debt securities can reduce the "overinvestment" problem—undertaking riskier projects in lieu of less risky ones with a higher expected value, because much of the risk is allocated to creditors, whereas much of the potential gains will accrue to equityholders. Michael Friedman & P.V. Viswanath, *Agency Problems of Debt, Convertible Securities, and Deviation from Absolute Priority in Bankruptcy*, 37 J.L. & ECON. 455, 455 (1994).

⁵⁹ E.g., CHARLES W. WOLFRAM, *MODERN LEGAL ETHICS* 146 (student ed. 1986).

⁶⁰ Robert W. Emerson, *Rule 2(e) Revisited: SEC Disciplining of Attorneys Since in re Carter*, 29 AM. BUS. L.J. 155, 173–88, 243 (1991) (describing securities lawyers as a "christened 'auxiliary police force' for the SEC"); Ronald J. Gilson, *The Devolution of the Legal Profession: A Demand Side Perspective*, 49 MD. L. REV. 869, 884 (1990) ("The lawyer functions 'as a kind of buffer between the illegitimate desires of his clients and the social interest.'") (quoting Talcott Parsons, *A Sociologist Looks at the Legal Profession*, in *ESSAYS IN SOCIOLOGICAL THEORY* 370, 384 (rev. ed. 1954)); Robert W. Gordon, *Corporate Law Practices as a Public Calling*, 49 MD. L. REV. 255, 258 (1990) ("The ideal of law as a public profession thus conceived supposes that lawyers will develop some vision of the common good or public interest, and try to realize it in their practices, if necessary against the immediate wishes of their clients."); Ann Maxey, *SEC Enforcement Actions Against Securities Lawyers: New Remedies vs. Old Policies*, 22 DEL. J. CORP. L. 537, 537–38 (1997) [hereinafter Maxey, *SEC Enforcement Actions*] ("Lawyers are responsible to the public even while they owe their primary duty of loyalty to the client."); Ann Maxey, *Competing Duties? Securities' Lawyers Liability After Central Bank*, 64 FORDHAM L. REV. 2185, 2186 (1996) [hereinafter Maxey, *Competing Duties*] ("In serving their unique function, lawyers owe a primary obligation to their clients, but they also assume responsibilities to the society that is the source of their authority."); Richard W. Painter, *The Moral Interdependence of Corporate Lawyers and Their Clients*, 67 S. CAL. L. REV. 507, 520–35 (1994) (discussing corporate lawyers' possible duties to constituencies other than their clients); Harlan F. Stone, *The Public Influence of the Bar*, 48 HARV. L. REV. 1, 8 (1934) ("Even the lawyer's devotion to the interests of his clients is a manifestation of a selfless loyalty to an ideal, though it may not always be seen in true perspective in relation to the public interest which it is also his duty to serve."). *Contra* J. Gordon Cooney, *The Registration Process: The Role of the Lawyer in Disclosure*, 33 BUS. LAW. 1329, 1332–37 (rejecting the view that lawyers owe duties to a broader constituency). See generally *Barker v. Henderson*, Franklin, Starnes & Holt, 797 F.2d 490, 497 (7th Cir. 1986) ("The extent to which lawyers and accountants should reveal their clients' wrongdoing—and to whom they should reveal—is a question of great moment. There are proposals to change the rules of legal ethics and the SEC's regulations governing accountants. The professions and the regulatory agencies will debate questions raised by cases such as this one for years to come. We express no opinion on whether the Firms did what they should, whether there was malpractice under state law, or whether the rules of ethics (or other fiduciary doctrines) ought to require lawyers and accountants to blow the whistle in equivalent circumstances. We are satisfied, however, that

As noted above,⁶¹ effective securities markets depend on the proper functioning of various independent professionals. Although formally a law firm's principal is the client, because the proper functioning of the securities markets depends on the proper performance by lawyers of their duties, the investing public is at least an interested party in an evaluation of the propriety of the law firm's conduct in a public offering.

In some circumstances, it may be (or appear to be) profitable for the individuals managing a company to have the firm engage in securities fraud. One role of a corporate law firm is to require disclosure in securities offerings of information that may adversely affect the value of its client's securities.⁶² A review of applicable federal securities laws indicates law firm investments in clients can create financial incentives for the respective law firms to suppress

an award of damages under the securities laws is not the way to blaze the trail toward improved ethical standards in the legal and accounting professions. Liability depends on an existing duty to disclose. The securities law therefore must lag behind changes in ethical and fiduciary standards. The plaintiffs have not pointed to any rule imposing on either Firm a duty to blow the whistle.”); Donald C. Langevoort, *Where Were the Lawyers? A Behavioral Inquiry into Lawyers' Responsibility for Clients' Fraud*, 46 VAND. L. REV. 75, 78 (1993) (“On one hand (and to an accelerating degree) the profession and the law demand loyalty to clients and respect for even their dark confidences. At the same time, an attorney's loyalty is subject to the overriding general norm, in both ethics and law, that lawyers must not knowingly give substantial assistance to client fraud. This Article considers the possibility that this general norm has been undermined sufficiently that, at least implicitly, loyalty emerges as the dominant justification, thus providing a basis for lawyers to rationalize continued involvement.”); Arnold W. Messer, *Role and Reasonable Expectations of the Underwriter, Lawyer and Independent Securities Auditor in the Efficient Provision of Verified Information: “Truth in Securities” Reinforced*, 52 NEB. L. REV. 429, 446–58 (1973) (discussing whether a lawyer should have a duty to investors); Marshall L. Small, *An Attorney's Responsibilities Under Federal and State Securities Laws: Private Counselor or Public Servant?*, 61 CAL. L. REV. 1189, 1208, 1213–28 (1973) (noting the tension between a lawyer's obligation to require disclosure of material, negative information and the financial interest of his client and discussing a law firm's liability to the investing public); Stone, *supra*, at 7 (“Steadily the best skill and capacity of the profession has been drawn into the exacting and highly specialized service of business and finance. At its best the changed system has brought to the command of the business world loyalty and a superb proficiency and technical skill. At its worst it has made the learned profession of an earlier day the obsequious servant of business, and tainted it with the morals and manners of the market place in its most anti-social manifestations.”).

⁶¹ See *supra* notes 7–12 and accompanying text.

⁶² See generally Cooney, *supra* note 60, at 1330, 1335–37 (describing the process).

disclosure of certain material, negative information.⁶³ Where the financial incentives of a law firm conflict with the fulfillment of its professional obligations, it can be ineffectual to rely on professionalism of lawyers to cause lawyers to disregard their financial incentives and fulfill expectations of the investing public.⁶⁴ The details of those incentives follow.

A. Issuers' Liability

Federal securities laws impose incentives on an issuer to be truthful in describing its financial position. Section 11 of the 1933 Act (section 11) imposes liability on an issuer that sells securities in an IPO registered by a registration statement that contains a false or misleading prospectus.⁶⁵ The liability is "strict"—the issuer does not

⁶³ Klein addresses incentives arising in the representation of a takeover target. Klein, *supra* note 5, at 355–56. He notes that an investment in a client can diminish the incentive to derail the acquisition in order to continue receipt of legal fees. *Id.* Klein, who does not detail the source of divergent incentives discussed below, *see infra* pp. 399–407, notes the incentives may be misaligned, but dismisses the impact of any misalignment, stating, "[T]hey do not appear to be any more significant than they are in the contingent fee setting." Klein, *supra* note 5, at 352–53. *See generally* Maxey, *Competing Duties*, *supra* note 60, at 2228–29 ("A disclosure duty does not necessarily serve the interests of the public. The integrity of the securities issuance process may be undermined by lawyers who abandon their clients at the first hint of trouble. Lawyers who desert too quickly their misguided but honest clients may harm the public's interests. Most clients want to comply with disclosure laws, but want to do so in a way that does not harm perceived interests of the issuer—e.g., disclosure of information useful to competitors; premature release of information that will cause the stock price to rise or fall; and premature release of news that hurts employee morale. . . . Clients also have a legitimate interest in obtaining a second opinion in difficult judgment situations. Lawyers should not be required to protect themselves from liability by abandoning too quickly a client that appears to be acting in good faith.").

⁶⁴ *See* Prentice, *supra* note 7, at 1604–53 (collecting empirical evidence of a self-serving bias from numerous studies in various contexts). *But see* Steinberg, *supra* note 7, at 708 ("At times, counsel may be pushed by her clients to short-circuit due diligence or to draft less than full disclosure documents. The presence of counsel to withstand this pressure is a matter that business attorneys must face with some frequency. Yet the fabric of the American capitalist system is interwoven with the lawyer's professionalism to stand firm when so confronted." (footnotes omitted)).

⁶⁵ 15 U.S.C. § 77k(a) (1994). In particular, that section creates a cause of action against an issuer, where the registration statement "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.*

have a due diligence defense.⁶⁶ False or misleading offering documents could also result in an issuer's liability under Rule 10b-5 (Rule 10b-5),⁶⁷ liability under which requires proof of scienter.⁶⁸ The statute of limitations requires that a lawsuit asserting violation of section 11 be brought within three years of the offering date.⁶⁹ A similar statute of limitations applies to private actions under Rule 10b-5.⁷⁰ The length of these statutes of limitations gives rise to incentives that vary between an issuer and investors.

The contours of this liability remove most of the possible financial return to an *issuer* itself for engaging in fraud in the offering of securities. Substantial remedies are available to purchasers. The remedies are imperfect, as is frequently the case with legal remedies. Fraud that goes undetected for more than three years, which one would suppose not to be common, may be profitable. Problems of proof may prevent an otherwise meritorious lawsuit from succeeding. And the computation of damages may be imperfect to remove all incentive for an issuer to engage in fraud in the offering of securities.

Damages under section 11, for example, for one who purchases in the offering and holds the securities equal the difference between the purchase price and the value at the time the lawsuit was commenced, less the amount proved by the defendant to be attributable to factors other than the registration statement being misleading.⁷¹ Consider an offering at \$10 per share. Assume the registration statement includes a material misstatement, and, if the truth had been revealed, the offering price would have been \$9 per share. By the time the lawsuit is filed, the market as a whole has increased by eleven percent. So, the stock is trading at \$10, representing an eleven percent increase over the actual value of the stock at the time of the offering. No damages can be recovered under section 11.

But the relationship is asymmetric, as the issuer need not pay damages attributable to market declines. This asymmetry allows for

⁶⁶ See *id.* § 77k(b) (excluding the issuer from those persons who can assert a due diligence defense under paragraph (b)).

⁶⁷ 17 C.F.R. § 240.10b-5 (2000).

⁶⁸ *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 (1976).

⁶⁹ 15 U.S.C. § 77m (Supp. V 1999). The statute of limitations may terminate earlier, depending on the date the violation should have been discovered. *Id.*

⁷⁰ *Lampf, Pleva, Lipkind, Propp & Petigrow v. Gilbertson*, 501 U.S. 350, 364 (1991).

⁷¹ 15 U.S.C. § 77k(e).

an incentive, albeit modest, before considering litigation costs, not to disclose fully all material information.⁷²

Computation of damages under Rule 10b-5 is more complex.⁷³ As liability under that rule requires proof of scienter, however, that rule also will not prevent fraud in securities offerings from having a positive expected value (before considering litigation costs).

Together, section 11 and Rule 10b-5 eliminate much of the incentive that would otherwise exist for an issuer to be less than fully candid in IPO disclosure. The remedies are not perfect. Nevertheless, when one also considers the cost of litigation, these provisions would seem essentially to eliminate the value to the issuer of providing less-than-complete disclosure in an IPO. The same cannot be said, however, for those who have invested in the issuer.

B. Law Firm Liability

Neither section 11 nor Rule 10b-5 generally allows one who has a viable cause of action to pierce the corporate veil. There are some exceptions. Most notably, a person who controls an issuer is also liable for a violation by the issuer of section 11 or Rule 10b-5, subject to certain defenses.⁷⁴ But, in general, the loss imposed on a

⁷² One commentator, however, suggests that, in some circumstances, aggregate per share damages in a class action lawsuit could exceed the difference between the offering price and the price at the time a class action lawsuit is commenced. Paul Grier, *A Methodology for the Calculation of Section 11 Damages*, 5 STANFORD J.L. BUS. & FIN. 99, 119 (1999). That result requires that the security value at some time between the offer date and the date the lawsuit is filed is less than the value at the time the lawsuit is filed. *Id.* This circumstance may partially mitigate the consequences of the asymmetry discussed in the text.

⁷³ See, e.g., Lewis D. Lowenfels & Alan R. Bromberg, *Compensatory Damages in Rule 10b-5 Actions: Pragmatic Justice or Chaos?*, 30 SETON HALL L. REV. 1083, 1083-84 (2000) ("Damage awards in private actions under section 10(b) of the Securities Exchange Act of 1934 . . . and Securities and Exchange Commission . . . Rule 10b-5 promulgated thereunder may be either an area where flexibility, pragmatism, and justice prevail or 'a confused area of the law where the courts, forced to rely on their own wits, have created a myriad of approaches.' Or perhaps both descriptions are accurate and together render a more complete description of the state of the law of compensatory damages under Rule 10b-5. The reader will have to judge for himself. In any event, there is no clear rule guiding the measure of damages under Rule 10b-5 and hence little predictability for counsel or the client." (footnotes omitted)).

⁷⁴ 15 U.S.C. §§ 77o, 78t(a) (1994). See generally Lewis D. Lowenfels & Alan R. Bromberg, *Controlling Person Liability Under Section 20(a) of the Securities Exchange Act and Section 15 of the Securities Act*, 53 BUS. LAW. 1, 1 (1997) (discussing control person liability and stating, "After the U.S. Supreme Court decision in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver*,

shareholder for a disclosure violation arises from the decrease in the value of his interest in the issuer. If a holder of securities at the time of a disclosure violation sells those securities before the disclosure violation becomes public, it is very unlikely the securityholder will ever bear the cost of the violation.

A law firm having an equity investment in its client has a different time horizon from its client. Some information, if not disclosed in offering documents, will become public shortly thereafter, e.g., at the end of the current fiscal quarter. As to that information, the incentives created by an investment in a client are aligned with those of the client. But as to information that would become public, absent disclosure in the offering documents, within three years of the offering but after any transfer limitations on the securities in the hands of a law firm would expire,⁷⁵ an investment by a law firm creates incentives different from those of the principal. The law firm would have an incentive, not shared by the issuer, to postpone disclosure and sell the securities in the market as soon as possible.

This strategy for a law firm is not entirely riskless. There is a theoretical possibility that a law firm would be held responsible for inadequate disclosure in offering documents it participated in preparing.⁷⁶ A law firm cannot be liable under section 11, other than for portions of the prospectus included on the authority of the law

N.A., . . . it is reasonable to expect more emphasis on private actions involving control person liability within federal law and similar state law.”). A defense is available to the controlling person, which varies between the two statutes. The control person is not liable under section 11 if he had no reason to know of the violation. 15 U.S.C. § 77o. The control person has no liability under Rule 10b-5 if he acted in good faith and did not directly or indirectly induce the violation. 15 U.S.C. § 78t(a).

A law firm's mere “ability to influence” a primary violator's conduct has been held insufficient, as a matter of law, to constitute control. *Wenneman v. Brown*, 49 F. Supp. 2d 1283, 1290 (D. Utah 1999). Cox, however, asserts, “Even lawyers, with sufficient involvement, can be control persons of their client corporation and its officers.” James D. Cox, *Just Deserts for Accountants and Attorneys After Bank of Denver*, 38 ARIZ. L. REV. 519, 534 n.80 (1996).

⁷⁵ See *supra* note 50 and accompanying text.

⁷⁶ See generally Richard W. Painter & Jennifer E. Duggan, *Lawyer Disclosure of Corporate Fraud: Establishing a Firm Foundation*, 50 SMU L. REV. 225, 239 (1996) (stating that only a small percentage of the law firms practicing in the securities area have been named as defendants in “high profile” securities litigation).

firm as an expert.⁷⁷ That is usually limited to the description of the validity of the securities issued⁷⁸ and any description of the tax consequences of acquiring the security or certain other unusual descriptions of legal matters, *e.g.*, descriptions of certain applicable regulations.⁷⁹ A law firm also normally would not be liable under section 12 of the Securities Act of 1933,⁸⁰ as it would not normally be one who “offered” or “sold” securities.⁸¹

A law firm might conceivably be liable to purchasers under Rule 10b-5. There is some empirical evidence sketching the scope of attor-

⁷⁷ See 15 U.S.C. § 77k(a) (1994) (not listing law firms as liable parties, other than as experts); see generally *Herman & MacLean v. Huddleston*, 459 U.S. 375, 387 n.22 (1983) (“Moreover, certain individuals who play a part in preparing the registration statement generally cannot be reached by a Section 11 action. These include corporate officers other than those specified in 15 U.S.C. § 77k(a), lawyers not acting as ‘experts,’ and accountants with respect to parts of a registration statement which they are not named as having prepared or certified.”); *Kitchens v. United States Shelter*, No. 82-1951-1, 1988 U.S. Dist. LEXIS 18,546, at *116 (D.S.C. June 30, 1988); *Escott v. BarChris Constr. Corp.*, 283 F. Supp. 643, 683 (S.D.N.Y. 1968) (“To say that the entire registration statement is expertised because some lawyer prepared it would be an unreasonable construction of the statute.”). An individual lawyer who represented the issuer and who also was a director of the issuer, however, could be liable under section 11 arising from his capacity as a director. 15 U.S.C. § 77k(a).

⁷⁸ See 9 LOUIS LOSS & JOEL SELIGMAN, *SECURITIES REGULATION* 4260 n.160 (3d ed. 1992) (stating that an opinion sometimes addresses “a variety of other questions, like validity of a title or a patent”); James H. Cheek, III, *Counsel Named in a Prospectus*, 6 REV. SEC. REG. 939, 942-43 (1973) (“[I]t is likely that a court would hold counsel to be an ‘expert’ in the Section 11 sense with respect to his conclusions and statements as to the legality of the securities being sold, and as to such matters as tax consequences or patent validity.”); Painter & Duggan, *supra* note 76, at 242 (identifying due incorporation, corporate authority, and tax consequences as matters typically addressed in legal opinions included or referenced in registration statements); Small, *supra* note 60, at 1192-93 (arguing that a lawyer is an expert for purposes of the validity of securities offered). But see Messer, *supra* note 60, at 455 (“The lawyer is not an ‘expert’ for section 11 liability purposes.”). Maxey notes that liability risk on the legality opinion is small. Maxey, *Competing Duties*, *supra* note 60, at 2188 n.9.

⁷⁹ See Painter & Duggan, *supra* note 76, at 242 (identifying due incorporation, corporate authority, and tax consequences as matters typically addressed in legal opinions included or referenced in registration statements).

⁸⁰ 15 U.S.C. § 77(a)(2) (Supp. V 1999).

⁸¹ *Pinter v. Dahl*, 486 U.S. 622, 651 (1988) (stating, as to lawyers and accountants providing normal professional services in an offering, “The buyer does not, in any meaningful sense, ‘purchas[e] the security from’ such a person.”); *Wilson v. Saintine Exploration & Drilling Corp.*, 872 F.2d 1124, 1126-27 (2d Cir. 1989); Painter & Duggan, *supra* note 76, at 243.

ney liability, which suggests only a modest potential liability.⁸² That data, moreover, predates relevant changes in federal law favorable to law firms representing issuers.⁸³ The Supreme Court held in 1994 that there is no private cause of action available under Rule 10b-5 against one who merely "aids and abets" a violation of that rule by another.⁸⁴ Based on that opinion, it has been held there is no cause of action against someone for conspiring to violate Rule 10b-5.⁸⁵

⁸² Marino and Marino developed statistics bearing on law firm liability. Steven P. Marino & Renee D. Marino, *An Empirical Study of Recent Securities Class Action Settlements Involving Accountants, Attorneys, or Underwriters*, 22 SEC. REG. L.J. 115 (1994). They find that attorneys made payments in settlements of securities class actions with slightly more than one-half the corresponding frequency for accountants and less than half the corresponding frequency for underwriters. *Id.* at 159. The average contribution of the lawyers was sixteen percent of the settlements, or \$1.06 million. *Id.* at 162 & tbl.13. Only a small portion of the law firms (thirteen percent) were large firms (one of the 250 largest firms). *Id.*

These numbers appear to overstate the relative frequency with which a law firm will settle, relative to accountants and underwriters, in a traditional offering. The reason is as follows: Sixty-nine percent of the offerings in their sample involving lawyer-defendants were bond offerings or limited partnerships. *Id.* at 160. Both types of offerings frequently will involve special tax opinions. *Id.* In the same sample, only twenty-two percent of the lawsuits in which accountants and underwriters were defendants involved bond offerings or limited partnership investments. *Id.*

Representation of government-insured financial institutions, however, presents unique, and potentially substantial, risks. *See infra* note 91 and accompanying text.

⁸³ Marino and Marino's data is not directly relevant to current securities practice, as the sample period ended in February of 1994, Marino & Marino, *supra* note 82, at 121, the year the Supreme Court held there is no private cause of action for aiding and abetting a violation of Rule 10b-5, and before the adoption of the Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737, which, inter alia, limited discovery, provided a safe harbor for certain forward-looking statements (not including statements in IPOs), and limited the application of joint and several liability. *See generally* William S. Lerach, "The Private Securities Litigation Reform Act of 1995—27 Months Later": *Securities Class Action Litigation Under the Private Securities Litigation Reform Act's Brave New World*, 76 WASH. U.L.Q. 597 (1998) (discussing the implications of the Act).

⁸⁴ *Cent. Bank v. First Interstate Bank*, 511 U.S. 164, 191 (1994).

⁸⁵ *Dinsmore v. Squadron, Ellenoff, Plesent, Sheinfeld & Sorkin*, 135 F.3d 837, 841, 843 (2d Cir. 1998) ("[E]very court to have addressed the viability of a conspiracy cause of action under § 10(b) and Rule 10b-5 in the wake of *Central Bank* has agreed that *Central Bank* precludes such a cause of action."). *Contra Wenneman v. Brown*, 49 F. Supp. 2d 1283, 1289-90 (D. Utah 1999) (holding actionable allegations that the defendant law firm "knowingly engaging in a conspiracy the object of which was to mislead . . . investors"). *See generally* Mary M. Wynne, Comment, *Primary Liability Amongst Secondary Actors: Why the Second Circuit's "Bright Line" Standard Should Prevail*, 44 ST. LOUIS U.L.J. 1607, 1611 (2000) (discussing *Dinsmore v. Squadron, Ellenoff*).

However, a law firm might, in a particular case, be considered a primary violator.⁸⁶

Certainly, there could be liability where members of a law firm, possessing the requisite mental state, directly communicate to prospective investors false or misleading statements.⁸⁷ A victim

⁸⁶ *Central Bank* spawned a wealth of law review commentary. See, e.g., Douglas M. Branson, *Chasing the Rogue Professional After the Private Securities Litigation Reform Act of 1995*, 50 SMU L. REV. 91, 110–15 (1996) (discussing primary liability after *Central Bank*); Cox, *supra* note 74 (discussing the implications of *Central Bank*); Donald C. Langevoort, *Words from on High About Rule 10b-5: Chiarella's History, Central Bank's Future*, 20 DEL. J. CORP. L. 865, 885–96 (1995); Melissa Harrison, *The Assault on the Liability of Outside Professionals: Are Lawyers and Accountants off the Hook?*, 65 U. CIN. L. REV. 473, 498–513 (1997); Lewis D. Lowenfels & Alan R. Bromberg, *Liabilities of Lawyers and Accountants Under Rule 10b-5*, 53 BUS. LAW. 1157, 1167–80 (1998); Jill E. Fisch, *The Scope of Private Securities Litigation: In Search of Liability Standards for Secondary Defendants*, 99 COLUM. L. REV. 1293, 1300–03 (1999); Maxey, *Competing Duties*, *supra* note 60 (discussing the consequences of *Central Bank*); Robert A. Prentice, *Locating That "Indistinct" and "Virtually Nonexistent" Line Between Primary and Secondary Liability Under Section 10(b)*, 75 N.C. L. REV. 691, 717–59 (1997); Steinberg, *supra* note 7, at 713–14 (stating that some authority exists for holding that drafting fraudulent disclosure is a primary violation); Richard H. Walker & David M. Levine, *The Limits of Central Bank's Textualist Approach—Attempts to Overdraw the Bank Prove Unsuccessful*, 26 HOFSTRA L. REV. 1 (1997); Amanda J. Aymond, Comment, *You'd Better Watch What They Say: An Examination of Primary Liability for Secondary Actors Under Section 10(b)*, 68 U. CIN. L. REV. 835 (2000); Patricia Blanchini, Note, *The Statement Someone Else Makes May Be Your Own: Primary Liability Under Section 10(b) After Central Bank*, 71 ST. JOHN'S L. REV. 767 (1997); Rodney D. Chrisman, Note, *"Bright Line," "Substantial Participation," or Something Else: Who Is a Primary Violator Under Rule 10b-5?*, 89 KY. L.J. 201 (2000); Carrie E. Goodwin, Note, *Central Bank v. First Interstate Bank: Not Just the End of Aiding and Abetting Under Section 10(b)*, 52 WASH. & LEE L. REV. 1387 (1995); Barry D. Hunter, *Liability of Issuer's Counsel in the Wake of Central Bank of Denver—to Whom Is the Lawyer's Due Diligence Due?*, 86 KY. L.J. 413 (1997); John Kalmbach, Note, *Central Bank of Denver v. First Interstate Bank of Denver: Rethinking Established Section 10(b) Doctrines*, 55 LA. L. REV. 1009 (1995); Ameena Y. Majid, Comment, *Diminishing the Expected Impact of Central Bank of Denver v. First Interstate Bank of Denver: Secondary Liability Masquerading as Primary Liability Under Section 10(b)*, 28 LOY. U. CHI. L.J. 551 (1997); Ben D. Orlanski, Comment, *Whose Representations Are These Anyway? Attorney Prospectus Liability After Central Bank*, 42 UCLA L. REV. 885 (1995); Glenn Wallace Roberts II, Note, *10(b) or Not 10(b): Central Bank of Denver v. First Interstate Bank of Denver*, 73 N.C. L. REV. 1239 (1995); Glen Shu, Comment, *Take a Second Look: Central Bank After the Private Securities Litigation Reform Act of 1995*, 33 HOUS. L. REV. 539 (1996).

⁸⁷ *Rubin v. Schottenstein, Zox & Dunn*, 143 F.3d 263, 267–68 (6th Cir. 1998); see also *United States v. Benjamin*, 328 F.2d 854, 863 (2d Cir. 1964) (affirming criminal conviction of lawyer who, *inter alia*, made deceptive statements and sought to obfuscate the fraudulent scheme in a discussion with a victim by stating "he was acting as a 'trustee' for some of the principals and, when [the victim] sought elucidation, explained that 'as a trustee and as an

alternatively might attempt to characterize a law firm's participation in drafting false or misleading disclosure documents as constituting a primary violation. The U.S. Court of Appeals for the Third Circuit, in a subsequently vacated opinion, opined:

[W]e hold that a lawyer who can fairly be characterized as an author or a co-author of a client's fraudulent document may be held primarily liable to a third-party investor under the federal securities laws for the material misstatements or omissions contained in the document, even when the lawyer did not sign or endorse the document and the investor is therefore unaware of the lawyer's role in the fraud.

...
We later set forth the following specific requirements to hold such a lawyer liable: (1) the lawyer knows (or is reckless in not knowing) that the statement will be relied upon by investors, (2) the lawyer is aware (or is reckless in not being aware) of the material misstatement or omission, (3) the lawyer played such a substantial role in the creation of the statement that the lawyer could fairly be said to be the "author" or "co-author" of the statement, and (4) the other requirements of primary liability are satisfied.⁸⁸

Although this opinion was vacated, there remains other authority supporting categorizing law firm acts in drafting offering documents as primary violations.⁸⁹

attorney *** licensed in the State of New York, *** he was not obligated to reveal any of the sources and it is enough for anyone to accept a legal document from a trustee who was an attorney and the trustee was not required to reveal the source of the legal document or who the principals were behind the legal document"—surely a novel contribution to the law of trusts”).

⁸⁸ Klein v. Boyd, Nos. 97-1143, 97-1261 (3d Cir. Feb. 12, 1998), <http://vls.law.vill.edu/locator/3d/Feb1998/98a1795p.txt>, vacated on grant of reh'g en banc, Nos. 97-1143, 97-1261, 1998 U.S. App. LEXIS 4121 (Mar. 9, 1998).

⁸⁹ Relevant authority includes *Beard v. Sachnoff & Weaver, Ltd.*, 941 F.2d 142 (2d Cir. 1991) (finding, in an opinion that does not reference aiding or abetting, that allegations of fraud were adequately pled against a law firm that drafted an offering memorandum, in a case decided before *Central Bank*); *Molecular Technology Corp. v. Valentine*, 925 F.2d 910, 913-11, 917-19 (6th Cir. 1991) (affirming, in a case decided before *Central Bank*, a jury verdict against a lawyer for violation of Rule 10b-5, apparently on a primary basis, for failure to include material information in editorial comments made on an offering circular); *Wernreman v. Brown*, 49 F. Supp. 2d 1283, 1289 (D. Utah 1999) (relying on participation in preparation of allegedly misleading offering materials, in addition to more serious malfeasance, in failing to dismiss a lawsuit against legal counsel); *Employers Insurance v. Musick, Peeler, & Gurrrett*, 871 F. Supp. 381, 388-89 (S.D. Cal. 1994) (denying dismissal of a claim against counsel alleging violation of Rule 10b-5 arising from participation in the drafting of an allegedly misleading

Two additional avenues of liability exist. There is potential liability in this context in a civil action brought by the SEC, which can bring a lawsuit against one who "knowingly provides substantial assistance" to a violator.⁹⁰ Lastly, a law firm could find itself in the unenviable position of being sued by a receiver appointed to run the law firm's former client, for alleged malpractice in preparing allegedly inadequate disclosure.⁹¹

Thus, there is some financial risk to a law firm for its participation in drafting a misleading offering document. The availability of private theories against a law firm are, however, subject to some doubt and require proof of scienter. The likelihood of a successful lawsuit against a law firm is therefore lower than the corresponding likelihood for the issuer, which is subject to strict liability under section 11. An investment by a law firm in a client it is taking public therefore provides some incentive for the law firm to be more aggressive in limiting prospectus disclosure than is in the interest of the issuer itself.

Addressing the relative probabilities that an issuer and a lawyer will be sued does not, however, fully address the extent to which

disclosure document), *corrected and reconsideration granted in part*, 948 F. Supp. 942 (S.D. Cal. 1995); *Atlantis Group, Inc. v. Rospatch Corp.* (In re Rospatch Sec. Litig.), [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,939 (W.D. Mich. July 8, 1992). Cf. *Wilson v. Great Am. Indus., Inc.*, 855 F.2d 987, 990, 995 (2d Cir. 1988) (reversing judgment for the defendants, including, among others, a lawyer who also was a director and Secretary of the issuer, in a bench trial concerning alleged violation of Rule 14a-9, 17 C.F.R. § 240.14a-9). *Contra* *Abell v. Potomac Ins. Co.*, 858 F.2d 1104, 1124-25 (5th Cir. 1988) (holding underwriters' counsel not liable for misleading offering materials; limiting liability to misleading opinion letters), *vacated sub nom.* *Fryar v. Abell*, 492 U.S. 914 (1989); *Ames v. Uranus, Inc.*, No. 92-2170-JWL, 1994 U.S. Dist. LEXIS 12,639, at *25-30 (D. Kan. Aug. 24, 1994) (granting summary judgment in favor of a law firm, not mentioned in a disclosure document, where the law firm provided comments on the disclosure without performing due diligence), *reconsideration denied*, No. 92-2170-JWL, 1994 U.S. Dist. LEXIS 15,956 (D. Kan. Oct. 21, 1994).

⁹⁰ 15 U.S.C. § 78t(e) (Supp. V 1999). See generally *SEC v. Nat'l Student Mktg. Corp.*, 457 F. Supp. 682, 713-15 (D.D.C. 1978) (finding aiding-and-abetting liability in connection with inadequate steps to disclose adverse financial information at the closing of a merger).

⁹¹ See *FDIC v. O'Melveny & Myers*, 969 F.2d 744 (9th Cir. 1992) (reversing a grant of summary judgment in favor of a law firm on claims, brought by the receiver of the client, of malpractice in the drafting of offering materials), *rev'd*, 512 U.S. 79 (1994), *on remand*, 61 F.3d 17 (adopting the same conclusion reached in *FDIC v. O'Melveny & Myers*, 969 F.2d 744 (9th Cir. 1992)); cf., e.g., Dennis E. Curtis, *Old Knights and New Champions: Kaye, Scholer, the Office of Thrift Supervision, and the Pursuit of the Dollar*, 66 S. CAL. L. REV. 985 (1993) (discussing a prominent case of a law firm pursued by a regulator of the firm's client).

investments affect the alignment of the interests of a law firm and its client. The relative magnitudes of the possible losses and possible gains also are important. A very small investment by a law firm might give rise to no incentive to prepare aggressive (incomplete) disclosure, because the possible loss in litigation, even if remote, might dwarf any possible return on the investment.

For another reason, a law firm's financial interest in its client may not produce aggregate incentives that make it in a law firm's interest to disclose less information than is in the best interest of the client to disclose.⁹² A law firm may assign value to its reputation for providing professional, i.e., independent, services.⁹³ A law firm with a reputation for exercising its professional obligations independently may provide a value to a client by providing increased certification of the accuracy of the client's disclosure.⁹⁴ That reputation may increase

⁹² The client's managers also may desire to withhold information whose disclosure is in the best interests of the client itself. That may be the product of an incorrect assessment of the likelihood of various outcomes or internal agency problems (a divergence in the incentives of the issuer and its managers). In that case, a law firm may reluctantly participate in preparation of a disclosure document the law firm believes to be inadequate, in order to maintain an ongoing client relationship. See generally Prentice, *supra* note 7, at 1644-49 (collecting various empirical studies supporting the principle that a desire to maintain a client relationship affects how accounting firms resolve accounting issues in audits).

⁹³ Painter & Duggan, *supra* note 76, at 239-40 (asserting that law firms are more sensitive to allegations of misconduct than are accounting firms). But cf. Langevoort, *supra* note 60, at 112 ("A firm charged with going too far in the representation of a client may find other and prospective clients unbothered, perhaps even pleased."). See generally Larry E. Ribstein, *Ethical Rules, Agency Costs, and Law Firm Structure*, 84 VA. L. REV. 1707, 1714-20 (1998) (discussing the relationship between law firm structure and reputational bonding).

⁹⁴ Black, *supra* note 12, at 787; Ronald J. Gilson, *Value Creation by Business Lawyers: Legal Skills and Asset Pricing*, 94 YALE L.J. 239, 288-91 (1984) (addressing acquisitions of businesses); Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 621 n.197 (1984) ("The certification function of lawyers, accountants and engineers, while real . . . is substantially more limited [than that of underwriters]."); Maxey, *Competing Duties*, *supra* note 60, at 2218 (addressing securities offerings); Karl S. Okamoto, *Reputation and the Value of Lawyers*, 74 OR. L. REV. 15, 18 ("[S]ervice as a reputational intermediary is a defining aspect of lawyers' work."); Painter & Duggan, *supra* note 76, at 258 n.200; Prentice, *supra* note 86, at 743-44; cf. Diana R. Franz et al., *The Impact of Litigation Against an Audit Firm on the Market Value of Nonlitigating Clients*, 13 J. ACCT. AUDITING & FIN. 117, 117 (1998) (finding "clients not involved in the litigation [alleging audit failure] experience significant negative returns at the announcement of litigation against their audit firm").

the marketability of the law firm, thereby increasing its revenue.⁹⁵

The prospect of other sanctions from the SEC also may cause a law firm not to produce misleading disclosure. The SEC can institute proceedings under Rule 102(e) to suspend a lawyer who has engaged in "unethical" or "improper" professional conduct from practice before the agency.⁹⁶ This avenue, however, has only infrequently been the basis of lawyer discipline,⁹⁷ and the SEC ordinarily will not initiate a proceeding under this rule unless there has been a prior criminal conviction or a prior issuance of an injunction in a civil proceeding finding a violation of securities law.⁹⁸ Alternatively, the SEC could enter a cease-and-desist order against a lawyer, if he were found to be the "cause" of a violation.⁹⁹

⁹⁵ Okamoto, *supra* note 94, at 24 (stating that professionals with greater reputations can command higher fees for the lending of their reputations).

⁹⁶ 17 C.F.R. § 201.102(e)(1)(ii) (2000); Painter & Duggan, *supra* note 76, at 227. See generally Emerson, *supra* note 60, at 173–88 (providing detailed statistics concerning the use of the procedure, which was formerly set forth at 17 C.F.R. § 201.2(e) (1990), and indicating that a thorough search uncovered only 139 reported cases); Maxey, *SEC Enforcement Actions*, *supra* note 60, at 547–64 (discussing the application of the rule). Lawyer culpability under this theory appears to require scienter, although the contours of this liability are not entirely clear. Compare Painter & Duggan, *supra* note 76, at 244–55 (citing *In re Carter*, Exchange Act Release No. 17,597, 1981 SEC LEXIS 1940 (Feb. 28, 1981), and *Checkosky v. SEC*, 23 F.3d 452 (D.C. Cir. 1994), and stating, "Thirteen years earlier, the Commission had issued its release in *Carter & Johnson*, stating that attorneys 'could not be sanctioned under Rule 2(e)(1)(iii) for willfully aiding and abetting [a client's securities law] violations unless they 'were aware or knew that their role was part of an activity that was improper or illegal . . .'" (quoting *Checkosky v. SEC*, 23 F.3d at 484)), with *In re Checkosky*, Exchange Act Release No. 38,183, 1997 SEC LEXIS 137, at *37 n.50 (Jan. 21, 1997) ("Respondents make certain arguments based on the recognized inherent powers of an administrative agency to discipline attorneys and the mental state required for such action. However, while we have such inherent powers, we do not agree with Respondents' arguments that those powers mandate a bad faith finding.").

⁹⁷ Emerson, *supra* note 60, at 178 (noting that the SEC had disbarred or suspended 141 lawyers over fifty years).

⁹⁸ Phyllis Diamond, *Walker Sees SEC Continuing Restraint in Charging Lawyers over Illegal Conduct*, 31 Sec. Reg. & L. Rep. (BNA) 1067 (Aug. 13, 1999).

⁹⁹ 15 U.S.C. §§ 77h-1(a), 78u-3(a) (1994); *In re Candie's*, Securities Act Release No. 7263, 1996 SEC LEXIS 654, at *13 (Feb. 21, 1996) (accepting offer of settlement concerning a law firm's participation in scheme to evade provisions of Regulation S, 17 C.F.R. §§ 230.901–.905); *In re Goodman*, Securities Act Release No. 7248, 1995 SEC LEXIS 3610, at *4–8 (Dec. 14, 1995) (concerning false statements in offering circulars); *In re Schaeffer*, Exchange Act Release No. 36,052, 1995 SEC LEXIS 1971, at *17–18 (accepting offer of settlement from lawyers who signed a misleading Form 10-K); *In re Fillmore*, Exchange Act Release No.

C. Summary

Part I has discussed the contours of the ethical restrictions on law firms investing in their clients. Part II has addressed the extent to which these investments can create divergent incentives. The incentives that exist are complex and have conflicting influences. Definitive conclusions cannot be reached merely by reliance on a theoretical analysis. An empirical analysis is required.

III. THE IPO PROCESS AND LAWYERS' ROLES

The process by which securities are brought to market in an IPO presents a context in which one can make an empirical assessment of the relationship between law firm investments and performance of professional obligations. This Part reviews the mechanics of that process relevant to understanding the empirical tests.

An issuer that determines to go public must first assemble a team of professionals. It will select an accounting firm to perform the required audit and legal counsel to guide it through various regulatory hurdles. The legal counsel may be one that has represented the firm in corporate and other matters for some time, or it may be first hired by the issuer for the IPO.

The issuer will then select an investment bank to manage the offering. The competition in which the investment bank is selected is sometimes called a "beauty pageant."¹⁰⁰ In the beauty pageant, the issuer will interview investment banks and select the one making the most attractive presentation. During the beauty pageant, the investment banks will discuss with the issuer the prices they believe the company ultimately could realize in its IPO. Issuers consider the

36,259, 1995 SEC LEXIS 2471, at *7-9 (Sept. 21, 1995) (accepting a settlement arising from a lawyer's improper distribution of funds from a trust account, which funds were required to be used to effect an acquisition); *In re Feldman*, Securities Act Release No. 7014, 1993 SEC LEXIS 2401, at *10-12 (Sept. 20, 1993) (Commission finding a violation had been "aided and abetted and caused" by the provision of inaccurate legal advice that certain securities need not be registered); Painter & Duggan, *supra* note 76, at 227, 232-33 (addressing whether lawyers could be considered to be the cause of a violation).

¹⁰⁰ See, e.g., Avital Louria Hahn, *Investment Banks Continue Hunt for Telecom Research*, INVESTMENT DEALERS DIG., Jan. 10, 2000, at 10 (using the term in that context).

various price estimates, in addition to other factors, in selecting an investment bank to manage the IPO.¹⁰¹

Any price that is discussed at that time is only an estimate. The actual price is not set until immediately before the IPO begins¹⁰²—ordinarily a few months following the conclusion of the beauty pageant,¹⁰³ absent changes in market conditions. In the intervening period, a preliminary prospectus is prepared. SEC rules require that a preliminary prospectus used for marketing before the IPO begins disclose an estimate of the IPO price.¹⁰⁴ The price estimate first disclosed in a preliminary prospectus, which is frequently stated in the form of a range, is the best publicly available evidence of the estimate expressed by the managing underwriter in the beauty pageant—prior to any due diligence.

The lawyers and the investment bank will perform due diligence after the beauty pageant and before the IPO is actually priced.¹⁰⁵ Compliance with the provisions of section 11 described above¹⁰⁶ requires material negative information discovered during these procedures be disclosed in the prospectus. The investment bank will tour plants, where the bank believes doing so to be necessary.¹⁰⁷ It may seek to find relevant information from customers or suppliers.¹⁰⁸

¹⁰¹ Abby M. Alderman & Kenneth Y. Hao, *The Initial Public Offering Process*, in HOW TO PREPARE AN INITIAL PUBLIC OFFERING 1995, at 405, 411 (PLI Corporate Law & Practice Course Handbook Series No. B-904, 1995); William J. Grant, Jr., *Overview of the Underwriting Process*, in SECURITIES UNDERWRITING: A PRACTITIONER'S GUIDE 25, 26–27 (Kenneth J. Bialkin & William J. Grant, Jr. eds., 1985).

¹⁰² Laird H. Simons, III, *Considerations in Selecting the Managing Underwriter(s) for an Initial Public Offering*, in HOW TO PREPARE AN INITIAL PUBLIC OFFERING 1993, at 27, 45 (PLI Corporate Law & Practice Course Handbook Series No. B-817, 1993).

¹⁰³ John K. Hoyns, *Sample Time and Responsibility Schedule for an Initial Public Offering of Common Stock*, in HOW TO PREPARE AN INITIAL PUBLIC OFFERING 1993, *supra* note 102, at 51, 55 (stating that the managing underwriter is selected within several months before the commencement of the preparation of the registration statement).

¹⁰⁴ 17 C.F.R. §§ 228.501(a)(8)(i), 229.501(b)(3) instructions (2000).

¹⁰⁵ *Cf.* JOHNSON & McLAUGHLIN, *supra* note 50, at 283 (“Immediately after the investment banking firm decides to proceed with a financing, its counsel will usually send the issuer a letter requesting basic documents regarding the issuer.”).

¹⁰⁶ See *supra* note 65 and accompanying text.

¹⁰⁷ JOHNSON & McLAUGHLIN, *supra* note 50, at 292.

¹⁰⁸ *In re Software Toolworks, Inc. Sec. Litig.*, 789 F. Supp. 1489, 1497–98 (N.D. Cal. 1992) (discussing the diligence contacts with various customers), *aff'd in part and rev'd in part*, 50 F.3d 615, 622 (9th Cir. 1994).

The due diligence activities of the lawyers (both the issuer's counsel and the underwriters' counsel) include both discussions with key personnel and, in addition, a review of documents. They will assess the existence of risks arising from contractual relationships. The nature and extent of the lawyers' diligence is determined by the law firms themselves, based on the particular issuer. It will generally include, for example, the review of the issuer's board minutes and the issuer's material contracts.¹⁰⁹ The purpose is to identify negative information that needs to be disclosed—information that, if not disclosed, would make the IPO prospectus misleading. Illustrative items are cross-defaults (contractual arrangements that make a default under one contract a default under a second contract—a second contract that may be with entirely different parties), negative pledge agreements (in which the issuer agrees not to grant security interests to third parties) and transactions with affiliated parties.¹¹⁰

A law firm exercises discretion in deciding what information has to be disclosed to the public. There are certain items SEC rules expressly require be disclosed.¹¹¹ But, in addition, SEC rules provide that all material information has to be disclosed in a prospectus, even if there is no express requirement calling for disclosure of the particular item in question.¹¹² Assessing the materiality of information is a matter of judgment.¹¹³ A law firm participating in an IPO thus has to exercise judgment in deciding the scope of its diligence investigation, in determining what information has to be

¹⁰⁹ JOHNSON & MCLAUGHLIN, *supra* note 50, at 293–94.

¹¹⁰ *See generally* Cetahn Ward, *Prison Realty Investors File Lawsuit over Merger*, TENNESSEAN, May 28, 1999, at 3E (describing a lawsuit alleging improper disclosure of a transaction with an affiliate).

¹¹¹ 17 C.F.R. §§ 228.101–228.511, 229.101–229.511 (2000).

¹¹² *Id.* § 230.408.

¹¹³ Small, *supra* note 60, at 1211–12 (“[R]easonable men may still differ on whether a particular fact is material.”). Reflecting the fact that ascertaining materiality is a question of judgment, materiality of information and adequacy of the disclosure of material information ordinarily are jury questions. *Durning v. First Boston Corp.*, 815 F.2d 1265, 1268 (9th Cir. 1987).

disclosed, and in setting the nuance¹¹⁴ and the level of detail of that disclosure.

Two sets of law firms participate in a traditional IPO: issuer's counsel and underwriters' counsel. It is not merely the underwriters' counsel that is responsible for disclosure of negative information and requires negative information be disclosed. That is part of the role of the issuer's counsel, and one that it fulfills (as is the case with all professionals, to varying degrees) notwithstanding the protestations of its client (the issuer). For example, the role played by a lawyer at a prominent firm representing the issuer in one offering, in the drafting of a portion of a prospectus describing a crucial risk (reliance on a single supplier), was recounted as follows:

As always, the guy with the pen, in this case Dave Segre of Wilson Sonsini, was the butt of much of this [humor]. He soon gained the nickname Ernie.

Said [the issuer's chief financial officer], "I started calling him Ernest Hemingway because every time we gave him a revision to the document, the document came back looking very different from what we'd told him to do. So I began accusing him of doing a Hemingway on me—you know, creative writing. Eventually, we just called him Ernie."¹¹⁵

In practice, when drafting the prospectus turns to disclosure of negative information, the parties can, and frequently do, realign themselves, with the lawyers on one side and the businessmen on the other side.¹¹⁶

¹¹⁴ For example, one institutional investor's review of a prospectus was described as follows:

[A senior technology analyst for Hambrecht & Quist] next reached the seven pages of charts and footnotes and again focused on the MD&A [management's discussion and analysis of financial position and results of operations] section. This time he read it line by line. "Oh, look! One more time we're reminded that technology revenue is non-recurring. You can tell the lawyers were very careful on that. They understood what the issue was."

MICHAEL S. MALONE, *GOING PUBLIC* 125 (1991).

¹¹⁵ *Id.* at 89.

¹¹⁶ *Cf. id.* at 79 ("As one might imagine, choosing what goes into the risk factors section and how it should be phrased often divides the prospectus writing team into opposing camps, with the company representatives on one side, the lawyers on the other, and the underwriters and everyone else dancing in between.").

The author's personal experience presented another paradigm: a game of "chicken" between the lawyers. Requiring disclosure of material businessmen would prefer not to disclose does not enhance one's standing with one's client. Where the lawyers concur that

IV. EMPIRICAL MODELING OF LAW FIRM INVESTMENTS

A. *Theory of the Models*

One of the roles of lawyers participating in an IPO is to assure that all material information about the issuer is disclosed to the public. One condition to the closing of the IPO will be the delivery of legal opinions that address whether the IPO prospectus is misleading.¹¹⁷ Law firms perform the due diligence investigations referenced above¹¹⁸ as part of rendering these opinions.

The principle to be addressed by the empirical models is whether law firm investments affect the disclosure in an issuer's offering document. The effect could be in the form of (i) not requiring disclosure of information that would be required to be disclosed were the law firm not to have an investment in the client; (ii) allowing the disclosure to be in more innocuous language, i.e., burying the disclosure; or (iii) decreased diligence procedures that result in the law firm not becoming aware of adverse information that it otherwise would uncover.

For this purpose, the empirical models examine the price at which stock is sold in an IPO. That price "reflects" the disclosure, in the sense that the price of the stock sold in the IPO should incorporate an assessment of all material information contained in the final prospectus.¹¹⁹ SEC rules require that those expected to purchase in

negative disclosure is required, one may postpone taking a hard line, i.e., postpone requiring disclosure, until it becomes clear the other side's counsel will not.

¹¹⁷ JOHNSON & McLAUGHLIN, *supra* note 50, at 90. It is customary to provide "negative assurance" that the law firm is not aware of any information that would make the prospectus misleading. *Id.*; Comm. on Legal Opinions, *Third-Party Legal Opinion Report, Including the Legal Opinion Accord of the Section of Business Law, American Bar Association*, 47 BUS. LAW. 167, 228 (1991). Formally, this statement is different from providing a statement that the law firm is of the opinion that the prospectus is not misleading. See generally Comm. on Legal Opinions, *supra*, at 228 ("[T]he format normally used is other than the traditional legal opinion . . .").

¹¹⁸ See *supra* notes 109–10 and accompanying text.

¹¹⁹ It is possible the final prospectus would include disclosure not included in a preliminary prospectus previously shown to prospective investors. However, where the additional disclosure is material, ordinarily an issuer would recirculate a revised preliminary prospectus, updated to reflect this additional disclosure, before the pricing of the offering. Cf. John J. Jenkins, *Recirculation of a Preliminary Prospectus: Statutory Basis and Analytical Techniques for Resolving Recirculation Issues*, 55 BUS. LAW. 135, 145 (1999) ("As is apparent from a review of the provisions of the federal securities laws implicated in the recirculation issue, any decision

the IPO be sent a preliminary prospectus at least forty-eight hours before a confirmation of a sale is sent.¹²⁰ The managing underwriter prices the IPO based on indications of interest received from prospective purchasers.¹²¹ Indications of interest are not helpful to the managing underwriter in pricing the offering to the extent they are stale. The managing underwriter, therefore, has an incentive to assure that indications of interest are based on all information that will be disclosed in the final prospectus.

The IPO price therefore reflects the disclosure in the final prospectus. The price per share is, in some sense, arbitrary. The price itself is not meaningful, because the number of shares to be outstanding after the offering affects the per share value of securities. What is relevant, however, is a comparison—how does the fact that a law firm has an interest in the issuer affect the change in price to the actual IPO price from estimates prepared before the law firm's diligence has commenced and the law firm has participated in preparing the disclosure? Thus, the empirical models set forth below examine the price per share change, on a dollar and on a percentage basis, from an estimate prepared some period of time before the IPO is priced. This price estimate is compared to the actual IPO price. In particular, it is hypothesized that the price change will be *greater* where the law firm has an interest in its client.

One final observation about the theory of the models merits explanation. If a law firm interest in a client causes the law firm to perform diminished diligence, one might expect the fact that a law firm had invested in an issuer to decrease the price realized in an IPO (i.e., a relationship opposite that described in the immediately preceding paragraph). If the market understood a law firm investment to convey diminished certification of the issuer and its disclosure, one might suppose that would cause a decrease in the value investors would be willing to pay for the securities, *ceteris paribus*, and therefore cause the price changes examined in the models to be lower where the issuer is represented by a law firm that has an interest in its client.

concerning recirculation should be based on whether the new disclosures contained in a revised preliminary prospectus are 'material.'").

¹²⁰ 17 C.F.R. § 240.15c2-8(b) (2000).

¹²¹ Jaikaran Singh, Note, *Watch Your Mouth: Section 12(a)(2) Liability for Oral Statements Made at Road Shows*, 23 J. CORP. L. 541, 548 (1998).

There are two reasons why that view does not affect the results of the models described below. First, whatever information content is associated with a law firm investment, that information concerning investments made before the beauty pageant should already be impounded in the estimate arrived at during the beauty pageant. The models address a *change* in price from that estimate to the actual IPO price. Were there such an effect, it should affect both the IPO price and the estimate, producing no net effect on the price change from the estimated IPO price to the actual IPO price.

Moreover, as discussed above,¹²² an issuer is strictly liable for false or misleading statements in a prospectus by which it sells an IPO. One might consider section 11 and Rule 10b-5 as providing a warranty that the firm is as disclosed. Thus, absent unusual cases of substantial fraud, e.g., fraud of a magnitude damages for which could potentially render responsible parties insolvent, purchasers in an IPO acquire rights valued at approximately the same value as the rights that are described in the prospectus. Any deficiency in disclosure is “made up” by the value of a right to a securities law claim.

The types of changes in disclosure that this model seeks to identify are of the more modest type—shadings in disclosure or omission of disclosure in the close cases. That is, the contemplated changes are not so large as they would create potentially ruinous liability for the issuer. Thus, the remedy provisions of section 11 and Rule 10b-5 should be adequate to allow purchasers not to decrease the price they are willing to pay for securities in IPOs because the law firms have interests in the issuers.

The best price to use as the initial price would be the estimated price arrived at during the beauty pageant. That price, however, is not publicly available. The models thus use, as a proxy for that price, the estimated price first disclosed in a preliminary prospectus. The price change examined thus is the change in price from that price estimate to the actual IPO price. Prior finance literature has used this price change for purposes of assessing the thoroughness of procedures subsequent to the beauty pageant, i.e., for similar purposes.¹²³

A substantial portion of the lawyers’ due diligence will have occurred by the time a preliminary prospectus disclosing an estimated

¹²² See *supra* notes 65–66 and accompanying text.

¹²³ See *infra* note 152 and accompanying text.

price will have been filed with the SEC.¹²⁴ Similarly, much of the nuance of disclosure of identified adverse information will have been determined as of that time. These facts, however, do not make inappropriate the use of the estimated price first disclosed in a preliminary prospectus as a proxy for the pricing discussed in the beauty pageant. The reasons are set forth below.

Literature discussing the IPO process suggests¹²⁵ investment banks frequently delay delivery of negative information to prospective issuers. Books advising prospective IPO issuers on selecting underwriters note prospective issuers should ask previous customers about such delays. Some authors note prospective issuers should ask previous clients about the difference between preliminary pricing and final pricing¹²⁶ or last-minute surprises.¹²⁷

An investment bank underwriting an IPO has two customers with competing interests: the issuer and the investors, who will have ongoing trading relationships with the investment bank. Investment banks have increasingly favored the interests of the investors.¹²⁸

The reason for the delay in disclosing negative information is that, over time, there is a shift in the relative bargaining strengths of the parties. The passage of time impedes the ability of the issuer to

¹²⁴ It will not end, however, until the end of the process, when the IPO is priced. See PricewaterhouseCoopers, *The Guide to Going Public* 41 (1999) (noting that a due diligence meeting will occur shortly before the prospectus is finalized), at <http://www.pwcglobal.com/extweb/pwcpublishations.nsf/DocID/08EFF19170E0794E8525687800563767>. A principal concern at that time will be expectations concerning the next quarter. And, as Johnson and McLaughlin note, "[A]ccounting matters are too important to be left to the accountants." JOHNSON & MCLAUGHLIN, *supra* note 50, at 287.

¹²⁵ It is not surprising that the references should be oblique; it would often be contrary to an investment banker's financial interest to disclose publically an absence of candor with his clients.

¹²⁶ STEPHEN C. BLOWERS ET AL., *THE ERNST & YOUNG LLP GUIDE TO THE IPO VALUE JOURNEY* 88 (1999) ("Some questions you may wish to ask are: . . . Did the underwriters significantly reduce the . . . estimated selling price during the registration process?"); DAVID P. SUTTON & M. WILLIAM BENEDETTO, *INITIAL PUBLIC OFFERINGS* 97 (1988) ("Questions to ask the underwriter include the following: . . . How close to the preliminary pricing was the final price for other deals?").

¹²⁷ ARKEBAUER & SCHULTZ, *supra* note 6, at 170 ("Some questions to ask include these: Were there any last-minute surprises?"); BLOWERS ET AL., *supra* note 126, at 88 ("Did the underwriters present any last-minute surprises or demands?").

¹²⁸ Shawn Tully, *Betrayal on Wall Street*, *FORTUNE*, May 14, 2001, at 84, LEXIS, News Library, Allnws File.

change underwriters, as some of the pre-IPO activities, e.g., some diligence, would have to be repeated were the managing underwriter replaced.¹²⁹ Thus, two commentators, in discussing IPOs of firms in the biotechnology field, write, "Pricing is a factor that caught many senior managers by surprise. By the time the pricing meeting occurs, companies typically are not negotiating from a position of strength."¹³⁰ One commentator provides a similar, but more detailed view:

Stock prices are typically set just days before the issue, when the state of the market and the health of the company are pretty well known. Pricing sessions often become the moment when the first hints of distrust between the company and underwriters surface. Wars can break out over a dollar a share difference, lifelong animosities can develop over four bits. Underwriters see the pricing session as the moment when their wisdom and expertise in the stock market come to the fore and when they often have to pull company executives down out of the clouds to reality, force them to abandon their greedy personal dreams of wealth, and face the fact they are about to be a public company, answerable to shareholders. The company executives, in turn, often come away from the pricing session embittered. Until this moment, the underwriter may have seemed to be their greatest advocate, but now, when it is too late to turn back, the underwriter turns on them; indifferent to the company's needs, the underwriter now takes care of its own image, low-balling the price to guarantee the maximum number of shares sold to look good in the proposal to the next sucker.¹³¹

Reflecting the assessment that the price estimate disclosed in a preliminary prospectus is an appropriate proxy for the price discussed in the beauty pageant, Cooney et al. indicate that material deviations

¹²⁹ See generally Nicholas Denton, *Deutsche Telekom in Row with Investment Bankers*, FIN. TIMES, Nov. 4, 1996, at 1, LEXIS, News Library, Allnws File ("Deutsche Telekom has excluded Goldman Sachs from a leading role in the flotation of one of its associated companies after a row with the US investment bank over the pricing of Deutsche Telekom's current initial public offering.").

¹³⁰ Carol Hall & Cynthia Robbins-Roth, *Going Public Without Panic*, RECORDER, May 6, 1992, at 8, LEXIS, News Library, Allnws File; see also *The Making of a Millionaire, INC.*, May 1995, at 86, LEXIS, News Library, Allnws File (describing the underwriters as stating a price in a particular IPO with a message, "take it or leave it").

¹³¹ MALONE, *supra* note 114, at 197-98. One chief financial officer described pricing discussions more colorfully: "I feel like I've been to a proctologist—and he had a very cold finger." Robert D. Hof & Gabrielle Saveri, *Inside an Internet IPO*, BUS. WK., Sept. 6, 1999, at 60, LEXIS, News Library, Allnws File.

of the actual IPO price from the estimate disclosed in the preliminary prospectus imply a renegotiation of pricing issues previously addressed in the beauty pageant.¹³²

Using the estimated price first disclosed in a preliminary prospectus as a proxy for the price estimate arrived at during the beauty pageant in fact creates a bias against the models finding results. If there is a relationship between law firm investments and price adjustment from the beauty pageant to the actual IPO price, examining price changes from the first circulated preliminary prospectus to the IPO price simply eliminates a portion of the actual price changes in which one is interested. Eliminating some of the price changes makes identifying the changes more difficult.

B. Data

For this investigation, a sample of IPOs in 1998 and 1999 was assembled. Using the Securities Data Company (SDC) database, all common stock IPOs in those two years were identified. The sample was reduced to 665 IPOs by eliminating the following IPOs: offerings of issuers in the areas of finance, insurance, and real estate; offerings involving combinations of stock and warrants, including units; and offerings in which SDC's data were incomplete. Those financial, insurance, and real estate firms were identified by the reported primary SIC code—issuers with primary SIC codes in the range of 6011 to 6799 were eliminated. This step eliminates a number of IPOs of firms having characteristics not relevant to this investigation, such as offerings of real estate investment trusts with no prior operating history, and unusual IPOs, such as offerings as part of the demutualization of insurance companies.

Forty-seven offerings for which SDC did not report all the information required in the regressions below were removed, reducing the sample to 618 offerings.¹³³ Various statistics of those 618 offerings for which the corresponding prospectuses could be located through EDGAR (the SEC's database of filings) are reported in Table 1.

¹³² John W. Cooney, Jr. et al., *The IPO Partial-Adjustment Phenomenon and Underwriter Reputation 2* (Feb. 28, 1999) (unpublished manuscript, on file with author).

¹³³ The author's experience using this database indicates that SDC periodically updates the historical information for offerings; the offerings within a specified time period meeting certain criteria or for which certain fields of information are provided may vary when one accesses the database at different times.

Table 1
Descriptive Statistics of 618 IPOs in 1998 and 1999

	Mean	Median	Standard Deviation	Min	Max
Price Adjustment (\$)	1.34	0.97	3.75	-6.91	32.11
Price Adjustment (%)	12.45	7.69	34.49	-58.33	344.44
Offer Price (\$)	13.64	13.21	5.98	3.95	94.39
Estimated Offer Price (\$)	12.30	11.68	4.65	2.19	87.58
Law Firm Investment (\$)	292,328	0	1,459,721	0	24,159,073
Any Issuer's Lawyer Investment (%)	36				
Underwriter Rank (%)	6.25	3.99	7.14	0.01	27.15
Est. Offer Size (\$100 millions)	0.94	0.48	2.75	0.03	41.52
Est. Price to Book Value	5.98	3.69	11.68	0.40	230.41
Pre-IPO Equity Value (\$100 millions)	4.20	1.40	16.34	0.00	223.95
Issue Year	1998.65				
Greater San Francisco Lawyers (%)	27				

As reported in Table 1, those statistics include the mean [median] of the following variables: offer price per share of \$13.64¹³⁴ [\$13.21]; *estimated offer price* (constituting the estimated offer price first disclosed in a preliminary prospectus, or the midpoint in the case of an estimate in the form of a range) of \$12.30 [\$11.68]; *price adjustment* (representing the offer price minus *estimated offer price*) of \$1.34 [\$0.97]; percentage price adjustment of 12.45% [7.69%]; initially estimated domestic offer size, based on the preliminary prospectus, of \$94 million [\$48 million], excluding the overallotment option (referenced as the *est. offer size*); the *estimated offer price* to book value, at the time of the IPO (*est. price to book value*), of 5.98 [3.69]; and *Pre-IPO equity value* (shares outstanding before the IPO times the *estimated offer price*) of \$420 million [\$140 million].

Underwriter annual market shares, in terms of the dollar amount of IPOs lead managed, of all the non-financial, common stock IPOs

¹³⁴ All dollar amounts in this paper are expressed in 1997 dollars, deflated using the implicit GDP price deflator.

in 1998 and 1999 were computed.¹³⁵ In these computations, the entire IPO was generally assigned to the managing underwriter of the offering. In a few cases, SDC indicates an IPO has two managing underwriters. In those cases, one-half the IPO was assigned to each of those investment banks. The mean [median] of the underwriter market share, referenced below as the *underwriter rank*, is 6.25% [3.99%].

SEC rules for IPOs expressly require that a prospectus, unless in the more abbreviated format used by small business issuers, disclose any “substantial” interest owned in an issuer by a law firm representing the issuer or the underwriters.¹³⁶ The rules applicable to small business issuers do not expressly require disclosure of interests owned prior to the offering—the expressly required disclosure is limited to contingent fees or interests acquired around the time of the offering.¹³⁷ However, there is a general requirement that a prospectus include all material information, even if the information is not expressly required to be disclosed.¹³⁸ Thus, even small business issuers would be obligated to disclose those investments where material to assessing the roles played by counsel.

Each prospectus was reviewed to identify disclosure of interests of legal counsel to be owned as of the consummation of the IPO. For example, the prospectus for the June 1998 IPO of Inktomi discloses the following interest of Wilson Sonsini Goodrich & Rosati, counsel to the issuer: “As of the date of this prospectus, WS Investment Company 97A, an investment partnership composed of certain current and former members of and persons associated with Wilson Sonsini Goodrich & Rosati, Professional Corporation, beneficially

¹³⁵ This market share information is derived from the 618 IPOs in the sample and an additional forty seven non financial, common stock IPOs for which SDC reported size and underwriter information, although other information used in the models was not reported.

Professionals participating in IPOs can change their names over time. Those name changes can result from mergers, changes in business form, or marketing reasons unaccompanied by a substantive change in the organization. In addition, the SDC database occasionally has typographical errors in firm names. Each law firm and investment bank name reported by SDC was manually reviewed for purposes of identifying those alternative names that should be referenced as a single firm.

¹³⁶ 17 C.F.R. § 229.509 (2000).

¹³⁷ *Id.* § 228.509. Interests not more than \$50,000 are expressly not subject to disclosure. *Id.*

¹³⁸ *Id.* § 230.408.

owns an aggregate of 12,829 shares of the Company's Common Stock."¹³⁹ As in this example, the interest is generally stated in terms of the number of shares owned.

The disclosure can take other forms. For example, the prospectus can indicate that the law firm owns preferred stock to be converted into common stock at the closing of the IPO.¹⁴⁰ Or the interest may be owned by an individual lawyer.¹⁴¹ Occasionally, the disclosure indicates that lawyers are expected to purchase stock in the IPO itself or otherwise are going to have an increased interest as of the closing of the IPO.¹⁴² In each case, an aggregate law firm interest was computed, consisting of the extent of the beneficial interest owned as of consummation of the IPO by the issuer's law firm and lawyers associated with that law firm, valued at the *estimated offer price* described above.

The mean [median] interest (referenced as *law firm investment*) was valued at \$292,328 [\$0]. The issuer's law firm disclosed it had an equity interest in the issuer (whether quantified or not) in 36% (referenced as *any issuer's lawyer investment*) of the IPOs. Two of the offerings had unusually high interests. The three greatest interests were valued at \$24 million, \$23 million, and \$4.6 million. The percentage of offerings in which there were these interests (quantified or not) increased from 1998 (30%) to 1999 (40%). The mean investment, however, actually decreased slightly over these two years—\$299,253 in 1998 to \$288,527 in 1999.

A material number of these offerings involved law firms that participated only infrequently in the IPO process. For example, in only 433 of these 618 IPOs did the issuer's law firm represent issuers at least three times in non-financial IPOs in the 1998 through 1999 period.

¹³⁹ Inktomi Corp., 2,254,000 Shares of Common Stock 62 (June 12, 1998) (prospectus), <http://www.sec.gov/Archives/edgar/data/1024302/0001012870-98-001571.txt>.

¹⁴⁰ *E.g.*, Calico Commerce, Inc., 4,000,000 Shares of Common Stock 69, 91 (Oct. 6, 1999) (prospectus), <http://www.sec.gov/Archives/edgar/data/1081154/0000891618-99-004480-index.html>.

¹⁴¹ *E.g.*, Xpedior Corp., 8,535,000 Shares of Common Stock 76 (Dec. 15, 1999), <http://www.sec.gov/Archives/edgar/data/1096287/0000950129-99-005447-index.html>.

¹⁴² *E.g.*, Agency.com Ltd., 5,900,000 Shares of Common Stock 89 (Dec. 8, 1999) (registration statement), <http://www.sec.gov/Archives/edgar/data/1086403/0000912057-99-008583-index.html>.

SEC rules also require disclosure of interests owned by underwriters' counsel.¹⁴³ In only seven IPOs was that type of interest disclosed. Based on the small frequency, interests of underwriters' counsel were disregarded.

Occasionally, the existence of an interest is disclosed without an indication of its magnitude.¹⁴⁴ In those cases, a *law firm investment* of zero was assigned. Also disregarded were contingent fee arrangements, in which issuer's counsel contracted to receive a larger fee if the IPO were successfully completed. The prospectus for the 1998 IPO of Advanced Communications Group provides an example. In that case, the prospectus states the issuer's counsel would "receive a premium over their normal hourly billing rates for the legal services performed by them in connection with the Offering if the Offering is completed and [would] accept a substantially reduced fee payment in the event that the Offering is not completed."¹⁴⁵

The prospectus disclosure generally does not identify the date of the law firm investment. Thus, the prospectus disclosure does not typically allow one to assess whether the investment was made within a few months of the IPO, i.e., subsequent to the beauty pageant. However, part II of each of the forms of registration statements on which IPOs are required to be filed require that an issuer disclose recent sales of unregistered securities.¹⁴⁶ This information was reviewed in an attempt to determine for the offerings in the data set whether any investment by the issuers' law firms had taken place shortly before the corresponding IPOs. However, the scope of the disclosure frequently given is insufficient for this purpose; the identities of those making purchases at various times frequently are omitted.

Identifying the timing of investments could be important. Consider an issuer about whom favorable information became known after the beauty pageant. If lawyers could learn this information and invest

¹⁴³ 17 C.F.R. §§ 228.509, 229.509 (2000).

¹⁴⁴ *E.g.*, Reltec Corp., 5,500,000 Shares of Common Stock 71 (Mar. 12, 1998), <http://www.sec.gov/Archives/edgar/data/1052637/0001047469-98-009809.txt>.

¹⁴⁵ Advanced Communications Group Inc., 8,000,000 Shares of Common Stock 90 (Feb. 12, 1998), <http://www.sec.gov/Archives/edgar/data/1047643/0000950136-98-000292.txt>.

¹⁴⁶ 17 C.F.R. §§ 228.701, 229.701 (2000); Form S-1, 2 Fed. Sec. L. Rep. (CCH) ¶ 7121, at 6239, Item 15 (issue no. 1965, Feb. 21, 2001); Form SB-2, 2 Fed. Sec. L. Rep. (CCH) ¶ 7313, at 6509, Item 26.

between the beauty pageant and the offering, that would produce a positive relationship between *law firm investment* and *price adjustment*. That relationship would be independent of change in performance of professional duties arising from the law firm investment.

There are a few reasons to expect why investments in that time frame—between the beauty pageant, based on information first known after the beauty pageant, and the IPO date—are unlikely. First, as noted above,¹⁴⁷ the time period is short—generally only a few months. Second, for the investment to occur, the issuer must sell the securities (assuming, as ordinarily will be the case,¹⁴⁸ there is no market in the securities). It does not seem likely that an issuer will decide to sell securities in a private placement while it is in the process of registering its IPO. Doing so raises integration issues; the sale might not be exempt from registration because it would be integrated into—considered a part of—the pending public offering.¹⁴⁹

After the beauty pageant, a law firm could elect or arrange to take its fee for the IPO in stock. That could give rise to an interest created between the beauty pageant and the closing of the IPO that could be reflected in the data. Anecdotal evidence suggests that does not principally account for the law firm interests.¹⁵⁰

Popular press reports indicate San Francisco area lawyers are more likely to invest in firms they take public than their East Coast counterparts.¹⁵¹ For this reason, offering statistics were separately prepared for offerings SDC reports as involving lawyers located either

¹⁴⁷ See *supra* notes 102–03 and accompanying text.

¹⁴⁸ See *supra* note 39 and accompanying text.

¹⁴⁹ See generally 3 LOSS & SELIGMAN, *supra* note 78, at 1231–48 (3d ed., rev. vol. 1999) (discussing integration).

¹⁵⁰ See Miller, *supra* note 14, at 438–41 (noting that a firm known for taking equity stakes indicates those interest are not in lieu of hourly fees, although payment of the hourly fees may be deferred until financing has been obtained); Baker, *supra* note 5 (quoting the general counsel of a prominent California-based firm known for taking these interests as saying, “It is a great myth that most firms in California make investments by taking stock as fees. . . . We’ve always felt that when you’re running a law firm, you get paid for what you do, and you get paid in cash.”).

¹⁵¹ Renee Deger, *Taking Stock: Cashing in Big on Client IPOs*, RECORDER, Jan. 21, 1999, at 1. But cf. Coffee, *supra* note 4 (stating, in discussing an SEC no-action letter addressed to Ropes & Gray, a Boston-based law firm, concerning whether law firm investment vehicles are subject to the Investment Company Act of 1940, 15 U.S.C. §§ 80a-1 to -64 (1994 & Supp. V 1999), “At a minimum, this SEC action shows that stock for legal services appears to have become acceptable even among the Boston Brahmins.”).

inside or outside the greater San Francisco area (San Francisco, Palo Alto, and Menlo Park). Twenty-seven percent of the issuers engaged lawyers located in the greater San Francisco area. Table 2 reports statistics for the offerings in which SDC reports the issuers' lawyers were not from the greater San Francisco area, with the information for offerings involving lawyers SDC reports as being in the greater San Francisco area in Table 3. Consistent with the notion expressed in the popular press, the issuer's lawyer had an interest in its client of any type, quantified in the prospectus or not, in twenty-seven percent of the offerings involving issuers' lawyers from outside the greater San Francisco area, whereas the corresponding number for offerings involving issuers' lawyers from the greater San Francisco area was sixty-one percent. There are similar differences in the mean value of the law firm investment in the issuer—\$226,733 for offerings involving issuers' lawyers from outside the greater San Francisco area and \$469,474 for offerings involving issuers' lawyers from the greater San Francisco area.

C. *Regressions*

To investigate the relationship between IPO price and law firm investment, ordinary least squares regressions were prepared. The dependent variable in each regression, referenced as the *price adjustment*, reflects the change from the estimated offer price per share first disclosed in a preliminary prospectus (the midpoint in the case of a range), referenced as the *estimated offer price*, to the actual IPO price per share. The change from the *estimated offer price* to the actual offer price has been previously used in the finance literature for examining the extent of the activity taken by participants—in that case, the underwriters—before an IPO.¹⁵²

¹⁵² Kathleen Weiss Hanley, *The Underpricing of Initial Public Offerings and the Partial Adjustment Phenomenon*, 34 J. FIN. ECON. 231, 241 (1993).

Table 2
Descriptive Statistics for 451 IPOs in 1998–1999 Where
the Issuer's Lawyers Were Not from the Greater San Francisco Area

	Mean	Median	Standard Deviation	Min	Max
Price Adjustment (\$)	0.80	0.49	3.67	-6.91	32.11
Price Adjustment (%)	7.85	4.55	34.27	-58.33	344.44
Offer Price (\$)	13.48	12.84	6.44	3.95	94.39
Estimated Offer Price (\$)	12.68	11.85	5.23	2.19	87.58
Law Firm Investment (\$)	226,733	0	1,245,908	0	23,069,852
Any Issuer's Lawyer Investment (%)	27				
Underwriter Rank (%)	5.62	3.68	7.13	0.01	27.15
Est. Offer Size (\$100 millions)	1.09	0.49	3.19	0.03	41.52
Est. Price to Book Value	5.15	3.51	6.83	0.40	96.24
Pre-IPO Equity Value (\$100 millions)	4.69	1.32	18.84	0.00	223.95
Issue Year	1998.60				

Table 3
Descriptive Statistics for 167 IPOs in 1998–1999 Where
the Issuer's Lawyers Were from the Greater San Francisco Area

	Mean	Median	Standard Deviation	Min	Max
Price Adjustment (\$)	2.79	2.92	3.60	-4.94	17.52
Price Adjustment (%)	24.87	23.08	32.00	-41.67	150.00
Offer Price (\$)	14.07	13.62	4.49	6.81	33.08
Estimated Offer Price (\$)	11.28	10.70	2.19	6.33	21.41
Law Firm Investment (\$)	469,474	120,378	1,915,354	0	24,159,073
Any Issuer's Lawyer Investment (%)	61				
Underwriter Rank (%)	7.94	5.45	6.89	0.05	26.67
Est. Offer Size (\$100 millions)	0.53	0.44	0.39	0.12	3.57
Est. Price to Book Value	8.22	4.31	19.32	0.74	230.41
Pre-IPO Equity Value (\$100 millions)	2.87	1.57	5.27	0.04	60.25
Issue Year	1998.78				

For each set of independent variables used, results are reported for models having as a dependent variable the *price adjustment*, expressed in either dollars or on a percentage basis. This variable and all other variables in units of dollars were deflated using the GDP implicit price deflator (1997=100). As discussed above,¹⁵³ the *estimated offer price* provides, and has been described by others as providing, a proxy for the price arrived at during the beauty pageant. That price should reflect all material information that can be practicably conveyed to investment banks about the issuer during the beauty pageant.

The focus of the empirical examination is relationship between *price adjustment* and a measure of law firm investment. A proper model, however, cannot include only these two variables. Rather, a proper model must include other factors that are hypothesized to affect the price adjustment. For example, one might expect there to be a relationship between the type of investment bank and these price adjustments. For example, low-quality investment banks might be more prone to lying during the beauty pageant—overstating the anticipated price to secure business—than their more reputable colleagues. A proper model should take that into account. Thus, a proper empirical model can take the form of considering the *price adjustment* as being a function of a variety of other factors, including the measure of the law firm investment and other variables, such as the prestige of the managing underwriter, that influence the *price adjustment*.

Reflecting these considerations, a relationship of the following form is considered:

price adjustment =

$$\beta_0 + \beta_1 \text{ law firm investment term} + \beta_2 \text{ other factor}_1 + \dots \beta_{n+1} \text{ other factor}_n$$

In this model, the β_i s represent coefficients, which are estimated in the regressions.

Preparation of the model requires specification of the other factors that may influence the price adjustment. In other circumstances, one might need to include numerous variables reflecting the characteristics of the firm. However, in this case, the choice of the

¹⁵³ See *supra* note 132.

dependent variable, *price adjustment*, decreases the number of other variables that are needed. This variable reflects the change in price from an estimate that is based on various characteristics of the issuer. Thus, only additional variables bearing on matters that may produce a bias in the original estimate, given those firm characteristics, need be incorporated in the model.

The additional variables used include the following: A variable representing the managing underwriter's market share, *underwriter rank*, for which descriptive statistics are described above,¹⁵⁴ is included. The managing underwriter's prestige may affect how it approaches valuation during the beauty pageant and, therefore, be associated with the price adjustment. Underwriter market share has been previously used in the finance literature as a proxy for underwriter quality.¹⁵⁵

Three additional variables address aspects of the issuer and its contemplated offering that may affect the price adjustment: *log(est. offer size)*, *est. price to book value* and *log(Pre-IPO equity value)*. The dollar amounts for the first and third variables are expressed in \$100 millions.

The estimated size of the offer will affect competition during the beauty pageant. The fees paid to investment banks for underwriting an IPO are a percentage of the offer size, typically approximately seven percent.¹⁵⁶ Larger offerings therefore can attract greater interest from prospective underwriters. The level of the competition in the beauty pageant may affect the level of aggressiveness investment banks bring to estimating the IPO price.

To incorporate the size of the offering, the models use the variable *log(est. offer size)*, defined as the natural logarithm of the estimated size of the domestic portion of the offering, as initially disclosed in a preliminary prospectus (excluding the overallotment option),¹⁵⁷ expressed in \$100 millions. The natural logarithm of the variable is

¹⁵⁴ See *supra* tbls. 1–3.

¹⁵⁵ Megginson & Weiss, *supra* note 42, at 890.

¹⁵⁶ Hsuan-Chi Chen & Jay R. Ritter, *The Seven Percent Solution*, 55 J. FIN. 1105, 1105 (2000).

¹⁵⁷ An overallotment option refers to additional shares the underwriters have the option to purchase, to cover overallotments of shares in the offering, i.e., sales of shares in an aggregate amount greater than the number of shares the underwriters are required to purchase in the offering. 1 LOSS & SELIGMAN, *supra* note 78, at 336–37 (3d ed. 1989). The option can be for no more than fifteen percent of the number of shares the underwriters agree to purchase. See *id.* at 337.

used, because the effect is not expected to be linear—a \$10 million increase in size is much more important for an offering that otherwise would be only \$5 million than one that otherwise would be \$1 billion.

In prior finance literature examining securities offerings, actual offer size, as opposed to estimated size, has been used.¹⁵⁸ However, Hansen identifies concerns with that variable.¹⁵⁹ Changes in the offer price will cause corresponding changes in the size of an offering, holding constant the number of shares offered. This fact could result in a spurious correlation between actual proceeds and IPO price, and could adversely affect other relationships.

A second additional variable, *log(est. price to book value)*, is incorporated, which bears on the difficulty in valuing the issuer during the beauty pageant. This variable equals the natural logarithm of the ratio of the *estimated offer price* to book value, as of closing of the IPO. Estimated prices may vary more for IPOs to be priced at a substantial variance from book value.

A third additional variable incorporated in the models is *log(Pre-IPO equity value)*, which is the natural logarithm of the product, expressed in \$100 millions, of the number of shares outstanding before the IPO multiplied by the *estimated offer price*. This variable may also address factors relevant to the ease of estimating the actual IPO price.

Because there are regional variations in the extent to which law firms invest in their clients, and, in particular, in the San Francisco area, some models (Models 3 through 6) incorporate a dummy variable reflecting the participation of lawyers representing the issuer from the greater San Francisco area (including San Francisco, Menlo Park, and Palo Alto). In addition, some models (Models 5 and 6) interact the lawyer investment variables of interest with this location variable.

At various times, the IPO market, and segments of the IPO market based on the line of business of the issuer, are “hot.”¹⁶⁰ A dummy

¹⁵⁸ E.g., Richard B. Carter et al., *Underwriter Reputation, Initial Returns, and the Long Run Performance of IPO Stocks*, 53 J. FIN. 285, 292 (1998) (“The natural logarithm of gross proceeds . . . has been included in virtually all previous work.”); Megginson & Weiss, *supra* note 42, at 896.

¹⁵⁹ Robert S. Hansen, *Do Investment Banks Compete in IPOs? The Advent of the “7% Plus Contract”*, 59 J. FIN. ECON. 313, 339 (2001).

¹⁶⁰ Franklin Allen & Gerald R. Faulhaber, *Signaling by Underpricing in the IPO Market*, 23 J. FIN. ECON. 303, 303, 316 (1989).

variable for the year of issue was included for 1998 (1999 being the “hold-out”). In addition, the models account for “hot” IPO market segments by incorporating certain dummy variables identifying primary two-digit SIC issuer codes. Dummy variables were included in each model for each two-digit SIC code for which there are at least three IPOs in the sample in each year studied, a criterion suggested by another investigation of offerings.¹⁶¹ There were fourteen of those two-digit SIC code classifications.¹⁶²

The price of an IPO may change from the beauty pageant estimate in response to changes in the overall market. For this reason, each of the models incorporates a variable reflecting a change in the NASDAQ Composite Index, from the initial filing date reported by SDC to the business day before the commencement of the IPO. The NASDAQ Composite Index information was taken from the Center for Research in Security Prices database. In models having a dependent variable having units of dollars, the variable (referenced below as *NASDAQ change x est. offer price*) consists of:

$$\frac{\text{NASDAQ (business day before IPO)} - \text{NASDAQ (day preliminary prospectus filed)}}{\text{NASDAQ (day preliminary prospectus filed)}} \times \text{estimated offer price}$$

where “NASDAQ” references the closing price of the NASDAQ Composite Index for the identified day. In models having a dependent variable having units of percentage points, the variable reflecting the change in the NASDAQ Composite Index (referenced below as *NASDAQ change (%)*) consists of the percentage change in the NASDAQ Composite Index from the date the preliminary prospectus was filed to the business day before the IPO.

¹⁶¹ See Craig C. Dunbar, *Factors Affecting Investment Bank Initial Public Offering Market Share*, 55 J. FIN. ECON. 3, 23 n.6 (2000).

¹⁶² Those SIC classifications were 20 (Food and Kindred Products); 27 (Printing, Publishing, and Allied Industries); 28 (Chemicals and Allied Products); 35 (Industrial and Commercial Machinery and Computer Equipment); 36 (Electronic and Other Electrical Equipment and Components, Except Computer Equipment); 38 (Measuring, Analyzing, and Controlling Instruments; Photographic, Medical and Optical Goods; Watches and Clocks); 47 (Transportation Services); 48 (Communications); 50 (Wholesale Trade—durable Goods); 51 (Wholesale Trade—non-durable Goods); 59 (Miscellaneous Retail); 73 (Business Services); 80 (Health Services); and 87 (Engineering, Accounting, Research, Management, and Related Services). See generally <http://www.osha.gov/oshstats/sicser.html> (last visited Sept. 9, 2001) (identifying SIC code groups).

1. *Offering-Specific Investments*

That completes the variables used to identify firm-specific or offering-specific characteristics. The final specification of the models requires more precise identification of the law firm investment term. Empirical models were prepared using two different forms of law firm investment term. For one set of models—those presented in Table 4—the law firm investment term is the variable $\log(1 + \text{Law Firm Investment})$. This variable consists of the natural logarithm of one plus the dollar amount of the issuer's law firm's beneficial interest in the issuer, in deflated dollars, based on the *estimated offer price* referenced above. These models therefore address whether there is a relationship between an investment in the particular issuer by its law firm and pricing.

The equation representing the principal models (Models 1 and 2) presented in Table 4 therefore is of the form:

price adjustment =

$$\beta_0 + \beta_1 \log(1 + \text{law firm investment}) + \beta_2 \text{underwriter rank} + \beta_3 \log(\text{est. offer size}) + \beta_4 \log(\text{est. price to book value}) + \beta_5 \log(\text{pre-IPO equity value}) + \beta_6 \text{SIC code classification dummy}_1 + \dots + \beta_{19} \text{SIC code classification dummy}_{14} + \beta_{20} \text{year of issue dummy} + B_{21} \text{NASDAQ variable}$$

Results for models using that dependent variable are presented in Table 4.

The results in Table 4 show a positive relationship between law firm investment, expressed in terms of dollars, and the price adjustment. The relationship is significant¹⁶³ at the 1% level (two-tailed) in the model that does not include the San Francisco dummy variable (see Table 4, Model 1). When that variable is included, the relationship is significant at the 10% level (see Table 4, Model 3), and is significant at the 10% level when interacted with the participation of a law firm located outside the greater San Francisco area (see Table 4, Model 5). The variable is not significant when interacted

¹⁶³ All significance levels have been computed using heteroskedasticity-corrected standard errors, following White's procedure. See Halbert White, *A Heteroskedasticity-Consistent Covariance Matrix Estimator and a Direct Test for Heteroskedasticity*, 48 *ECONOMETRICA* 817 (1980).

Table 4
Regression Results Showing the Relationship Between
IPO Price Adjustment and Law Firms' Investments in Clients

Ordinary least squares regressions; data set comprises a total of 618 common stock IPOs, in 1998 and 1999, involving firms not in the fields of finance, insurance, and real estate.

The results of each model are presented for each of two dependent variables. Both dependent variables reflect the change from the estimated IPO price first disclosed in a preliminary prospectus (the *estimated offer price*) to the IPO price per share. The dependent variable *Price Adjustment (\$)* reflects the dollar amount of that per share price change; the dependent variable *Price Adjustment (%)* reflects the percentage amount of that dollar per share price change.

The independent variable reflecting the law firm investment is $\log(1 + \text{Law Firm Investment})$, the natural log of 1 plus the dollar amount of the beneficial interest in the issuer owned by the issuer's counsel as of the closing of the IPO, valued at the *estimated offer price* (in $\log(\$)$).

Other independent variables include: *underwriter rank*, the annual percentage market share of the managing underwriter of the offering, based on dollar volume of IPOs lead managed; $\log(\text{ext. offer size (in \$100 millions)})$, the natural log of the estimated size of the offer first disclosed in a preliminary prospectus (excluding the overallotment option); $\log(\text{est. price to book value})$, the natural log of the ratio of the *estimated offer price* to book value, as of the closing of the IPO; $\log(\text{pre-IPO equity value (in \$100 millions)})$, the natural log of the number of shares outstanding before the IPO multiplied by the *estimated offer price*; and a variable reflecting the change in the NASDAQ Composite Index. For models having a dependent variable in units of percentage points, the variable reflecting the change in the NASDAQ consists of the percentage change in the closing NASDAQ Composite Index from the initial filing date reported by SDC to the business day before the IPO. For models having a dependent variable in units of dollars, the variable reflecting the change in the NASDAQ consists of that percentage change multiplied by the *estimated offer price* divided by 100.

Included in some models is the dummy variable *San Francisco*, which equals one where the issuer's law firm is located in the greater San Francisco area (San Francisco, Menlo Park, and Palo Alto). Models 5 and 6 also interact the law firm investment variable with variables reflecting whether the issuer's law firm is located in the greater San Francisco area.

Each model also includes a dummy variable (unreported) for each of the fourteen two-digit primary issuer SIC codes, representing the classifications for which there were at least three IPOs in the sample in both 1998 and 1999. Also included in each model is a dummy variable reflecting the year of issuance of 1998 (also unreported).

Below parameter estimates, in parentheses, are *t*-statistics computed using heteroskedasticity-corrected standard errors. Significance at the 1%, 5%, and 10% levels (two-tailed) are identified by ***, **, and *, respectively. All dollar amounts are expressed in 1997 dollars, deflated using the GDP implicit price deflator.

Independent Variable	Dependent Variable—Price Adjustment Expressed as \$ or %:					
	(1)	(2)	(3)	(4)	(5)	(6)
	\$	%	\$	%	\$	%
Intercept	-0.885 (-1.724)*	-7.348 (-1.649)*	-0.909 (-1.782)*	-7.450 (-1.678)*	-0.934 (-1.825)*	-7.548 (-1.712)*
log(1 + Law Firm Investment (\$))	0.064 (2.665)***	0.406 (1.783)*	0.046 (1.861)*	0.241 (1.062)		
Not San Francisco x log(1 + Law Firm Investment (\$))					0.061 (1.863)*	0.302 (1.015)
San Francisco x log(1 + Law Firm Investment (\$))					0.018 (0.448)	0.123 (0.356)
Underwriter Rank	0.129 (5.622)***	1.236 (6.616)***	0.123 (5.230)***	1.183 (6.193)***	0.124 (5.221)***	1.184 (6.195)***
log(Est. Offer Size (\$100 million))	-1.746 (-7.549)***	-16.697 (-7.663)***	-1.703 (-7.274)***	-16.286 (-7.371)***	-1.691 (-7.277)***	-16.238 (-7.288)***
log(Est. Price to Book Value)	-0.921 (-4.730)***	-7.986 (-4.564)***	-0.955 (-4.937)***	-8.303 (-4.755)***	-0.961 (-4.943)***	-8.327 (-4.739)***
log(Pre-IPO Equity Value (\$100 millions))	1.276 (7.909)***	9.694 (6.902)***	1.253 (7.780)***	9.494 (6.814)***	1.255 (7.760)***	9.502 (6.792)***
NASDAQ Change x Est. Offer Price	0.176 (1.528)		0.183 (1.594)		0.183 (1.615)	
NASDAQ Change (%)		0.290 (1.662)*		0.292 (1.674)*		0.292 (1.681)*
San Francisco			0.914 (2.641)***	8.398 (2.713)***	1.171 (3.177)***	9.451 (2.667)***
Adj. R ²	0.28	0.24	0.29	0.24	0.29	0.24

with the participation of a greater San Francisco area law firm (see Table 4, Model 5). The relationship is of the same sign, but, with one exception, not statistically significant when examining percentage price adjustment.

2. *Frequency of Investment in Clients*

The frequency with which lawyers invest in their clients has increased over time and has varied among communities. As noted above,¹⁶⁴ data from the sample and popular press reports both indicate San Francisco area lawyers are more likely to invest in firms they take public than their East Coast counterparts. Other anecdotal evidence indicates that there may be different standards of legal practice among different communities and, in particular, in that area of California.¹⁶⁵

The models presented in Table 4 address a relationship between a law firm's investment in a particular issuer and the performance by the lawyers in their representation of that client. However, there could be a second type of relationship between law firm investment and law firm performance. As is the case with professionals generally, lawyers will vary in terms of how they approach their professional duties. Some will be more aggressive than others in requiring disclosure. Some will be more willing to invest in their clients than others. These two characteristics may be related—lawyers more willing to invest in their clients may generally require different levels of disclosure, even in the case of issuers in which they do not have an equity interest. To put it another way, lawyers that are conservative, relative to their peers, in construing their ethical obligations, and who therefore avoid taking financial interests in their clients, may also be conservative, relative to their peers, in the sense of requiring more, or more detailed, disclosure in prospectuses of adverse information. If so, there should be a relationship between the frequency with which the

¹⁶⁴ See *supra* note 151 and accompanying text.

¹⁶⁵ Lisa Bernstein, *The Silicon Valley Lawyer as Transaction Cost Engineer?*, 74 OR. L. REV. 239, 249–50 (1995) (“[A Silicon Valley] lawyer noted, ‘when I deal with lawyers in other parts of the country, they . . . will go crazy over a lot of stuff that would just draw a yawn from a Silicon Valley law firm.’”). See generally John C. Coates IV, *Explaining Variation in Takeover Defenses: Blame the Lawyers*, 89 CAL. L. REV. 1301, 1383 (2001) (concluding, after an empirical analysis, “Silicon Valley law firms . . . seem to have provided inferior advice to IPO clients on takeover defenses in the early 1990s.”).

law firm has an equity interest in the firms that it takes public and the price realized in an IPO.

For this purpose, one can define a variable for each law firm equal to the percentage of the issuers that law firm represented in IPOs in which the law firm had a beneficial equity interest of some type. This variable is referenced as the *frequency issuer's lawyer invests*.¹⁶⁶ The results of the models incorporating this variable are presented in Table 5.

To reflect this alternative formulation, Models 1 and 2 presented in Table 5 are therefore of the form:

price adjustment =

$$\beta_0 + \beta_1 \log(1 + \text{freq. issuer's lawyer invests}) + \beta_2 \text{underwriter rank} + \beta_3 \log(\text{est. offer size}) + \beta_4 \log(\text{est. price to book value}) + \beta_5 \log(\text{pre-IPO equity value}) + \beta_6 \text{SIC code classification dummy}_1 + \dots + \beta_{19} \text{SIC code classification dummy}_{14} + \beta_{20} \text{year of issue dummy} + \beta_{21} \text{NASDAQ variable}$$

Table 5 addresses the relationship between *price adjustment* and the frequency with which the law firm invests in clients it takes public. The results show a positive relationship, significant at the 1% level in the models not incorporating the San Francisco dummy variable (see Table 5, Models 1 and 2), and significant at the 5% level for models incorporating the San Francisco dummy variable (see Table 5, Models 3 and 4). The level of significance is the same, whether the dependent variable is stated on a dollar or on a percentage basis. Variables interacting the frequency of law firm investment with San Francisco or non-San Francisco dummy variables are only significant in the non-San Francisco cases (see Table 5, Models 5 and 6).

¹⁶⁶ In particular, the variable equals the fraction, expressed as a percentage, computed as follows: The numerator is the number of IPOs in the sample in which the law firm participated and had a beneficial interest in the issuer (whether quantified or not). The denominator of the fraction is the number of IPOs in the sample in which that law firm participated. For example, if a law firm participated in four IPOs in the sample and it had a beneficial equity interest in one of those issuers, then the variable *frequency issuer's lawyer invests* for each of those four IPOs would be twenty-five percent.

Table 5
Regression Results Showing the Relationship Between
IPO Price Adjustment and Law Firms' Frequency of Investments in Clients

Ordinary least squares regressions; data set comprises a total of 416 common stock IPOs, in 1998 and 1999, involving firms not in the fields of finance, insurance, and real estate, restricted to offerings involving law firms that represented at least three issuers in the sample.

The results of each model are presented for each of two dependent variables. Both dependent variables reflect the change from the estimated IPO price first disclosed in a preliminary prospectus (the *estimated offer price*) to the IPO price per share. The dependent variable *Price Adjustment (\$)* reflects the dollar amount of that per share price change; the dependent variable *Price Adjustment (%)* reflects the percentage amount of that dollar per share price change.

The independent variable reflecting this frequency, *freq. issuer's lawyer invests*, represents the ratio, expressed as a percentage, having as the numerator the number of issuers in the sample the law firm represented in which it had a disclosed beneficial interest, whether quantified or not, and having as the denominator the number of issuers in the sample the law firm represented.

Other independent variables include: *underwriter rank*, the annual percentage market share of the managing underwriter of the offering, based on dollar volume of IPOs lead managed; *log(est. offer size (in \$100 millions))*, the natural log of the estimated size of the offer first disclosed in a preliminary prospectus (excluding the overallotment option); *log(est. price to book value)*, the natural log of the ratio of the *estimated offer price* to book value, as of the closing of the IPO; *log(Pre-IPO equity value (in \$100 millions))*, the natural log of the number of shares outstanding before the IPO multiplied by the *estimated offer price*; and a variable reflecting the change in the NASDAQ Composite Index. For models having a dependent variable in the units of percentage points, the variable reflecting the change in the NASDAQ consists of the percentage change in the closing NASDAQ Composite Index from the initial filing date reported by SDC to the business day before the IPO. For models having a dependent variable in units of dollars, the variable reflecting the change in the NASDAQ consists of that percentage change multiplied by the *estimated offer price* divided by 100.

Included in some models is the dummy variable *San Francisco*, which equals one where the issuer's law firm is located in the greater San Francisco area. Models 5 and 6 also interact the law firm investment variable with variables reflecting whether the issuer's law firm is located in the greater San Francisco area.

Each model also includes a dummy variable (unreported) for each of the fourteen two-digit primary issuer SIC codes, representing the classifications for which there were at least three IPOs in the full sample in both 1998 and 1999. Also included in each model is a dummy variable reflecting the year of issuance of 1998 (also unreported).

Below the parameter estimates, in parentheses, are *t*-statistics computed using heteroskedasticity-corrected standard errors. Significance at the 1%, 5%, and 10% levels (two-tailed) are identified by ***, **, and *, respectively. All dollar amounts are expressed in 1997 dollars, deflated using the GDP implicit price deflator.

	Dependent Variable—Price Adjustment Expressed as \$ or %:					
	(1)	(2)	(3)	(4)	(5)	(6)
Independent Variable	\$	%	\$	%	\$	%
Intercept	-1.148 (-1.805)*	-8.987 (-1.906)*	-1.091 (-1.704)*	-8.342 (-1.758)*	-1.258 (-1.948)*	-9.523 (-1.978)**
Freq. Issuer's Lawyer Invests (%)	0.019 (2.661)***	0.177 (2.794)***	0.016 (2.033)**	0.139 (2.005)**		
Not San Francisco x Freq. Issuer's Lawyer Invests (%)					0.022 (2.427)**	0.183 (2.351)**
San Francisco x Freq. Issuer's Lawyer Invests (%)					0.004 (0.245)	0.051 (0.396)
Underwriter Rank (%)	0.131 (4.965)***	1.165 (5.598)***	0.129 (4.875)***	1.149 (5.509)***	0.130 (4.907)***	1.154 (5.539)***
log(Est. Offer Size (\$100 million))	-2.047 (-6.125)***	-18.641 (-7.768)***	-2.015 (-5.921)***	-18.308 (-7.468)***	-2.017 (-5.936)***	-18.322 (-7.475)***
log(Est. Price to Book Value)	-1.039 (-4.510)***	-9.269 (-4.932)***	-1.045 (-4.555)***	-9.336 (-5.008)***	-1.058 (-4.622)***	-9.438 (-5.068)***
log(Pre-IPO Equity Value (\$100 millions))	1.478 (7.204)***	11.776 (7.326)***	1.470 (7.127)***	11.695 (7.242)***	1.480 (7.121)***	11.766 (7.218)***
NASDAQ Change x Est. Offer Price	0.179 (1.211)		0.180 (1.219)		0.181 (1.237)	
NASDAQ Change (%)		0.210 (1.350)		0.209 (1.343)		0.207 (1.351)
San Francisco			0.364 (0.910)	3.775 (1.084)	1.255 (1.388)	10.196 (1.359)
Adj. R ²	0.30	0.31	0.30	0.31	0.30	0.31

The results reported in Table 5 are all based on a restricted subsample of 432 IPOs in which the issuer's law firm participated in at least three IPOs in the sample. That limitation restricts the sample to offers in which the issuer's law firm has participated in a sufficient number of IPOs to have some pattern of investment (or absence of investment). To confirm the robustness of the results, Models 5 and 6 in Table 5 were re-estimated on the sub-sample of IPOs in which the issuer's law firm participated in at least five offerings. The results were similar, with *t*-statistics for the variable *not San Francisco x frequency issuer's lawyer invests (%)* in Models 5 and 6 of 2.37 and 2.40, respectively, as compared to 2.43 and 2.35 for the reported results in Models 5 and 6, respectively.

D. Analysis of Results

Different persons might construe the results reported above in different fashions. One might argue that any results are produced by an inadequate methodology. That argument would be: (i) the time-frame examined was one in which certain IPOs (those of certain technology firms) performed unusually well; (ii) the participation of lawyers from the greater San Francisco area is associated with issuers in that industry; and (iii) the industry controls are inadequate. Use of models similar to those used in the existing literature, as done in this article,¹⁶⁷ decreases the concern that improper model specification accounts for any results. The data set used in this article consists of essentially all non-financial, common stock IPOs over the most recent two-year period ended before work on this investigation was commenced. The sizes of data sets used in other empirical examinations of IPOs are of magnitudes similar to that of the data set used in this study.¹⁶⁸ It is clear, however, that the nature of these

¹⁶⁷ See *supra* note 161 and accompanying text.

¹⁶⁸ See, e.g., Randolph P. Beatty & Jay R. Ritter, *Investment Banking, Reputation, and the Underpricing of Initial Public Offerings*, 13 J. FIN. ECON. 213, 222 (1986) (using a sample of 545 firms in a model); Randolph P. Beatty & Ivo Welch, *Issuer Expenses and Legal Liability in Initial Public Offerings*, 39 J.L. & ECON. 545, 556 (examining 960 initial public offerings over a three year period); Megginson & Weiss, *supra* note 42, at 894 tbl.VI (examining 991 IPOs and a subset (matched sample) of 640 IPOs).

The adequacy of the data set used in this Article can be assessed by comparison with that used in another piece of prominent legal literature. Alexander prepared a study, Janet Cooper Alexander, *Do the Merits Matter? A Study of Settlements in Securities Class Actions*, 43 STAN. L. REV. 497 (1991), which was heavily relied upon by the proponents of the Private

relationships may change over time. Thus, for example, Beatty and Welch find the relationship between investment bank quality and IPO underpricing changed sign from the early 1980s to the early 1990s.¹⁶⁹

Alternatively, if the methodology is considered satisfactory, one may inquire as to whether any price effect is only associated with the participation of greater San Francisco area lawyers (the results for each San Francisco dummy variable—not the interaction variables—in Table 4 being significant). One can argue there is some evidence consistent with a general relationship, i.e., a price association that is not specific to the participation of greater San Francisco area lawyers. The pertinent results are as follows:

First, in the results of Model 3 of Table 4, after accounting for whether greater San Francisco area lawyers participate, the *p*-value for rejecting the hypothesis that law firm investment in the particular issuer is not associated with price adjustment, on a dollar basis, is 0.063. This result provides some evidence consistent with a price association that is not confined to participation of lawyers from the greater San Francisco area.

Second, in the results of Model 5 of Table 4, after accounting for whether greater San Francisco area lawyers participate, the *p*-value for rejecting the hypothesis that a law firm investment in the particular issuer, when interacted with the participation of non-San Francisco lawyers, is not associated with price adjustment, on a dollar basis, is 0.063. This result also provides some evidence consistent with a price association that is not confined to participation of lawyers from the greater San Francisco area.

Third, in the results of Model 3 of Table 5, after accounting for whether greater San Francisco area lawyers participate, the *p*-value for rejecting the hypothesis that the general frequency of law firm

Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737. Lerach, *supra* note 83, at 598. She concluded that for an important class of securities litigation, "expected trial outcomes seem to have little if any influence on the settlement amount." Alexander, *supra*, at 596. The empirical basis of her conclusions was derived from a sample of nine IPOs, in the first half of 1983, all of computer or computer-related companies. *See id.* at 510, 517 tbl.4. *See generally* Leonard B. Simon & William S. Dato, *Legislating on a False Foundation: The Erroneous Academic Underpinnings of the Private Securities Litigation Reform Act of 1995*, 33 SAN DIEGO L. REV. 959, 966-76 (1996) (criticizing the size of Alexander's sample and her restriction of her sample to a particular industry, referenced as "convenience sampling").

¹⁶⁹ Beatty & Welch, *supra* note 168, at 556, 588-89.

investment is not associated with price adjustment, on a dollar basis, is 0.043. Fourth, in the results of Model 4 of Table 5, after accounting for whether greater San Francisco area lawyers participate, the p -value for rejecting the hypothesis that the general frequency of law firm investment is not associated with price adjustment, on a percentage basis, is 0.046. Fifth, in the results of Model 5 of Table 5, after accounting for whether greater San Francisco area lawyers participate, the p -value for rejecting the hypothesis that the general frequency of law firm investment, when interacted with the participation of lawyers not from the greater San Francisco area, is not associated with price adjustment, on a dollar basis, is 0.016. Sixth, in the results of Model 6 of Table 5, after accounting for whether greater San Francisco area lawyers participate, the p -value for rejecting the hypothesis that the general frequency of law firm investment, when interacted with the participation of lawyers not from the greater San Francisco area, is not associated with price adjustment, on a percentage basis, is 0.019.

If one is satisfied with concluding p -values of approximately 0.06 are consistent with rejecting the null hypothesis, one can view the first and second listed results as providing some support consistent with the view that any price association of law firm investment extends to parts of the country outside the greater San Francisco area, i.e., it is not limited to the participation of greater San Francisco area lawyers. The third through sixth identified results also provide some evidence consistent with the view that, whatever price association exists for law firm investments in clients, it is not merely a phenomenon associated with the participation of greater San Francisco area lawyers. Those results all indicate that frequency of investment in clients is associated with upward price adjustments, whether viewed for lawyers throughout the country (the results identified after "third" and "fourth," above) or whether viewed for lawyers outside the greater San Francisco area (the results after "fifth" and "sixth," above).

Some caution is necessary, however, in considering the results from this type of model. Although the model can indicate association, it does not prove causation. There is, however, one unambiguously incorrect manner of interpreting the results: one cannot look at the results for the variables $\log(1 + \text{Law Firm Investment } (\$))$ in Model 4 of Table 4 and $\text{Not San Francisco} \times \log(1 + \text{Law Firm Investment } (\$))$ in Model 6 of Table 4 and conclude there is no price association of law firm investments and the participation of non-greater San Francisco

area lawyers. The results for the parameter estimates are of the predicted signs, but the p -values for those two results are, respectively, 0.298 and 0.311. It is not clear why those models, which have a dependent variable in the form of a percentage price change, as opposed to a dollar amount of price change, and that have a somewhat decreased adjusted R^2 relative to their counterparts having a different dependent variable formulation, produce results not statistically significant at customary levels, whereas the p -values for the corresponding models having a dependent variable in the form of a dollar price change are approximately 0.06. Even if those results were the only results, i.e., disregarding all the other results, it would be incorrect to assert that a parameter estimate of the expected sign and having a p -value of approximately 0.3 signifies there is no relationship.¹⁷⁰ Those results, on their own, simply provide a confidence interval centered about a point having the expected, i.e., positive, sign, where the tails of the confidence interval include a true parameter of zero. To conclude that law firm investment is not associated with a positive price adjustment, one would have to find a statistically significant relationship of the opposite sign. The models do not yield those results. Moreover, as noted above,¹⁷¹ embedded in the model formulation is a bias against finding results. The statistical evidence consistent with a price association, however, includes various other results mentioned above consistent with a relationship not confined to the participation of greater San Francisco area lawyers.

Embellishment of the “strength” of the relationship is a matter of judgment, on which reasonable minds may differ. For example, Bohn and Choi describe results significant at only the twenty percent level, i.e., “weaker” than significance at the ten percent level, as providing “strong evidence.”¹⁷² Reasonable minds can differ in associating adjectives reflecting a subjective assessment to the

¹⁷⁰ See DAMODAR N. GUJARATI, *BASIC ECONOMETRICS* 129 (3d ed. 1995) (“If on the basis of a test of significance . . . we decide to ‘accept’ the null hypothesis, all we are saying is that on the basis of the sample evidence we have no reason to reject it; we are *not* saying that the null hypothesis is true beyond any doubt Better still . . . ‘the conclusion of a statistical test is “do not reject” rather than “accept.” ’” (emphasis added) (quoting JAN KMENTA, *ELEMENTS OF ECONOMETRICS* 114 (1971)).

¹⁷¹ See *supra* p. 417.

¹⁷² James Bohn & Stephen Choi, *Fraud in the New-Issues Market: Empirical Evidence on Securities Class Actions*, 144 U. PA. L. REV. 903, 953 (1996).

significance of a statistical relationship. In the author's view, the statistics ultimately speak for themselves; the purpose of this Article is to report what, to the author's knowledge, are the first results to address the price relationship of law firm investments in IPOs. Further embellishment of the significance of this relationship would be simply hand-waving. The results, however, clearly do not conclusively prove these law firm investments affect how lawyers perform their professional obligations (although it seems somewhat self-serving for lawyers to assert that they, unique among professionals, are able to disregard their financial incentives in performing their professional obligations). Further investigation may yield additional information bearing on the origins of the relevant relationships.

No judgment is made concerning whether the relationship is the product of conscious malfeasance.¹⁷³ A burgeoning "behavioralist" literature argues that financial incentives can produce subconscious acts consistent with those incentives.¹⁷⁴

E. Implications

To the extent one believes there is a relationship between law firm investment and IPO pricing, such a relationship would raise a number of policy concerns. Three merit mention. First, the scope of disclosure currently provided is insufficient to convey information relevant to a material relationship. Current disclosure frequently does not address when law firms acquired their interests. As law firm financial interests in clients are significantly associated with pricing in

¹⁷³ See generally D.C. Bar Legal Ethics Comm., *supra* note 19, at 7 (noting that investments can "wittingly or unwittingly" influence performance of professional services).

¹⁷⁴ E.g., Christine Jolls et al., *A Behavioral Approach to Law and Economics*, 50 STAN. L. REV. 1471, 1502-04 (1998) (detailing the bias and addressing the extent to which lawyers may be affected to a lesser extent); Russell B. Korobkin & Thomas S. Ulen, *Law and Behavioral Science: Removing the Rationality Assumption from Law and Economics*, 83 CAL. L. REV. 1051, 1093-95 (2000) (detailing the bias); Donald C. Langevoort, *Organized Illusions: A Behavioral Theory of Why Corporations Mislead Stock Market Investors (and Cause Other Social Harms)*, 146 U. PA. L. REV. 101, 143-46 (1997) (same); Donald C. Langevoort & Robert K. Rasmussen, *Skewing the Results: The Role of Lawyers in Transmitting Legal Rules*, 5 S. CAL. INTERDISC. L.J. 375, 423-30 (1997) (discussing the bias within the provision of legal services); Robert A. Prentice, *The Case of the Irrational Auditor: A Behavioral Insight into Securities Fraud Litigation*, 95 NW. U. L. REV. 133, 168-70 (2000) (detailing the bias).

some model specifications, it would seem appropriate to require disclosure of the timing of those investments.

An assessment of the desirability of requiring this disclosure depends on the value of the disclosure as well as the cost of making the disclosure. The value cannot be fully assessed, because the information has not been disclosed uniformly in the past. Nevertheless, the information is relevant to a relationship that is significant, which militates in favor of the desirability of the disclosure. Moreover, the cost of making the disclosure should not be large. Because these investments can give rise to conflicts of interest or potential violations of rules of professional responsibility, one would hope law firms making these investments would keep records sufficient to allow relatively easy generation of the required information.

The second possible implication involves whether these interests should be proscribed. The answer to this question depends on one's assessment of the role played by law firms. One view would look to the role the SEC requires lawyers to fulfill. A registration statement for an IPO of stock is required to include an opinion of counsel.¹⁷⁵ However, the scope of the required opinion is extremely limited; the issuer must provide an opinion of counsel as to the legality of the securities being registered, indicating whether they will, when sold, be legally issued, fully paid and non-assessable.¹⁷⁶ It does not seem likely that a law firm's investment would affect the manner of issuing such an opinion. The matter is too straightforward and too fundamental.

If the public is only entitled to rely on the participating law firm to the extent of assuring the accuracy of that legal opinion, there would be little need, in order to protect the investing public, to prevent law firms from having investments in clients they take public. However, one can perceive lawyers as fulfilling a larger role for the investing public. It is public knowledge that the conditions to the closing of an IPO will include the delivery of an opinion of counsel to the issuer concerning the accuracy of the disclosure. This condition may be explicitly set forth in a publicly available document—the form of

¹⁷⁵ 17 C.F.R. §§ 228.601 exhibit tbl., 229.601 exhibit tbl. (2000).

¹⁷⁶ *Id.* §§ 228.601(b)(5), 229.601(b)(5).

underwriting agreement filed as an exhibit to the corresponding registration statement.¹⁷⁷

One could argue that it is not relevant whether the public can rely on this more detailed opinion, in the sense of investors being able successfully to sue the law firm if this opinion is inaccurate. One might argue that if a law firm is named as participating in an offering, the investing public is entitled to expect some appropriate level of performance by that law firm, even if there is no available legal remedy. The argument would conclude that the evidence is consistent with these investments being associated with changes in law firm behavior and therefore should be proscribed. The evidence reported in this paper provides one factor relevant to assessing that issue. For those persuaded by the existence of a price association, the evidence is not conclusive as to whether the investments should be proscribed, because any price association would be consistent with either (i) a general willingness to invest in clients being associated with a more general, different approach to professional obligations generally¹⁷⁸ or (ii) an investment in a client affecting representation of that client.

This policy consideration should only be assessed in its context. To the extent evidence is less than compelling, or an alternative perspective provides conflicting results, one has to assess both the harm from failing to proscribe these relationships, if they adversely affect lawyer performance, and the harm from proscribing these relationships where they in fact do not affect law firm performance. No persuasive evidence has been presented that clients will be unable to receive necessary legal advice unless their counsel takes equity stakes. Even for cash-strapped firms, equity is not the only solution. Debt, which would raise diminished conflicts of interest, could be used in those cases.

The third, and perhaps most interesting, implication involves due diligence. One primary function of the more detailed legal opinion

¹⁷⁷ *Id.* §§ 228.601 exhibit tbl. (requiring the filing of the underwriting agreement as an exhibit to the registration statement), 229.601 exhibit tbl. (same); John E. Riley, *Letters of Intent and Underwriting Agreements in Initial Public Offerings*, in *HOW TO PREPARE AN INITIAL PUBLIC OFFERING* 1995, *supra* note 101, at 423, 494 (form underwriting agreement detailing the negative assurance to be provided in the legal opinion to be delivered at closing).

¹⁷⁸ See *supra* notes 165–66 and accompanying text.

referenced above,¹⁷⁹ which is delivered at the closing, is to provide a basis for a potential due diligence defense. The opinion will typically indicate that nothing has come to the attention of the law firm that would lead it to believe the offering materials are false or misleading.¹⁸⁰ The final inquiry is, then, whether reliance by an underwriter or other person sued for violation of section 11 or section 12(a)(2) of the Securities Act of 1933¹⁸¹ on an opinion of counsel issued by a law firm that had an investment in the particular issuer, or that frequently has such an interest, could support a due diligence defense.¹⁸²

The due diligence defense provided in section 11 provides: “[T]he standard of reasonableness shall be that required of a prudent man in the management of his own property.”¹⁸³ The evidence reported above can be viewed as consistent with these law firm investments affecting the extent to which a due diligence defense should be provided by reliance on an opinion of counsel that had an interest in the issuer or that frequently has an interest in issuers being taken public.

As a general matter, one is less likely to rely on the advice of a third party where the third party has a potential conflict of interest. The difference here is that there is some statistical evidence consistent with this potential conflict of interest affecting how the third parties perform their duties. The evidence is not definitive, in that not all pertinent parameter estimates are statistically significant at customary levels and investments between the time of the beauty pageant and the final pricing may account for the identified relationship. And, as is the case with all such models, there may be other, unforeseen factors that explain the relationship, in whole or in part. Nevertheless, this

¹⁷⁹ See *supra* note 117.

¹⁸⁰ See *id.*

¹⁸¹ 15 U.S.C. §§ 77k, 77l (1994 & Supp. V 1999).

¹⁸² Coffee makes a related point. He argues the standard of liability under existing securities laws should be increased for an attorney having an interest, at an unspecified level, in his client. Coffee, *supra* note 4.

¹⁸³ 15 U.S.C. § 77k(c). See also 17 C.F.R. § 230.176 (2000) (identifying factors relevant to making that determination). Section 12(a)(2) provides a similar defense, by stating that a person will only be liable under that section where he “shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission” 15 U.S.C. § 77l(a)(2).

circumstance is one of the unusual cases where one can start to quantify the consequences of potential conflicts of interest.

V. CONCLUSION

This Article has examines two principal hypotheses:

Hypothesis 1: Law firm investments in clients diminish the extent to which those law firms require issuers to disclose adverse information in IPO prospectuses.

Hypothesis 2: Those law firms that are willing to invest in their clients are generally less aggressive in requiring their clients, in their IPOs, to disclose adverse information in their IPO prospectuses.

Collectively, the results presented in this article can be viewed as consistent with the notion that there is a relationship between law firm investment and price adjustment in IPOs (and they certainly are not inconsistent with that notion). With the available data, the precise origin of the relationship cannot be ascertained. It is not out of the mainstream of legal scholarship to argue that the actions of law firms may be influenced by their incentives. That people's actions are influenced by their financial incentives is a principal tenet of much legal scholarship and analysis.¹⁸⁴ It would be more surprising to argue the converse—that lawyers are uniquely (or at least unusually) impervious to the influence of their own financial interests.

It is well understood that the absence of a statistically significant relationship does not prove the absence of a relationship. Even if no statistically significant relationship had been found between these law firm investments and law firm performance in a particular model, that would not imply there is no such relationship. That is particularly the case where, as here, there is a strong theoretical basis for expecting there to be such a relationship.

Nevertheless, it is possible that other factors account for the statistically significant results or that the relationships will change over time, as has been reported in other literature examining offerings.¹⁸⁵ One might therefore view this article as the first in what may be a series of attempts to remove from the realm of mere speculation the investigation and analysis of the implications of law firm investments in their clients.

¹⁸⁴ See *supra* note 58 and accompanying text.

¹⁸⁵ See *supra* text accompanying note 169.