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IPO Gatekeeper Liability

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Abstract

This article explores an understudied aspect of the Securities Act, the gatekeeping regime for new companies seeking to offer their shares on the public markets. The Securities Act constitutes a notoriously heavy hammer not only on issuers who make material misstatements and omissions in their offering documents, but on the gatekeepers that serve them. Among these are the auditors, who review a company's financials, and the underwriters, investment banks who price, market, and sell the issuance. The threat of Securities Act liability for gatekeepers has, for years, been understood as a key enforcement mechanism for insuring good gatekeeping. But is it? Using a dataset of over 3800 IPOS and IPO-related Securities Act lawsuits spanning from 2000-2019, I find that that payments by auditors and underwriters in settlements under the Securities Act are extremely rare, even in issuances with potential indicia of faulty gatekeeping. Securities Act claims against auditors are also rare, although such claims against underwriters are far more common. This raises an important question: Does the threat of Securities Act liability for gatekeepers have bite? I suggest that indemnification practices and the institutional structure of most securities class actions may undermine some deterrent effect of the Securities Act against gatekeepers.

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I. Introduction

IPOs have been and remain the signature way for companies to go public. For nearly the last hundred years, the heart of the regime governing IPOs has been the Securities Act of 1933, which punishes material misstatements and omissions in a firm's registration statement and prospectus. This liability is virtually strict. Issuers have no defense for such misstatements. In the IPO process, firms are assisted by gatekeepers, predominantly investment banks, who select and underwrite the offerings, and accounting firms, who prepare the firm's financials for public disclosure. These gatekeepers are also jointly and severally liable for material misstatements and omissions in the offering documents. The rationale for this system is generally thought to be that newly public companies, about which little is known, should be induced to take great care in their statements to potential investors, since few or no other sources of information are available to the markets. This rationale also applies to the investment banks and accounting firms – generally household names – vetting those statements and marketing the securities lend their substantial cachet to fledgling companies. These gatekeepers are also on the hook under the Securities Act should the company not be all it claims to be.[1] While they may benefit from a due diligence defense, the bar for it is high and highly fact-specific.[2] The Securities Act is the "classic example" of the imposition of rigid liability both on issuers and on gatekeepers to prevent corporate wrongdoing.[3]

The primacy of the IPO has been challenged in recent years, as firms seeking the liquidity of the public markets have sought more streamlined, less expensive alternatives. The financial news has been larded with stories on unicorns, direct listings, SPACs, and lamentations about the fewer, larger firms that do ultimately conduct conventional IPOs.[4] Yet despite

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[1] See, e.g., Donald C. Langevoort, Hillary A. Sale, Corporate Adolescence: Why Did "We" Not Work?, 99 Tex. L. Rev. 1347, 1374 (2021) ("[O]nly when faced with the public regime, [and] their own potential for strict liability. . . [were WeWork's underwriters] forced to recalibrate and withdraw the offering."); Brent J. Horton, Direct Listings and the Weakening of Investor Protections, 50 Fla. St. U. L. Rev. 279, 306–07 (2023) ("This second phase of merit review is motivated by the underwriter's desire to avoid liability. Section 11 of the Securities Act imposes liability on the underwriter for any material misstatement in the registration statement unless it can show that it had performed a reasonable investigation giving rise to a reasonable belief that the statements were true.").

[2] Escott v. BarChris Constr. Corp., 283 F. Supp. 643 (S.D.N.Y. 1968); In re WorldCom, Inc. Sec. Litig., 346 F. Supp. 2d 628 (S.D.N.Y. 2004).

[3] John C. Coffee, Jr., *Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms*, 84 B.U. L. Rev. 301, 335 (2004)

[4]

experimentation (or perhaps because of it), there is a growing consensus among commentators that the IPO process works: the tremendous effort and extraordinary fees involved in the diligence process – the checking and double-checking of the company's statements about itself as it goes public – appear to result in public markets composed of firms that, by and large, are non-fraudulent with at least a plausible business plan, in which it not patently unsafe to invest.[5]

In this article, I explore how much gatekeeper liability under the Securities Act has to do with this happy result. Using a dataset of over 3,800 IPOs from 1997 to 2019, I investigate the incidence and characteristics of Securities Act claims against auditors and underwriters. Lawsuits under the Securities Act, because of their potential harshness, are intentionally difficult to bring; indeed, there are only 261 brought based on IPOs between 2000 and 2019, the duration of my sample of lawsuits. This amounts to just shy of 7%, which is roughly consistent with other studies[6] (although the percentage is higher in more recent years). More striking is the rarity with which either auditors or underwriters pay into settlements: only nine accounting firms and seven investment banks made identified contributions to settlement awards over the almost twenty-year course of the sample. Accounting firms are also sued remarkably infrequently: sixteen Securities Act claims in the sample name the auditor for the issuance. Investment bankers, though they rarely pay in settlements, are sued much more frequently, in roughly 80% of the Securities Act claims.

What drives this dearth of successful Securities Act claims against gatekeepers? One possibility is that underwriters and auditors, motivated by the threat of substantial monetary liability under the act and hoping to benefit from the due diligence defense in the event of a lawsuit, simply perform excellent diligence. Thus, there is little reason to sue them, and no reason for them to pay into settlements. Some characteristics of my sample could support this argument. Of the 3,805 IPOs in my sample, only 85 (2.2%) file for bankruptcy within three years of the IPO, and 16 (.39%) restate their financials for fraud-related reasons within the same period. Only a handful of directors or officers, representing .2% of the sample firms, left their posts for nefarious reasons within three years of the IPO. These numbers may suggest that underwriters and other gatekeepers in the IPO process are doing

[5] See, e.g., Patrick M. Corrigan, Do the Securities Laws Actually Protect Investors (and How)? Lessons from Spacs, 101 Wash. U.L. Rev. 1123 (2024).

[6] Emily Strauss, *Suing SPACs,* 96 S. Cal. L. Rev. 553 (2023).

their jobs; the firms that survive the rigors of the diligence process generally do not immediately go belly-up, or reveal themselves to be frauds.

It is also possible, however, that claims against gatekeepers are not being brought and settlements against them are not being won even where there may be reason to win them. Fraud-related restatements of financials are rare in my sample, and do attract Securities Act claims against issuers. Yet only one such restatement drew a Securities Act claim naming the auditor. Similarly, there are over 300 instances in my sample of an IPO being conducted by auditors who were simultaneously engaged in misconduct serious enough that it resulted in a PCAOB sanction – only three resulted in lawsuits naming the accounting firm. Chinese firms listing on U.S. exchanges are prevented by Chinese regulators from providing documentation to outsiders, such as their underwriters and accountants, effectively precluding adequate diligence. But while underwriters are more likely to be named in a complaint involving a Chinese issuer, they are not more likely to pay into a settlement.

Potential explanations might stem from the complex interactions between the procedural features of the due diligence defense, the reputational focus and consolidation of investment banks and accounting firms, and the incentives of the securities plaintiffs' bar.[7] Whether a gatekeeper can assert the due diligence defense is a highly fact specific inquiry, meaning that independently of the issuer, gatekeepers can rarely extricate themselves without slogging through months of expensive, disruptive discovery. Under similar circumstances, many defendants would prefer to pay an earlier, smaller settlement, rather than deal with the trouble and expense of having the claims dismissed, and indeed, many shareholder plaintiffs' firms have

[7] For extensive scholarly discussions of such incentives, see, e.g., Choi, Stephen J. and Erickson, Jessica and Pritchard, Adam C., The Business of Securities Class Action Lawyering (May 9, 2023). NYU Law and Economics Research Paper No. 23-20, Indiana Law Journal, Forthcoming, U of Michigan Law & Econ Research Paper No. 23-023, Available at SSRN: https://ssrn.com/abstract=4350971 or http://dx.doi.org/10.2139/ssrn.4350971; Choi, Stephen J. and Erickson, Jessica and Pritchard, Adam C., Working Hard or Making Work? Plaintiffs' Attorneys Fees in Securities Fraud Class Actions (May 1, 2020). NYU Law and Economics Research Paper No. 19-31, U of Michigan Law & Econ Research Paper, Choi, Stephen J., Jessica Erickson, and Adam C. Pritchard. "Working Hard or Making Work? Plaintiffs' Attorneys Fees in Securities Fraud Class Actions." J. Empirical Legal Stud. 17, no. 3 (2020): 438-65. DOI: https://doi.org/10.1111/jels.12262, Available at SSRN: https://ssrn.com/abstract=3420222 or http://dx.doi.org/10.2139/ssrn.3420222.

built their business models on leveraging the discovery process, extracting payments to go away even where claims may lack merit.[8]

The gatekeepers in my sample do not appear to pay such nuisance settlements. This may reflect the long-held resistance of accounting firms, in particular, to paying small-dollar fees for frivolous claims. Accounting firms have long been willing to force plaintiffs to prove their claims in court, perhaps because they are part of a closed, highly consolidated industry where reputation counts for everything. Accordingly, although due diligence is an expensive defense to prove, it is also an expensive defense for plaintiffs' lawyers – who are paid on a contingency basis and must front their own costs – to overcome. Against auditors, plaintiffs' lawyers appear largely to have stopped trying.

In Securities Act claims against underwriters, potential analysis is more complex because underwriters, unlike auditors, are indemnified by the issuer for liabilities arising out of the securities regime. Although multiple courts have found these indemnification provisions to be unenforceable on public policy grounds,[9] they are rarely negotiated and rarely contested.[10] That underwriters are named frequently in Securities Act lawsuits but rarely pay out in settlements could reflect the reality that virtually all claims against underwriters are actually paid by the issuer. Although the due diligence

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[8] See *id.*; see also Pritchard, Adam C. "Do Institutions Matter? The Impact of the Lead Plaintiff Provision of the Private Securities Litigation Reform Act." S. J. Choi and J. E. Fisch, co-authors. Wash. U. L. Q. 83, no. 4 (2005): 869-905. For examination of this phenomenon in the M&A context, see Cain, Matthew D. and Fisch, Jill E. and Davidoff Solomon, Steven and Thomas, Randall S. and Thomas, Randall S., The Shifting Tides of Merger Litigation (December 4, 2017). Vanderbilt Law Review, Vol. 71, p. 603, 2018, U of Penn, Inst for Law & Econ Research Paper No. 17-6, UC Berkeley Public Law Research Paper No. 2922121, Vanderbilt Law Research Paper No. 17-19, European Corporate Governance Institute (ECGI) - Law Working Paper No. 375/2017, Available at SSRN: https://ssrn.com/abstract=2922121 or http://dx.doi.org/10.2139/ssrn.2922121; Cain, Matthew D. and Fisch, Jill E. and Davidoff Solomon, Steven and Thomas, Randall S. and Thomas, Randall S., Mootness Fees (2019). Vanderbilt Law Review, Vol. 72, p. 1777, 2019, U of Penn, Inst for Law & Econ Research Paper No. 19-26, Available at SSRN: https://ssrn.com/abstract=3398405.

[9] See, e.g., Globus v. Law Research Service, Inc., 418 F.2d 1276, 1288 (2d Cir. 1969), cert. denied, 397 U.S. 913, 90 S.Ct. 913, 25 L.Ed.2d 93 (1970); In re New York City Mun. Sec. Litig., 87 F.R.D. 572, 577 (S.D.N.Y. 1980);
Franklin v. Kaypro Corp., 884 F.2d 1222, 1232 (9th Cir. 1989); Eichenholtz v. Brennan, 52 F.3d 478, 484–85 (3d Cir. 1995); Baker, Watts & Co. v. Miles & Stockbridge, 876 F.2d 1101, 1108 (4th Cir. 1989); In re U.S. Oil & Gas Litigation, 967 F.2d 489 (11th Cir.1992); In re HealthSouth Corp. Sec. Litig., 572 F.3d 854, 860 (11th Cir. 2009).

[10] I conduct a survey of capital markets attorneys and numerous informal interviews to explore this issue.

defense would, as for auditors, be costly for plaintiffs to puncture, the willingness of investment banks to pay nuisance settlements is usually irrelevant (although they may well be reluctant to pay such fees). This is because easier, lower settlements are often pragmatically available on the underwriters' behalf via issuer indemnification.

If the heavy hammer of Securities Act liability for gatekeepers is intended to ensure that only new companies with truthful and plausible business models reach the public markets, my findings could suggest that most gatekeepers are screening well, and most IPOs appear to be relatively successful. If this is the case, do gatekeepers really conduct rigorous diligence of IPO firms because they fear monetary exposure under the Securities Act? And if not, why is the diligence process still rigorous enough to be effective? I conduct a survey and informal interviews of practitioners to help answer these questions. The results, though necessarily tentative, suggest that while gatekeepers may not be motivated by monetary liability under the Securities Act to conduct good diligence, their lawyers think that the due diligence defense is important. Thus, to the extent that gatekeepers are adequately performing their roles, it may be because they do not want to endanger their client relationships through association with inaccurate marketing materials, and because their lawyers tell them to.

Alternatively, based on the findings in this article, one might conclude that IPO gatekeeping is inadequate. Though bankruptcies in the three years following an IPO are rare, one could argue that they should be rarer still, especially in recent years as IPO proceeds have exploded – surely something must have been wrong for a firm to burn through its equity issuance within three years. Similarly, many firms have had the financials in their offering documents vetted by accounting firms engaged in substantial tomfoolery, and Chinese IPOs, where real diligence is virtually impossible, have mushroomed over the sample period. If one takes the view that the solution to all this is to tighten the screws on gatekeepers, several adjustments to the current regime are possible, though none of them are easy. Eliminating issuer indemnification of underwriters in practice as well as in judicial opinions would likely require direct intervention by the SEC, and would probably result in more expensive underwriting commissions, potentially further restricting smaller issuers from reaching the public markets. Even if this alteration were successful, it might result in a scenario where, because they refuse to pay nuisance settlements, accounting firms and investment banks simply are not sued under the Securities Act, even when they deserve it. Correcting this would likely require intensive reform of the plaintiffs' bar that is beyond the scope of this article.

This article proceeds as follows. Section II provides background on the IPO process, the Securities Act and the due diligence defense, and Section III reviews the existing literature. Section IV summarizes the data for the article, and Section V presents descriptive statistics and empirical results. Section VI evaluates the extent to which monetary liability under the Securities Act appears to motivate good gatekeeping by auditors and underwriters in IPOs, and Section VII assesses policy implications. Section VIII concludes.

II. Background: IPOs and Gatekeeper Liability under the Securities Act

The Securities Act of 1933 was passed in the aftermath of the Great Depression in response to flagrant abuses in the capital markets that had contributed to the financial meltdown of the country.[11] The Securities Act governs public offerings by companies (rather than the secondary market).[12] The Securities Act provides recourse for investors where there is a material misrepresentation or omission in a company's registration statement[13] or prospectus.[14] There are no scienter, reliance, or causation requirements for liability under the Securities Act, and liability for issuers is virtually strict.[15] Underwriters, experts (such as auditors) charged with preparing sections of the registration statement, the issuer's directors, and other signatories of the registration statement are also liable for material misstatements and omissions under the Securities Act.[16] For outside directors, liability is proportional to fault.[17] For all other parties, liability is generally joint and several,[18] and for underwriters is limited to "the total price at which the

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13 15 U.S.C. § 77k (hereinafter Securities Act Section 11).

14 14 15 U.S.C. § 771(a)(2) (hereinafter Securities Act Section 12(a)(2)).

15 James Bohn & Stephen Choi, Fraud in the New-Issues Market: Empirical Evidence on Securities Class Actions, 144 U. Pa. L. Rev. 903, 915 (1996)

16 Richard J. Link, Persons liable for false registration statement under § 11 of Securities Act of 1933 (15 U.S.C.A. § 77k), 114 A.L.R. Fed. 551 (Originally published in 1993)

17 § 5B:31. Section 11—Section 11(f)—Joint and several liability; Right to contribution, 2 Publicly Traded Corporations Handbook § 5B:31 (2023-2) ("Except for "outside directors," any and every one of the persons specified in Section 11(a) are jointly and severally liable. The PSLRA implemented a framework of proportionate liability for outside-directors who violate Section 11,3 and for all Exchange Act violators, who the PSLRA refers to as 'covered persons.'").

18 § 5B:31. Section 11—Section 11(f)—Joint and several liability; Right to contribution, 2 Publicly Traded Corporations Handbook § 5B:31 (2023-2).

securities underwritten by [a given underwriter] and distributed to the public were offered to the public."[19]

A primary rationale behind gatekeeper liability under the Securities Act is to induce gatekeepers to effectively police the offerings that their clients make to the public markets.[20] Unlike issuers, gatekeepers may benefit from a due diligence defense to Securities Act liability.[21] Some commentators have remarked that, consistent with the policing role that gatekeepers are expected to perform, the jurisprudence on this defense is notoriously rigid,[22] and "the burden of conducting a reasonable investigation is a heavy one."[23] The policing role of gatekeepers is arguably more important in the IPO context than in issuances for already-public companies because market information about fledgling issuers is not readily available; since the only information about the company comes from the company itself, the accuracy of IPO-related disclosures is especially important.

A related justification for Securities Act liability for gatekeepers is to guard against corporate misconduct and compensate investors for it under circumstances where liability against the issuer might not be sufficient, most obviously when the issuer is insolvent.[24] This rationale is also particularly germane in the IPO context, where companies may be more fragile than longstanding public companies, and therefore more likely to be judgment-proof in the aftermath of a corporate scandal.

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[19] *Id.*

[20] See Brent J. Horton, Direct Listings and the Weakening of Investor Protections, 50 Fla. St. U. L. Rev. 279, 304-305 (2023) (noting that "while the drafters of the Securities Act did not expressly require an underwriter to review the merits of the offering, a closer look at the Act reveals that such underwriter review is exactly what the Securities Act's drafters had in mind.").

[21] The due diligence defense as such applies to Section 11 liability, which is for material misstatements or omissions in the registration statement. Section 12(a)(2), which applies to material misstatements or omissions in a prospectus, includes a "reasonable investigation" defense for gatekeepers which is largely similar to the due diligence defense. Choi Pritchard. Because these defenses are similar and because Section 11 and Section 12 claims are almost always brought together, I refer for simplicity to both defenses as the "due diligence defense."

[22] See Escott v. BarChris Constr. Corp., 283 F. Supp. 643 (S.D.N.Y. 1968); In re WorldCom, Inc. Sec. Litig., 346 F. Supp. 2d 628 (S.D.N.Y. 2004).

[23] Brent J. Horton, Direct Listings and the Weakening of Investor Protections, 50 Fla. St. U. L. Rev. 279, 307 (2023)

[24] See Andrew F. Tuch, Multiple Gatekeepers, 96 Va. L. Rev. 1583, 1608–09 (2010) ("The standard case where gatekeeper liability is desirable arises where the corporation is insolvent.").

In general, the due diligence defense requires that gatekeepers "after a reasonable investigation, [] had a reasonable basis for believing, and did believe, that the registration statement was accurate and adequate."[25] Because it is a fact-intensive inquiry[26] and parties generally prefer to settle prior to reaching it, case law on the due diligence defense is not well developed.[27] The specific contours of the defense vary depending on the gatekeeper. Auditors are liable only for the "expertised" portions of the offering documents – that is, the financials they certify, unless they helped prepare or have knowledge of misstatements in other areas of the documents.[28] To conduct a reasonable investigation, and thus benefit from the due diligence defense, auditors must "conduct a GAAS-compliant audit, or in the instance of a departure from the Statements on Auditing Standards, show an objectively reasonable basis for the departure. If in the performance of a GAAS-compliant audit the accountant uncovers a failure, or evidence of a possible failure, of the company to comply with GAAP in presenting its financial statements, then the accountant must further investigate the issue and make the appropriate disclosures."[29] While compliance with accounting standards typically "discharges the accountant's professional obligation to act with reasonable care,"[30] "compliance with GAAP and GAAS [does] not immunize an accountant who consciously chooses not to disclose on a registration statement a known material fact."[31]

Obligations are broader for underwriters hoping to benefit from the due diligence defense. Underwriters are liable for material omissions or

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[25] 15 U.S.C. § 77k(b)(3).

[26] See, e.g., Andrew F. Tuch, Multiple Gatekeepers, 96 Va. L. Rev. 1583, 1638–40 (2010) ("Determining whether the due diligence defense has been established requires 'exquisitely' fact-intensive inquiries. . . . Red flags, or 'storm warnings,' have been variously defined as 'facts which come to a defendant's attention that would place a reasonable party in [the] defendant's position 'on notice that the [issuer] was engaged in wrongdoing to the detriment of its investors,' and as any information that 'strips a defendant of his confidence' in the accuracy and completeness of statements in relevant portions of a registration statement. The existence of red flags may be sufficient to deprive a gatekeeper of the benefit of either the due diligence or reliance defense. For the due diligence defense, red flags will require the gatekeeper to 'look deeper and question more' in order to be considered to have conducted a 'reasonable investigation.' For the reliance defense, red flags will give the underwriter 'reason to believe' an inaccuracy exists in the registration statement.").

[27] See In re WorldCom, Inc. Sec. Litig., 352 F. Supp. 2d 472, 492 (S.D.N.Y. 2005) ("There is limited guidance in the case law as to the contours generally of the due diligence defense under Section 11.").

[28] 15 U.S.C. § 77k(b)(3)(C).

[29] In re WorldCom, Inc. Sec. Litig., 352 F. Supp. 2d 472, 492–93 (S.D.N.Y. 2005)

[30] Monroe v. Hughes, 31 F.3d 772, 774 (9th Cir.1994).

[31] *Id.*

misstatements in the "non-expertised" portions of the offering documents.[32] They must also show that they investigated any "red flags" in the expertised portions of the registration statement, or that such red flags did not exist and they were entitled to rely on other experts (usually auditors).[33] Notably, unaudited interim financial information for which underwriters typically receive "comfort letters" from auditors does not fall within the "expertised" portion of the statement for which the auditors are liable, and does fall within the "non-expertised" portion that underwriters must investigate.[34] During the diligence process, underwriters interrogate the business, finances and industry of the issuer.[35] Underwriters assess these items through "review of issuer files, site visits and interviews of the issuer's senior management, lenders or financiers, suppliers and customers."[36] Courts have been highly critical of underwriters who blithely rely on representations by the management during this process.[37]

III. Literature Review

This article intersects with several strands of existing literature. First, it engages with existing theoretical and empirical work the desirability and efficacy of gatekeeper liability, including studies focusing on specific gatekeepers. It also engages the literature on the shareholder plaintiffs' bar, and critiques of alternatives to the IPO as a vehicle for going public.

First, and most obviously, this article engages the existing literature on gatekeeper liability. Classic commentaries in this area have discussed the reputational role of gatekeepers, particularly underwriters, in the going-

[32] Escott v. Bar-Chris, *supra* note 22.
[33] See In re Worldcom, *supra* note [].
[34] See In re WorldCom, Inc. Sec. Litig., 346 F. Supp. 2d 628, 664-65 (S.D.N.Y. 2004).
[35] William K. Sjostrom, Jr., The Due Diligence Defense Under Section 11 of the Securities Act of 1933, 44 Brandeis L.J. 549, 557 (2006) ("Business aspects include reviewing the issuer's competitive position, market size, management team, products, facilities, raw material sources, customers and intellectual property.[46] Financial aspects include, in addition to reviewing the issuer's financial statements, analyzing profit margins and trends, working capital requirements, cash flow, sales and earning projections, inventory levels, accounting principals utilized by the issuer, accounts receivable turnover, and previous financings.[47] Underwriter personnel also examine industry-wide issues such as market characteristics, financial results for comparable companies, and accounting conventions.").
[36] *Id.*
[37] Escott v. BarChris Const. Corp., 283 F. Supp. 643, 697 (S.D.N.Y. 1968) ("If they may escape that responsibility by taking at face value representations made to them by the company's management, then the inclusion of underwriters among those liable under Section 11 affords the investors no additional protection.").

public process.[38] Academic commentary in this area exploded in the aftermath of the Enron and Worldcom scandals and the Arthur Andersen bankruptcy, which brought gatekeepers to the forefront of the public mind. During this period, there was extensive scholarly debate on functions and perils of gatekeepers, particularly auditors, analysts, and outside directors, and on whether the contemporary liability regime provided sufficient incentives to keep those perils at bay.[39] This strand of literature expanded with the advent of the Financial Crisis, when scholars inquired more searchingly into the role of investment banks in the market collapse.[40]

The gatekeeper literature has also evolved to include empirical studies and models of liability for specific gatekeepers.[41] I note that with limited

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[38] *See, e.g.,* Donald C. Langevoort, *Information Technology and the Structure of Securities Regulation*, 98 HARV. L. REV. 747, 765 (1985) ("[S]ecurities regulation has long relied on underwriters to perform a policing function."); Michael P. Dooley, *The Effects of Civil Liability on Investment Banking and the New Issues Market*, 58 VA. L. REV. 776, 786 (1972) (underwriters may induce issuers to withhold an offering where their review reveals problems); Ronald J. Gilson Reinier, The Mechanisms of Market Efficiency, 70 Va. L. Rev. 549, 618 (1984) (arguing that underwriters serve as "information and reputational intermediar[ies]"); Reinier Kraakman, *Corporate Liability Strategies and the Costs of Legal Controls* ("The first requisite for gatekeeper liability is, of course, an outsider who can influence controlling managers to forgo offenses."); Stephen Choi, Market Lessons for Gatekeepers, 92 Nw. U. L. Rev. 916, 917 (1998).

[39] See, e.g., John C. Coffee, Jr., *Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms*, 84 B.U. L. Rev. 301, 335 (2004); Coffee book; Frank Partnoy, Barbarians at the Gatekeepers?: A Proposal for a Modified Strict Liability Regime, 79 Wash. U. L. Q. 491 (2001); Assaf Hamdani, Gatekeeper Liability, S. Cal. L. Rev. 53 (2003); Lawrence A. Cunningham, Beyond Liability: Rewarding Effective Gatekeepers, 92 Minn. L. Rev. 323 (2007); Hillary A. Sale, Gatekeepers, Disclosure, and Issuer Choice, 81 Wash. U. L.Q. 403, 406 (2003).

[40] Donald C. Langevoort, Chasing the Greased Pig Down Wall Street: A Gatekeeper's Guide to the Psychology, Culture, and Ethics of Financial Risk Taking, 96 Cornell L. Rev. 1209, 1212 (2011); Sale; Andrew F. Tuch, Multiple Gatekeepers, 96 Va. L. Rev. 1583, 1591 (2010); Stavros Gadinis and Colby Mangels University of California - Berkeley, Collaborative Gatekeepers, 73 Wash. & Lee L. Rev. 797 (2016).

[41] See, e.g., Bernard Black et. al., Outside Director Liability, 58 Stan. L. Rev. 1055, 1104 (2006); James J. Park, Auditor Settlements of Securities Class Actions, 14 J. of Empirical Legal Stud. 169 (2007); Honigsberg et al., The Changing Landscape of Auditor Liability, 63 J. of L. & Econ. 367 (2019); Bates, Thomas W. and Lv, Jin Roc and Neyland, Jordan, Do Lawyers Matter in Initial Public Offerings? (November 10, 2022). Available at SSRN: https://ssrn.com/abstract=4274529; Eric L. Talley, Cataclysmic Liability Risk Among Big Four Auditors, 106 Colum. L. Rev. 1641, 1646 (2006); Donelson, Dain C., The Potential for Catastrophic Auditor Litigation, 15 American Law and Economic Review 333–80 (2013).

exceptions,[42] these studies' samples consist of lawsuits, rather than transactions that did not draw lawsuits, and include Securities Act cases based on shelf offerings rather than IPOs, or cases brought under Rule 10b-5 that are based on secondary market activity. These studies also involve different gatekeepers. Black, Cheffins, and Klausner find that independent directors contribute to settlements only in a "perfect storm" where among other factors, culpability is high and access to issuer or insurer funds does not exist.[43] Park examines securities lawsuits against auditors and concludes that existing protections for accounting firms screen frivolous cases while allowing for penalties in meritorious cases.[44] Honigsberg, Rajopal and Srinavasan examine lawsuits against auditors and find that the incidence of such lawsuits has declined in the wake of opinions limiting liability under Rule 10b-5. Bates, Lv and Neyland examine the likelihood that an issuer will be sued following its IPO, and find that such likelihood is lower when issuers employ top-tier counsel.[45]

This article also engages with the literature on the shareholder plaintiffs' bar. Scholars have long engaged with the misalignment of incentives that may exist between shareholder plaintiffs, who often lack sufficient skin in the game to sue on their own, and their attorneys, who often drive the litigation.[46] Many of these accounts argue that plaintiffs' counsel in shareholder class actions may leverage nuisance litigation or outside investigations to minimize effort, and sell out their clients on the cheap for even meritorious claims.[47] Empirical literature in this vein has examined whether and when securities

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[42] Bates, Thomas W. and Lv, Jin Roc and Neyland, Jordan, Do Lawyers Matter in Initial Public Offerings? (November 10, 2022). Available at SSRN: https://ssrn.com/abstract=4274529

[43] Bernard Black et. al., Outside Director Liability, 58 Stan. L. Rev. 1055, 1104 (2006).

[44] James J. Park, Auditor Settlements of Securities Class Actions, 14 J. of Empirical Legal Stud. 169 (2007).

[45] Bates, Thomas W. and Lv, Jin Roc and Neyland, Jordan, Do Lawyers Matter in Initial Public Offerings? (November 10, 2022).

[46] See, e.g., John C. Coffee, Jr., Rescuing the Private Attorney General: Why the Model of the Lawyer As Bounty Hunter Is Not Working, 42 Md. L. Rev. 215, 220 (1983); John C. Coffee, Jr., The Unfaithful Champion: The Plaintiff As Monitor in Shareholder Litigation, Law & Contemp. Probs., Summer 1985; Jonathan R. Macey Geoffrey P. Miller, The Plaintiffs' Attorney's Role in Class Action and Derivative Litigation: Economic Analysis and Recommendations for Reform, 58 U. Chi. L. Rev. 1, 11 (1991); John C. Coffee, Jr., Understanding the Plaintiff's Attorney: The Implications of Economic Theory for Private Enforcement of Law Through Class and Derivative Actions, 86 Colum. L. Rev. 669 (1986); but see Morris Ratner, A New Model of Plaintiffs' Class Action Attorneys, 31 Rev. Litig. 757, 761 (2012) (arguing that the incentives of plaintiffs' lawyers are not monolithic).

[47]

class actions are frivolous,[48] with extensive examination of whether the PSLRA, designed to reduce strike suits, did in fact have the intended effect.[49] More recent empirical work has examined the stratification of the plaintiffs' bar and the variation in the lawsuits that they bring, arguing that lower-tiered plaintiffs' firms focus on filing complaints as a bulk business, and in the extreme, existing by generating nuisance settlements,[50] while higher-tiered plaintiffs' firms retain a stable of institutional investor clients to serve as lead plaintiffs, vet their cases carefully, and are willing to put in the work for high-value settlements.[51]

The final strand of literature to which this study relates is the general state of the IPO, and its status among shifting paths to the public markets. Commentators have for some time worried about the decreasing number of IPOs, and the increasing size of those firms that do choose to go public.[52] With the purported decline of IPOs has come a proliferation of experiments in alternative means to access the public markets. This has fueled academic commentary on the utility of IPO gatekeepers in policing the markets when presented with alternatives such as direct listings and SPACs. Academic commentators have often concluded that such alternative offerings may undermine the security of the capital markets, in part because they allow for circumvention of the rigorous gatekeeping enforced by the IPO process.[53]

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[48] Janet Alexander, DO the Merits Matter

[49] All those papers

[50] See, e.g., Cain et al., *Mootness Fees*, 72 Vand. L. Rev. 1777 (2019) (discussing nuisance litigation in the M&A context); Emily Strauss, Suing SPACs, 96 S. Cal. L. Rev. 553 (2023) (discussing nuisance and meritorious litigation in the SPAC context).

[51] Choi, Stephen J. and Erickson, Jessica and Pritchard, Adam C., The Business of Securities Class Action Lawyering (May 9, 2023). NYU Law and Economics Research Paper No. 23-20, Indiana Law Journal, Forthcoming, U of Michigan Law & Econ Research Paper No. 23-023, Available at SSRN: https://ssrn.com/abstract=4350971 or http://dx.doi.org/10.2139/ssrn.4350971.

[52] See, e.g., Elisabeth de Fontenay, The Deregulation of Private Capital and the Decline of the Public Company, 68 Hastings Law Journal 445-502 (2017); Frank Partnoy, The Death of the IPO, The Atlantic, Nov. 2018.

[53] See, e.g., Corrigan, Patrick, Do the Securities Laws Actually Protect Investors (and How)? Lessons from SPACs (May 24, 2023). Washington University Law Review, Vol. 101, No. 4, 2024, Available at SSRN: https://ssrn.com/abstract=4458430; Brent J. Horton, Direct Listings and the Weakening of Investor Protections, 50 Fla. St. U. L. Rev. 279 (2023); Brent J. Horton, Spotify's Direct Listing: Is It A Recipe for Gatekeeper Failure?, 72 SMU L. Rev. 177 (2019); Andrew F. Tuch, Joel Seligman, The Further Erosion of Investor Protection: Expanded Exemptions, Spac Mergers, and Direct Listings, 108 Iowa L. Rev. 303 (2022); James J. Park, Investor Protection in an Age of Entrepreneurship, 12 Harv. Bus. L. Rev. 107 (2022); Michael Klausner et. al., A Sober Look at Spacs, 39 Yale J. on Reg. 228, 286 (2022).

IV. Data

Assessing the impact of Securities Act liability on gatekeepers and, indirectly, on IPOs is a difficult task. This is because it is difficult to develop a benchmark first, for the success of an IPO, and second, for the success of IPO gatekeeping. Below I discuss some of the measures that I use to try, notwithstanding these difficulties, to assess Securities Act lawsuits and their potential effects on gatekeeping.

To assess the effect of gatekeepers and the liability regime to which they are subject on an IPO, it is necessary to have some benchmark for whether that IPO is successful. Different constituencies have different metrics for this, few of which include a quantitative threshold. Investors, of course, would simply like the stock price to rise rather than fall, but it is not clear what number or percentage is indicative of success. More to the point for my purposes, the Securities Act and nominally gatekeepers as well are not concerned with the success of an IPO as a matter of stock price. Rather, the concern of the Securities Act that gatekeepers are enlisted to enforce is the accuracy of the offering documents. There may be at least some consensus, however, about bankruptcy as a measure of IPO success from both perspectives. Obviously insolvency is a failure from an investor perspective. More tentatively, it may also be the case that where a firm goes bankrupt within three years of its IPO (the statute of repose for the Securities Act), something may have been wrong under the hood to begin with, particularly in the later part of the sample where IPOs are generally large. Even if that "something" does not take the form of fraud (which it might), underwriters in particular are expected by their institutional clients, though not the Securities Act, to conduct a qualitative review of the business. [54] Delisting may provide a similarly soft proxy for IPO success.

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[54] There is a plausible argument that underwriter review, though not explicitly merit-based, is precisely that. Underwriters from the outset do not agree to market the securities of firms that they think will be unsuccessful, as this could risk underwriters' relationships with their repeat clients, institutional investors. See Brent J. Horton, Direct Listings and the Weakening of Investor Protections, 50 Fla. St. U. L. Rev. 279, 306 (2023) ("[Ex ante] scrutiny allows the underwriter to avoid sponsoring an offering that will likely flop. The underwriter does not want to market a flop to the large institutional investors with whom it has long-term working relationships. If it does, it may find that those working relationships disappear."); see also Jeffrey J. Hass, Small Issue Public Offerings Conducted Over the Internet: Are They "Suitable" for the Retail Investor?, 72 S. CAL. L. REV. 67, 96-97 (1998) (stating that "[T]he merit review performed by underwriters" focuses on whether the offering will be profitable to the underwriter's investor clients). And even once an issuance is in the works, it may be called off if underwriters and other gatekeepers reveal information during the diligence process that there are serious problems with the issuer's business. The fact of an insolvency or a delisting within the statute of repose suggests that

Proxies for gatekeeping quality are similarly difficult. Notably, a Securities Act claim does not require fraud in the sense that there is no scienter element. Accordingly, negligence, rather than fraud, may constitute a diligence failure. A restatement of financials for fraud-related reasons is a common and probably good proxy for misconduct, [although it may be underinclusive.] Similarly, commonly used proxies for misconduct in studies of securities class actions include the departure of directors and officers and SEC enforcement actions. The departure of top personnel for nefarious reasons is relatively rare, and tends to signal severe misconduct. Similarly, numerous studies have used SEC investigations as "hard evidence" of misconduct because the SEC lacks the resources, and is therefore more likely to pursue enforcement actions where conduct is more likely to be fraudulent.[55] Conversely, broader proxies may be imprecise. One potential measure of auditor diligence is the presence of a PCAOB sanction against the auditing firm certifying the IPO firm's financials. Such sanctions are typically issued where there are multiple significant deficiencies in the firm's audits. Such a sanction signals other misconduct within the same period at the accounting firm, although it does not necessarily mean that an IPO audit conducted by the accounting firm during that period is flawed. Another

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this process failed. A well-known recent example is the failed IPO of We-Work in 2019. We-Work's primary underwriters, J.P. Morgan and Goldman Sachs, respectively forced the disclosure of multiple unappealing conflicts of interest, and realized that the company's business model would never make money. See Andrew Ross Sorkin, Behind WeWork Leader's Rise and Fall: A Wall St. Bank Playing Many Angles, N.Y. TIMES (Sept. 26, 2019); Oscar Williams-Grut, Goldman Sachs CEO Defends Work on Failed WeWork IPO, YAHOO! FIN. (Jan. 21, 2020). As problems became public and interest in We-Work waned, the IPO was ultimately withdrawn. See Brent J. Horton, Direct Listings and the Weakening of Investor Protections, 50 Fla. St. U. L. Rev. 279, 308 (2023) ("The conflicts of interest, coupled with a troubling financial picture presented in WeWork's registration statement led to--at the eventual insistence of the underwriters--the withdrawal of the offering. [David] Solomon [of Goldman Sachs] stated, 'I think that's a great example of the process working.'").

[55] See, e.g., James J. Park, Securities Class Actions and Bankrupt Companies, 111 MICH. L. REV. 547, 571 (2013); Stephen J. Choi, Karen K. Nelson & A.C. Pritchard, The Screening Effect of the Private Securities Litigation Reform Act, 6 J. EMPIRICAL LEGAL STUD. 35 (2009) [hereinafter Pritchard et al., Screening Effect]; Stephen J. Choi, Jill E. Fisch & A.C. Pritchard, Do Institutions Matter? The Impact of the Lead Plaintiff Provision of the Private Securities Litigation Reform Act, 83 WASH. U. L.Q. 869 (2005); Tom Baker & Sean J. Griffith, How the Merits Matter: Directors' and Officers' Insurance and Securities Settlements, 157 U. PA. L. REV. 755 (2009); Stephen J. Choi, Do the Merits Matter Less after the Private Securities Litigation Reform Act?, 23 J.L. ECON. & ORG. 598, 620–21 (2006); Dain C. Donelson, Justin J. Hopkins & Christopher G. Yust, The Role of Directors 'and Officers' Insurance in Securities Fraud Class Action Settlements, 58 J.L. & ECON. 747 (2015).

potentially broad proxy for gatekeeper, particularly underwriter diligence is whether the IPO firm is Chinese. Chinese firms are prohibited by their regulators from sharing much information with outsiders – including the auditors certifying their financials or the underwriters pricing the offering. Chinese firms listing on American exchanges have generated increasing concern over the last decade because, constrained by Chinese regulators, they provide little in the way of documentation and verification to their gatekeepers.[56] Accordingly, the verification process for these firms is unlikely to be thorough, although this does not necessarily mean that gatekeepers would catch problems or that any exist.

Finally, assessing the effect of the Securities Act on diligence is difficult. First, the Securities Act is designed to prevent IPOs with material misstatements or omissions in their offering materials. While gatekeeper diligence is an important component of this goal, it cannot be directly measured because a Securities Act claim may only be brought where there is a claim that the offering documents were flawed, which may only be a subset of the instances in which diligence, on some dimension, may have been inadequate. Using Securities Act claims as a lens for the adequacy of gatekeeper diligence is further complicated by the standing requirements of Section 11; a claim may only be brought where the price of the securities fall below the IPO price within their first year on the market, and even then, plaintiffs must be able to trace their shares to the IPO.

Despite their imperfections, however, these proxies can contribute to the understanding of IPO gatekeeping the impact of the Securities Act on it. To investigate these effects, I compose two samples. The first sample is composed of class actions based on public offerings that were initially gathered from Stanford Securities Litigation Analytics.[57] The sample begins in 2000; in effort to restrict it largely to lawsuits that have been resolved, I include only those that were filed before December 31, 2019, for a total of 261 lawsuits. The second sample consists of IPOs from 1997 to 2019 from Audit Analytics.[58] I also gather issuer law firm and underwriter information

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[56] See Division of Corporation Finance, Securities and Exchange Commission, Disclosure Considerations for China-Based Issuers, Nov. 23, 2020, https://www.sec.gov/corpfin/disclosure-considerations-china-based-issuers; Wang et al., U.S. SEC says Chinese IPO hopefuls must provide additional risk disclosures, Reuters, July 30, 2021, https://www.reuters.com/business/finance/exclusive-us-regulator-freezes-chinese-company-ipos-over-risk-disclosures-2021-07-30/.

[57] I am indebted to Michael Klausner for sharing this data.

[58] The sample begins in 1997 to account for the three-year statute of repose for Securities Act claims. In an effort to ensure that I capture only traditional IPOs of operational

from SDC Platinum, and pricing and delisting data from CRSP. I drop from the sample IPOs for which SDC did not have underwriter data, leaving a total sample of 3805 IPOs. I code the underwriters according to whether they fall within the generally-agreed top tier of investment banks known as the Bulge Bracket.[59] I do this to explore whether lawsuits are more likely to be brought against large investment banks (indicating a potential plaintiffs' preference for deep pockets), or, alternatively, whether small underwriters are more likely to be sued, possibly indicating less rigorous diligence by less resourced or more risk-tolerant smaller firms. Similarly, I code auditors based on whether they fall within the Big Four[60] plus Arthur Andersen. I code issuer transactional attorneys based on whether the firm is included in the top ten firms over a four-year period in the American Lawyer's Capital Markets Corporate Scorecard for issuer and underwriter counsel in IPO transactions.[61] I also code plaintiffs' counsel based on whether the firm falls within the top tier of firms identified in the literature to assess whether lawsuits or outcomes might be associated with the resources or business model of the plaintiffs' firm.[62] I gather data on bankruptcies and restatements of financials for fraud for the same period from Audit Analytics.

I take information on director and officer departures, which often signal serious problems in a firm, from Audit Analytics. The director/officer

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companies, I remove ABS issuances, REITs, funds, trusts, and municipal bond issuances from this data.

[59] See, e.g., Brian de Chasare, Top Investment Banks: Rankings of Banks by Tier and Category, https://mergersandinquisitions.com/top-investment-banks/#:~:text=representative%2C%20not%20comprehensive.-,Categories%20of%20Top%20Investment%20Banks,Barclays%3B%20Deutsche%20Bank%20and%20UBS; Bulge Bracket Banks: A Practical Guide to Break Into, FinanceWalk, https://financewalk.com/bulge-bracket-bank/; Bulge Bracket Investment Banks, WallStreetPrep, https://www.wallstreetprep.com/knowledge/top-global-bulge-bracket-investment-banks/. The bulge bracket banks are generally thought to consist of JPMorgan, Goldman Sachs, Morgan Stanley, Bank of America, Merrill Lynch, Citi, Credit Suisse, Deutsche Bank, Barclays, and UBS. Previously, Lehman Brothers and Bear Stearns were also considered Bulge Bracket investment banks, and I include them for coding purposes.

[60] Deloitte & Touche LLP, Ernst & Young LLP, KPMG LLP, and PriceWaterhouseCoopers LLP.

[61] Other studies have found that transactions involving higher quality issuers' law firms are sued less often, perhaps because those law firms provide better disclosures. See Bates, Thomas W. and Lv, Jin Roc and Neyland, Jordan, Do Lawyers Matter in Initial Public Offerings? (November 10, 2022).

[62] See Choi, Stephen J. and Erickson, Jessica and Pritchard, Adam C., The Business of Securities Class Action Lawyering (May 9, 2023). NYU Law and Economics Research Paper No. 23-20, Indiana Law Journal, Forthcoming, U of Michigan Law & Econ Research Paper No. 23-023, Available at SSRN: https://ssrn.com/abstract=4350971 or http://dx.doi.org/10.2139/ssrn.4350971. I am grateful to the authors for sharing their data.

departures are only counted if they arose because of actual or suspected misconduct, a government or internal investigation, or "for cause." I also gather information on PCAOB sanctions from the PCAOB website. A PCAOB sanction signals serious failures within an accounting firm. The average number of years in a random subsample between a PCAOB sanction and the first misconduct triggering that sanction is 4.86, so I generate a dummy equal to one if an IPO occurred in the five years prior to a PCAOB sanction of its auditor. To account for the vast size differential between the Big Four[63] auditors and all others, such that a PCAOB sanction may be a weaker signal of misconduct in a larger firm, I multiply the dummy by .25 if the auditor is a Big Four auditor. This is because the smallest of the Big Four, KPMG, has roughly four times the number of employees as the next largest accounting firm.[64] I generate a dummy equal to one if the IPO is a Chinese firm. Finally, I gather information on SEC enforcement actions from the NYU SEED database, supplemented with Lexis searches and examination of litigation and administrative releases from the SEC website.

V. Descriptive Statistics and Empirical Results

In this section, I explore the characteristics of the IPOs in my sample over time, including how many generated Securities Act claims naming the underwriter, the auditor, or the issuer and directors only. I also assess the characteristics of the lawsuits including Securities Act claims in my sample. Finally, I examine associations between lawsuits naming the underwriter and various transaction characteristics.

A. Characteristics of IPOs Over Time

Table 1 reports the descriptive statistics of the sample of IPOs by four-year period over the term of the sample. Total IPOs are at their height in the first period, at 757, dip during the Financial Crisis, and then rebound (though not completely). IPO sizes (adjusted for inflation) generally increase over the period of the sample. Bankruptcies, delistings, and restatements within the statute of repose are all at their height in the first period, though they are low at that time and only fall thereafter. Conversely, the percentage of IPOs conducted by bulge bracket underwriters and top transactional attorneys are

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[63] I also treat Arthur Andersen as a Big Four auditor for this purpose.

[64] https://accountingresume.net/mid-tier-accounting-firms/#:~:text=According%20to%20Accounting%20Today%2C%20the,with%20fewer%20than%2010%2C000%20employees.

at their lowest in the first period, and remain roughly consistent thereafter. SEC enforcement actions and director or officer departures are very low in all periods. The number of Chinese IPOs increases consistently over the course of the sample. The number of IPOs conducted by an accounting firm subject to a PCAOB sanction also generally increases over the sample period. The proportion of IPOs drawing Securities Act claims generally goes up over the course of the sample, as does the proportion of IPOs drawing a Securities Act claim naming the underwriter (though these figures lag the total Securities Act claims by a few percentage points in every period). There are few IPOs that draw Securities Act claims naming the auditor, and they are clustered in the 2000-2003 and 2008-2011 periods (perhaps reflecting the dotcom bubble collapse, the Enron/Tyco/Worldcom scandals and Sarbanes-Oxley, and the Financial Crisis).

B. Characteristics of Securities Act Lawsuits

Table 2 describes the lawsuits in my sample, describing the features of all Securities Act lawsuits, those that name the underwriter, and those that name the auditor. Roughly 21.5% of the lawsuits in my sample do not name the underwriter, and only 16 lawsuits name the auditor. Lawsuits naming the underwriter are more likely than Securities Act claims generally to be brought where the IPO involved a Chinese issuer. Underwriters are also significantly more likely to be named in jurisdictions that have held that underwriter indemnification agreements are not enforceable. They appear slightly more likely to target deals that do not have bulge bracket underwriters, although the t-statistic is not significant. The lawsuits naming underwriters do not differ significantly from Securities Act claims generally along most other dimensions, typically involving IPOs and stock price drops of similar size, settling and being dismissed at similar rates, and being led by institutional investors with similar frequency.[65] Securities Act claims naming the underwriter are less likely than Securities Act claims generally to be bundled with a Rule 10b-5 claim.

Lawsuits naming auditors are much rarer, 16 in total. They are significantly more likely than Securities Act claims generally to be brought where a

[65] I note that Securities Act claims against issuers and underwriters involve an institutional investor lead plaintiff roughly 40% of the time. This is very similar to the frequency with which institutional investors act as lead plaintiffs in securities class actions generally. See []. That institutions often retain their IPO shares for a sufficient period to act as lead plaintiffs suggests, consistent with some finance literature, that many institutional IPO investors do not immediately "flip" their shares. See [].

director or officer was dismissed or where there is an SEC enforcement action, both strong markers of misconduct. They are also significantly less likely to be dismissed, settle for significantly higher amounts, and are much more likely to involve both a Securities Act and a 10b-5 claim. They do not, however, involve larger IPOs or stock price drops, and nor are they brought more frequently where the IPO was brought within five years of a PCAOB sanction, where there is a restatement of financials within the statute of repose, or against Chinese issuers. They appear to be slightly more likely to be brought where the underwriter is not a bulge bracket underwriter, and when there is a bankruptcy in the statute of repose, although the difference falls short of statistical significance.

Table 3 shows the characteristics of lawsuits where the underwriters or auditors made identified contributions to the settlement. Underwriters contributed identified amounts to seven settlements in the sample, and auditors to nine. Three cases where the underwriter contributed involved an issuer bankruptcy in the statute of repose; for auditors, there are two issuer bankruptcies. Auditor contributions, when they occur, are somewhat higher, and IPOs in which auditors paid out are somewhat larger than those where the underwriter paid out, although the size of the total settlements are similar. Four cases involve an underwriter and an auditor payment.

Table 4 shows the results of OLS regressions where the dependent variable is a dummy equal to one if the firm was subject to a Securities Act claim relating to its IPO.[66] The independent variable of interest is a dummy equal to one if the firm experienced a bankruptcy within the statute of repose. I control for whether one of the lead underwriters of the IPO was a bulge bracket underwriter, whether the firm had a top law firm as issuer's counsel, whether the firm restated its financials for fraud within the statute of repose, whether there was a director or officer dismissal for misconduct-related reasons within the statute of repose, whether the IPO was a Chinese IPO, whether the IPO occurred within five years before a PCAOB sanction, the market-adjusted returns generated by the largest price drop from the IPO price within the statute of repose (before the lawsuit, in the case of sued firms), the time in days between the IPO and the lowest price within the statute of repose (or before the filing date for sued firms), and the log of the IPO proceeds. Firms whose price does not drop below the IPO price within the statute of repose are dropped. All specifications include year fixed effects and robust standard errors.

[66] Regression includes year fixed effects and robust standard errors. I run unreported logit regressions and obtain similar results.

The specification with the most controls shows that firms issuing a restatement within the statute of repose are nearly more likely to draw a Securities Act claim. These findings are significant at the 5% level. Firms experiencing a director or officer dismissal within the statute of repose are more likely to draw a Securities Act claim, although this result is only significant at the 10% level. Chinese IPOs are also more likely to draw a Securities Act claim, and this finding is significant at the 5% level. Firms that experienced an SEC enforcement action related to the IPO also are significantly more likely to draw a Securities Act claim. Unsurprisingly, firms experiencing a larger negative market-adjusted stock price drop from the IPO, firms experiencing a stock price drop sooner after the IPO, and large IPOs are more likely to draw a Securities Act claim, and these findings are strongly significant.

VI. Does Gatekeeper Liability Work?

The obvious purpose of gatekeeper liability is to deter bad gatekeeping, inducing underwriters and auditors to prevent new issuers from inflating their own prospects to raise more money. Gatekeepers, with expertise, access to the relevant information, and a reputation to uphold, are well-equipped, according to the literature, to undertake this task, and liability under the Securities Act is meant to provide incentives for them to perform it well.[67] But how well does Securities Act liability actually promote adequate gatekeeper monitoring?

The low number of lawsuits against gatekeepers, especially auditors, and the low rates at which gatekeepers contribute to settlements may suggest that perhaps Securities Act liability is not a strong deterrent to gatekeeper misconduct. But it is also possible that we observe few lawsuits and fewer settlements because gatekeepers are in fact deterred.[68] Perhaps, to avoid

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[68] See e.g., Ryan Bubb, Emiliano Catan & Holger Spamann, Shareholder Rights and Bargaining Structure in Controlled Transactions, June 12, 2023 at 18, chrome-extension://efaidnbmnnnibpcajpcglclefindmkaj/https://www.ecgi.global/sites/default/files/Paper%3A%20Shareholder%20Rights%20and%20the%20Bargaining%20Structure%20in%20Control%20Transactions%20%28Ryan%20Bubb%2C%20Emiliano%20Catan%2C%20Holger%20Spamann%29.pdf ("Of course, in equilibrium, we would not expect to see (much) litigation because the Manager anticipates the lawsuit and, assuming even some small personal cost of putting together the transaction, will only put forward transactions that pass judicial muster.") (describing equilibrium effects in litigation challenging controlled transactions).

expensive liability, gatekeepers invest resources in conducting diligence to benefit from the due diligence defense, and their efforts are sufficient to preempt lawsuits and/or settlements. Maybe no one is suing gatekeepers because there is nothing to sue them for. In the sections below, I assess these arguments as they relate to auditors and underwriters based on the cases in my sample.

A. Does Securities Act Liability Deter Auditors?

There are strikingly few Securities Act claims even naming auditors in my sample,[69] and even fewer instances in which they pay out in settlements. There are also remarkably few restatements of issuer financials within the statute of repose; since restatements are arguably among the best metrics of auditor negligence or misconduct, [70] one might argue that the low frequency of lawsuits against auditors simply reflects the fact that they generally do their work well. Auditors, unlike underwriters, lack a stake in the IPO, and therefore may have fewer incentives to engage in misconduct.[71] And even

[69] I note that prior literature has documented a higher frequency of Section 11 claims against auditors than this study. See, e.g., James J. Park, Auditor Settlements of Securities Class Actions, 14 J. of Empirical Legal Stud. 169, 183 (finding that auditors contributed to settlements in 33 Securities Act cases that fell within the 200 largest settlements of securities class actions between 1996-2007); Honigsberg et al., The Changing Landscape of Auditor Liability, 63 J. of L. & Econ. 367, 380 (finding 161 Section 11 claims naming auditors between 1996-2016). The reason for this is likely that unlike my sample, which contains only lawsuits involving IPOs, these samples include shelf offerings. [Shelf offerings not only occur more frequently than IPOs, which generally occur only once, but may be made by larger, more mature firms that are more attractive to plaintiffs. Moreover, the short notice on which such offerings may be made may lend itself more than the IPO process to diligence oversights. See Worldcom.]

[70] I note that while a few restatements in my sample involve truly deceptive conduct that would be difficult to detect, most involve improper recognition of revenue, which auditors are supposed to catch. See AICPA & CIMA, SAS 99, Consideration of Fraud in a Financial Statement Audit, chrome-extension://efaidnbmnnnibpcajpcglclefindmkaj/https://us.aicpa.org/content/dam/aicpa/research/standards/auditattest/downloadabledocuments/au-00316.pdf (requiring auditors to "ordinarily presume" that improper revenue recognition is a fraud risk on *all audit engagements*, and to explain any contrary conclusions. Practice guides indicate that "high level of care is always required in this area," which requires the auditor to "obtain a sufficient understanding of the client's industry and business, its products, its marketing and sales policies and strategies, its internal controls, and its accounting policies and procedures related to revenue recognition." Practice Alert 98-3, Responding to the Risk of Improper Revenue Recognition (April 15, 2004), https://egrove.olemiss.edu/cgi/viewcontent.cgi?filename=0&article=2936&context=aicpa_news&type=additional.

[71] But see Coffee on incentives of auditors.

where they are tempted, they may be deterred by a zealous watchdog, the PCAOB, and the increasingly distant but still potent specter of Arthur Andersen's collapse.

Nonetheless, while the small sample size makes it difficult to arrive at definite conclusions, I suggest that other features of these lawsuits might give us pause in ascribing their rarity to equilibrium effects. I note from the outset that liability under the Securities Act for auditors is relatively narrow. Auditors are liable only for the financial statements that they certify,[72] which, on its own, could account for some portion of the relatively lower frequency with which they are sued. Yet this seems to be only part of the story. While restatements of financials are rare within the statute of repose, it is even rarer that the auditors responsible for those statements draw a Securities Act lawsuit; while 16 sample issuers restated their financials within the statute of repose, the auditor of only one of these statements drew a Securities Act claim.[73]

Other markers of possible auditor negligence also do not lead to auditor lawsuits. 950 IPOs in the sample occurred in the five years before the auditor of the issuer drew a PCAOB sanction. 795 of these sanctions were of Big Four accounting firms, meaning that the misconduct prompting the sanction might not be pervasive due to the firm's large size; when I scale PCAOB sanctions to account for this, the number of affected IPOs in my sample reduces to 354. But even here, only two Big Four auditors were named in Securities Act complaints in connection with IPOs occurring within five years of a sanction, and only one smaller accounting firm was named within five years of such a sanction. This suggests that some instances of possible auditor misconduct that might affect IPOs that investor-plaintiffs and their lawyers may decline to pursue. Similarly, 74 of my 261 lawsuits allege GAAP or other accounting violations, yet only 16 name the auditor. Why?

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[72] See Securities Act§ 11(b)(3)(A), 15 U.S.C. §77k(a)(4) (2006); Andrew F. Tuch, Multiple Gatekeepers, 96 Va. L. Rev. 1583, 1637 (2010) ("In practical terms, accountants will typically face potential liability for audited financial statements, which are expertised portions that accountants will authorize.")

[73] This case is also the only one where there was a restatement of financials and the auditor contributed to the settlement. I note that the auditor's contribution, $12 million, accounts for most of the settlement ($17 million), and is one of the highest auditor contributions in the sample. The misconduct of the issuer, HPL Technologies, ultimately drew an SEC enforcement action, and involved inflation of revenues from 57% to 1067%. See SEC v. Lepejian, No. 02-4308, N.C. Cal. (Sept. 10, 2002), https://www.sec.gov/litigation/complaints/comp17718.htm.

One reason may be the interaction of the due diligence defense with the incentives of the plaintiffs' bar. The due diligence defense is highly fact intensive under the best of circumstances, and particularly little guidance exists "on the application of the defense to accountants."[74] On one hand, this means that the defense is generally not applicable on a motion to dismiss, meaning that auditors will not be able to extricate themselves on this basis early in the lawsuit, and will have to undergo expensive discovery. Under these circumstances, it is possible that defendants would rather pay plaintiffs' lawyers to go away than slog through the expensive fact-finding necessary to successfully assert the due diligence defense. Asserting the due diligence defense might be even more costly because of the dearth of case law, meaning that auditors must face an uncertain result in court. A highly plausible outcome of all this might be a high level of nuisance settlements by accounting firms who would rather pay than litigate. But we do not see high frequency of low payments by auditors.

On the other hand, because of its fact-intensiveness and the protracted discovery that must be undertaken, the due diligence defense is also expensive for plaintiffs to overcome, even where a claim has merit. Because plaintiffs' lawyers work on a contingency fee basis, it is possible that a claim must be exceptionally strong and the potential damages very large to justify such an undertaking. Notably, Securities Act claims naming auditors are far more likely than claims naming only the issuer and/or underwriter to be bundled with Rule 10b-5 claims. This may be because if a plaintiffs' firm is willing to put in the work to puncture a due diligence defense with respect to an auditor, it believes its case to be strong enough to merit digging up the factual details supporting scienter that would be necessary to make out a colorable 10b-5 claim.[75] Not all plaintiffs' law firms operate on a business model that allows for such extensive investigative digging.[76] Rather, many operate by filing a high volume of lawsuits and expending as little effort as possible to procure many relatively low settlements (perhaps independent of the merit of the underlying claims) to keep the lights on.[77]

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[74] 1n re WorldCom, Inc., Sec. Litig., 352 F. Supp.2d 472, 492 (S.D.N.Y. 2005).
[75] Claims under Rule 10b-5 against actors such as auditors have become even more difficult over the course of the sample as a result of *Stoneridge* in 2008 and *Janus* in 2011.
[76] Choi, Stephen J. and Erickson, Jessica and Pritchard, Adam C., The Business of Securities Class Action Lawyering (May 9, 2023). NYU Law and Economics Research Paper No. 23-20, Indiana Law Journal, Forthcoming, U of Michigan Law & Econ Research Paper No. 23-023, Available at SSRN: https://ssrn.com/abstract=4350971 or http://dx.doi.org/10.2139/ssrn.4350971.
[77] *Id.* These incentives may also explain, at least in part, why there are very few Securities Act claims against auditors that coincide with PCAOB sanctions. it may be significant that most PCAOB sanctions are imposed an average of five years after the first instance of

Accordingly, much may depend on the willingness of auditors to pay nuisance settlements. This, it seems, they rarely do. Commentators have observed for decades the propensity of accounting firms to take plaintiffs to the mat, developing reputations as "tough, hard-nosed litigators who will not settle weak cases."[78] In the years leading up to the passage of the PSLRA, many accounting firms resisted what they perceived as an onslaught of frivolous litigation by shouldering the expense of making plaintiffs prove their claims, even where settling for nuisance value would be easier.[79] There is even anecdotal evidence that auditors settling nuisance claims in some cases may endure a "first-fallen disadvantage" of sorts, suffering a reputational hit even for the low settlement of claims of questionable merit.[80] This is likely because the accounting industry is highly consolidated and extremely reputation-conscious, giving auditors nuisance-avoidance incentives that issuers generally may not have.[81]

The dearth of lawsuits and settlements against the auditors of IPOs may, therefore, have something to do with overall auditing quality, as illustrated

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misconduct. This is because the statute of limitations for Securities Act claims is a meager one year, and the statute of repose is only three. Other studies have found that plaintiffs' lawyers pursue misconduct where a government investigation is already public, likely to alleviate the discovery stay imposed by the PSLRA. See, e.g., Emily Strauss, *Is Everything Securities Fraud?*; Choi et al., []. PCAOB sanctions may fail to generate a similar result (perhaps among other reasons) because misconduct is beyond the limitations period by the time it is public.

[78] John C. Coffee, Jr., The Unfaithful Champion: The Plaintiff As Monitor in Shareholder Litigation, Law & Contemp. Probs., Summer 1985, at 5, 14.

[79] See id.; see also William C. Baskin III, Using Rule 9(b) to Reduce Nuisance Securities Litigation, 99 Yale L.J. 1591, 1609 (1990) ("Defendants who appear frequently in the securities litigation arena have incentives to focus on the long-term effects of each action and invest in reputational capital by resisting frivolous actions even when it would be cheaper to settle each individual case. By earning and maintaining reputations as "tough, hard-nosed litigators who will not settle weak cases," repeat players such as accounting firms and insurance companies seek to deter future nuisance actions.").

[80] See, e.g., John C. Coffee, Jr., The Unfaithful Champion: The Plaintiff As Monitor in Shareholder Litigation, Law & Contemp. Probs., Summer 1985, at 5, 14 (citing Klott, Uneasy Period for Anderson, N.Y. Times, Nov. 11, 1984, at D1) (commenting that "that other 'Big Eight' accounting firms were concerned that the willingness of Arthur Andersen to settle large actions against it in the wake of several large jury verdicts would adversely affect them by convincing plaintiffs that the industry would no longer take cases to trial; previously, Arthur Andersen 'had a reputation for taking cases to the mat [but] had become gun-shy' in the wake of these verdicts, according to these other firms).").

[81] See, e.g., the large literature on nuisance settlements in securities class actions and M&A, often finding no stock price effect as a result of being named in a lawsuit or paying a nuisance settlement [cite articles]. The tightknit nature of the accounting industry may also make it difficult for plaintiffs' firms to procure the experts necessary to demonstrate that auditors violated industry standards.

by the low number of restatements. But it may also have to do with the incentives of the plaintiffs' bar, the fact-intensiveness of the due diligence defense, and the willingness of auditors to play litigative hardball. That Securities Act claims naming auditors are more likely to be brought by institutional investors, that they are less likely to be dismissed and settle for higher amounts, that they tend to follow on generally agreed indicia of malfeasance (such as manager departure or an SEC enforcement action), and that they are bundled with more labor-intensive Rule 10b-5 claims all suggest that if you are going to sue an auditor, you have to mean it. It is possible, however, that this may leave some potentially meritorious claims against auditors on the table, as might be indicated by the number of IPOs that occurred when the auditor was engaged in serious misconduct, as illustrated by a PCAOB sanction, and the number of Securities Act claims not naming auditors that allege some accounting violation.

B. Does Securities Act Liability Deter Underwriters?

Whether the Securities Act induces good behavior by underwriters is a different question from whether it induces good behavior for auditors. Underwriters and auditors, while both central to the literature on gatekeeping, perform very different roles, are subject to different liability standards, and function against different institutional backdrops. To begin with, although accounting firms and investment banks are both few and reputation-conscious, there is a markedly larger lower tier of investment banks, some of whom specialize in smaller, riskier issuances.[82] Underwriters, unlike auditors, also act in syndicates. Although the Securities Act does not distinguish between lead and syndicate underwriters, syndicate underwriters typically delegate the bulk of the diligence process to the lead underwriters, and courts have held that syndicate underwriters generally "sink or swim"

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[82] For an example of how the bottom tier are sometimes regarded, see Complaint (citing Glassdoor.com review), chrome-extension://efaidnbmnnnibpcajpcglclefindmkaj/https://securities.stanford.edu/filings-documents/1062/SSHL00_01/2018216_r01c_17CV04572.pdf ("[Firm X] has the lowest quality reputation across the industry. If you are okay dealing with the vagaries of microcap companies, as well as private companies that are strategically destined for failure, then this is a great place. The quality of its prospects are of the lowest common denominator. [Firm X] will do any transaction for any company at any time. Its competitors know this, the companies know this, the regulators know this. . . Nearly every [Firm X] deal is a dog. Nearly every buy side client knows, or has been burned by a [Firm X] transaction. Universally, the street thinks of [Firm X] as a bucket shop. Its research analysts have zero credibility, and are bankers' puppets to support [Firm X] deals. . . . How senior management believe its clients to be credible is beyond imagination.").

with the lead underwriters with respect to Securities Act liability.[83] And critically, underwriters may be liable under the Securities Act for the non-expertised portions of the registration statement, meaning those that experts do not certify. This is potentially very broad. They may also be liable for the expertised portions to the extent that "red flags" exist indicating a potential problem. Accordingly, some scholars have characterized underwriters as "the first line of defense against disclosure errors,"[84] noting that "[b]ecause of the threat of liability and underwriters' interest in protecting their reputations, Section 11 made underwriters virtually full partners with the issuer in corroborating the truthfulness of the registration statement. Underwriters became prominent, if not dominant, participants in due diligence meetings for registered offerings."[85]

Perhaps a reflection of the "full partnership" between the underwriter and the issuer is the prevalence of comprehensive indemnification clauses in underwriting agreements. In these provisions, the issuers generally purport to indemnify the underwriters against any expenses or liabilities incurred in connection with the offering, including under the securities laws.[86] These provisions are generally drafted very broadly.[87] In general, underwriters

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[83] J. William Hicks, Misleading Registration Statements: Section 11, 17 Civil Liabilities: Enforcement and Litig. § 4:106 (2009) ("Section 11 does not, by its terms, distinguish between managing or lead underwriters and underwriters who participate as members of the underwriting group. Judicial interpretations of Section 11(b)(3)(A) indicate that participating underwriters sink or swim with the lead underwriters. If the lead underwriter proves a due diligence defense, then all of the participating underwriters are protected as well.").

[84] Andrew F. Tuch, Joel Seligman, The Further Erosion of Investor Protection: Expanded Exemptions, Spac Mergers, and Direct Listings, 108 Iowa L. Rev. 303, 313–14 (2022) (noting in addition that underwriters rely on certifications from other experts – accountants and lawyers – as conditions to underwriting an issuance).

[85] Andrew F. Tuch, Joel Seligman, The Further Erosion of Investor Protection: Expanded Exemptions, Spac Mergers, and Direct Listings, 108 Iowa L. Rev. 303, 312 (2022).

[86] Defending Underwriters Against Securities Claims, Practical Law Practice Note w-003-3972.

[87] See. e.g., ValueAmerica Inc., S1-A (Sept. 1, 1998) Underwriter Agreement, 24, https://www.sec.gov/Archives/edgar/data/1049889/0000916641-98-000986.txt ("The Company agrees to indemnify and hold harmless each indemnify and hold harmless each Underwriter against any losses, claims, damages or liabilities, joint or several, to which such Underwriter may become . . . under the Act, the Exchange Act or otherwise[.]"); Liquid Holdings Group, Inc. S1-A, Underwriter Agreement at 27, July 24, 2013, https://www.sec.gov/Archives/edgar/data/1562594/000119312513299995/d484709dex11.htm ("The Company shall indemnify and hold harmless each Underwriter against any losses, claims, damages or liabilities to which they or any of them may become subject, under the Act or otherwise, insofar as such losses, claims, damages or liabilities (or actions in respect thereof) arise out of or are based upon an untrue statement or alleged untrue statement of a

assume liability only for a very limited range of information, provided in a "blood letter" that accompanies the underwriting agreement.[88] This information is intended to be narrow in scope, and covers only items of which the underwriters could have "precise knowledge," including "the concessions that the underwriter will pay to selling group members in connection with sales;" "the underwriter's planned price stabilization transactions for the relevant securities, such as short sales and syndicate covering transactions;" and "the specific names of the co-underwriters participating in the offering."[89]

Accounting firms are generally not indemnified by issuers because the SEC[90] and other agencies[91] have opined that such agreements would undermine auditors' independence. While the American Institute of Certified Public Accountants (AICPA) published an ethics rule stating that indemnification for knowing misrepresentation by an issuer would not compromise an auditor's independence, the PCAOB has taken the position that because auditors must comply with SEC independence requirements, this rule has no

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material fact contained in any Preliminary Prospectus, the Registration Statement, the General Disclosure Package, the Prospectus, any Permitted Free Writing Prospectus, any individual Issuer-Represented Limited-Use Free Writing Prospectus or any Written Testing-the-Waters Communication, when considered together with the General Disclosure Package, or any amendment or supplement thereto, or arise out of or are based upon the omission or alleged omission to state therein a material fact required to be stated therein or necessary to make the statements therein not misleading, and will reimburse each such indemnified party for any legal or other expenses reasonably incurred by them in connection with investigating or defending any such action or claim as such expenses are incurred[.]").

[88] See, e.g., Morrison & Foerster, *Structured Note Pricing Supplements and Blood Letters*, Structured Thoughts, Vol. 9, Issue 4 at 3, June 28, 2018; LexisNexis, Sample Blood Letter.

[89] Morrison & Foerster, *Structured Note Pricing Supplements and Blood Letters*, Structured Thoughts, Vol. 9, Issue 4 at 3, June 28, 2018.

[90] See SEC and PCAOB Independence Pitfalls and How to Avoid Them, Audit Conduct, Winter 2018 Vol 3 Issue 2 ISSN 2151-0857, https://www.auditconduct.com/newsletters/pcaob-and-sec-independence-pitfalls-and-how-to-avoid-them#:~:text=For%20decades%2C%20the%20SEC%20has,template%20for%20an%20SEC%20engagement. ("For decades, the SEC has prohibited indemnification and liability-limiting clauses in audit engagement letters, which they believe removes an integral safeguard to the auditor's independence.").

[91] See Interagency Advisory on the Unsafe and Unsound Use of Limitation of Liability Provisions in External Audit Engagement Letters, Feb. 9, 2006, https://www.federalregister.gov/documents/2006/02/09/06-1189/interagency-advisory-on-the-unsafe-and-unsound-use-of-limitation-of-liability-provisions-in-external;

applicability to auditors of public companies.[92] Moreover, the SEC has conducted enforcement actions against auditors on the grounds that they represented their audits of issuers as independent when in fact they were not because the auditor engagement letter included an indemnification provision.[93]

By contrast, although indemnification of directors and officers for securities claims is not permitted,[94] the SEC so far has been silent on indemnification for underwriters. Nonetheless, the SEC's rationale for prohibiting director and officer indemnification, that it removes incentive for good gatekeeping by suspending the threat of monetary liability, it equally applicable to underwriters, and has been extended by courts to hold underwriter indemnification provisions void as a matter of public policy.[95] Courts in the Second,[96] Ninth,[97] Third,[98] Fourth[99] and Eleventh Circuits[100] have taken this position.[101] Notably, these jurisdictions hear the majority of securities class actions.

Despite judicial disapproval of underwriter indemnification in key jurisdictions, these provisions appear in virtually all underwriting

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[92] PCAOB, Standing Advisory Group Meeting, Feb. 9, 2006, at 3, chrome-extension://efaidnbmnnnibpcajpcglclefindmkaj/https://pcaobus.org/News/Events/Documents/02092006_SAGMeeting/Indemnification.pdf.

[93] See, e.g., In the Matter of Elliot R. Berman, CPA and Berman and Company, P.A., SECURITIES EXCHANGE ACT OF 1934 Release No. 77447 / March 25, 2016, chrome-extension://efaidnbmnnnibpcajpcglclefindmkaj/https://www.sec.gov/files/litigation/admin/2016/34-77447.pdf.

[94] 17 C.F.R. § 229.512.

[95] See, e.g., Eichenholtz v. Brennan, 52 F.3d 478, 484 (3d Cir. 1995) (arguing that underwriter indemnification defeats the purpose of gatekeeper liability, which is to induce gatekeepers to act as an effective check on issuers by exposing them to substantial monetary liability).

[96] Globus v. Law Research Service, Inc., 418 F.2d 1276, 1288 (2d Cir. 1969), cert. denied, 397 U.S. 913, 90 S.Ct. 913, 25 L.Ed.2d 93 (1970); In re New York City Mun. Sec. Litig., 87 F.R.D. 572, 577 (S.D.N.Y. 1980).

[97] Franklin v. Kaypro Corp., 884 F.2d 1222, 1232 (9th Cir. 1989);

[98] Eichenholtz v. Brennan, 52 F.3d 478, 484 (3d Cir. 1995).

[99] Baker, Watts & Co. v. Miles & Stockbridge, 876 F.2d 1101, 1108 (4th Cir. 1989).

[100] In re U.S. Oil & Gas Litigation, 967 F.2d 489 (11th Cir.1992); In re HealthSouth Corp. Sec. Litig., 572 F.3d 854, 860 (11th Cir. 2009).

[101] To the extent that the case law is developed, some jurisdictions voiding underwriter indemnification have held that it is valid where the underwriter has "successfully defended itself on the merits." Notably, this does not include instances where the underwriter settles, unless it has "actually demonstrate[d] that it was without fault." See Credit Suisse First Boston, LLC v. Intershop Commc'ns AG, 407 F. Supp. 2d 541, 547-48 (S.D.N.Y. 2006); Defending Underwriters Against Securities Claims, Practical Law Practice Note w-003-3972.

agreements,[102] and the consensus appears to be that they are generally honored by issuers.[103] These provisions are standard in the industry, such that practice guides include samples of such provisions and the accompanying "blood letter."[104] 72% of the respondents to my survey of capital markets attorneys stated that so long as the underwriter follows the proper procedures, issuers will pay their indemnification claims.[105] The informal interviewees I spoke with stated even more strongly that these provisions are generally honored by issuers, and could not think of instances in which an issuer opportunistically refused to pay in light of the judicial uncertainty surrounding the enforceability of these provisions.[106]

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[102] Over half of issuers are advised by top firms in connection with their IPOs, according to my data. Accordingly, it seems unlikely that indemnification provisions are included in the underwriter agreement without the issuer's knowledge, or without the issuers' knowledge that such provisions are of uncertain validity. See Cf. Charles A. Sullivan, The Puzzling Persistence of Unenforceable Contract Terms, 70 Ohio St. L.J. 1127 (2009) ("Contracts frequently contain clauses that are not enforceable-at least, not enforceable as written. While mistake may explain some such clauses, invalid terms are often used by sophisticated actors who are well aware that they are unenforceable as written. Presumably, this is because such clauses have utility for those who impose them, and the most obvious reason is that the other party to the contract (or, conceivably, some third party) does not realize the clause is unenforceable as written or is unwilling to risk the resources needed to establish its invalidity.").

[103] More specifically, the issuer's D&O insurer will pay indemnification claims unless the issuer is bankrupt, in which case the D&O proceeds become part of the bankruptcy estate. See Gallagher, D&O Policies in Bankruptcy Proceedings, https://www.ajg.com/us/news-and-insights/2020/aug/d-o-insurance-in-bankruptcy-proceedings/#:~:text=Because%20the%20bankruptcy%20court%20typically,unless%20the%20bankruptcy%20court%20consents ("Because the bankruptcy court typically considers proceeds under the D&O insurance policy to be part of the bankruptcy estate, claims are not generally paid to indemnify Insured Individuals unless the bankruptcy court consents.").

[104] See, e.g., Morrison & Foerster, *Structured Note Pricing Supplements and Blood Letters*, Structured Thoughts, Vol. 9, Issue 4 at 3, June 28, 2018; LexisNexis, Sample Blood Letter.

[105] I sent my survey to 49 transactional attorneys who specialize in capital markets transactions, and 42 plaintiffs' attorneys who specialize in securities fraud cases. My response rates were 20.4% and 21.4% respectively, which is similar to existing studies. See, e.g., See, e.g., Gompers P. A., W. Gornall, S. N. Kaplan and I. A. Strebulaev. 2020. How do venture capitalists make decisions? Journal of Financial Economics 135:169–90; Graham J., J. Grennan, C. Harvey and S. Rajgopal. 2022. Corporate culture: Evidence from the field. Journal of Financial Economics 146:552–93; Graham J. and C. Harvey. 2001. The theory and practice of corporate finance: Evidence from the field. Journal of Financial Economics 60:187–243. Non-ordinal responses were randomized for survey respondents. Respondents were allowed to skip questions and still submit the survey. Responses were anonymous. Survey results are reported in Appendices A and B.

[106] Notes on file with author.

Why are underwriter indemnification provisions so pervasive despite judicial disapproval? The obvious explanation stems from the relative bargaining power of the underwriters as compared to the issuers. The investment banking sector has consolidated dramatically over the period of my sample, most acutely in the aftermath of the financial crisis, when many erstwhile investment banking giants failed or were absorbed by commercial banks.[108] The result is that an increasingly smaller set of investment banks are underwriting IPOs. The household names among these – Goldman Sachs, Morgan Stanley, and the other bulge bracket investment banks – account for []% of the IPO market.

Accordingly, investment banks may be largely able to dictate some terms of their engagement for an IPO. This idea is consistent with the comments of interviewees I spoke with, who told me that indemnification provisions between underwriters and issuers are rarely negotiated. It also aligns with the indemnification provisions I reviewed, which are generally boilerplate and show little substantive variation. Underwriters are a relatively small, prestigious group, and the completion of an IPO does not mean an issuer will never need one again. On the contrary, underwriters are well-known repeat players,[109] even on an issuer-by-issuer basis, providing advice and services for shelf offerings, mergers, and the like. Even those issuers who have leverage in negotiations against their underwriters may decide that it is best applied to other terms. [110]

The pragmatic availability of issuer indemnification for claims against underwriters complicates analysis of the efficacy of the Securities Act in promoting underwriter diligence. Like auditors, underwriters contribute to Securities Act settlements involving IPOs very rarely. Unlike auditors, however, they are sued much more frequently, and are named over the full

[108] See George J. Papaioannou, Commercial Banks in Underwriters and the Decline of the Independent Investment Bank Model, 9 J. Int'l Bus. & L. 79 (2010)
("[C]ontrary to the expectations of those advocating the full deregulation of investment banking in 1999, eleven years later the industry has undergone a consolidation wave that has perpetuated the traditional structure of investment banking as an industry dominated by a limited number of organizations.").
[109] See, e.g., Jeremy McClane, The Agency Costs of Teamwork, 101 Cornell L. Rev. 1229, 1232–33 (2016) (noting that other gatekeepers, such as lawyers, "have an incentive to ingratiate themselves with the investment banks who are repeat players in the IPO market.").
[110] See, e.g., Patrick M. Corrigan, The Seller's Curse and the Underwriter's Pricing Pivot: A Behavioral Theory of Ipo Pricing, 13 Va. L. & Bus. Rev. 335, 407 (2019) (arguing that issuers with bargaining power should require concessions "only [for the] price and not nonprice terms of a contract.").

period of the sample in just shy of 80% of Securities Act claims. These claims against underwriters are significantly more likely where the issuer is a Chinese company. This suggests that plaintiffs may be naming underwriters where diligence was in fact more likely to be incomplete.

However, very few underwriters ultimately pay into settlements. Like auditors, one possible explanation for the dearth of underwriter payouts is a deterrence explanation; that is, because they fear Securities Act liability, underwriters conduct thorough diligence and successfully assert the due diligence defense, or are assumed to be able to do so.[111] But as with auditors, there is a near-total absence of underwriter payments even in IPOs where diligence may not have been thorough. Despite the propensity of plaintiffs to sue underwriters in lawsuits arising out of Chinese IPOs, out of 243 IPOs of Chinese issuers over the sample period, only one drew a Securities Act claim resulting in a payout by an underwriter.

[111] It is unlikely that underwriters do not pay into settlements because they actually benefit from the due diligence defense. Of the 164 lawsuits in my sample that settled (which is to say, all claims were not dismissed), only 17 were dismissed as to the underwriters. These dismissals overwhelmingly occurred on a motion to dismiss, rather than a motion for summary judgment, and in general, dismissal was on grounds such as lack of standing or lapse of the statute of limitations (only one year for Securities Act claims). Irrespective of the stage of the lawsuit, I was only able to find seven underwriter defendants in my sample that raised the due diligence defense at all. This is perhaps unsurprising. The due diligence defense generally cannot be raised until the summary judgment phase, and requires intensive fact-finding. Because of the intensity of the pressure to settle once a motion to dismiss is denied, it is rare even to enter the procedural territory where the due diligence defense is meaningful. My lawsuits reflect this intuition; only one court dismissed the Securities Act claims against the underwriters where the underwriters asserted a due diligence defense, and even there, the dismissal was on other grounds. See In re Resonant Inc. Securities Litigation, Mem. Of Points and Authorities in Support of MDB Capital's Motion to Dismiss the Second Amended Class Action Complaint, 15-cv-01970, Dkt. No. 90-1 (C.D. Cal. Mar. 22, 2016) ("A 'Due Diligence' Defense Is Established On The Face Of The SAC, Defeating The Section 11 Claim Against MDB Capital."); In re Resonant Inc. Securities Litigation, Order Granting in Part and Denying in Part Motion to Dismiss, 15-cv-01970, Dkt. No. 99 (C.D. Cal. July 11, 2016) at 8 ("Here, the Court cannot draw a reasonable inference that Defendants knew it would not be able to meet the Skyworks specifications at the time when Defendants made purported misstatements in public filings related to the IPO. The Court GRANTS Defendants' Motions to dismiss the Section 11 claims with leave to amend."). All this suggests that when the rubber meets the road and the underwriter has been sued, the due diligence defense does not do much work. (I note that because several fact-intensive documents were filed under seal, I cannot say with complete certainty exactly how many dispositive motions actually raise the due diligence defense. There are eight such lawsuits where dispositive motions are unavailable. However, six of these are motions to dismiss, where the due diligence defense is less likely to be raised).

What is the reason for this? One possibility is that many plaintiffs' lawyers, as with auditors, are not interested in investing the time and money to puncture the underwriters' due diligence defense even if such an endeavor might ultimately be fruitful.[112] Unlike auditors, however, easy if smaller settlements are available to plaintiffs' lawyers who sue the underwriters because issuers must cover any potential liability or costs they incur. Accordingly, plaintiffs' attorneys may give up even meritorious claims against underwriters in favor of settling up to the amount of the issuer's D&O policy.[113] The total settlement amounts obtained in Securities Act cases against Chinese issuers could support this conclusion. While the aggregate mean and median settlements for Securities Act claims in my sample generally are $17.4 million and $6.01 million, the aggregate mean and median settlements against Chinese issuers are $5.4 million and $3.75 million.

The availability of issuer indemnification may also explain the general trend in claims against underwriters, which tend to track claims against issuers. Claims of both types have increased steadily over the sample period (in contrast to claims against auditors, which appear more responsive to external events, peaking in the aftermath of the Enron and Financial Crises). Plaintiffs' lawyers are more likely to name the underwriter in jurisdictions where courts have held that indemnification provisions are unenforceable, but in most cases this seems to be largely symbolic; even in no-indemnification jurisdictions, payouts by underwriters are remarkably rare.[114]

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[112] This disinterest may to some extent be reflected in the engagement of underwriters in their own defense in earlier litigation stages. Such engagement varies widely. While some underwriters submit full briefs on motions to dismiss, this is not the dominant strategy; rather, many file truncated motions to dismiss that merely reiterate or add arguments to the issuer's motion, and a substantial percentage simply join the issuer's motion. One imagines that in these instances, underwriters are 1) ambivalent as to their own defense because they are indemnified, and/or 2) saving their effort and defense funds for the fact-intensive due diligence fight at summary judgment, should the case ever arrive there. I note in addition that underwriters are less likely to be named in complaints that bundle Securities Act claims with Rule 10b-5 claims. This may also suggest that plaintiffs' lawyers are not interested in pursuing labor-intensive cases against underwriters especially as the standard for secondary liability under Rule 10b-5 has become more rigid under *Stoneridge* and *Janus*.

[113] Most U.S.-listed Chinese companies do have D&O insurance, though for relatively low amounts. See Kevin Lacroix & Peter M. Gillon, Pillsbury Advisory: Surge of Securities Litigation Against U.S.Listed Chinese Companies Raises Critical D&O Insurance Issues, July 14, 2011, chrome-extension://efaidnbmnnnibpcajpcglclefindmkaj/https://www.pillsburylaw.com/a/web/3678/ChinaAdvisorySurgeofSecuritiesLitigationAgainstUSListedChineseCo.pdf at 3.

[114]

More broadly, Table 4 shows that in general, Securities Act claims are more likely where there is some indication of faulty gatekeeping, such as a restatement of financials, a director or officer dismissal, a bankruptcy (to the extent that this is an indicator of faulty gatekeeping, which is more likely later in the sample when IPOs are larger), and where the issuer is Chinese. However, one metric that may be associated specifically with auditor negligence – PCAOB sanctions – is not associated with a stronger overall likelihood of a Securities Act lawsuit. This may suggest that diligence failure is prosecuted by plaintiffs' lawyers primarily where there is a good likelihood of extracting a settlement from the issuer, which is possible for underwriter misconduct, but not for auditor misconduct. All this may suggest that the large number of claims naming the underwriter are window-dressing, and the real goal is to extract an issuer settlement. The low number of underwriter settlements – similar to auditor settlements – could reinforce this interpretation.[115]

C. Gatekeeper Liability and Issuer Insolvency

A secondary purpose of gatekeeper liability is to provide wrists to slap and deep pockets to reach into where issuers are insolvent.[116] These are the instances where gatekeeper liability is likely most important from a plaintiff-investor's perspective, since other sources of settlement funds may be limited. Yet lawsuits against gatekeepers where the issuer is in danger of insolvency are relatively rare, with 17 claims against underwriters where the issuer experienced a bankruptcy within the statute of repose, and only three against auditors. Only three and two bankrupt issuers drew Securities Act claims where underwriters and auditors respectively contributed to a settlement. And where issuers are actually bankrupt prior to any action being brought, claims against gatekeepers are rarer still, with only two in the sample for both auditors and underwriters.

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[115] One important inquiry obscured by underwriter indemnification is whether underwriters are as resistant to nuisance settlements as auditors. There are reasons to think that they might be; investment banking is also a highly consolidated, reputation-conscious industry.

[116] See, e.g., Andrew Tuch, Multiple Gatekeepers, 96 Va. L. Rev. 1583, 1610 (2010); A.C. Pritchard, O'Melveny & Myers v. FDIC: Imputation of Fraud and Optimal Monitoring, 4 Sup. Ct. Econ. Rev. 179, 191-199 (1995) (suggesting that gatekeeper liability is justified where gatekeepers fail to detect an insolvent firm's wrongdoing); Howell E. Jackson, Reflections on Kaye, Scholer: Enlisting Lawyers To Improve The Regulation of Financial Institutions, 66 S. Cal. L. Rev. 1019 (1993) (explaining that gatekeeper liability "makes sense" where a corporation becomes insolvent before its misconduct is exposed).

Prior studies have analyzed settlement incentives in shareholder lawsuits with insolvent issuers in connection with outside director liability. Professors Black, Cheffins and Klausner argue that even where the issuer is insolvent and the expected damages award is greater than the issuer's D&O policy limit, plaintiffs may rationally settle for the remains of the insurance funds rather than proceed to trial against director defendants.[117] This is because the amount of insurance proceeds decreases as the litigation proceeds, as they will be used to pay the expenses of the lawsuit, and because plaintiffs fear that they will be unable to collect funds from individual defendants even if they win at trial.[118] Neither of these incentives are at play with underwriter or auditor defendants, who are generally large, deep-pocketed institutions with their own insurance policies. This should mitigate the fear that continuing the lawsuit will eke away any funds available for an award, and the likelihood that an adverse trial result would bankrupt an underwriter or auditor seems remote. Pursuing such a defendant where the primary offender is insolvent seems like common sense.

The responses of plaintiffs' lawyers to my survey are consistent with the conventional wisdom that the advantages of suing the gatekeepers are most acute when the issuers are insolvent. But here again, the disinclination of plaintiffs' lawyers to go to the trouble of overcoming the due diligence defense may explain why we see relatively few Securities Act claims against gatekeepers in the leadup or aftermath of an insolvency. Where the issuer is unavailable as an ultimate source of settlement funds and any gatekeeper payout will be the result of a protracted fact-finding mission, undertaking a lawsuit at all may simply not be worth the trouble.

An alternative, or perhaps complementary explanation may be that insolvency is simply not a good indicator of a viable Securities Act claim. Indeed, some results of my survey support this explanation; no respondent thought that insolvency within the statute of repose was the best indicator of a viable Securities Act claim, although half of respondents ranked it as the second through fourth best indicator. This variation in ranking could in part be the product of variation in IPO size. It may be that in the later years of the sample, when IPOs are very large, there is likely something amiss in a newly public firm that burned through the cash from its equity issuance in less than

[117] Bernard Black et. al., Outside Director Liability, 58 Stan. L. Rev. 1055, 1104 (2006).
[118] *Id.*

three years. However, this is less likely to be true in the earlier years of the sample, when IPO proceeds were substantially smaller.[119]

VII. Policy Implications: "What Gatekeeper Liability?"

Although this may be an unsatisfying conclusion, policy implications for the findings in this paper depend largely on what one thinks of the state of the IPO market in general. This question elicits sharply divergent viewpoints,[120] which this article does not purport to resolve. Nonetheless, my findings could certainly be construed to suggest that the IPO market in general is working reasonably well, and rejiggering gatekeeper liability under the Securities Act is not necessary; alternatively, they may suggest that the IPO market is not working as desired and tightening the screws on gatekeepers would be appropriate.[121] I explore both these options in turn.

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[119] Proportional fault rules might also incentivize plaintiffs' lawyers to focus on issuers and to forgo the lawsuit entirely if the issuer is insolvent. However, although the PSLRA did amend the Securities Act to make liability proportional to fault instead of joint and several, it did so only for outside directors, not for underwriters or auditors. § 5B:31. Section 11—Section 11(f)—Joint and several liability; Right to contribution, 2 Publicly Traded Corporations Handbook § 5B:31 (2023-2). Commentators have noted that "one can expect [the] influence" of the PSLRA's proportional fault rules in actions under other provisions of the securities laws, such as gatekeeper liability under section 11. See, e.g., James D. Cox et al., Securities Regulation: Cases and Materials 641, 851 (3d ed. 2001). However, the Securities Act cases in my sample pursued against underwriters after the bankruptcy or delisting of the issuer are on the smaller side, suggesting that shadow proportional fault rules (which would require a deal to be enormous to make pursuing the gatekeeper alone worthwhile) may not be at play. For example, the two lawsuits that were brought after bankruptcy, Digital Domain and Creditrust, had adjusted IPO proceeds of roughly $44.4 million and $29.2 million. Settlements in those cases were $5.5 million and $7.5 million respectively (not adjusted for inflation). Similarly, only nine issuers were sued following a delisting, and the mean and median adjusted IPO proceeds of those issuers were $44.4 million and $50.3 million respectively. I note that even among the firms that went bankrupt or were delisted within the statute of repose, it is the relatively small IPOs that drew lawsuits; the mean and median adjusted IPO proceeds of the IPOs that went bankrupt within the statute of repose are $142 million and $65.5 million. The IPOs that were delisted within the statute of repose have adjusted mean and median IPO proceeds of $75.5 million and $41.4 million.

[120] []

[121] I note that my results do not seem to support a theory that Securities Act liability may overdeter misconduct, which commentators have explored in other securities law contexts. See, e.g., Amanda Rose, *The Multi-Enforcer Approach To Securities Fraud Deterrence: A Critical Analysis*, 158 U. Penn. L. Rev. 2173 (2010).

A. Norm and Reputation-Driven Gatekeeping: A Success Story

One quite plausible interpretation of this article's findings is that IPOs, in general, are pretty good. Restatements for fraud and bankruptcies within the statute of repose are quite rare, and have generally declined further throughout the sample period. If our objective in imposing gatekeeper liability under the Securities Act is to keep investors safe by ensuring that as few companies as possible are fraudulent or immediately go belly-up, we might think the current regime is reasonably successful, and we might further deduce that gatekeepers are doing their jobs to make it so. But where the likelihood of monetary liability under the Securities Act is vanishingly low, why do they do this?

One obvious explanation is that reputation matters to gatekeepers. 67% of the capital markets attorneys who responded to my survey stated that avoiding the reputational damage with institutional investor clients that might result from association with inaccurate marketing materials was one of the top two reasons that underwriters engage in due diligence. I also heard this idea echoed in informal interviews, where interviewees stated that underwriters uniformly understand that the market will punish them for inaccurate offering statements.[122]

Capital markets attorneys themselves may also play a role. Despite their functional status as gatekeepers, lawyers themselves are almost never sued under the Securities Act in connection with the IPO transactions they advise.[123] But notwithstanding the low likelihood of a payout by themselves or their investment bank clients, 89% of the capital markets attorneys who answered my survey ranked the establishment of a due diligence defense to avoid monetary exposure under the Securities Act as one of the top two reasons why underwriters perform diligence in IPOs.

This raises the question of why capital markets lawyers, who themselves draft the indemnification provisions of the underwriter agreements and know them to be largely effective, nonetheless counsel their underwriter clients to

[122] Informal interview. Notes on file with author.

[123] See Andrew F. Tuch, Joel Seligman, The Further Erosion of Investor Protection: Expanded Exemptions, Spac Mergers, and Direct Listings, 108 Iowa L. Rev. 303, 313–14 (2022) (stating that lawyers "rarely" face liability under Section 11); see also Marc Steinberg, *Ethical and Practical Lawyering with Vanishing Gatekeeper Liability*, Symposium on the Corporate Attorney, 88 Fordham L. Rev. 1575 (2020) (stating that "The days of expansive attorney liability under the federal securities laws are gone," though noting that this change is most pronounced "outside of section 11 liability.").

conduct rigorous diligence. To be sure, there is the chance that the issuer will become insolvent and indemnification will be ineffective. But as my sample demonstrates, the likelihood of insolvency is not high, and even if it occurs, the probability of a lawsuit in the aftermath is remote. Perhaps it is because, despite their practical experience that might indicate to the contrary, lawyers are trained to think that the Securities Act matters.[124] Some commentators have argued that "the socialization process involved in professional training" accounts for adherence to the law under such circumstances.[125] Despite what they may observe in connection with their specific practice, lawyers' "decisions [may be] guided by a set of widely shared norms-- some of which are formulated as legal rules . . . Adherence to th[ese] norm[s]"[126] may offer at least a partial explanation for the diligence that gatekeepers – particularly underwriters – seem to do.[127] In other words, it is possible that gatekeepers, irrespective of the odds of liability, do diligence simply because their lawyers tell them to.

Is there any feature of the Securities Act that makes the likelihood if bearing liability under it as a gatekeeper the subject of such divergence between professional legal opinion and factual outcome? This gap is striking, particularly when juxtaposed with general attitudes among lawyers about underwriter indemnification; though these provisions are judicially unenforceable in several important jurisdictions, attorneys on both sides seem quite clear-eyed about their effectiveness. One possible explanation is simply the relative rarity of Securities Act claims in connection with IPOs, and thus the difficulty for lawyers of aggregating lived experience that might contradict the law school textbooks. Every IPO includes an underwriter indemnification provision. But since the proportion of Securities Act claims arising from IPOs is relatively low, few lawyers may be prepared to take the litigation results incongruous with their training as anything more than anomalies. This may be especially true of capital markets transactional attorneys, whose practical distance from trends of plaintiffs' lawyers bringing such lawsuits is considerable. But even the plaintiffs' lawyers are not

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[124] The same reasoning may explain why we see investor plaintiffs suing undewriters at all. If underwriters are indemnified anyway and breaching the due diligence defense is not worth the trouble, why bother? While one informal interviewee did express this view, every respondent to my survey indicated that they would always include the underwriters in a Securities Act claim. This suggests another area where lawyers may be perpetuating their own mythology about the Securities Act.

[125] Pauline T. Kim, Lower Court Discretion, 82 N.Y.U. L. Rev. 383, 406–07 (2007).

[126] *Id.*

[127] This explanation may have less power for auditors, where a dedicated federal regulator, the PCAOB, and a strong professional organization, the AICPA, likely provide additional incentive for adherence to professional norms.

generally steeped in such lawsuits; among the plaintiffs' lawyers that responded to my survey, only 22% reported that Securities Act claims in IPOs made up more than 50% of their practice. This may mean that the dearth of gatekeeper payouts simply goes under the radar.

Another complementary possibility may simply be that due diligence is an internalized norm in the legal community. Prior commentators have noted that such norms may be adhered to sometimes, or by some actors, as the result of an internal cost-benefit analysis (i.e., the likelihood of paying a significant monetary penalty under the Securities Act). However, "most actors who have internalized an obligational norm will usually apply the norm reflexively, as a natural expression of their moral and social character, rather than calculatingly, on the basis of a cost-benefit analysis."[128] A possible analogy is to the directorial duty of care under Delaware law where due to DGCL 102(b)(7) waivers, monetary penalties are generally not only unlikely, but impossible.[129] Yet scholars have noted a general increase in directors' care that was likely the result of a shifting norm in the legal and business community, and "[p]retty clearly, not an increased threat of liability."[130]

The key point, however, is that with respect to the practice of due diligence, the apparent disconnect between the lawyerly narrative and the true odds of liability may actually produce good IPOs. Though the likelihood of monetary exposure is slight, it is possible that gatekeepers' counsel nonetheless advise their clients to conduct thorough diligence – and underwriters and auditors generally do it. That the SEC so far has declined to specifically invalidate underwriter indemnification agreements may reflect a judgment that the diminution of underwriter deterrence affected by these provisions does not outweigh the costs of eliminating them.[131] The benefit may be that the current system is, by many measures, chugging along adequately. The costs may include, as described above, an increase in the expense of going public which may be hard to constrain in an industry as consolidated as investment

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[128] Melvin A. Eisenberg, Corporate Law and Social Norms, 99 Colum. L. Rev. 1253, 1259–60 (1999).
[129] *Id.* at 1266.
[130] *Id.*
[131] An analogous remedy to avoid an increase in underwriter fees but (possibly) increase transparency might be to eliminate underwriter indemnification, but retailor the due diligence defense to make it decidable on a motion to dismiss. However, this might gut the efficacy of the defense which, rightly, focuses on the actions that an underwriter actually took in connection with a particular issuance. Moreover, retooling the defense in courts is likely to be a cumbersome and patchwork exercise which would undermine, or at least, delay, any benefit of this approach.

banking, and which may ultimately damage the already precarious ability of smaller firms to go public.

Moreover, increasing gatekeeper deterrence may not be a useful exercise. It is highly likely that savvy institutional investors are generally uninterested in diligence so long as they achieve good returns on their investments.[132] This perspective substitutes concerns about disclosure accuracy (which the Securities Act protects) with business success (which it does not). In many instances, the market conflation of business success with disclosure accuracy may bear out; again, it seems that something must be wrong under the hood for a new issuer to go bankrupt within three years of an IPO. Being on the lookout for such problems might be sufficient incentive to gatekeep, particularly in a tight-knit industry of repeat players.

But additional checks may be at work. Where the market metric by which gatekeepers are judged is success, their primary concern in practice might be convincing their institutional investor clients that the new firm whose stock they are selling is likely to be successful. Outright fraud could serve this goal. History has demonstrated that it may be perilous to rely on reputation alone as a check on the behavior of large financial institutions,[133] and indeed, much legislation has been spawned to this effect in the aftermath of various crises. Most important, perhaps, for my purposes, is the Sarbanes-Oxley Act, which drew many critical eyes to the conduct of gatekeepers following the Enron scandal.[134] Sarbanes-Oxley did not alter the Securities Act, which has been acknowledged by scholars as the “classic example” of judicial gatekeeping enforcement,[135] but it did generate a wealth of commentary by lawyers on the importance of gatekeeping.[136] Accordingly, it is perhaps not outrageous to hypothesize that the idea that gatekeeping matters has been successfully socialized in lawyers. In the end, it may be these lawyers who enforce a diligence process, that, at the margin, discourages bad behavior, notwithstanding the lack of monetary penalties.

This socialization may be generational, and lawyers may not always counsel their gatekeeper clients to conduct thorough diligence if the narrative of gatekeeper liability fades. But the complex equilibrium between diligence and deterrence, and between financial and reputational consequences may, for the moment, produce good-enough results.

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[132] Notes on file with author.
[133] Enron; Financial Crisis
[134]
[135] Coffee book
[136] See, e.g., [all the gatekeeping articles]

B. The Failure of Gatekeeper Liability

An alternative interpretation of my findings, however, is that gatekeeper liability for IPOs under the Securities Act is an utter failure. While bankruptcy rates within the statute of repose are low, one might construe it as shocking that they are not lower still, given the cash infusion from which IPO firms by definition benefit. Chinese issuances, in which good diligence is often difficult, have flourished over the sample period. Accounting firms engaging in other misconduct simultaneously audit the financials of firms going public at a substantial rate. These could be interpreted as signals that gatekeeping in the IPO market is in need of correction. More broadly, despite the threat of joint and several liability, no gatekeepers are likely to bear the costs of inaccuracies in an issuer's offering documents. Surely, it might be argued, this undermines carefully calibrated congressional incentives to keep gatekeepers vigilant, and is not what Congress had in mind in 1933 when it drafted the Act.

This may be especially true in light of what scholars have dubbed the "circularity problem." Many commentators have criticized securities litigation generally on the ground that any damages or settlement merely transfer wealth from one set of shareholders to another, with a percentage taken out for plaintiffs' lawyers, thus undercutting the utility of securities litigation as a compensation mechanism for investors.[137] But gatekeeper liability circumvents this critique. Since any settlement or damages in theory come from outside the offending issuer, investors can be truly made whole without a decline in the value of their shares. But such settlements under the Securities Act are extremely rare, and in fact, underwriter indemnification makes litigation a worse compensation mechanism for investors, since the issuer must pay not only its own costs, but those of the underwriter as well.

If one espouses the view that the current system does not serve the purposes for which the Securities Act was designed, the most immediate and specific fix would be for the SEC to refuse to accelerate registration statements, or to

[137] See, e.g., Merritt B. Fox, Why Civil Liability for Disclosure Violations When Issuers Do Not Trade?, 2009 WISC. L. REV. 297; Lawrence E. Mitchell, The "Innocent Shareholder": An Essay on Compensation and Deterrence in Securities Class-Action Lawsuits, 2009 WISC. L. REV. 243; John C. Coffee, Jr., Reforming the Securities Class Action: An Essay on Deterrence and Its Implementation, 106 COLUM. L. REV. 1534, 1545–50 (2006) (arguing that private litigation fails to achieve either compensation or deterrence objectives);

initiate enforcement actions against issuers whose underwriter agreements include indemnification provisions. The disapproval of courts has clearly not done the job, and if actual elimination of this practice is the object, more immediate sanctions are likely necessary. The results of such a tactic could include bargaining by underwriters for higher fees in IPOs, in order to offset the risk of expensive liability (or insurance premiums) for Securities Act violations. If sufficient in scale, the increase in fees might further constrict the IPO market, a topic already of worry to some commentators.[138]

It is possible that a further consequence of doing away with underwriter indemnification might be a higher volume of nuisance claims aimed at underwriters, whose primary defense – due diligence – is generally not available until quite late in a lawsuit. But it is also possible that underwriters, like auditors, will strenuously resist such settlements. In a universe where underwriters are no longer indemnified but, like accounting firms, are willing to shoulder the expense to make plaintiffs' lawyers prove their claims, we might see very few gatekeepers sued at all under the Securities Act. If one thinks that greater incentives are needed for gatekeepers to safeguard the IPO process and if one believes that the Securities Act is the appropriate mechanism for this,[139] the first step is to reexamine the relationship between the due diligence defense and the incentives of plaintiffs' lawyers.

This would be a difficult needle to thread. Constraining vexatious litigation, particularly against appealingly deep-pocketed professional firms, has been an important goal of some thirty years of development in securities law, and should not be abandoned. Yet the agency problems driving some issues in the plaintiffs' bar – particularly the sometime propensity to sell out the class for a settlement where potentially meritorious claims require greater effort and expense to prosecute – are well documented, and perhaps more successful reform efforts might lie in this direction.

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[138] Elisabeth de Fontenay, The Deregulation of Private Capital and the Decline of the Public Company, 68 Hastings L.J. 445, 454 (2017) ("The public stock market's continued power to command our attention conceals an arresting development, however: the market's traditional role of helping companies to raise large amounts of equity capital is in decline."); Frank Partnoy, *The Death of the IPO*, The Atlantic, Nov. 2018, https://www.theatlantic.com/magazine/archive/2018/11/private-inequity/570808/.

[139] It may well be, as other studies have noted that the PSLRA and recent decisions have measurably constrained lawsuits against gatekeepers – specifically, auditors – in recent years. See Honigsberg et al., The Changing Landscape of Auditor Liability, 63 J. of L. & Econ. 367 (2019).

VIII. Conclusion

Although the threat of monetary liability for gatekeepers under the Securities Act is theoretically substantial, in practice, gatekeepers almost never pay out under the Act for their conduct, even in IPO transactions with indicia of faulty gatekeeping. While underwriters are sued more frequently than auditors, this is likely because they are indemnified by issuers, who may be willing to pay nuisance settlements. To the extent that gatekeeping in IPOs nonetheless appears to be adequate, this may be the result of professional norms and reputational discipline, rather than Securities Act liability. If further gatekeeper discipline under the Securities Act is required, solutions likely involve examining the interaction of the due diligence defense with the incentives of the plaintiffs' bar.

Table 1: Descriptive Statistics of IPOs by Four-Year Period

IPO Date	1997-1999	2000-2003	2004-2007	2008-2011	2012-2015	2016-2019
No. IPOs	757	511	718	379	756	684
Mean IPO Proceeds ($m)	72.6	141	174	240	282	261
Std. Dev. ($m)	225	386	283	928	1130	532
Med. IPO Proceeds ($m)	33.9	59.3	94.3	104	107	66.1
Vulnerable Industries	304	228	231	133	374	354
%	40.16%	44.62%	32.17%	35.09%	49.07%	51.75%
Bankruptcies in SOR	38	20	9	3	9	6
%	5.02%	3.91%	1.25%	0.79%	1.19%	0.88%
Delistings in SOR	89	41	20	10	17	10
%	11.76%	8.02%	2.79%	2.64%	2.25%	1.46%
Restatements in SOR	6	4	1	1	3	1
%	0.79%	0.78%	0.14%	0.26%	0.40%	0.15%
SEC Enforcement Actions	1	1	1	1	1	1
%	.13%	.20%	.14%	.26%	.13%	.15%
Bulge Bracket UW	297	322	518	245	526	431
%	39.23%	63.01%	72.14%	64.64%	69.58%	63.01%
Top Issuer Firm	310	274	413	217	464	434
%	41.11%	53.94%	57.68%	58.65%	61.38%	64.20%
Chinese IPO	2	7	50	70	33	81
	0.26%	1.37%	6.96%	18.47%	4.37%	11.84%
D&O Dismissal	0	0	4	2	1	0
	0.00%	0.00%	0.56%	0.53%	0.13%	0.00%
PCAOB Sanction	0	2.5	50.75	36.75	86	134.75
	0.00%	0.49%	7.07%	9.70%	11.40%	19.70%
Securities Act Claims	21	38	56	30	53	61
%	2.77%	7.44%	7.80%	7.92%	7.01%	8.92%
Securities Act Claims Naming Underwriter	13	25	41	25	47	54
	1.72%	4.89%	5.71%	6.60%	6.22%	7.89%

Securities Act Claims Naming Auditor	2	5	3	5	0	1
	0.26%	0.98%	0.42%	1.31%	0%	0.15%

This table shows characteristics of the sample of IPOs in four-year intervals. I show the number of IPOs; the mean and median IPO proceeds; the number of IPOs in industries that have been found in other studies to be vulnerable to securities litigation; the number of issuers that declared bankruptcy within the statute of repose (three years after the IPO); the number of issuers that restated their financials for fraud within the statute of repose (three years from the IPO); the number of IPOs involving a lead underwriter from the Bulge Bracket; the number of IPOs involving top issuers' counsel based on American Lawyer Capital Markets Scorecards; the number of IPOs by Chinese issuers; the number of issuers whose director or officer left the firm for a misconduct-related reason within three years of the IPO; the number of IPOs occurring in the 5-year period before the issuer's auditor received a PCAOB sanction; the number of lawsuits including Securities Act claims involving an IPO; the number of lawsuits including Securities Act claims involving an IPO naming the underwriter; and the number of lawsuits including Securities Act claims involving an IPO naming the auditor. Dollar amounts are adjusted for inflation.

Table 2: Descriptive Statistics: Securities Act Claims

	Securities Act Claims		Securities Act Claims Naming Underwriter			Securities Act Claims Naming Auditor		
	Mean	Med.	Mean	Med.	T-stat	Mean	Med.	T-stat
Bankruptcy in SOR	.0728	0	.0829	0	-1.2039	.1875	0	-1.8274
Restatement in SOR	.0268	0	.0244	0	0.4633	.0625	0	-0.9097
PCAOB Sanction	.0881	0	.0939	0	-1.0046	.0938	0	-0.1304
Chinese firm	.1303	0	.1512	0	-1.9303	.125	0	0.0644
D&O Departure	.0077	0	.0097	0	-0.7399	.0625	0	-2.6203
Vulnerable Industry	.4265	0	.4244	0	-0.1830	.5625	1	-1.1779
Bulge Bracket Underwriter	.7568	1	.7366	1	1.4747	.5625	1	1.8752
Top Issuer Firm	.6525	1	.6373	1	0.9910	.5625	1	0.7785
Top Plaintiff Firm	.5249	1	.5268	1	-0.1187	.6250	1	-0.8254
Institutional Investor Lead Plaintiff	.3908	0	.4048	0	-0.8895	.6250	1	-1.9890
SEC Enforcement	.0115	0	.0146	0	-0.9085	.0625	0	-1.9828
10b-5 Claims	.4866	0	.4488	0	2.3541	.8125	1	-2.7197
No Indemnity Court	.8084	1	.8488	1	-3.2198	.8750	1	-0.6964
Dismissed/dropped	.3333	0	.3318	0	-1.0757	.0625	0	2.3887
Aggregate settlement amount	$17.4m	$6.01m	$19.2m	$6.32m	-1.0757	$37.4.	$10.4m	-2.1077
IPO Proceeds	$530m	$133m	$132m	$536m	-0.1065	$104m	$274m	0.6349
Price drop from IPO (market adjusted)	-.5728	-.5865	-.5770	-.5881	0.4364	-.6177	-.6681	0.6280
Price drop days from IPO	294.83	241.5	286.93	238	0.9619	290.14	291.5	0.0762
Total Obs.	261		205			16		

This table shows the characteristics of lawsuits including Securities Act claims involving IPOs, lawsuits including Securities Act lawsuits involving IPOs that name the underwriter, and lawsuits including Securities Act claims involving IPOs that name the auditor. The table reports the number of lawsuits involving issuers that declared bankruptcy within the statute of repose (three years after the IPO); the number of lawsuits involving issuers that restated their financials for fraud within the statute of repose (three years from the IPO); the number of lawsuits involving IPOs occurring in the 5-year period before the issuer's auditor received a PCAOB sanction; the number of lawsuits involving IPOs by Chinese issuers; the number of lawsuits involving issuers whose director or officer left the firm for a misconduct-related reason within three years of the IPO; the number of lawsuits involving IPOs in industries that have been found in other studies to be vulnerable to securities litigation; the number of lawsuits involving IPOs that had a lead underwriter from the Bulge Bracket; the number of lawsuits involving IPOs that had top issuers' counsel based on American Lawyer Capital Markets Scorecards;

the number of lawsuits involving top securities plaintiffs' law firms; the number of lawsuits brought in circuits where courts have invalidated underwriter indemnification agreements; the number of lawsuits that were dismissed or dropped; the aggregate mean and median settlement amounts for each type of lawsuit; and the mean and median IPO proceeds for the transactions involved in each type of lawsuit. Dollar amounts are adjusted for inflation.

Table 3: Descriptive Statistics: Securities Act Lawsuits Where Gatekeepers Contribute to Settlement

	Lawsuits where UW contributed to settlement	Lawsuits where auditor contributed to settlement
Bankruptcy in SOR	3	2
Delisting in SOR	6	5
Restatement in SOR	0	1
PCAOB Sanction	1	1.25
Chinese IPO	1	0
D&O Dismissal	0	0
Bulge Bracket UW	4	6
Top Plaintiffs' Firm	3	6
No Indemnification Cir.	6	7
Mean/Median Settlement Contribution	$5.86m/$3.5m	$8.24m/$5.5m
Mean/Median Total Settlement	$59.7m/$17.8m	$57.5m/$15m
Mean/Median IPO Proceeds	$170m/$110m	$384m/$116m
Other Gatekeeper Contributed	4	4
Obs.	7	9

This table shows the characteristics of lawsuits where underwriters or auditors contributed an identified amount to settle the lawsuit. The table reports the number of lawsuits involving issuers that declared bankruptcy within the statute of repose (three years after the IPO); the number of lawsuits involving issuers that were delisted within the statute of repose (three years after the IPO); the number of lawsuits involving issuers that restated their financials for fraud within the statute of repose (three years from the IPO); the number of lawsuits involving IPOs occurring in the 5-year period before the issuer's auditor received a PCAOB sanction; the number of lawsuits involving IPOs by Chinese issuers; the number of lawsuits involving issuers whose director or officer left the firm for a misconduct-related reason within three years of the IPO; the number of lawsuits involving IPOs that had a lead underwriter from the Bulge Bracket; the number of lawsuits involving top securities plaintiffs' law firms; the number of lawsuits brought in circuits where courts have invalidated underwriter indemnification agreements; the number of lawsuits that were dismissed or dropped; the mean and median settlement contribution of the underwriter or auditor respectively; the mean and median total settlement amount; the mean and median IPO proceeds; and whether the other gatekeeper also contributed to the settlement.

Table 4: Securities Act Lawsuits - OLS Regressions

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)
Bankruptcy in SOR	0.133**	0.137**	0.136**	0.135**	0.138**	0.139**	0.132**	0.104*	0.0711	0.0609
	(2.78)	(2.85)	(2.84)	(2.87)	(2.92)	(2.92)	(2.83)	(2.15)	(1.57)	(1.40)
Bulge Bracket Lead UW		0.0426**	0.0380*	0.0409*	0.0390*	0.0390*	0.0374*	0.0412*	0.0497**	-0.0140
		(2.71)	(2.30)	(2.50)	(2.39)	(2.38)	(2.29)	(2.36)	(2.97)	(-0.78)
Top Issuer Firm			0.0144	0.0127	0.0101	0.0102	0.0114	0.00705	0.00172	-0.00863
			(0.89)	(0.79)	(0.63)	(0.64)	(0.71)	(0.43)	(0.11)	(-0.56)
Restatement in SOR				0.384**	0.377**	0.377**	0.379**	0.430**	0.411**	0.410**
				(2.93)	(2.80)	(2.80)	(2.80)	(3.17)	(3.23)	(3.17)
D/O Departure in SOR				0.544*	0.516*	0.518*	0.517*	0.505*	0.491*	0.454*
				(2.10)	(2.10)	(2.11)	(2.10)	(2.03)	(2.57)	(2.38)
Chinese IPO					0.134**	0.134**	0.134**	0.130**	0.114**	0.122**
					(3.12)	(3.11)	(3.11)	(2.88)	(2.74)	(2.98)
PCAOB Sanction						0.0102	0.0113	0.0586	0.0550	0.0505
						(0.18)	(0.20)	(0.76)	(0.74)	(0.70)
SEC Enforcement							0.484*	0.501*	0.485**	0.364***
							(1.98)	(2.09)	(2.76)	(3.69)
Price Drop from IPO (market adjusted)								-0.0751**	-0.240***	-0.287***
								(-2.93)	(-7.84)	(-9.14)
Price Drop Time from IPO (days)									-0.000354***	-0.000357***

									(-11.81)	(-11.95)
Log IPO Proceeds										0.0678***
										(7.27)
Year fixed effects	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
_cons	-1.04e-14	-0.0126*	-0.0161*	-0.0164*	-0.0149*	-0.0150*	-0.0149*	-0.0820**	-0.0270	-1.231***
	(.)	(-2.30)	(-2.36)	(-2.39)	(-2.21)	(-2.22)	(-2.22)	(-3.15)	(-1.01)	(-7.35)
r2_a	0.0306	0.0334	0.0333	0.0455	0.0538	0.0533	0.0563	0.0982	0.177	0.207
N	1844	1844	1841	1841	1841	1841	1841	1722	1722	1719

t statistics in parentheses
* $p < 0.05$, ** $p < 0.01$, *** $p < 0.001$

The dependent variable is a dummy equal to one if the IPO drew a Securities Act claim. The independent variable of interest is a dummy equal to one if there was a bankruptcy in the statute of repose (three years from the IPO). I control for whether one of the lead underwriters of the IPO was a bulge bracket underwriter, whether the firm had a top law firm as issuer's counsel, whether the firm restated its financials for fraud within the statute of repose, whether there was a director or officer dismissal for misconduct-related reasons within the statute of repose, whether the IPO was a Chinese IPO, whether the IPO occurred within five years before a PCAOB sanction, the market-adjusted returns generated by the largest price drop from the IPO price within the statute of repose (before the lawsuit, in the case of sued firms), the time in days between the IPO and the lowest price within the statute of repose (or before the filing date for sued firms), and the log of the IPO proceeds. Firms whose price does not drop below the IPO price within the statute of repose are dropped. All specifications include year fixed effects and robust standard errors.

Appendix A: Capital Markets Attorneys Survey

Question 1: In the capital markets transactions in my practice, I represent

Always the underwriter	0	0
Usually the underwriter and sometimes the issuer	1	10%
The underwriter and the issuer with equal frequency	3	30%
Usually the issuer and sometimes the underwriter	5	50%
Always the issuer	1	10%

Question 2: In my experience, a non-bankrupt issuer or its insurer will pay an underwriter's indemnification claims, if proper procedures are followed

Always	3	43%
Often	2	29%
Sometimes	0	0
Rarely	2	29%
Never	0	0

Question 3: Please rank the reasons why underwriters engage in due diligence during the IPO process (1=most important, 6=least important)

Reason	Rank					
	1	2	3	4	5	6
Establish due diligence defense to avoid monetary exposure in a lawsuit brought under the Securities Act	7	1	0	1	1	0
Association with inaccurate IPO materials may affect reputation with institutional investors	2	4	2	1	0	0
Association with inaccurate IPO materials may affect reputation with future firms conducting IPOs	0	2	4	2	1	0
Association with unsuccessful new firm may affect reputation with institutional investors	0	1	2	2	4	0
Association with unsuccessful new firm may affect reputation with future firms conducting IPOs	0	1	1	3	4	0
Other	0	0	0	0	0	9

Question 4: Following the decision in In re Worldcom Securities Litigation, 346 F. Supp. 2d 628 (S.D.N.Y. 2004), my experience is that

Underwriters are generally advised to conduct a more rigorous diligence process than before Worldcom	3	30%
Underwriters are generally advised to use the same rigor as before Worldcom, but the case provides additional incentive to be careful	1	10%
The underwriter diligence process did not change meaningfully as a result of Worldcom	2	20%
Not applicable	4	40%

Appendix B: Plaintiffs' Attorney Survey

Question 1: In my practice, Securities Act claims involving IPOs constitute roughly the following percentage of claims brought:

80%-100%	1	11%
60%-80%	1	11%
40%-60%	0	0%
20%-40%	4	44%
0%-20%	3	27%

Question 2: In my experience, if investor-plaintiffs bring a Securities Act claim but decline to name the underwriter, it is because (choose all that apply):

Underwriter liability is capped at the total public offering price of the securities purchased by the underwriter, meaning that damages may be limited even if the claim is successful	0	0%
In practice, overcoming the due diligence defense for underwriters is often difficult	0	0%
In my experience, underwriters are always named in Securities Act claims	8	89%
Some other reason (please describe)*	1	11%

*Write-in response was "unsure."

Question 3: If an issuer has declared bankruptcy, my experience is that investor-plaintiffs are (assume claims are of equal merit)

Less likely to bring a Securities Act claim against the bankrupt issuer's gatekeepers than against a solvent issuer and its gatekeepers	1	11%
Equally likely to bring a Securities Act claim against the bankrupt issuer's gatekeepers as against a solvent issuer and its gatekeepers	6	67%
More likely to bring a Securities Act claim against the bankrupt issuer's gatekeepers than against a solvent issuer and its gatekeepers	2	22%

Question 4: Please rank the following indicators that an issuer's conduct may support a viable Securities Act claim (1=best indicator of a viable claim, 6=worst indicator of a viable claim):

Question	Rank						
	1	2	3	4	5	6	7
Insolvency of the issuer within the statute of limitations	0	1	2	1	2	1	1
Restatement of financials within the statute of limitations	4	3	0	1	0	0	0
Change of directors/officers within the statute of limitations	0	0	0	0	2	5	1
Investigation by government agency other than SEC or DOJ	0	0	3	2	1	2	0
Investigation by SEC or DOJ	1	3	3	1	0	0	0
A dramatic stock price drop	1	1	0	3	3	0	0
Other (please describe)*	2	0	0	0	0	0	6

*Write-in responses were
1) Credible exposure by whistleblower
2) Significant insider dealing/conflicts of interest
3) News suggesting misrepresentation in offering documents or misconduct

Note: Surveys in this paper are IRB exempt.