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“THE SUPERCHARGED IPO”

Victor Fleischer
University of San Diego Law School
and
Nancy Staudt
USC, Gould School of Law

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SCHEDULE FOR 2014 NYU TAX POLICY COLLOQUIUM

(All sessions meet Thursday 4:00-5:50 p.m., Vanderbilt-208, NYU Law School)

1. January 21 – Saul Levmore, University of Chicago Law School, “From Helmets to Savings and Inheritance Taxes: Regulatory Intensity, Information Revelation, and Internalities.” (Main discussion paper); and “Internality Regulation Through Public Choice.” (Background paper).
2. January 28 – Fadi Shaheen, Rutgers-School of Law, Newark, “The GAAP Lock-Out Effect and the Investment Behavior of Multinational Firms.”; “Evaluating Investments of Locked-Out Earnings (An Outline).
3. **February 4 – Nancy Staudt, University of Southern California, Gould School of Law, and Victor Fleischer, University of San Diego Law School, “The Supercharged IPO.”**
4. February 11 – Thomas J. Brennan, Northwestern University School of Law, “Smooth Retirement Accounts.”
5. February 25 – Chris Sanchirico, University of Pennsylvania Law School.
6. March 4 – James R. Hines, University of Michigan Economics Department and Law School.
7. March 11 – Stephanie Sikes, Wharton School, Accounting Department, University of Pennsylvania.
8. March 25 – Matthew C. Weinzierl, Harvard Business School, “Revisiting the Classical View of Benefits-based Taxation.”
9. April 1 – Andrew Biggs, American Enterprise Institute, “The Risk to State and Local Budgets Posed by Public Employee Pensions.”
10. April 8 – Susannah Camic Tahk, University of Wisconsin Law School, “Charity Governance Patterns: Empirical Evidence.”
11. April 15 – Nirupama Rao, NYU Wagner School,
12. April 22 – Kimberly Clausing, Reed College, Economics Department, “Lessons for International Tax Reform from the U.S. State Experience under Formulary Apportionment.”
13. April 29 – David Gamage, Berkeley Law School, “On Double-Distortion Arguments, Distribution Policy, and the Optimal Choice of Tax Instruments.”
14. May 6 – Mitchell Kane, NYU School of Law, “Reflections on the Coherence of Source Rules in International Taxation.”

THE SUPERCHARGED IPO

By
Victor Fleischer*
Nancy Staudt**

A new innovation on the IPO landscape has emerged in the last two decades, allowing owner-founders to extract billions of dollars from newly-public companies. These IPOs—labeled supercharged IPOs—have been the subject of widespread debate and controversy: lawyers, financial experts, journalists, and Members of Congress have all weighed in on the topic. Some have argued that supercharged IPOs are “brilliant, just brilliant,” while others have argued they are “underhanded” and “bizarre.”

In this article, we explore the supercharged IPO and explain how and why this new deal structure differs from the more traditional IPO. We then outline various theories of financial innovation and note that the extant literature provides useful explanations for why supercharged IPOs emerged and spread so quickly across industries and geographic areas. Theory provides support for both legitimate and opportunistic uses of the supercharged IPO.

With the help of a large-N quantitative study—the first of its kind—we investigate the adoption and diffusion of this new innovation. We find that the reason parties have begun to supercharge their IPO is not linked to a desire to steal from naïve investors, but rather for tax planning purposes. Supercharged IPOs enable both owner-founders and public investors to save substantial amounts of money in federal and state taxes. We conclude our study by demonstrating how our empirical findings can be used to 1) advance the literature on innovation, 2) assist firms going public in the future, and 3) shape legal reform.

* Victor Fleischer is a Professor of Law at the University of San Diego and a columnist for DEALBOOK, a financial news service that reports on mergers, acquisitions, venture capital and hedge funds produced by the NEW YORK TIMES.

** Nancy Staudt is the Vice Dean of Faculty and Academic Affairs, the Edward G. Lewis Professor in Law and Public Policy and the Academic Director of the Schwarzenegger Institute at the University of Southern California. The authors would like to thank Terrance Chorvat, Eric Allen, Bernie Black, Josh Blank, Lee Epstein, David Gamage, Ed Kleinbard, Andrew Martin, Ajay Mehrotra, Shu-Yi Oei, Jason Oh, Daria Roithmayr, Chris Sanchirico, Ted Seto, Steven Sheffrin, Kirk Stark, David Walker, the stellar librarians at USC Law School, and participants at the 2010 summer empirical tax workshop at Colorado Law School, the 2012 ISNIE conference, the 2013 ALEA conference, and the law school faculty workshops at Indiana University, Loyola University of LA, Emory University, Seoul National University, Toronto University, Tulane University, UC Davis, UCLA, USC, and the University of San Diego. Please send thoughts and comments to victor.fleischer@gmail.com or nstaudt@law.usc.edu.

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INTRODUCTION

Suppose you make an offer to purchase a new home. While reviewing the offer, the seller sees that you plan to get a home mortgage, which in turn means that you may qualify for the home mortgage interest tax deduction.¹ This deduction is potentially quite valuable and could save you tens of thousands of dollars in taxes over the period in which you make interest payments.² Recognizing this value, the seller counter-offers, proposing a deal whereby you give her 85% of your tax savings. If your mortgage interest deduction saves you \$1000 in taxes each year, this deal would require that you make annual transfers of \$850 to the seller as you obtain that tax break. Put differently, the proposed deal would require you to make an up-front payment for the purchase of the property in the year of the sale, along with an additional \$850 every year thereafter while you maintain your mortgage and take advantage of the mortgage interest tax deduction.

¹ Dean Stansel and Anthony Randazzo, *Unmasking the Mortgage Interest Deduction: Who Benefits and By How Much*, 394 POL’Y STUD. (July 2011), http://reason.org/files/mortgage_interest_deduction.pdf (IRS estimates 20-25% of tax returns claim a home mortgage interest deduction) (last visited Feb. 17, 2013)

² *Id.* (average annual tax saving from mortgage interest deduction is between \$96 and \$2221).

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Why would you ever agree to share your tax benefits with the seller?³

As it turns out, tax sharing agreements, often labeled “tax receivable agreements” (TRAs), are common in many corners of the legal and financial landscape.⁴ TRAs, for example, routinely emerge between partners in small businesses,⁵ employers and employees,⁶ and corporations and their shareholders.⁷ These sharing agreements come in many different forms but they all involve the same underlying feature: the parties apportion tax benefits (and sometimes tax liabilities) according to a pre-agreed upon formula.

In this article, we focus on TRAs that have made their way into an entirely new arena: initial public offerings (IPOs). Owners of private companies who sell their business assets in a public offering now sometimes demand that the new public company share the value of various underlying tax benefits, such as tax deductions and tax credits, well after the deal has been completed. These types of IPOs—deals supercharged with post-sale payments—were unseen and unheard of prior to 1993.⁸ Today, they involve the

³ After all, it is commonly believed that the tax benefit of the home mortgage interest deduction is capitalized into the price of residential property. See e.g., Richard Voith, *Does the Federal Tax Treatment of Housing Affect the Pattern of Metropolitan Development?*, BUS. REV. 1, 6 (Mar. 1999). In the IPO context, the focus of this paper, it is less clear whether the tax benefits associated with the deal are fully capitalized into price. See *infra* notes 64-65 and accompanying text.

⁴ That the sharing of tax benefits and liabilities occurs both implicitly and explicitly is widely understood and extensively studied. See e.g., Dan Dhaliwal, Merle Erickson & Shane Heitzman, *The Effect of Seller Income Taxes on Acquisition Prices: Evidence from Purchases of Taxable and Tax-Exempt Hospitals*, 26 J. AM. TAX. ASSOC. 1-21 (2004) (large tax liabilities generated by sale increase the price of assets); Douglas Shackelford & Terry Shevlin, *Empirical Tax Research in Accounting*, 31 J. ACCT. & ECON. 321-87 (2001) (tax sharing agreements studied extensively in accounting literature); Merle Erickson & Deward Maydew, *Implicit Taxes in High Dividend Yield Stocks*, 73 ACCT. REV. 435-58 (1998) (implicit tax sharing when tax favored preferred stock produce lower returns); Anne Beatty, *The Cash Flow and Informational Effects of Employee Stock Ownership Plans*, 38 J. FIN. ECON. 211-40 (1994); Douglas Shackelford, *The Market for Tax Benefits: Evidence from Leveraged ESOPS*, 14 J. ACCT. & ECON. 117-145 (1991) (competitive market more likely to cause companies to share tax benefits with investors).

⁵ J. WILLIAM CALLISON AND MAUREEN A. SULLIVAN, *PARTNERSHIP LAW AND PRACTICE: GENERAL AND LIMITED PARTNERSHIPS* § 4.15 (2012) (partners share tax benefits and tax liabilities).

⁶ Shackelford & Shevlin, *supra* note 4 at 331 (companies tradeoff higher salaries for tax deductions).

⁷ Lynda Livingston, Amy Kast, and Kyle M. Benson, *Investigating the DARPS Meltdown Through an Investments Project*, 2 BUS. EDUC. & ADMIN. 77 (2010) (non-taxable companies issue stock with the explicit purpose of enabling fully taxable corporate investors to share benefits of tax breaks); Merle M. Erickson and Shiing-wu Wang, *Exploiting and Sharing Tax Benefits: Seagram and DuPont*, 21 J. AM. TAX. ASSOC. 35 (1999) (tax benefits shared between corporation and corporate shareholder in widely admired tax plan).

⁸ The first supercharged IPO emerged in 1993, and then did not appear again until 2004. See Amy S. Elliot, *IPO Agreements that Shift the Basis of Step-Up to Sellers Proliferate*, TAX NOTES 334 (July 25, 2011) (brief history of TRAs in IPO context).

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transfer of billions of dollars back to the original owners on an annual basis,⁹ and they have become more than a little controversial.¹⁰

Commentators and analysts have argued these payments are “a little bit underhanded,”¹¹ “unusually one-sided,”¹² a “pure gravy,”¹³ and a “bizarre siphoning off of cash.”¹⁴ Skeptics argue that insiders are taking advantage of the great uncertainty associated with IPO pricing, which may not reflect the post-sale TRA payments made to the original owner-founders. At the same time, advocates argue that financial innovators have devised a useful means to compensate founders for the company they created and the costs of going public. There is “nothing nefarious about it,”¹⁵ notes Robert Willens, a leading tax expert and the one who coined the term “supercharged IPO.”¹⁶ The agreements are “all disclosed” to the public well before the IPO takes place.¹⁷ Notwithstanding the vocal skepticism over the deals’ rationale and underlying fairness, many experts describe supercharged IPOs as “masterful,”¹⁸ works of “artistry,”¹⁹ and “brilliant, just brilliant.”²⁰

Supercharged IPOs have generated substantial notice, debate and controversy, but no commentator has posed the question: why now? After all, owners and founders have

⁹ Reuters, *Blackstone Partners May Avoid Tax on IPO Gains* (July 13, 2007) (citing Lee Sheppard) (one 2007 deal enabled sellers to roughly \$900 million in post-sale payments), <http://www.reuters.com/article/2007/07/13/us-blackstone-tax-idUSN1325038320070713> (last visited Feb. 17, 2013).

¹⁰ Tax Receivable Agreements (TRAs) invite suspicion for a couple of reasons. First, the founders appear to take advantage of a tax arbitrage: payments received under the TRA are treated as capital gains—as a portion of the sales proceeds from the IPO—while the public holding company takes deductions at the higher ordinary income rate. See *infra* notes 58-60 and accompanying text. Second, when the dust settles, the selling founders are effectively reimbursed for any taxes they have paid to the government. As a New York Times reporter noted, “these guys have figured out how to turn paying taxes into an annuity.” David Cay Johnston, *Blackstone Devises Way to Avoid Taxes on \$3.7 billion*, N.Y. TIMES (2007) (critiquing TRAs as fundamentally unfair).

¹¹ Elliott, *supra* note 8 at 334 (citing Robert Willens).

¹² See Reuters, *supra* note 9 (citing Lee Sheppard).

¹³ Elliott, *supra* note 8 at 337.

¹⁴ PEU Report, *Carlyle's "Cash Tax Savings" Won't Go to Unit Holders* (May 5, 2012), <http://peureport.blogspot.com/2012/05/carlyles-cash-tax-savings-wont-go-to.html> (last visited Feb. 17, 2013).

¹⁵ Elliott, *supra* note 8 at 339.

¹⁶ Robert Willens, *General Electric 'Supercharges' the Genworth Financial IPO*, TAX NOTES 661 (2004).

¹⁷ Elliott, *supra* note 8 at 339; see also Debevoise & Plimpton, *Monetizing the Shield: Tax Receivable Agreements in Private Equity Deals*, 11 PRIVATE EQUITY REP. 9 (Fall 2010) (TRAs have risks and drawbacks, but some argue they have a “certain symmetry because existing owners receive tax benefits associated with a tax liability they have borne”).

¹⁸ Allan Sloan, *GE Perfects the Fine Art of Tax Savings*, WASH. POST (Dec. 13 2005), <http://www.washingtonpost.com/wp-dyn/content/article/2005/12/12/AR2005121201510.html> (last visited Feb. 17, 2013).

¹⁹ *Id.*

²⁰ *Id.* (citing Robert Willens).

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taken companies public for well over four hundred years,²¹ yet these unusual payout schemes emerged just two decades ago. Moreover, this new-style IPO has spread across industries and geographic areas, a process that raises the question of how and why financial innovations diffuse. Finally, and perhaps most importantly, the supercharged IPO raises the question of who actually benefits: the owner-founders, the public investors, or both? In this study, we seek to answer these questions with the help of a large database of IPO transactions—the first of its kind—and one that includes both conventional and supercharged deals over the course of the last several decades.

Our study begins, in Sections IIA and B, by comparing and contrasting traditional IPOs with the new supercharged version of taking a company public.²² We note that supercharged IPOs come in different forms and have gone through a series of complex iterations over the course of time, but they all contain one key component: a TRA that requires the new public company to transfer large sums of cash to the owner-founders in the post-IPO period. After describing supercharged IPOs as an important financial innovation, Section IIC then outlines the means by which companies disclose the details of the payout schemes to their investors, highlighting the various risks that each party undertakes.²³

In Section III, we turn to the theoretical literature to understand how and why financial innovations, such as supercharged IPOs, enter the market.²⁴ We focus first on the drivers of the financial innovation. We observe that the incentive to generate new strategies is not a discoverer's passion and zeal, but a desire to solve specific problems that arise in the transactional context, like risk aversion, information asymmetry, and regulatory costs.²⁵ We then explore the underlying theories for how and why innovations diffuse across markets and industries and find that many theorists associate this process with factors such as elite financial intermediaries, professional networks, firm culture,

²¹ Bill Baue and Marcy Murningham, *The Accountability Web: Weaving Corporate Accountability and Interactive Technology*, CORPORATE SOCIAL RESP. INITIATIVE WORKING PAPER 58, available at http://www.hks.harvard.edu/m-rcbg/CSRI/publications/workingpaper_58_baue murningham_full.pdf (last visited Feb. 17, 2013) (Dutch East India Trading Company conducted world's first IPO in 1602).

²² See *infra* notes 34-68 and accompanying text.

²³ See *infra* notes 69-73 and accompanying text.

²⁴ Quite a few scholars have investigated financial innovation from both a theoretical and qualitative perspective. Many historical and sociological studies, for example, have cataloged significant inventions throughout history, and economists have proffered a variety of theories for why inventions emerge and proliferate. See Darrell Duffie, *Financial Market Innovation and Security Design: An Introduction*, 65 J. ECON. THEORY 1, 5-7 (1993) (listing economic events and innovations that followed between 1971-86); see also, Symposium Issue on Financial Market Innovation and Security Design in 93 J. ECON. THEORY (1993) (articles investigating innovation from various perspectives).

²⁵ MYRON S. SCHOLES ET AL., *TAXES & BUSINESS STRATEGY* (4th ed. 2008) (outlining various factors that drive innovation); David M Schizer, *Frictions as a Constraint on Tax Planning*, 101 COLUM. L. REV. 1312 (2001) (innovations emerge to address problem with market frictions); EVERETT M. ROGERS, *DIFFUSION OF INNOVATIONS* (1995) (establishing framework to describe how innovations spread); see *infra* notes 74-110 and accompanying text.

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and media coverage.²⁶ Sections III presents a series of interconnected theories and thus throughout this Section we present a series of hypotheses that explain the rise and the spread of the supercharged IPO, thereby framing our empirical investigation in Section IV.²⁷

Few scholars have attempted an empirical exploration of financial innovations,²⁸ and no scholar or team of scholars has sought to explain the emergence of the supercharged IPOs. In this study, we seek to fill these surprising gaps. Section IVA outlines our data collection process and explains our statistical models.²⁹ Section IVB presents our findings vis-à-vis the rise and proliferation of the supercharged IPO. We find the initial motivation for pursuing this new deal structure relates to tax planning, not opportunism as some critics has alleged. More specifically, our data indicate that supercharged IPOs are highly correlated with the existence of a tax arbitrage opportunity, namely the ability to sell the company's assets (and pay tax at a low capital gains rates) while the new public company amortizes that same asset at higher ordinary income rates.³⁰ By contrast, we find little evidence of devious planning by owner-founders to profit from naïve investors. If the desire to sneak money away from shareholders was the motivating force, we would expect to find more supercharged IPOs in the absence of tax arbitrage, and we would expect it to be more frequent in deals where information costs are high and shareholders more vulnerable.³¹ With respect to the diffusion of new ideas in the financial sector, we find that the diffusion process is best explained by two factors: elite lawyers and professional networks—especially those located in New York City.³²

Finally in Section V, we note that our findings have important implications for transactional lawyers, legislators, and the theoretical literature on financial innovation generally.³³ Our qualitative analyses indicate that supercharged IPOs enable the parties to save substantial amounts of money in taxes when the parties are subject to different tax

²⁶ See *infra* notes 111-122 and accompanying text.

²⁷ See *infra* notes 74-122 and accompanying text.

²⁸ See Mahbrouk Abir and Mamoghli Chokri, *Dynamic Financial Innovation and Performance of Banking Firms: Context of an Emerging Banking Industry*, 51 INT'L RES. J. FIN. AND ECON. 17, 18 (2010) ("in spite of extensive descriptive literature on financial innovation, there is a paucity of empirical studies"); Josh Lerner, *The New New Financial Thing: The Origins of Financial Innovations*, 79 J. FIN. ECON. 223, 224 (2006) (despite the importance of financial innovation, only 39 empirical studies exist on the topic); Jala Akhavein, W. Scott Frame, and Lawrence J. White, *The Diffusion of Financial Innovations: An Examination of the Adoption of Small Business Credit Scoring by Large Banking Organizations*, 78 J. BUS. 577, 578 (2005) (7 quantitative studies investigating the process by which innovation diffuses). This gap in the literature is not surprising: it is often difficult to identify the specific time and place of most innovations, and diffusion patterns depend on data that is obscure and frequently unavailable to outside private firms. Fortunately, these hurdles do not exist for our study in large part because federal securities laws require public companies to disclose details of the post-IPO payouts, and for this reason we are able to track both the emergence and the diffusion of the supercharged IPO.

²⁹ See *infra* notes 123-31 and accompanying text.

³⁰ See *infra* notes 132-50 and accompanying text.

³¹ See *infra* notes 132-50 and accompanying text.

³² See *infra* notes 153-55 and accompanying text.

³³ See *infra* notes 155-88 and accompanying text.

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rates, making tax arbitrage a possibility. We highlight the specific means by which transactional lawyers and deal planners can achieve these results, given the findings of our study. This tax avoidance opportunity, however, raises the normative question of whether the revenue losses from these innovative deals reduce overall social welfare. Congress has proposed legislation to eliminate their tax benefits, but our analysis indicates the extant proposals are under-inclusive and may not achieve the stated goals. We propose alternative routes that would enable legal reformers to close the perceived loophole both in the IPO context, and more broadly. Finally, our study advances the existing literature on financial innovation. The literature is largely theoretical and often presents a series of competing explanations for any given innovation. Our approach builds on this scholarship and demonstrates how scholars can use empirical data to test the competing theories and shows that it is possible to extricate the value of each theory for explaining financial innovation.

II. INITIAL PUBLIC OFFERINGS

Initial public offerings (IPOs) are transactions where privately-held companies register and sell stock to the public for the first time. A successful IPO infuses the company with substantial cash, thereby making it possible to expand and diversify the business, increase research and development, retire debt obligations, and so forth.³⁴ By creating a public market in a company's shares, IPOs often also provide liquidity and exit options for the founders, investors, and employees who own shares in the company. Indeed, for many insiders, the true benefit of going public is the monetization of the pre-IPO owners' interest in the company: founders often realize a sizable return by selling shares directly to the public, or by selling shares in a secondary offering a few months after the IPO.³⁵

Pricing a company for sale to the public is, however, a complex endeavor that involves consideration of many factors including the underlying company assets, trends in sales and earnings, adequacy of present and projected capital and cash flow, and the experience, integrity, and quality of management.³⁶ The first factor—the company's underlying assets—often includes a category labeled “tax assets,” which are simply the tax deductions, credits, and exemptions that generate tax savings for the company in the future just like the home mortgage interest deduction works for individuals.³⁷ For

³⁴ Companies that go public file a prospectus that includes a description of the business along with the growth plans. *See, e.g.*, Fortress Investment Group LLC, Form S-1 (Feb. 2, 2007), <http://www.sec.gov/Archives/edgar/data/1380393/000095013607000635/file1.htm> (last visited Feb. 17, 2013). For a useful review of the IPO process and theories for why companies go public, *see* PATRICK J. SCHULTHEIS, ET AL., *THE INITIAL PUBLIC OFFERING: A GUIDEBOOK FOR EXECUTIVES AND BOARDS OF DIRECTORS* 1-12 (2004); CARL W. SCHNEIDER, JOSEPH M. MANKO, ROBERT S. KANT, *GOING PUBLIC: PRACTICE, PROCEDURE AND CONSEQUENCES* 1-5 (2002); Jay Ritter and Ivo Welch, *A Review of IPO Activity, Pricing and Allocations*, 57 J. FIN. 1795, 1816 (2002).

³⁵ Andrew W. Needham, *Private Equity Funds*, 735 TAX MGMT. PORTFOLIO 2d A-90 (2010).

³⁶ SCHULTHEIS, ET AL., *supra* note 34 at 31.

³⁷ For a useful and detailed discussion of tax assets, *see generally* ANJA DE WAEGENAERE, RICHARD SANSING, AND JACCO L. WIELHOUWER, *VALUATION OF DEFERRED TAX ASSETS FROM A NET*

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example, if a company purchases goodwill (an item associated with corporate identity, customer relationships, and so forth) for \$15 million and ratably amortizes the cost of that asset over fifteen years on its tax return, it would take a deduction of \$1 million a year. At a 35% tax rate, this deduction could save the company a total of \$5,250,000 in taxes over fifteen years.³⁸ Because the ability to reduce the corporate tax burden is valuable to a corporation's bottom line, future tax deductions—or deferred tax assets as they are more formally known—are accounted for on a company's balance sheet, just as future tax liabilities are.³⁹ This information, in turn, can play a role in the valuation process when companies go public in an IPO: as the value of net tax assets increase, so should a company's market value.

Tax assets are routinely tracked and valued by companies on their balance sheets, but there is some debate as to whether and how well these assets are priced into the stock at the time of an IPO. The value of a deferred tax asset, for example, is a function of the company's future profits and future tax rate, factors that force managers and accountants to exercise some discretion in valuing the tax assets.⁴⁰ Indeed many argue that the valuation process is more art than science given the inherent unpredictability of profits and tax rates.⁴¹ Moreover, and perhaps more alarming, there is some reason to think that IPO stock analysts pay little attention to tax assets, focusing instead on the valuation of comparable companies that already trade on the public markets.⁴² As we discuss below, the presence of tax assets, and the uncertainty of their role in IPO pricing are prime motivators for the supercharged IPO deals.

A. The Traditional IPO

To understand the supercharged IPO as a financial innovation, it is useful to consider the traditional IPO. To begin, assume that Founders Co., a privately-held corporation, operates its business through a subsidiary. Assume also that the assets of the company include real property that can be depreciated (such as a building)⁴³ and intangible property that cannot be depreciated (such as self-created goodwill).⁴⁴ This

OPERATING LOSS CARRYOVER (2001), Gregory Miller and Douglas J. Skinner, *Determinants of the Valuation Allowance for Deferred Tax Assets under SFAS No. 109*, 73 ACCT. REV. 213 (1998).

³⁸ \$15,000,000 x .35 = \$5,250,000

³⁹ See generally, Miller and Skinner, *supra* note 37.

⁴⁰ Robert Willens, *Accounting for Deferred Tax Assets and Liabilities—Citigroup*, 7 WILLENS REPORT 1 (Jan. 9, 2013) (realization of future tax benefits depend on many factors and decisions); Miller and Skinner, *supra* note 37 at 218-19 (same).

⁴¹ Miller and Skinner, *supra* note 36 at 218-19.

⁴² See Robert Stammers, *What Does an IPO Price Mean?* FORBES (Sept. 16, 2011), <http://www.forbes.com/sites/cfainstitute/2011/09/16/what-does-an-ipo-price-mean/> (last visited Feb. 17, 2013) (discussing the asset-based, income, and market approaches for valuing companies in an IPO); Sanjeev Bhojraj and Charles M.C. Lee, *Who is My Peer? A Valuation-Based Approach to the Selection of Comparable Firms*, J. ACCT. RES. 407, 407-435 (2002) (the comparable firm approach is widely used and success depends on the identification of appropriate peer firms).

⁴³ I.R.C. §§ 167-68 (2006).

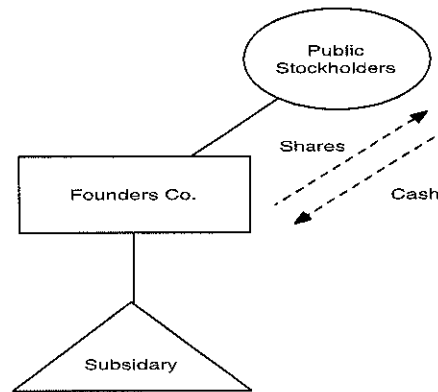
⁴⁴ Congress defines goodwill as “the value of a trade or business that is attributable to the expectancy of continued customer patronage, whether due to the name of a trade or business, the reputation of a trade or business, or any other factor.” Treas. Reg. § 1.197-2(b)(1) (2007). In the

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company, in short, has three assets: the building, the goodwill, and a tax asset linked to the future depreciation tax deductions—all of which will be listed on the company's balance sheet.

If Founders Co. chooses to go public in a traditional IPO, it will sell newly issued shares of stock to the public for an agreed upon price as depicted in Figure 1, a structure that reflects a simplified version of the IPO. The public offering infuses Founders Co. with substantial cash based on the value of the underlying assets (or possibly based on comparable firms trading on the market, as just noted). From a tax perspective, however, the IPO is a non-event—typically, none of the parties will pay any tax on the deal.⁴⁵

Figure 1: The traditional IPO



Note: Founders Co. sells stock to the public and obtains substantial cash, but the transaction does not generate any tax costs for any of the parties.

The traditional IPO generates substantial cash for the company and avoids tax costs, but many commentators view the transaction as inefficient and wasteful for at least two reasons. First, the deal could have been structured to accomplish the parties' goals

accounting context, the term is an indication on the balance sheet that the whole is greater than the sum of its parts. See Note, *Treatment of Goodwill by the Seller Under I.R.C. Section 197*, 43 KAN. L. REV. 903, 903 (1995). Many corporate assets give rise to amortization and depreciation tax deductions, thereby enabling the company to recover its costs and save substantial monies in taxes over the course of years. Goodwill, however, is subject to a unique rule: if the asset is *self-generated* it cannot be amortized, but if it is *purchased*, the tax laws allow the purchaser to amortize the cost of the asset over a fifteen-year period. I.R.C. § 197 (2006). As we will see, acquired goodwill—along with the tax benefits this asset provides—is a key factor underlying many of the recent supercharged IPOs.

⁴⁵ See I.R.C. § 1032(a) (2008) (“No gain or loss shall be recognized to a corporation on the receipt of money or other property in exchange for stock (including treasury stock) of such corporation”). If the founders sell some of their own stock in connection with or after the IPO, they will typically pay tax at long-term capital gains rates, see I.R.C. §§ 1(h), 1221-1223 (2012), but these sales will typically have no effect on the tax profile of the company.

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while reducing taxes.⁴⁶ Second, experts believe that IPO investors routinely undervalue companies given the arcane nature of the “tax assets” that reside inside the company, and thus founders are under-compensated for their companies.⁴⁷ A tax receivable agreement (TRA) could address these twin problems, enabling the parties to capture most of the value lost by the overpayment of taxes and/or the undervaluation of the stock price.⁴⁸

B. The Supercharged IPO

A supercharged IPO differs from a traditional IPO for one key reason: it *always* involves a TRA that calls for the parties to share the value of the company’s underlying tax assets. Recall from above that tax assets are simply deductions, credits, or exemptions that allow a company to reduce its tax liability down the road. Since 1993, when the first supercharged IPO appeared, several different formulations of the deal have emerged, but each new generation has built on the basics of the earliest deals. For this reason we limit our discussion to two iterations of these new deal structures to illustrate the key features. As we note below, experts justify each new wave with a different underlying rationale ranging from legitimate and efficiency-enhancing to pure thievery on the part of the founders.

The most typical supercharged IPO deal structure enables the parties to reduce future taxes by *creating* new tax assets for the company. To accomplish this feat, the parties add some additional steps to the deal. First, Founders Co. transfers its subsidiary to a newly created corporation, Public Co., in exchange for Public Co.’s stock. Founders Co. and Public Co. then sell a large percentage of Public Co. stock to a third party (the investing public).⁴⁹ This arrangement depicted in figure 2 below, is an alternative to that

⁴⁶ See *infra* notes 49-57 and accompanying text.

⁴⁷ See *infra* notes 36-42 and accompanying text for an explanation of tax assets, see *infra* notes 61-67 and accompanying text for a discussion of investor undervaluation of companies with tax assets.

⁴⁸ Willens, *supra* note 16 at 661 (outlining ways in which the TRA addresses inefficiencies of traditional IPO).

⁴⁹ Actually, Founders Co. sells the shares to an investment bank, which then sells to the public. SCHULTHEIS, ET AL, *supra* note 34 at 35-45; SCHNEIDER, ET AL, *supra* note 33 at 20-30. From a tax perspective, this arrangement can have important consequences. The deal can be structured to fail the so-called “control” test, turning the deal from a tax non-recognition event into a mere taxable exchange without tax consequences. I.R.C. §§ 351, 338(h)(3)(A)(iii) (2006). In the lexicon of tax lawyers, this means that the deal is a “busted 351 transaction,” as such, qualifies as a taxable transaction. The tax treatment is important here because it determines the basis of Public Co.’s assets. The tax basis in an asset is the amount that generates depreciation deductions, I.R.C. §§ 167-68, and is adjusted as depreciation tax deductions are taken. I.R.C. § 1011 (2006). Thus if Public Co. inherits a “carry-over basis” in an ordinary 351 transaction, it would obtain assets with a low basis that has been depreciated down in the hands of Founders Co. Of course, Public Co. does not want the carry-over basis but prefers a “stepped-up basis” that reflects the fair market value of the asset (and allows for substantially more depreciation down the road). Public Co. will thus want the parties to make a section 338(h) election and treat the transaction as sale. I.R.C. § 338(h) (2008). This election enables Public Co. to obtain a stepped-up basis in the underlying assets reflecting their current fair market value. For a description of these rules, see Rev. Rul. 79-70, 1979-1 C.B. 144; Rev. Rul. 79-194, 1979-1 C.B. 145 (Aug. 1979); TAM 9747001 (July 1, 1997); PLR 9541039 (July 20, 1995), as modified by PLR 9549036 (Sept. 12, 1995); PLR 9142013 (July 17, 1991).

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presented in figure 1, and has the advantage of not only transferring Founders Co.'s pre-existing tax assets to Public Co.—but also generating new tax assets.

It is easy to understand the role of pre-existing tax assets in the deal: these assets are listed on the company's balance sheet and, like all the other company assets, they are transferred to Public Co., thereby enabling Public Co. to use them to reduce taxes down the road.⁵⁰ But how are new tax assets created in the deal? The answer to this question has to do with an unusual provision found inside the tax code: after taking the steps just described, Founders Co. and Public Co. can elect to treat the transaction as a "sale" of assets.⁵¹ While our goal in this study is not to explain the tax-related intricacies of going public, it is useful to understand that the parties have control over the size and extent of the tax assets that will reside inside the new Public Co. If the parties elect to treat the transaction as a sale, they literally create new tax assets for Public Co.⁵² Recall from above, for example, that Founders Co. has goodwill that it could not amortize because it was self-created, but if Public Co. is viewed as having purchased that goodwill then the latter will be permitted to amortize the value of the asset.⁵³ Public Co.'s new tax assets—the amortization tax deductions permitted due to the elected sale—are far from inconsequential. The new company stands to save millions of dollars *each* year well into the future.⁵⁴ These deductions were not available to Founders Co. and would not be available to Public Co. absent the steps described above and the election to treat the transaction as a sale in the supercharged deal structure.

Public Co. and its investors, obviously, reap valuable benefits in this new-style deal (they have access to new tax assets absent in the traditional IPO), but there is also a major drawback. The deal is likely to generate substantial taxes on Founders Co. and its owners.⁵⁵ The important take-away for purposes of this article is the fact that in the

⁵⁰ Pre-existing tax assets residing inside the company may include items such as deductible net operating losses, tax credits and so forth. Willens, *supra* note 40 at 1.

⁵¹ The parties make a Section 338(h)(10) election to treat the transfer of subsidiary stock as an asset sale, triggering a step-up in basis. *See supra* note 49 discussing the details of the I.R.C. § 338(h)(10) election. In this supercharged IPO structure, the selling founders must sell at least 50% of the Public Co. stock within 2 years, which may force a quicker exit than intended. *See supra* noted 49; PLR 200427011 (Sept. 12, 1995) (private letter ruling regarding GE/Genworth IPO discussing the election); Willens, *supra* note 16 at 661 (same). Furthermore, the Founders effectively pay tax on all the built-in gain up front, albeit at the lower capital gains rate. I.R.C. §§ 1(f), 1221-23. Recall from above, that the traditional IPO involved only the company's sale of stock to the public, no transfer of assets. *See supra* note 45.

⁵² *See supra* notes 49-50.

⁵³ *See supra* notes 42-43 and accompanying text; *supra* note 47.

⁵⁴ Robert Willens, *ILFC Will Exit the AIG Family with a Valuable "Basis Step-Up"*, WILLENS BULL. (Sep. 2, 2011) (basis step-up can save companies billions in taxation, if not eliminate the tax bill altogether).

⁵⁵ This double tax is associated with the fact that the parties elected to treat the deal as a sale of assets and not a mere contribution of property to a controlled corporation. *See supra* note 49. Founders Co. may suffer a taxable gain at the subsidiary level, depending on a number of factors such as the amount of unrealized gain and the availability of net operating losses. Moreover, to the extent that Founders Co. has appreciated in value, the original owner-founders may still have to pay a second level of tax when they sell or liquidate Founders Co. MARTIN D. GINSBURG AND JACK S. LEVIN, *MERGERS, ACQUISITIONS, AND BUYOUTS* ¶ 405 (2011) (discussing tax consequences); Willens, *supra* note 16 at

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traditional IPO structure there were no new tax assets created but there were also no immediate tax burdens triggered. These two factors—new tax assets plus new tax liabilities—are the reasons for the emergence of IPOs supercharged with a TRA.

Founders Co. must pay tax on the sale in the supercharged IPO, but Public Co. agrees to compensate Founders Co. for incurring this tax with a TRA. The typical TRA requires Public Co. to pay Founders Co. 85% of the tax benefits realized as a result of the tax savings that were not be available in the traditional IPO. Above we noted that if Public Co. amortized its new asset, say goodwill, worth \$15 million ratably over fifteen years, it would take a deduction of \$1 million a year and would save \$5,250,000 in taxes over the amortization period.⁵⁶ If the parties executed a TRA, Public Co. would be required to pay the founders 85% of this amount, or \$4,462,500. The timing of the individual payments corresponds to the deductions as they are used to reduce the corporate tax burden. Public Co., in other words, makes the TRA payments to the founders as it realizes the tax savings and not before this time.⁵⁷ Figure 2 is a simplified depiction of an early-supercharged IPO where Founders Co. exacts payments from Public Co. through a TRA in return for allowing Public Co. to benefit from the tax assets that were transferred and created in the multi-step transaction.

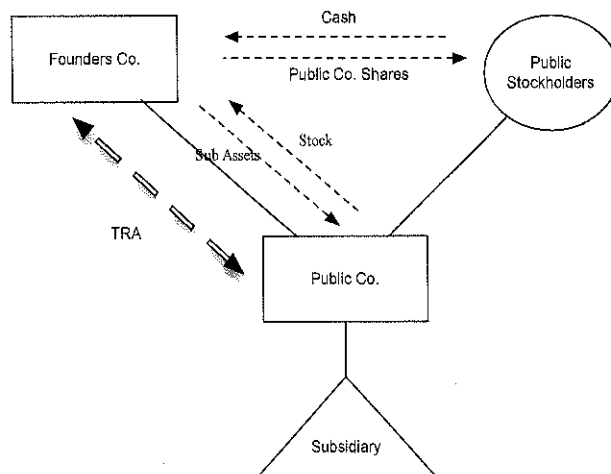
661 (same). The basis step up occurs when Founders Co. contributes stock, assets or subsidiary interests to Public Co. in a “busted” 351 transaction—a strategy that the buyers almost always prefer and gives the sellers’ some initial hesitation. See discussion *supra* note 49; GINSBURG & LEVIN, *supra* at ¶ 405-406; Willens, *supra* note 16 at 661.

⁵⁶ See *supra* notes 37-39 and accompanying text, see also Debevoise & Plimpton, *supra* note 17 at 9.

⁵⁷ Debevoise & Plimpton, *supra* note 17 at 9. The amounts transferred under the TRA are determined on an annual basis comparing Public Co.’s actual tax liability to its notional tax liability as if such deductions were unavailable and makes a payment equal to 85% of that difference per the parties’ TRA; although some agreements indicate that the pre-IPO investors can accelerate the payments. An interesting feature of the TRA payments is linked to the effects of the obligation going forward. Because each TRA payment is viewed as part of the purchase price of the stock or partnership interest by Public Co., every payment causes the basis in the underlying assets to increase, which in turn leads to additional TRA payments to the pre-IPO owners. *Id.*

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Figure 2: The supercharged IPO: seller extracts more cash with a TRA



Note: As described in the text, Founders Co. first transfers its subsidiary to Public Co. in exchange for stock; then Founders Co. sells the stock to the public and at the same time executes a tax receivable agreement (TRA) with Public Co. Ultimately, Public Co. will make payments to Founders Co. in the post-IPO period per the terms of the TRA.

Many IPO commentators have noted that it may not appear rational for the parties to agree to the supercharged deal because it is possible that the net costs to Founders Co. will equal (or exceed) the net benefits to Public Co.—making the deal complicated without any payoff.⁵⁸ This potential drawback, however, is addressed by the fact that the deals often involve a partnership and a corporation, rather than two corporations.⁵⁹ When Founders Co. is operating as a partnership for tax purposes—Founders LLC—it will be subject to fewer and lower tax liabilities than the tax benefits obtained by Public Co.—a reality that exists due to the differential tax rates applied to these two different types of entities.⁶⁰ We discuss this tax arbitrage opportunity—and the way that the surplus is

⁵⁸ GINSBURG & LEVIN, *supra* note 55 at ¶ 405-406.

⁵⁹ Robert Willens, *Up-C Incorporations Feature “Tax Receivable Agreements,”* 5 WILLENS REP. 1 (2011) (the rules are even more “felicitous” when partnerships sell assets to public corporations in the context of an IPO); Washington National Tax Services, *This Month in M&A*, 2 <http://www.publications.pwc.com/DisplayFile.aspx?Attachmentid=5083&Mailinstanceid=22326> (last visited Feb. 17, 2013) (the new IPO structure involving partnerships and corporations can provide selling partners with up to 30-40% more in compensation).

⁶⁰ The basic structure of the deal is the same when “Founders LLC” is organized as a partnership—the founders simply sell their partnership interests to Public Co. in exchange for cash or stock. See Eric Sloan, *Partnerships in the Public Space*, in PLI, THE CORPORATE TAX PRACTICE SERIES: STRATEGIES FOR ACQUISITIONS, DISPOSITION, SPIN-OFFS, JOINT VENTURES, FINANCINGS, REORGANIZATIONS & RESTRUCTURINGS, VOL. 8 (2010); Mark Silverman, et al, *Thinking Outside the Box and Inside the Circle (or Triangle?): Use of LLCs in Consolidated Return Context, in Corporate Acquisitions, and Otherwise, in the Public Space*, PLI, THE CORPORATE TAX PRACTICE SERIES: STRATEGIES FOR ACQUISITIONS, DISPOSITION, SPIN-OFFS, JOINT VENTURES, FINANCINGS, REORGANIZATIONS & RESTRUCTURINGS, VOL. 8 (2010); Willens, *supra* note 59 at 1; Washington National Tax Services, *supra*

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divided between all the parties—in more detail below and in the appendix and find that it helps to explain the popularity of supercharged IPOs.

In some more recent supercharged IPOs, however, the deal structure begins to look substantially more fishy from the perspective of Public Co. and the investors. In some of the most recent deals, the parties engage in an IPO that looks very much like that presented in figure 2, but they do not elect to treat the transaction as a sale of assets for tax purposes.⁶¹ This eliminates the two effects discussed above. First, while Public Co. inherits Founders Co.'s preexisting tax assets, it does not gain the benefits associated with newly-created tax assets.⁶² Second, foregoing the election to treat the transaction as a sale eliminates the tax liability on Founders Co. and its owners.⁶³ In short, the substance of this deal looks very much like the traditional IPO—in the sense that it does not create new tax assets nor generate a tax burden—and yet the form of the is akin to the supercharged IPO and the parties execute a TRA, enabling the founders to share in the value of the underlying tax assets transferred.

Why the parties would pursue this strategy is related to investors' perceived failure to understand or value tax assets accurately. While tax assets, as we know, are simply the estimated savings associated with deductions and credits and they are listed on company balance sheet, many believe that public investors simply do not account for these types of assets when purchasing stock. The lack of knowledge may be due to the assets' esoteric nature, or perhaps to investment banks' choice to disregard these assets when valuing a company for purposes of an IPO.⁶⁴ Whatever the reason, if investors refuse to pay for the assets that reside inside the company at the time of a stock purchase, then it is rational for Founders Co. to retain this value with the help of a TRA.⁶⁵

note 59 at 2-3.

Because partnerships do not pay an entity-level tax, there is no tax owed at the entity level, nor any tax associated with the distribution of cash to the selling partners. Willens, *supra* note 59 at 1; Washington National Tax Services, *supra* note 59 at 2-3. And generally speaking, the sale of a partnership is treated as the sale of a capital asset, and so selling partners pay tax on any gains at the lower long-term capital gains rate. Willens, *supra* note 59 at 1; Washington National Tax Services, *supra* note 59 at 2-3. On the other side of the transaction, Public Co is still treated as purchasing goodwill, amortizable at the higher ordinary income rate of 35%. Willens, *supra* note 59 at 1; Washington National Tax Services, *supra* note 59 at 2-3. This tax arbitrage—selling goodwill at capital gains rates, while generating deductions at ordinary income rates—made supercharged IPOs especially attractive for companies that operated as partnerships before going public. Willens, *supra* note 59 at 1; Washington National Tax Services, *supra* note 59 at 2-3.

⁶¹ Robert Willens, *Is an NOL "Personal" to the Shareholders?*, WILLENS BULL. 1 (Oct. 2010) (new trend is to execute a TRAs without the elections to treat the transaction as a sale).

⁶² See *supra* notes 47-56 and accompanying text.

⁶³ See *supra* notes 47-56 and accompanying text.

⁶⁴ Debevoise & Plimpton, *supra* note 17 at 9.

⁶⁵ To understand the justification for this newer wave of supercharged IPOs more fully, suppose Founders Co. owns exactly one asset: an oyster with a valuable pearl that cannot be harvested for three years. Also imagine that Founders Co. would like to sell the entire asset but the investors value only the shell and not the pearl (either because the purchaser does not understand the nature of the hidden gem or because it simply desires to own the shell itself and nothing else). Founders Co. has several options: 1) refuse to sell, 2) sell but demand an up-front price that reflects the value of the hidden pearl, or 3) sell the shell and retain the rights to the pearl when it becomes available three years hence. If Founders

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Owners of private companies, in short, have adopted a complex series of steps to take their businesses public, and now routinely demand large payments from public companies in the post-IPO period. One justification for these innovative IPOs relates to the tax liability that the owners suffer in order to generate new tax assets and the opportunity for tax arbitrage; a second justification revolves around the idea that investors fail to pay for the pre-existing tax assets that the new public company inherits.⁶⁶ Various commentators argue that owners are simply enhancing the efficiency of the deals and assuring they receive a fair price for their business, while others argue owners are nothing more than thieves taking advantage of new companies and public investors.⁶⁷ We empirically investigate these theories below,⁶⁸ but first note that all companies going public divulge the details of the TRA well before the IPO takes place.

C. Company Disclosures and Risk Projections

While supercharged IPOs are controversial and subject to widespread debate, a company that goes public must disclose the details of the TRA in the prospectus and attach a copy of the TRA to its SEC filings.⁶⁹ Not only are the terms of the TRA and the cash payments disclosed to investors at the time of the IPO,⁷⁰ the potential risks of

Co. selects the third option, the parties will execute a supplemental contract provision that supercharges the deal with a “pearl receivable agreement.”

The key question that must be asked with respect to this newer wave of supercharged IPOs is this: does the purchase price reflect the true value of the company—along with its tax assets—at the time of the IPO, or are investors refusing to pay for these assets? Finding the answer to this question is important because it will settle a debate among scholars and commentators with respect to the underlying motivation of the second generation of supercharged IPOs. *See supra* notes 10-19 and accompanying text.

⁶⁶ *See supra* notes 48-54 and accompanying text.

⁶⁷ *See supra* notes 10-19 and accompanying text.

⁶⁸ *See* Section IV *infra* notes 123-155 and accompanying text.

⁶⁹ The Securities Act of 1933 requires issuers to disclose material information to investors, and Section 11 of the Act allows investors to sue with respect to material misstatements or omissions in the prospectus or registration statement. 15 U.S.C. § 77(f), (j), (k). This law explains why the IPO innovators cannot keep the details of the deal secret in order to profit from the idea. For a discussion of patented tax advice, see Anish Parikh, *The Proliferation of Tax Strategy Patents: Has Patenting Gone Too Far?*, 7 J. MARSHALL REV. INTELL. PROP. L. 202 (2007).

⁷⁰ To give just one example, Evercore Partners (the owner-founders of the firm) filed documents with the SEC containing language describing the terms of their TRA along with the relevant tax code provisions and the advantages to Evercore, Inc. (Public Co. in our discussion above) associated with the structure of the deal and, by implication, its shareholders in the following language:

The exchanges may result in increases in the tax basis of the tangible and intangible assets of Evercore LP [the owner-founders] that otherwise would not have been available. These increases in tax basis would increase (for tax purposes) amortization and, therefore, reduce the amount of tax that we would otherwise be required to pay in the future... We [i.e. Public Co.] have entered into a tax receivable agreement . . . that provides for the payment by us to an exchanging Evercore partner [i.e. an owner-founder] of 85 percent of the amount of cash savings, if any, in U.S. federal, state and local income tax that we actually realize as a result of these increases in tax basis. We expect to benefit from the remaining 15 percent of cash savings, if any, in income tax that we realize.

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entering into this agreement are also outlined. Payments under the TRA are contingent on Public Co.'s income; that is to say, absent taxable income the amortization deductions are worthless to Public Co., so the new company *must* operate at a profit to gain the advantage of the tax deductions. This reality poses a risk that neither Public Co. nor the owner-founders will actually receive benefits identified in the TRA.⁷¹ Moreover, the IRS could scrutinize the tax components of the supercharged IPO, jeopardizing the value of the tax assets and the TRA to both Public Co. and the owner-founders.

Because of the amount of money at stake along with the negative view that many experts and commentators have of TRAs as “underhanded,” and “one-sided,”⁷² Public Co.'s obligation could also, theoretically, be challenged down the road by angry shareholders who feel cheated.⁷³ This could result in a scenario whereby the company retains the tax asset, and at the same time, eliminates the payment obligation to the owner-founders under the TRA.

In the next section, we explore competing explanations for why the parties would agree to a supercharged IPO, notwithstanding the deals' complexity, bad optics, and risks. As our discussion illustrates, some explanations suggest that supercharged IPOs are a very good way for the parties to reduce tax costs, while others imply opportunism on the part of the owner-founders.

Evercore Investment Group LLC, Form S-1 (Feb. 18, 2009), <http://www.sec.gov/Archives/edgar/data/1360901/000119312507086555/ds1.htm> (last visited Feb. 17, 2013).

⁷¹ These risks, and others, were identified by Fortress Investment Group at the time of their supercharged IPO, and outlined in the SEC filings:

Although we [i.e. Public Co.] are not aware of any issue that would cause the IRS to challenge a tax basis increase, our principals [i.e. the owner-founders] will not reimburse the corporate taxpayers for any payments that have been previously made under the tax receivable agreement. . . . The corporate taxpayers' ability to achieve benefits from any tax basis increase, and the payments to be made under this agreement, will depend upon a number of factors, including the timing and amount of our [i.e. Public Co.'s] future income.

Fortress Investment Group LLC, Form S-1 (Feb. 2, 2007), <http://www.sec.gov/Archives/edgar/data/1380393/000095013607000635/file1.htm> (last visited Feb. 17, 2013).

⁷² See *supra* notes 10-17 and accompanying text.

⁷³ We have not identified any litigation involving supercharged IPOs. In other contexts, however, TRAs have been the subject of litigation. See, e.g., *Third National Bank in Nashville v. Wedge Group Incorporated*, 882 F.2d 1087 (1989) (defendant denies liability under the TRA). Shareholders have also sued in the IPO context, although not with respect to the existence of the TRAs that were involved. See, e.g., Peter Lattman, *Court Revives Suit over Blackston IPO*, DEALBO%K, <http://dealbook.nytimes.com/2011/02/10/court-revives-shareholder-suit-over-blackstone-i-p-o/>, (last visited Feb. 18, 2013).

III. COMPETING THEORIES OF FINANCIAL INNOVATION: DISCOVERY AND DIFFUSION

Innovation in the financial context is not new; historians have documented creative solutions to financial problems for centuries.⁷⁴ For the most part, scholars and policymakers have applauded these efforts as important means for making markets complete and efficient. When it comes to policymaking choices, Ben Bernanke noted in 2007, “we should always keep in view the enormous economic benefits that flow from a healthy and innovative financial sector; the increasing sophistication and depth of financial markets promote economic growth by allocating capital where it can be most productive.”⁷⁵ Two years after making this statement, and in the wake of the 2008 financial collapse, Bernanke acknowledged that financial innovation also has its drawbacks. “Indeed innovation once held up as the solution is now more often than not perceived as the problem . . . we have seen only too clearly during the past two years, innovation that is inappropriately implemented can be positively harmful.”⁷⁶

Good and bad, financial innovators are part of the economic landscape and for this reason it is useful to understand the environment that fosters creative financing, the factors that enable its diffusion, and the chosen allocation of costs and benefits between and among the parties. Scholars have set forth a range of theories that address these issues,⁷⁷ and the goal in this section is to provide a brief outline of the extant literature as it applies to supercharged IPOs. We then offer hypotheses with respect to why supercharged IPOs emerged and why they spread across geographic zones and industries.

⁷⁴ Political and religious organizations, for example, have long barred or extensively limited bankers’ ability to charge interest, but these restrictions have never eliminated the active market for credit. Instead, lenders have found novel ways to obtain interest payments, sometimes at usury rates, with the help of third parties, unusual contracts, and a variety of other means. See, Michael Knoll, *The Ancient Roots of Modern Financial Innovation: The Early History of Regulatory Arbitrage*, 87 OR. L. REV. 93 (2008); see also Jonathon Barron Baskin, *The Development of Corporate Financial Markets In Britain and the United States, 1600–1914: Overcoming Asymmetric Information*, 62 BUS. HIST. REV. 199 (1988); Larry Neal, *Trust Companies and Financial Innovation, 1897–1914*, 45 BUS. HIST. REV. 35 (1971). KRISTEN STILT, *ISLAMIC LAW IN ACTION AUTHORITY, DISCRETION, AND EVERYDAY EXPERIENCES IN MAMLUK EGYPT* (2011), Knoll, *supra* at 101–13.

⁷⁵ Chairman Ben S. Bernanke, *To the Federal Reserve of Atlanta’s 2007 Financial Markets Conference*, Sea Island, Georgia (May 15, 2007), <http://www.federalreserve.gov/newsevents/speech/bernanke20070515a.htm> (last visited Feb. 17, 2013); see also, M. Watson, D. Mathieson, R. Kincaid, E. Katler, *International Capital Markets: Developments and Prospects*, INTERNATIONAL MONETARY FUND, Paper No. 43 at 15, Feb. 1986 (on balance the innovations have been almost certainly beneficial for the system as a whole).

⁷⁶ Chairman Ben S. Bernanke, *Financial Innovation and Consumer Protection, Speech Given at the Federal Reserve System’s Sixth Biennial Community Affairs Research Conference, Washington, D.C., April 17, 2009*, <http://www.federalreserve.gov/newsevents/speech/bernanke20090417a.htm> (last visited Feb. 17, 2013).

⁷⁷ See e.g., Peter Tufano, *Financial Innovation* in THE HANDBOOK OF ECONOMICS OF FINANCE, GEORGE CONSTANTINIDES, MILT HARRIS AND RENE STULZ, EDS. (2002) (outlining theories of financial innovation); W. Scott Frame and Lawrence J. White, *Financial Studies of Financial Innovation: Lots of Talk, Little Action*, 42 J. ECON. LIT. 116 (2004) (same); Robert C. Merton and Zvi Bodi, *The Design of Financial Systems: Towards a Synthesis of Functions and Structure*, NBER WORKING PAPER 10620 (discussing financial innovation, neo-classical finance, frictions, and behavioral economics).

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A. Innovation and Discovery: Five Competing Models

In a perfectly efficient world, free of taxes, regulations, and transaction costs, financial innovation would provide little or no benefit and would likely play an insignificant role in the economy.⁷⁸ Markets, however, are neither perfectly efficient nor free from regulation and, as we know, financial innovation is pervasive. The extant theoretical literature has converged on a range of factors, often believed to operate simultaneously, that motivate financial experts to innovate.⁷⁹ While the mainstream account often assumes that financial innovation is driven primarily by investor demand,⁸⁰ we will see that questionable and self-serving motives can also inspire financial engineers to the detriment of shareholders and investors.

1. Taxes, regulations, and accounting standards

Taxes, regulations, and formal industry standards are widely viewed as an impediment to market activities, but they also operate as a major incentive to innovation.⁸¹ Milton Merton, along with many other scholars in a wide range of fields, have discussed and debated financial creativity,⁸² but all agree that financial engineers spend significant time and energy avoiding taxes,⁸³ maneuvering around regulations,⁸⁴ and devising creative accounting and reporting strategies.⁸⁵

⁷⁸ Tufano, *supra* note 77 at 5 (financial innovation in a world free of “imperfections” would benefit no one).

⁷⁹ Bruno Rossignoli and Francesca Arnaboldi, *Financial Innovation: Theoretical Issues and Empirical Evidence in Italy*, 56 J. INT. REV. ECON. 275, 280–81 (2009) (various drivers of innovation exist and tend to work simultaneously); Tufano, *supra* note 77 at 10 (all the stimuli operate together to promote innovation).

⁸⁰ FRANKLIN ALLEN AND DOUGLAS GALE, FINANCIAL INNOVATION AND RISK SHARING 5-10 (1994) (demand drives innovation); Nicola Gennaioli, Andrei Shleifer, and Robert Vishny, *Neglected Risks, Financial Innovation, and Financial Fragility*, 104 J. FIN. ECON. 452, 452 (2012) (episodes of financial innovation share a common narrative and it begins with investor demand); Josh Lerner and Peter Tufano, *The Consequences of Financial Innovation: A Counterfactual Research Agenda*, NBER WORKING PAPER 16780 at 10 (2001) (same).

⁸¹ Darrell Duffie and Rohit Rahi, *Financial Market Innovation and Security Design: An Introduction*, 65 J. ECON. THEORY 1, 2 (1995) (“new securities are often designed in response to accounting standards, regulations and tax codes”).

⁸² Merton Miller, *Financial Innovation: The Last Twenty Years and the Next*, 21 J. OF FIN. & QUANT. ANAL. 459 (1986) (“the major impulses to successful financial innovation over the last twenty years have come . . . from regulations and taxes”); Michael Carter, *Financial Innovation and Financial Fragility*, 23 J. ECON. ISSUES 779, 783 (1989) (tax and regulation drive innovation).

⁸³ See generally, Charles Pouncy, *Contemporary Financial Innovation: Orthodoxy and Alternative*, 15 SMU L. REV. 505 (2009) (discussing time and energy devoted to innovation in financial context); Edward Kleinbard, *Equity Derivative Products: Financial Innovation’s Newest Challenge to the Tax System*, 69 TEX. L. REV. 1319 (1990) (same); Alvin C. Warren, *Financial Contract Innovation and Income Tax Policy*, 107 HARV. L. REV. 460 (1993) (same).

⁸⁴ Scholars have noted that innovators often create means to avoid regulation by designing investment opportunities in unregulated or minimally regulated industries. Banking policy, for example, long limited banks’ ability to pay interest on savings accounts and this led non-bank intermediaries who operated outside the jurisdiction of the banking regulators to devise money market and mutual fund accounts that mimicked the attributes of savings deposits but could pay interest. Pouncy, *supra* note 82 at 546–48 (2009); Joseph C. Shenker and Anthony J. Colletta, *Asset*

SUPERCHARGED IPOs

Tax rules addressing goodwill may have played an important role in the rise of the supercharged IPO. Prior to 1993, the cost of creating *or* acquiring goodwill could not always be amortized, but with the adoption of Section 197, acquirers are not able to amortize the cost of this asset ratably over a fifteen-year period.⁸⁶ Because goodwill is often the most valuable asset sold in an IPO, the change in the law effectively enabled investors to “recover” (through tax deductions obtained by the company) a portion of their investment if the deal was structured as a “sale” to give Public Co. the ability to amortize its assets. In short, due to Section 197, the true cost of buying shares of stock in an IPO would be substantially less than the nominal or “headline” price in light of the cash savings down the road associated with the tax deductions for goodwill.

The 1993 tax reform was followed by a major change in accounting standards, making goodwill even more valuable to the company. Prior to 2001, companies were required to charge a portion of the amortized goodwill to their income statement—signaling the depletion of an asset, and having the effect of reducing earnings and showing smaller company profits. In 2001, the Financial Accounting Standards Board (FASB) issued FAS 142,⁸⁷ eliminating this mandate. The importance of this reform should not be underestimated: it led to a vast increase in many companies’ annual reported profits, often by billions of dollars.⁸⁸ In short, the current tax and accounting

Securitization: Evolution, Current Issues and New Frontiers, 69 TEX. L. REV. 1369 (1990); Henry T.C. Hu, *Swaps, The Modern Process of Financial Innovation and the Vulnerability of a Regulatory Paradigm*, 138 U. PENN. L. REV. 333 (1989); Carter, at 782–84; James Tobin, *Financial Innovation and Deregulation in Perspective*, 3 MONETARY AND ECON. STUD. 19 (1985).

⁸⁵ Many have argued that accounting firms are uniquely positioned to engage in financial innovation given the background expertise in accounting, taxation, and regulations and numerous firms now market themselves as experts not only in accounting services but in the design of “structured investment vehicles” that enable firms to creatively avoid the limits of accounting standards and tax rules. Patricia Arnold, *Global Financial Crisis: The Challenge to Accounting Research*, 34 ACCT. ORG. & SOC’Y 803 (2009); Norio Sawaabe, *Co-Evolution of Accounting Rules and Creative Accounting Instruments—The Case of a Rules-Based Approach to Accounting Standard Setting*, 1 EVOL. INST. ECON. REV. 177 (2005); Eric R. Hake, *Financial Illusion: Accounting for Profits in an Enron World*, 39 J. ECON. ISSUES 595, 603 (2005); Atul K. Shah, *Creative Compliance in Financial Reporting*, 21 ACCT., ORGS. & SOC’Y 23–39 (1996); Atul K. Shah, *Regulatory Arbitrage through Financial Innovation*, 10 ACCT., AUDITING & SOC’Y 85–104 (1996); Atul K. Shah, *Exploring the influences and constraints on creative accounting in the United Kingdom*, 7 EUR. ACCT. REV. 83–104 (1998); see also D. MACBARNET, AND C. WHELAN, *CREATIVE ACCOUNTING AND THE CROSS-EYED JAVELIN THROWER* (1999).

⁸⁶ I.R.C. §197 (2006). For a good discussion of how and why the change in the tax rules associated with goodwill has led to the proliferation of IPOs, see, Romina Weiss, *Fifteen Years of Antichurning: It’s Time to Make Butter*, TAX NOTES 227, 234–36 (January 12, 2009) (tax and accounting rules motivate innovate deals); see also Robert Willens, *Depreciating (Not Depreciating) Matt Kemp*, 6 WILLENS REP. (May 31, 2012) (same).

⁸⁷ Goodwill and intangible assets are not presumed to be wasting assets; instead, they are presumed to have indefinite useful lives and are tested periodically for impairment. See Financial Accounting Standards Board, *Summary of Statement No. 142: Goodwill and Other Intangibles* (2001), <http://www.fasb.org/summary/stsum142.shtml> (last visited Feb. 17, 2013)..

⁸⁸ Ronad J. Huefner and James A. Largay, *The Effects of the New Goodwill Accounting Rules on Financial Statements*, THE ONLINE CPA JOURNAL, <http://www.nysscpa.org/cpajournal/2004/1004/essentials/p30.htm> (last visited Feb. 17, 2013).