

THE SUPERCHARGED IPO

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INTRODUCTION

If you were asked to name the greatest inventions ever made, you would probably include the light bulb, the telephone, and the personal computer.¹ Less interesting advancements, such as microcredit loans, checkbooks, or ATMs would almost certainly go unmentioned. Yet these types of achievements—inventions that emerge in the financial sector—have long played a key role in the daily lives of individuals and organizations the world over.

While often ignored and overlooked, financial innovators have recently gained notoriety due, in part, to the widespread view that their products and ideas were the cause of the global financial meltdown in 2008.² Historians, however, have documented creativity and inventiveness in the financial context throughout history.³ Trading, retailing, and innovative financing emerged thousands of years ago with the development of maps, coinage, contracts, and ancient lending practices, and these advancements quickly spread across the globe and persist today in modern formulations.⁴ Moreover, students of finance have long noted that financial innovation is not only a centuries-old phenomenon, it has also operates as a double-edged sword: innovation is essential to economic growth and development but it also, undeniably, has the potential to generate “positively harmful” consequences when inappropriately implemented.⁵

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¹ See Albert L. Winsemen, *Electricity Retains Power as Greatest Invention*, Gallup Poll available at <http://www.gallup.com/poll/17881/electricity-retains-power-greatest-invention.aspx> (similar answers to the same question over the decades).

² Manuel Sanchez, *Financial Innovation and the Global Crisis*, 5 Internat’l J. of Bus. & Mngmnt 26 (2010) (“the recent global financial crisis has highlighted the limitations and hazards of financial innovation while dimming the light on its core benefits for an economy”).

³ Josh Lerner and Peter Tufano, *The Consequences of Financial Innovation: A Counterfactual Research Agenda*, NBER Working Paper No. 1670 at 2

⁴ KEITH ROBERTS, *THE ORIGINS OF BUSINESS, MONEY AND MARKETS* (2011); Peter Tufano, *Financial Innovation* in GEORGE CONSTANTINIDES, MILT HARRIS, AND RENE STULZ, EDS, *THE HANDBOOK OF THE ECONOMICS OF FINANCE* (2003) (“history shows that financial innovation has been a critical and persistent part of the economic landscape over the past few centuries”).

⁵ Chairman Ben S. Bernanke, *Financial Innovation and Consumer Protection* (2009), speech available at <http://www.federalreserve.gov/newsevents/speech/bernanke20090417a.htm>. Government policymakers have also set up agencies to investigate the means by which policy can promote useful inventions while putting a stop to those that cause harm. See <http://www.sec.gov/divisions/riskfin.shtml>

In this article, we investigate a new and widely discussed financial innovation: the supercharged initial public offering (IPO). A supercharged IPO differs from a conventional IPO because it involves a contract provision that enables the original owners of a firm to extract large amounts of money from the company in the post-IPO period. Stated most directly, the supercharged IPO involves an agreement—unseen and unheard of prior to 1993—whereby a newly public company agrees to pay (often) billions of dollars to its founding owners over the course of a fifteen-year period after the IPO takes place.⁶

Supercharged IPOs have not entered the market quietly. Some have argued this new and innovative IPO is “a little bit underhanded,”⁷ “unusually one-sided,”⁸ a “true windfall,”⁹ and a “bizarre siphoning off of cash” by the founder-owners of the company.¹⁰ At the same time, others argue that financial engineers have found a useful means to compensate founders for the costs incurred of going public, while at the same time avoiding unnecessary losses. There is “nothing nefarious about it,”¹¹ notes Robert Willens, a leading finance expert and the one who coined the terms “supercharged IPO,” the agreements are “all disclosed” to the public well before the IPO takes place.¹²

The supercharged IPOs have generated substantial debate and controversy but no commentator has thus far posed the question: why now? After all, owners and founders have taken companies public for at least three hundred years,¹³ yet the unusual payout scheme emerged just two decades ago. Moreover, this new-style IPO, while not routine, has spread across industries and geographic areas, a process that raises the question of how and why innovations diffuse after the initial discovery takes place. Finally, and perhaps most importantly, the supercharged IPO raises the question of who actually benefits: the architects of the plan, the investing public, or both? In this study, we seek to find answers to these questions with the help of a large IPO database—the first of its kind—and one that includes both conventional and supercharged IPOs over the course of the last several decades.

Quite a few scholars have investigated financial innovation from both a theoretical and qualitative perspective. Many historical and sociological studies, for example, have cataloged important inventions throughout history, and economists have

⁶ The first supercharged IPO emerged in 1993, and then not again until the 2004. See Amy S. Elliott, *IPO Agreements that Shift the Basis of Step-Up to Sellers Proliferate*, TAX NOTES 334 (July 25, 2011). The 1993 IPO involved Belden, Inc., a division of Cooper Industries, and a subsequent 1994 IPO involved of O’Sullivan Industries—the first two deals to incorporate a tax receivable agreement—a key component of the supercharged IPO.

⁷ Amy S. Elliott, *IPO Agreements that Shift Basis Step-up to Sellers Proliferate*, TAX NOTES, July 25, 2011, at 334 (citing Robert Willens’).

⁸ Reuters, *Blackstone Partners May Avoid Tax on IPO Gains* (July 13 2007) (citing Lee Sheppard) available <http://www.reuters.com/article/2007/07/13/us-blackstone-tax-idUSN1325038320070713>.

⁹ Robert Willens, (“The thing that fuels this is that it is truly a windfall”); Amy S. Elliott, *IPO Agreements that Shift Basis Step-up to Sellers Proliferate*, TAX NOTES, July 25, 2011, at 337 (“pure gravy”).

¹⁰ PEU Report, *Carlyle’s “Cash Tax Savings” Won’t Go to Unit Holders* (May 5, 2012) available at <http://peureport.blogspot.com/2012/05/carlyles-cash-tax-savings-wont-go-to.html>.

¹¹ Amy S. Elliott, *IPO Agreements that Shift Basis Step-up to Sellers Proliferate*, TAX NOTES, July 25, 2011, at 339 (citing Robert Willens).

¹² Amy S. Elliott, *IPO Agreements that Shift Basis Step-up to Sellers Proliferate*, TAX NOTES, July 25, 2011, at 339 (citing Robert Willens).

¹³ West India Trading Company in the year 1650. [Get citation.]

proffered a variety of theories for why inventions emerge and then proliferate. Few scholars or teams of scholars, however, have attempted to conduct a large- N quantitative study on the topic.¹⁴ This gap in the literature is not surprising given the difficulty of identifying the specific time and place of most innovations, as well as the precise patterns of diffusion, given the fact that much of the relevant data is obscure and often unavailable outside private firms. Fortunately, these hurdles do not exist for our study. An existing legal mandate requires that companies disclose the details of the post-IPO payouts in SEC filings, and for this reason we are able to track both the emergence and the diffusion of the supercharged IPO.¹⁵

Our study begins, in Section II, with a brief definition of financial innovation, followed by a description and comparison of the conventional and supercharged IPO. While we focus on a simple illustration of the supercharged IPO, we note that the earliest deals generated an innovation spiral,¹⁶ a phenomenon whereby the first innovation generates a series of subsequent and highly complex iterations, thereby satisfying the parties' aims and goals to the greatest extent possible. This section concludes with a discussion of the costs and benefits of the supercharged IPO to the parties involved. In Section III, we turn to the extant theoretical literature. Section IIIA focuses on the drivers of innovation and notes that the incentive to innovate is often not individual passion and zeal, but mundane factors, such as risk aversion, information asymmetries, and legal and regulatory regimes.¹⁷ Section IIIB explores how and why innovation diffuses across markets and industries.

In Section IV, we turn to the empirical component of our study. We first outlined our statistical model, along with several hypotheses that grow out of the theory presented in Section III. Upon the completion of the data collection process, we will then fit the data to our model in order to understand and explain the financial innovation that has taken place in the IPO context over the last several decades.

II. FINANCIAL INNOVATION ON THE IPO LANDSCAPE

To begin our discussion, it is useful to explore briefly the concept of financial innovation.¹⁸ While no single definition exists, there is scholarly consensus that

¹⁴ Mahbrouk Abir and Mamoghli Chokri, *Dynamic Financial Innovation and Performance of Banking Firms: Context of an Emerging Banking Industry*, 51 Int'l Res. J. of Finance 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. of 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. of Bus. 577, 578 (2005) (only seven quantitative studies investigating the process by which innovation diffuses).

¹⁵ Dealings with related parties. Cite.

¹⁶ Cite.

¹⁷ MYRON S. SCHOLES ET AL., *TAXES & BUSINESS STRATEGY* (4th ed. 2008); David M Schizer, *Frictions as a Constraint on Tax Planning*, 101 COLUM. L. REV. 1312 (2001).; EVERETT M. ROGERS, *DIFFUSION OF INNOVATIONS* (1995) (establishing framework to describe how innovations spread).

¹⁸ Merton Miller is given credit for coining the terms "financial innovation." See Merton Miller, *Financial Innovation: The Last Twenty Years and the Next*, 21 J. FIN. & QUANT. ANALYSIS 459 (1986); Ewald Engelen, Ismail Erturk, at al., *Reconceptualizing Financial Innovation: Frame, Conjecture and Bricolage*, 39 ECON. & SOC'Y, 33, 38 (2010) (the financial economists, like Merton Miller, explicitly

innovation in the financial context encompasses a notable change in the on-going and available processes, products, and instruments. In the words of John Finnerty, it involves the “development, and implementation of innovative financial instruments and processes, and the formulation of creative solutions to problems of finance.”¹⁹ Many scholars have noted that financial ingenuity tends to originate with investment banks, commercial banks, and other types of financial intermediaries,²⁰ but important inventions have also emerged in a wide range of other industries often as a means to facilitate the purchase of a non-financial asset.²¹ As we discuss below, the supercharged IPO is a clever innovation on the conventional deal, and apparently driven by a network of both financial intermediaries and knowledgeable lawyers.

A. Initial Public Offerings

Initial public offerings (IPOs) are transactions whereby 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.²² IPOs 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 fact that the offering monetizes the value of the pre-IPO owners’ interest in the

coupled the terms “finance” and “innovation” to create a leading metaphor); Charles Pouncy, *Contemporary Financial Innovation: Orthodoxy and Alternative*, 15 SMU LAW REV 505, 545-46 (2009) (citing Miller as the first to argue that “financial innovation” begins with changes in tax and regulatory policy).

¹⁹ J.D Finnerty, *Financial Engineering in Corporate Finance: An Overview*, 17 Finance Mangmt, 14 (1988); W.S. Frame and L.J. White, *Empirical Studies of Financial Innovation: Lots of Talk, Little Action?* (2002) (“financial innovation represents something that reduces costs, reduces risks and provides an improved product/service/instrument”); Peter Tufano, *Financial Innovation* in GEORGE CONSTANTINIDES, MILT HARRIS, AND RENE STULZ, EDS, *THE HANDBOOK OF THE ECONOMICS OF FINANCE* (2003) (discussing concept).

²⁰ Bhattacharyya and Nanda (2000) model the incentives for innovation within the investment banking industry. They find that banks with larger market shares will tend to innovate, as will banks whose clients are more sticky.

²¹ Ford Motor Company, for example, instituted the Red Carpet Options Project that involved creative financing and pricing options in order to maintain its competitive edge. See generally, Shyan-Rong Chou, Sunwu Chen, Honghsiang Chen, *The Applications of Financial Innovation in Taiwan’s Automobile Industry: Operation, Pricing, and Strategic Implications*, 9 J. OF AM. ACAD. BUS. (2006). Like most inventors, financial inventors routinely seek to patent their discoveries and will not hesitate to litigate if patent infringement is believed to have taken place. See Josh Lerner, *The Litigation of Financial Innovation*, 53 J. OF LAW AND ECON. 807 (2010) (patents for financial products are granted and then litigated more often than patents in other areas); Yuan K. Chou, *Modeling Financial Innovation and Economic Growth: Why the Financial Sector Matters to the Real Economy*, 38 J. OF ECON. EDUC. 78, 87 (2005) (financial service companies, such as Morgan Stanley and Citigroup, have aggressively obtained patents in recent years); see also Praveen Kumar and Stuart M. Turnbull, *Optimal Patenting and Licensing of Financial Innovations*, 54 MANGMT SCI. 2012 (2008) (modeling patent choices). For patent controversies that have reached the courts, see e.g., *In re Bilski*, 543 F. 3d 943 (Fed. Cir. 2008), *en banc* (upholding denial of patent for method of hedging in commodities trading); *State Street Bank v. Signature Financial* 47 U.S. P.Q2d (BNA) 1596 (Fed. Cir. 1998) (upholding Signature’s patent relating to computerized methods for valuing mutual funds).

²² Companies that go public file a prospectus that includes a description of the business along with the growth plans. See, e.g., [cite S-1 and prospectus] For a useful review of the IPO process, 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).

company.²³ 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. At the same time, founders usually do not sell all of their shares: they often seek to (and do) retain control over their company after it has gone public.²⁴ In this paper, we dig into a new and innovative means by which a firm's pre-IPO owners extract substantial amounts of cash from their company as it goes public, while at the same time maintaining control in the post-IPO period.

1. The Traditional IPO

To understand the supercharged IPO as an important financial innovation, it is useful first to consider traditional IPOs. To begin, assume that Founders Co., a privately held corporation operating its business through a subsidiary, is a successful business. Assume also that Founders Co. has several assets, including goodwill, a valuable asset associated with its corporate identity, customer relationships, and so forth.²⁵ Many corporate assets give rise to amortization and depreciation deductions, thereby enabling the taxpayer to recover cost and save substantial monies in taxes. Goodwill, however is subject to a unique rule: if the asset is self-generated it cannot be amortized, but if it is acquired—the tax laws allow the purchaser to amortize the cost of the asset over a fifteen-year period.²⁶ As we will see, acquired goodwill—along with the tax benefits that it generates over fifteen years—is a key factor underlying many of the recent supercharged IPOs.

If Founders Co. chooses to take advantage of its success with the help of an IPO, it is likely to sell newly issued shares of stock to the public for cash as depicted in figure 1—a structure that reflects a traditional IPO. The public offering infuses Founders Co. with substantial monies based on its underlying value (including goodwill), but from a tax perspective it is a non-event for both Founders Co. and its subsidiary.²⁷ Note that this structure enables the public to own shares of Founders Co., but Founders Co. is still in direct control of all the assets.

²³ Andrew W. Needham, *Private Equity Funds*, 735 TAX MANAGEMENT PORTFOLIO 2nd A-90 (2010).

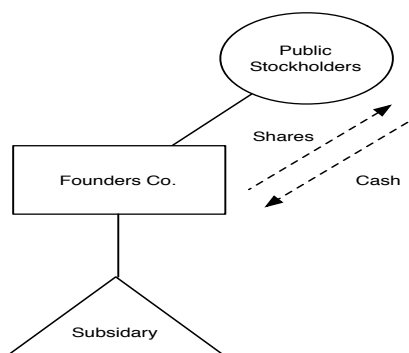
²⁴ Andrew W. Needham, *Private Equity Funds*, 735 TAX MANAGEMENT PORTFOLIO 2nd A-90 (2010).

²⁵ 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.” In accounting, the term is “The acknowledgement in the balance sheet that the whole is greater than the sum of its part.” See Note, *Treatment of Goodwill by the Seller Under I.R.C. Section 197*, 43 KAN. L. REV. 903, 903 (1995).

²⁶ I.R.C. Section 197.

²⁷ See I.R.C. § 1032(a) (“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.”).

Figure 1: Traditional IPO



The traditional IPO generates substantial cash, assures the owners retain control of the company, and avoids tax costs. Resourceful lawyers nonetheless view the transaction as inefficient and wasteful for at least two reasons. First, it is likely that the deal could have been structured to accomplish the parties' goals while at the same time *reducing* taxes. Second, even absent a potential tax savings, experts believe that owner-founders leave serious money on the table due to a variety of hidden but valuable tax assets that banks and investors seem to ignore in the IPO context. An alternative and more innovative approach to address these issues is more complex, but allows the parties to recapture and divide this value with the help of a subsidiary agreement. This last feature of the innovation—the sharing agreement between the parties—has led commentators to label it a “supercharged IPO.”²⁸

2. The Supercharged IPO

A supercharged IPO differs from a traditional IPO because the former always contains two key elements: (1) a deal structure that triggers or encompasses valuable tax assets for the new public entity, and (2) an agreement whereby the new public entity promises to pay the pre-IPO owners roughly 85% of the tax savings associated with those assets.²⁹ “Tax assets” are assets on the company’s balance sheet that are used to reduce the amount of tax owed in a later period and often save the company substantial amounts of money. Because the supercharged IPO enables the newly public company to gain access to these valuable tax benefits,³⁰ the company agrees to share them with the owner-founders in the post-IPO period pursuant to a “tax receivable agreement” (TRA).³¹ While

²⁸ See Robert Willens, General Electric “Supercharges” the Genworth Financial IPO, Tax Notes 661 (Aug. 9, 2004) [hereinafter, “Supercharged IPOs”]

²⁹ A handful of deals include TRAs where the tax asset in question is a NOL carryforward rather than a basis step up. Contracts that mandate parties share the benefits and burdens of taxation are not new.

³⁰ A tax asset is an accounting concept that refers to an item that reduces the amount of a future tax burden.

³¹ That tax sharing 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); Douglas Shackelford & Terry Shevlin, *Empirical Tax Research in Accounting*, 31 J. ACCT. & ECON. 321-87 (2001); Merle Erickson & Edward Maydew, *Implicit Taxes in High Dividend Yield Stocks*, 73 ACCT. REV. 435-58 (1998); Anne Beatty, *The Cash Flow and Informational Effects of Employee Stock Ownership Plans*, 38 J. FINANCIAL ECON. 211-40 (1994); Douglas Shackelford, *The Market for Tax Benefits: Evidence from Leveraged ESOPS*, 14 J. ACCT. & ECON 117-145 (1991).

supercharged IPOs represent just a small fraction of the deals that take place (approximately two percent), they involve millions, often billions, of dollars in cash transfers from newly public companies to a small group of pre-IPO owners. The agreements, in short, are relatively rare but they are also extraordinarily lucrative for the individuals selling their company.

Supercharged IPOs can take many different forms, but all involve steps that are absent from the traditional IPO depicted in figure 1. In the most simplified form, they unfold as follows. First Founders Co. transfers its subsidiary to a newly created corporation, Public Co., in exchange for Public Co.'s stock. Founders Co. then agrees to sell a large percentage of this newly acquired Public Co. stock to a third party (the investing public).³² This arrangement, an alternative to that presented in figure 1, has important tax advantages. Under the relevant laws, the new public company will be viewed as having purchased Founders Co.'s assets, and thus will have a basis in the assets equal to their fair market value, thereby assuring large amortization and depreciation deductions. Moreover, because Public Co. has acquired Founders Co.'s goodwill—it will take amortization deductions over a fifteen-year period that were denied to Founders Co. These tax savings are not minor: they can reach into the billions of dollars *each* year. Because the savings are so valuable, they show up on the company's balance sheet as "tax assets," and experts estimate they can save investors roughly 20 to 25 percent of the purchase price paid for the stock shares. Put differently, the supercharged IPO means that investors actually pay just 75 to 80 percent of the "headline" price for their shares of stock given the hidden asset found on the internal company books.

Public Co. and its investors reap valuable benefits but there are also drawbacks. First, Founders Co. must sell the majority of its stock in Public Co. to investors and thus it will lose control over the business. Moreover, Founders Co. is likely to 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.³³ Moreover, to the extent that Founders Co. has appreciated in value, the original owner-founders will still have to pay a second level of tax when they sell or liquidate Founders Co. This double tax did not exist in the structure presented in figure 1—indeed there were *no* tax consequences.

Setting aside the problem of corporate control, we might still wonder why Founders Co. would agree to pay tax on the sale of stock simply to provide Public Co.

³² Actually, Founders Co. sells the shares to the investment bank, which then sells to the public. This arrangement causes the transaction to fail the section 351 "control" test and the related party rule in section 338(h)(3)(A)(iii). The deal, in short, is a "busted 351 transaction" and as such qualifies as a *stock sale*, leaving Public Co. with a carryover basis in the underlying assets and the public investors with its stock. The parties, however, do not want the carry-over basis so they will make a section 338(h) election and treat the transaction as a hypothetical *asset sale*. This treatment, in turn, enables Public Co. to obtain a stepped-up basis in the underlying assets reflecting their current fair market value. See Rev. Rul. 79-70, 1979-1 C.B. 144; see also Rev. Rul. 79-194, 1979-1 C.B. 145; TAM 9747001 (July 1, 1997); PLR 9541039 (July 20, 1995), as modified by PLR 9549036 (Sept. 12, 1995); PLR 9142013 (July 17, 1991).

³³ Robert Willens, *General Electric "Supercharges" the Genworth Financial IPO*, TAX NOTES 661 (Aug. 9, 2004) [hereinafter, "Supercharged IPOs"]; MARTIN D. GINSBURG AND JACK S. LEVIN, *MERGERS, ACQUISITIONS, AND BUYOUTS* ¶ 405 (2011). 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 Willens, *Supercharged IPOs*, *supra*; GINSBURG & LEVIN, *MERGERS, ACQUISITIONS, AND BUYOUTS*, *supra*.

(and its investors) with a major tax savings. The answer is this: Founders Co. will be compensated for the cost it incurs. One possible, and very simple, compensatory plan would involve charging the new shareholder-investors a higher price per share at the time of the IPO—since Founders Co. is selling the shares the higher price would reimburse the owners for their hidden tax costs, and still enable investors to recover this cost in the form of amortization deductions taken at the company level over the course of the next fifteen years. Alternatively, Public Co. could agree to make a single lump sum payment to Founders Co. as compensation for the costs it incurred in transferring the valuable tax asset to Public Co. and its investors. The parties, however, eschewed these and other simple options and adopted a far more complicated plan. Founders Co. and Public Co. supercharged the deal by executing a tax receivable agreement (TRA) that requires Public Co. to pay a portion of the value of the tax asset over a fifteen-year period.

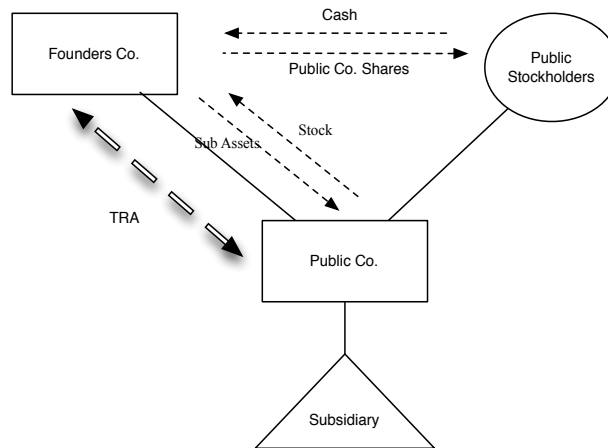
More specifically, the typical TRA requires Public Co. to pay the seller 85 percent of the tax benefits realized as a result of the depreciation and amortization tax deductions that would have been *unavailable* in the absence of the IPO. The timing of the payments corresponds to the deductions as they are obtained; Public Co., in other words, makes the TRA payments to the founders as it realizes the tax savings and not before this time.³⁴ 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 did not exist. In short, the value of the tax benefit is measured on a “with and without” basis: Public Co. measures what its taxable income would be with and without the amortization deductions, and makes a payment equal to 85 percent of that difference per the parties’ TRA.³⁵

Figure 2 is a simplified depiction of an early-supercharged IPO where Founders Co. exacted payments from Public Co. through a TRA in return for allowing Public Co. to benefit from the tax assets. As described above, Founders Co. first transferred its subsidiary to Public Co. in exchange for stock; then Founders Co. sold the stock to the public and at the same time executed a TRA with Public Co. as indicated in the parties SEC filings.

³⁴ Although some agreements indicate that the pre-IPO investors can accelerate the payments. See, e.g., [cite]

³⁵ 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.

Figure 2: Supercharged IPO: seller extracts more cash with a TRA



The supercharged IPO discussed above is grounded in the fact that Founders Co. incurs tax costs in order to enable Public Co. (and its investors) to benefit from tax deductions down the road. Many experts believe, however, that tax assets unlike other types of familiar assets such as real property, are so esoteric that most investors fail to understand their value. Moreover, and perhaps more importantly, banks often rely on valuation methods that ignore tax assets in the context of an IPO. This means that even when present and comprehensible, investors will not pay for the tax assets or will seriously discount their value. As we discuss in more detail below, this provides one explanation for why the parties have adopted the complex TRA payout scheme, but it also led owner-founders to devise a deal that is even more favorable to them.

The second wave of supercharged IPOs look similar to the deal depicted in figure 2 and described above. But there is one key difference—Founders Co. transfers its subsidiary to Public Co. in a manner that gives Public Co. the carry-over basis in the underlying assets—not the large stepped-up basis. This has two consequences: Public Co. has smaller depreciation and amortization deductions and Founders Co. does not suffer a tax. The deal, however, is nonetheless supercharged with a TRA that awards Founders Co. 85 percent of the value of those deductions. Now we must ask why Public Co. would agree to compensate Founders Co. with a TRA, when the latter incurred no tax costs? The reason is suggested above: banks ignore tax assets when valuing a company in the IPO and yet these assets undeniably provide value to Public Co. going forward. This would be akin to a deal involving a pearl oyster—if the purchaser values the asset without accounting for pearl imbedded inside and is only willing to pay for the shell—perhaps the seller should find a way to retain the pearl rather than leaving this value on the table.

We now understand that supercharged IPOs are motivated by the tax law and accounting standards, but it is unclear why the parties would choose the first or second form of the deal. Moreover, irrespective of whether Founders Co. and Public Co. choose a deal that gives the latter a stepped-up basis or a carry-over basis, why the parties have systematically chosen the complex TRA rather than a more simple and straightforward compensation plan is unclear. We address precisely these questions in the next section.

when we investigate the drivers of financial innovation. Before we take up these issues, however, we provide a few more details with respect to subsequent innovations that built on the initial deals and the TRAs that accompanied them.

a. The innovation spiral

The early-supercharged IPOs were innovative because they addressed hidden tax assets and incorporated TRAs, but they also had drawbacks associated with Founders Co.'s loss of control and the potential double tax when the owner-founders chose a deal form that gave Public Co. a stepped-up basis in the assets. These drawbacks led to a series of new innovations that enabled founders-owners to retain the upside of the early deals and at the same time eliminate most of the downside.

To address the problem associated with control, Founders Co. innovated by devising two classes of stock. Recall in the early supercharged IPOs discussed above, Founders Co. transferred its subsidiary to Public Co. in exchange for all of Public Co.'s stock and then sold the majority of that stock to public investors. This process also takes place in the later supercharged IPOs, but it now involves Public Co. issuing "Class A" and "Class B" stock in exchange for Founders Co.'s assets. The Class A stock has economic rights but little or no voting rights and is sold to the public, while the Class B stock has voting rights but little or no economic rights and is retained by Founders Co. In this way, Founders Co. retains complete control over the new Public Co. because only it has the power to vote on corporate matters.

Issuing two classes of stock was an important advancement for purposes of enabling Founders Co. to retain control, but it did not eliminate the potential double tax noted above. To eliminate this problem, the parties devised yet another innovation. The original owner-founders of the business, eschewed corporate entities (subject to the corporate tax and the cause of the double tax) and instead set up tax-free entities (partnerships).³⁶ The partnerships were then sold to the public in an IPO with two classes of stock, thereby assuring that gain was subject to just one level of tax while at the same time allowing the original owner-founders to retain control of their company.³⁷

³⁶ Because corporations are generally subject to tax at both the entity and shareholder level, they are not tax efficient and a newer strategy was devised by the tax innovators. See Eric Sloan, *Partnerships in the Public Space*, in PLI, THE CORPORATE TAX PRACTICE SERIES: STRATEGIES FOR ACQUISITIONS, DISPOSITIONS, 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*, in PLI, THE CORPORATE TAX PRACTICE SERIES: STRATEGIES FOR ACQUISITIONS, DISPOSITIONS, SPIN-OFFS, JOINT VENTURES, FINANCINGS, REORGANIZATIONS & RESTRUCTURINGS, VOL. 8 (2010) [hereinafter, *Thinking Outside the Box*].

While this innovation took off, often tax strategies look good on paper, but if the tax savings are outweighed by nontax costs like weak corporate governance or bad accounting treatment, the strategy will fail to get adopted in practice. The decision of VC-backed start-ups to organize as corporations rather than as partnerships or LLCs, for example, can be viewed as a rational decision given legal constraints on the ability to use tax losses and the nontax costs associated with operating in the partnership form. Victor Fleischer, *The Rational Exuberance of Structuring Venture Capital Start-ups*, 57 TAX L. REV. 137 (2003). For start-ups that do not seek VC funding, by contrast, operating in partnership form often makes sense. The importance of frictions is captured in the idea that the goal of tax planning is to maximize after-tax income, not to minimize taxes.

³⁷ As noted above, the early deals, with corporate sponsors, were structured to take subsidiaries public with a qualified stock purchase and a basis step-up resulting from a deemed asset sale triggered by a

The details of the innovation spiral are contained in the appendix.³⁸ Importantly, for our purposes, each new generation of the supercharged IPO contained a TRA similar to the one that emerged in all the earliest deals, mandating that the new public entity make payments back to the original owner-founders over the course of a fifteen-year period. Moreover, while the cascade of changes that emerged on the IPO landscape have gained widespread attention, the most extensively discussed and debated component of the supercharged IPO continues to be the payout scheme required under the TRA. Some have argued that the agreements are a “byzantine” means by which companies avoid taxes while allowing owner-founders to “siphon” cash from the pockets of public investors. Others argue the agreements are convenient features of tax-efficient deals and are fair and beneficial to all the parties involved. At the same time, policymakers have begun to worry about revenue loss and have proposed tax reforms that would eliminate some of the tax advantages that have emerged in the IPO innovation spiral.³⁹ We discuss these issues in more detail below, but first offer a generalized version of how the costs and benefits associated with the TRA are allocated between the parties.

b. Calculating costs and benefits

Recall, the point of the TRA is to compensate the original founders for tax costs associated with a deal that enables Public Co. to gain access to lucrative tax benefits. The parties, of course, could execute a traditional IPO and avoid taxes altogether, but this approach would forego valuable tax benefits or leave money on the table. Given the fact that TRAs involve a complex payout, it is useful to investigate the costs and benefits of the deal to each party.

For purposes of illustration, we will assume that the parties have taken advantage of the innovation spiral and have eliminated the possible double tax by selling the shares of a non-taxable entity, such as a partnership, in the IPO. For purposes of ease, assume the owner-founders of the partnership have one asset, goodwill, valued at \$1 million dollars. If structured as a supercharged IPO that allows Public Co. to get a stepped-up basis, the owner-founders will pay tax at a rate of fifteen percent on the \$1 million that they are paid at the time of the IPO, and thus will pay \$150,000 in tax. The new public company, however, will have an asset that it can ratably amortize over the course of fifteen years, saving a total of \$350,000 in taxes over that time period if all goes well.

Now consider the effect of the TRA, which requires Public Co. to transfer 85% (\$297,500) of the tax benefit associated with the amortization deductions back to the owner-founders, leaving it with the remaining 15% (\$52,500) of the tax savings. The TRA payments to the owner-founders, of course, are also taxable at a fifteen percent rate and thus the after-tax benefit of the TRA is actually \$252,875 to the owner-founders.

Section 338(h)(10) election. The later post-2004 deals, however, have almost uniformly involved partnerships moving into the public sphere primarily with the aid of the Up-C structure discussed above, many with an approach involving a publicly traded partnership in lieu of the publicly traded corporation.

³⁸ Lerner and Tufano (2010), at 14 (discussing concept of innovation spiral).

³⁹ See 2007 TAX NOTES Today 217-31.

Table 1: The costs and benefits of a TRA in a supercharged IPO

Assume the asset goodwill is valued at \$1,000,000 and can be amortized ratably by Public Co. over the course of 15 years			
	Traditional IPO	Super- charged IPO	Present Value of Super- charged IPO
Nominal Tax Benefits from Goodwill			
Owner-Founders	0	0	
Public Co.	0	350,000	242,192
Actual Tax Benefit from Goodwill Due to Tax Receivable Agreement (TRA)			
Owner-Founders	0	297,500	205,863
Public Co.	0	52,500	36,328
Total Tax Costs in Deal			
Owner-Founders	0	194,925	180,879
Public Co.	0	0	
Total After-Tax Benefits with TRA			
Owner-Founders	0	102,575	24,983
Public Co.	0	52,500	36,325

* The present value of the supercharged IPO was calculated with an assumed 5% interest rate. If the parties forecast a low rate of 0.25% then Founders Co. would obtain a total of \$97,888 and Public Co. would obtain \$51,464. If the parties forecast a high rate of 9.75% then Founders Co. would end up losing and would receive -\$19,923 and Public Co. would obtain \$27,005.

To provide a comparison of the total after-tax benefits to the parties—the last several rows of the table provide a summary of the deal. The numbers initially suggest that Founders Co. will obtain \$102,575 while Public Co. will receive \$52,500. When we account for the time value of money, however, we see that Founders Co. obtains \$24,983 and Public Co. obtains \$36,325. We discuss why the parties would allocate the benefits in this fashion is discussed in the next section. Before we turn to that issue, however, we note that the TRAs have risks, which are disclosed by the company in their SEC pre-IPO filing.

B. Company Disclosures and Risk Projections

While TRAs are controversial and subject to widespread debate, a company that go public must disclose the details of the agreement in the prospectus and attach a copy of the TRA as an exhibit to the SEC filings. To give just one example, Evercore Partners (the owner-founders of a firm) filed documents with the SEC containing language describing the terms of the 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 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 have entered into a tax receivable agreement . . . that provides for the payment by us to an exchanging Evercore partner of 85% 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% of cash savings, if any, in income tax that we realize.⁴⁰

Not only are the terms of the TRA and the concomitant cash payments disclosed to investors at the time of the IPO, the potential risks of entering into this type of agreement are also outlined. Payments under the TRA are contingent on Public Co.'s income—absent taxable income the amortization deductions are literally worthless. This poses a risk to the owner-founders that they will not actually receive the payments although they will have incurred the taxes discussed above. Moreover, the IRS may not look fondly on the basis step-up obtained in the supercharged IPO and this means neither Public Co. nor the owner-founders would obtain the expected benefits outlined in the TRA. 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 are not aware of any issue that would cause the IRS to challenge a tax basis increase, our principals will not reimburse the corporate taxpayers for any payments that have been previously made under the tax receivable agreement. As a result, in certain circumstances, payments could be made to our principals under the tax receivable agreement in excess of the corporate taxpayers' cash tax savings. 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 future income.⁴¹

TRAs have risks and drawbacks, although come continue to argue they have a “certain symmetry because existing owners receive tax benefits associated with a tax liability they have borne.”⁴² 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,”⁴³ Public Co.'s obligation to pay appear symmetrical on paper, but theoretically could also be challenged down the road by angry shareholders who feel

⁴⁰ The Evercore deal involved a complicated transaction and the exchange referred to in the quoted language were subsequent to the IPO. Specifically the documents indicated that “Partnership units held by our Senior Managing Directors in Evercore LP may be exchanged in the future for shares of our Class A common stock Evercore LP intends to make an election under Section 754 of the Internal Revenue Code (the “Code”) effective for each taxable year in which an exchange of partnership units for shares occurs, which may result in an adjustment to the tax basis of the assets owned by Evercore LP at the time of an exchange of partnership units.”

⁴¹ Fortress S-1 [cite]

⁴² Debevoise & Plimpton Private Equity Report, *Monetizing the Shield: Tax Receivable Agreements in Private Equity Deals* at 9, Volume 11, no.1 (Fall 2010).

⁴³ See, Amy S. Eliot, TAX NOTES 334 (July 25, 2011); others.

cheated.⁴⁴ This could result in a scenario whereby the company retains the tax asset, and at the same time eliminates the mandated payments to the owner-founders under the TRA. We explore the allocation of costs and benefits, along with the perceived risks of the TRA in more detail below when we examine the extant theories for how and why financial innovators create new products and plans, such as the supercharged IPO.

III. 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.⁴⁵ Scholars and policymakers have, for the most part, applauded these efforts as important means by which markets become 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.”⁴⁶ Two years after making this statement, however, Bernanke acknowledged that financial innovation also had 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.”⁴⁷

Good and bad, financial innovators are part of the economic landscape and for this reason it is important to understand the environment that fosters creative financing, the factors that enable its diffusion, and the allocation of costs and benefits between the

⁴⁴ We have not identified any litigation involving a supercharged IPO. 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).

⁴⁵ 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 OREGON LAW 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, at 101-113; [more cites]. Indeed as Professor Kristen Stilt, Michael Knoll and many others have noted, financiers continue to innovate in order to facilitate their lending practices and to avoid violating contemporary laws and norms against paying or charging interest. The Islamic prohibition against paying interest has made it difficult for many Muslims in the United States to buy a home with the help of a mortgage. To avoid violating religious tenets, bankers have devised methods . . . Also, see *Bollinger* (bankers avoid state usury laws by setting up a conduit corporation).

⁴⁶ Chairman Ben S. Bernanke, *To the Federal Reserve of Atlanta’s 2007 Financial Markets Conference, Sea Island, Georgia* (May 15, 2007), available at <http://www.federalreserve.gov/newsevents/speech/bernanke20070515a.htm>. See also, M. Watson, D. Mathieson, R. Kincaid, E. Katler, *International Capital Markets: Developments and Prospects* at 15 International Monetary Fund, Paper No. 43, Feb. 1986 (on balance the innovations have been almost certainly beneficial for the system as a whole).

⁴⁷ 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*, available at <http://www.federalreserve.gov/newsevents/speech/bernanke20090417a.htm>

parties.⁴⁸ Scholars have set forth a range of theories that address these issues and our goal in this section is to provide a brief outline of the extant literature as it applies to supercharged IPOs and, more specifically, to TRAs. We then offer hypotheses with respect to why TRAs emerged and why they have diffused across geographic areas and industries.

A. Factors that Stimulate Financial Innovation

In a perfectly efficient world, free of taxes, regulations, information asymmetries, transaction costs, and so forth, financial innovation would provide little or no benefit and would likely play a less prominent role in the economy.⁴⁹ Markets, however, are notoriously incomplete and inefficient, and for this reason financial innovation is pervasive. As we discuss below, many variables, often operating simultaneously, motivate these innovations.⁵⁰ While the mainstream account assumes that financial innovation is driven primarily by investor demand,⁵¹ we will see that questionable and self-serving motives can also motivate financial engineers.

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.⁵² Milton Merton, along with many other scholars in a wide range of fields, have discussed and debated financial creativity,⁵³ but all agree that financial engineers spend significant time and energy avoiding taxes,⁵⁴ maneuvering around regulations,⁵⁵

⁴⁸ See e.g., Peter Tufano, *Financial Innovation* in THE HANDBOOK OF ECONOMICS OF FINANCE, GEORGE CONSTANTINIDES, MILT HARRIS AND RENE STULZ, EDS.; W. Scott Frame and Lawrence J. White, *Financial Studies of Financial Innovation: Lots of Talk, Little Action*, 42 J. OF ECON. LIT. 116 (2004); see also, 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).

⁴⁹ Peter Tufano, *Financial Innovation* in GEORGE CONSTANTINIDES, MILT HARRIS, AND RENE STULZ, EDS, THE HANDBOOK OF THE ECONOMICS OF FINANCE (2003) (financial innovation in a world free of “imperfections” would benefit no one).

⁵⁰ 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 they tend to work simultaneously); Peter Tufano, *Financial Innovation* in GEORGE CONSTANTINIDES, MILT HARRIS, AND RENE STULZ, EDS, THE HANDBOOK OF THE ECONOMICS OF FINANCE (2003) (all the stimuli operate together to promote innovation).

⁵¹ Josh Lerner and Peter Tufano, *The Consequences of Financial Innovation: A Counterfactual Research Agenda*, NBER Working Paper 16780 at 10; Ross (1976); Allen and Gale (1994).

⁵² 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”).

⁵³ Merton Miller, *Financial Innovation: The Law 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. OF ECON. ISSUES 779, 783 (1989).

⁵⁴ Charles Pouncy, *Contemporary Financial Innovation: Orthodoxy and Alternative*, 15 SMU LAW REV 505 (2009); Edward Kleinbard, *Equity Derivative Products: Financial Innovation’s Newest Challenge to the Tax System*, 69 TEX. LAW. REV 1319 (1990); Alvin C. Warren, *Financial Contract Innovation and Income Tax Policy*, 107 HARV. L. REV. 460 (1993);

⁵⁵ 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

and devising creative reporting strategies.⁵⁶ As long as policymakers generate differential tax and regulatory regimes, many argue, the market for financial innovation will flourish and succeed.

As suggested by the label attached to the innovation of interest in this study—the tax receivable agreement—it is obvious that tax law has played a role in its design. As discussed above, TRAs involve a 1) deal structure that triggers or encompasses valuable tax assets for the new public entity, and 2) and an agreement whereby the new public entity promises to pay the pre-IPO owners roughly 85% of the tax savings associated with the pre-identified assets. In order to understand why this arrangement is likely to have emerged, consider the following factors.

First, recall that the traditional IPO involves no tax costs or benefits to the parties. Many supercharged IPOs, by contrast, involve both: the benefit often emerges in the form of amortization deductions associated with valuable assets, and the cost is linked to the taxable income for the original owner-founders. If the new public entity is able to take deductions at rate that exceeds that imposed on the taxable income, then a supercharged IPO is tax-efficient because the benefits to the company will exceed the costs to owners—creating an overall tax savings. A tax rate differential, if it exists, is one possible explanation for the emergence of the supercharged IPO.

Second, sequential tax and accounting reforms addressing goodwill encouraged parties with substantial goodwill to supercharge their IPO. Prior to 1993, the cost of creating or acquiring goodwill could not be amortized, but with the adoption of Section 197 purchasers were permitted to amortize the costs of this asset ratably over a fifteen-year period.⁵⁷ Because goodwill is often the most value asset sold in an IPO, the change in the law effectively enabled investors to “recover” (through tax deductions

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. Charles Pouncy, *Contemporary Financial Innovation: Orthodoxy and Alternative*, 15 SMU LAW REV 505,546-48 (2009); Joseph C. Shenker and Anthony J. Colletta, *Asset 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).

⁵⁶ 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 ACCOUNTING, 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. Iss. 595, 603 (2005); Atul K. Shah, *Creative Compliance in Financial Reporting*, 21 ACCNT., ORGANIZATIONS & SOC’Y 23–39 (1996); Atul K. Shah, *Regulatory Arbitrage through Financial Innovation*, 10 ACCOUNTING, AUDITING & SOC’Y 85–104 (1996); Atul K. Shah, *Exploring the influences and constraints on creative accounting in the United Kingdom*, 7 EUROPEAN ACCOUNTING REVIEW 83–104 (1998); see also D. MACBARNET, AND C. WHELAN CREATIVE ACCOUNTING AND THE CROSS-EYED JAVELIN THROWER (1999).

⁵⁷ I.R.C. §197. 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, 234-236 (January 12, 2009); see also Robert Willens, *Depreciating (Not Depreciating) Matt Kemp*, 6 Willens Report (May 31, 2012).

obtained by the public company) a portion of their investment if the deal was set up to allow the basis step-up for Public Co. In short, the true cost of buying shares of stock in an IPO would be substantially less than the nominal or “headline” price due to the cash savings down the road. The 1993 tax reform was followed by a major change in accounting standards. In 2001, the Financial Accounting Standards Board (FASB) issued FAS 142 also addressing the treatment of goodwill.⁵⁸ Prior to 2001, companies were required to charge a portion of their amortized goodwill to their income statement—effectively reducing earnings and showing smaller profits—but this requirement was eliminated in 2001. The importance of this accounting reform cannot be understated: it led to a vast increase in companies’ annual reported profits often by billions of dollars.⁵⁹ This is because the company now has an asset—a tax asset associated with amortization deductions and virtually as good as cash—that when exhausted does not operate as a drag on the company’s earnings or value.⁶⁰

Public companies essentially keep two sets of books: internal books for tax filings and accounting books made available to the public. Together, the tax and accounting reforms allow the companies to reduce their *taxable* income through amortization deductions, while at the same time keeping their *reported* income to investors high. A company that is able to take advantage of Section 197 and FAS 142 straddles the best of both worlds. Because the supercharged IPO enables Public Co. to do just this, the reforms create a powerful incentive to undertake this type of deal.

The rate differential along with the tax and accounting reforms that took place over the course of the last several decades may explain why companies started to supercharge their IPOs in a manner that imposed a tax on Founders Co. But these factors do not explain why they chose to do so through the complex fifteen-year arrangement imbedded in the TRA, rather than through more simple means such as 1) demanding a higher price for the stock shares sold in the IPO, or 2) arranging for a single lump-sum payment by the company to the owner-founders soon after the IPO. To understand the complexity of the financial innovation it is useful to consider risk aversion and information asymmetry.

3. *Risk aversion*

Students of financial innovation argue that uncertainty is a key motivator for creativity.⁶¹ Financial uncertainty is often associated with market fluctuation, but the threat of political, social, and legal change may also pose unwanted and undesirable risk.

⁵⁸ 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* (2011).

⁵⁹ Ronad J. Huefner and James A. Largay, *The Effects of the New Goodwill Accounting Rules on Financial Statements*, The Online CPA Journal available at <http://www.nysscpa.org/cpajournal/2004/1004/essentials/p30.htm>.

⁶⁰ Bankers express company value in terms of earnings before interest, taxes, depreciation, and amortization (EBITA) and thus the tax assets and expenses are not reflected in EBITA.

⁶¹ Frame and White, page 8; Tufano, page 20; VOLKER SCHMID, FINANCIAL INNOVATION WITH A PARTICULAR VIEW ON THE ROLE OF BANKS 4-6 (2004); C. SMITH, C. SMITHSON, AND D. WILFORD, MANAGING FINANCIAL BUSINESS, THE INSTITUTIONAL INVESTOR SERIES IN FINANCE 20 (1990); FINANCIAL INNOVATIONS LAW REPORT: FINANCIAL INNOVATIONS FOR CATASTROPHIC RISK: CAT BONDS AND BEYOND (2008) (discussing mechanism to ensure against earthquakes, hurricanes, terrorism, and so forth).

⁶² Inventions that have enabled individuals and entities to manage risk are ubiquitous and often involve complex products, instruments, and processes.⁶³

There are various risks associated with an IPO supercharged to take advantage of the tax and accounting rules described above. First, the tax rate disparity that exists between owner-founders and the new public entity could disappear. Indeed, various Members of Congress have critiqued this differential as unfair and inappropriate and have proposed legislation that would force recognition of income by owner-founders at a higher tax rate, thereby eliminating the arbitrage opportunity.⁶⁴ The risk that the tax costs will exceed benefits down the road provides an incentive for the owner-founders to negotiate an immediate payout (through an increased stock price at the time of the IPO or a lump sum payment after the IPO). A TRA tied to the company's amortization deductions over the course of fifteen years, by contrast, subjects the owners to the potential unwanted tax increase.

There are, however, strong reasons to prefer the fifteen-year payout scheme rather than upfront payments. The tax benefits to the Public Co. are often associated with the basis-step up that occurs with the purchase of the goodwill, but it is also possible that IRS will disallow or limit that basis-step.⁶⁵ Moreover, because the tax saving is associated with tax deductions that offset Public Co.'s taxable income, the company *must* earn sufficient income to take advantage of the tax deductions. Absent sufficient income the tax asset could become partially or fully useless. These risks make it sensible for the company to insist that the payments be contingent on actual rather than forecast tax

⁶² Dionisis Th. Philippas and Costas Siriopoulos, *Influence of Financial Innovation to Validation of Operational Risk*, 35 MANAGERIAL FINANCE 940, 41 (2009) (risk can be associated with failed processes, people, systems, or external events).

⁶³ Scholars have noted that foreign exchange futures, swaps, options, interest rate futures, and so forth all emerged due to perceived uncertainty in the markets and the desire to eliminate it. A widely admired and relatively new form of catastrophic insurance, often labeled "cat bonds," for example, is an innovation that enables individuals to protect against hurricanes, earthquakes, and even terrorism. J. David Cummins, *CAT Bonds and Other Risk-Link Securities: State of the Market and Recent Developments*, 11 RISK MNGT. & INSUR. REV. 23 (2008) (describing types of CAT bonds available); Neil A. Doherty, *Financial Innovation in the Management of Catastrophe Risk*, 10 J. OF APP. CORP. FIN. 84 (1997) (discussing design issues for successful innovation in this area of insurance); Tufano, page 20-21. Of course, financial innovation can also create risk for investors. Susanne Trimmbath, *Financial Innovation: Wall Street's False Utopia*, 5 J. ACCOUNTING & ORG. CHANGE 108-111 (2009) (collateral mortgage obligations (CMOs) were created to spread risk and reduce agency costs but had the opposite effect).

⁶⁴ See Temporary Tax Relief Act of 2007 (H.R. 3996), as passed by the House of Representatives on November 9, 2007. The provision related to tax sharing agreements was not part of the final legislation enacted into law. See GINSBURG & LEVIN, *supra* note 10. See also David Cay Johnston, *Blackstone devises way to avoid taxes on \$3.7 billion*, N.Y. TIMES (2007). [The tax benefits in question are largely attributable to the way the tax system treats goodwill; the TRA merely shifts these benefits from one party to another. A TRA by itself does not cost the Treasury any revenue, except insofar as it enables IPO sponsors to adopt a more tax-efficient structure.]

⁶⁵ In fact, the regulators' response is often an expected feature of innovation. Robert C. Merton, *A Functional perspective of Financial Intermediation*, 24 FIN. MGMT. 23, 30 (1995) (discussing the innovation-regulation dialectic); Zachary J. Gubler, *The Financial Innovation Process: Theory and Application*, 36 DEL. J. OF CORP. LAW 55 (2011) (exploring various ways to regulate financial innovation with the help of new institutional economics); Samuel M. Kidder, *What's Your Position? Amending the Bankruptcy Disclosure Rules to Keep Pace with Financial Innovation*, 58 UCLA L.REV 803 (2010) (exploring the problem of "empty creditors" and appropriate policy reform); Frank Partnoy, *Financial Innovation in Corporate Law*, 31 J. OF CORP. 799, 819-20 (2006) (exploring how corporate law might address the problem of hybrid financial instruments).

benefits, thereby insuring that Public Co. and its investors pay for an asset that they actually receive.

The terms of the TRA enable the parties to share the risks associated with their plan. By requiring the company to transfer the majority of the tax savings to the owner-founders (85 percent), the deal provides a premium and essentially indemnifies the owner-founders from paying the costs associated with potential tax increases. By refusing to make a payout until the tax savings are actually received, however, the company protects itself from paying for a tax asset that it never obtains or is substantially more limited than expected at the time of the IPO. We now understand that tax and accounting rules incentivize parties to supercharge their IPOs, and risk aversion may help to explain why the TRAs are the vehicle chosen to compensate the owner-founders despite their complexity.

3. *Information Asymmetry.*

Supercharging an IPO with a complex fifteen-year payout plan is a choice that may also be driven by information asymmetries. When one party has more or better information than the other, an imbalance of power exists and this could lead to opportunistic behavior on the part of the more informed. The less informed party faced with this problem will often seek creative solutions that operate to restrict the opportunity for the more informed to take unfair advantage and/or to equalize the available information.⁶⁶ The TRA appears to accomplish both of these goals in the following ways.

First, the owner-founders of the company are likely to have the best information as to the value of the underlying assets, especially goodwill.⁶⁷ Recall that the early-supercharged IPOs assured that Public Co. would get a basis in the goodwill equal to the purchase price, and it is this basis that enables the future tax savings in the form of amortization deductions. A higher basis affords more deductions, but these deductions could also attract unwanted scrutiny by IRS auditors who might then challenge the basis by reallocating the costs of the deal. By linking the TRA payments to the actual tax deductions obtained, the company assures that the owner-founders have a stake in the deductions and the accuracy of the underlying basis reported to the IRS. A payment untethered to the tax deductions could incentivize the owner-founders to overstate the value in an effort to convince the company to overpay for the tax asset obtained in the IPO. In short the complex nature of the TRA operates to assure that relevant information is shared between the parties.

Second, as suggested above, bankers measure financial performance often using EBITA—a measure that calculates earnings before interest, taxes, depreciation, and amortization. EBITA essentially ignores tax assets and, consequently, if investors rely on this measure, owner-founders will not be able to convince them to pay a higher price per share even if undesirable risk and opportunistic behavior did not pose a threat. The investor's information deficit, perhaps caused by the bankers, means the shares will be purchased at a discount given the reality that the hidden tax assets are estimated to be

⁶⁶ Paul Healy and Krishna G. Palepu, *Information Asymmetry, Corporate Disclosure and the Capital Markets: A Review of the Empirical Disclosure Literature*, 31 J. OF ACCOUNT. & ECON. 405 (2001) (discussing solutions to information asymmetry).

⁶⁷ [Consider the Facebook IPO—claim of overvaluation and insider knowledge].

worth 20-25 percent of the IPO “headline” price. This information asymmetry works to the disadvantage of the owner-founders, and bars the simple approach for remedying the problem.

The information asymmetry with respect to the value of the tax assets also explains why owner-founders would set up a supercharged deal even without the important tax and accounting changes described above. If the investors simply refuse to pay for a portion of the company’s value—here the tax assets—then owner-founders would be rational to extract these assets at the time of the sale with the help of the TRA that recaptures this value. As just noted, the investors will not pay a higher price per share given their lack of knowledge, and a lump sum payment is. And as noted above, a lump-sum payment is also untenable due to the inherent risks imbedded in the assets.

Thus far, we have documented possible explanations for why the parties would jointly prefer a supercharged IPO (or at least would not object), along with a complicated payout scheme over a fifteen-year period, to a conventional IPO. It is possible, however, that the supercharged IPO *creates* information asymmetries that work to the distinct advantage of the owner-founders and thus is undesirable to investors and Public Co. As noted above, many commentators have argued that supercharged IPOs are “underhanded,” “one-sided,” and “bizarre.” Indeed one commentator notes that in analyzing and opining on a recent IPO, he “missed the major thrust of The Carlyle Group’s byzantine ‘cash tax savings’” plan associated with the TRA. This commentator noted that he “mistakenly thought Carlyle’s co-founders were being indemnified against any future tax increase on carried interest. Instead it’s a co-founder cash bleeding of affiliates.”⁶⁸ The allegation, stated most directly, is this: owner-founders are deceptively adding complex provisions into the IPO, thereby creating information asymmetries and allowing the owner-founders to steal from unsuspecting public investors with the help of huge post-IPO payouts.⁶⁹

The critics may have a point: if the experts fail to detect and understand the TRA, the investing public will surely fail to comprehend the nature of the agreement, making it a perfect vehicle for owner-founders to quietly extract money from the company in an unfair manner. Innovators claim that the investing public does not comprehend tax assets as a justification for the TRA, but if investors in fact are paying for these assets as the efficient market theory would expect—then the owner-founders may have adopted an underhanded scheme as suggested by critics.

4. *Transaction Costs*

The cost of engaging in a transaction beyond the price paid for the good or service obviously reduces the profitability of the investment. Quite a few scholars have argued that the presence of these costs provide a critical motivation for financial innovation,⁷⁰ and various empirical studies have found that transaction costs in fact are

⁶⁸ PEU Report, *Carlyle’s “Cash Tax Savings” Won’t Got to Unit Holders*, May 5, 2012 available at <http://peureport.blogspot.com/2012/05/carlyles-cash-tax-savings-wont-go-to.html>

⁶⁹ Nigle Jenkinson, Adrian Penalver, and Nicholas Vause, *Financial Innovation: What Have We Learnt*, 2008 QUARTERLY BULL. 330 (2008) (financial engineering can improve options for households and companies but can also create market imperfections);

⁷⁰ Tufano, at p.14-16; R.C. Merton, *On the Application of the Continuous Time Theory of Finance to Financial Intermediation and Insurance*, 14 GENEVA PAPERS ON RISK AND INSURANCE 225 (1989).

the causal mechanism for specific innovations.⁷¹ The TRA, however, *creates* complexity and thus requires supercharged IPO investors to *incur* costs beyond the price paid for shares simply to understand the nature of the deal. A complicated deal may, in turn, lead IPO investors to discount the price they are willing to pay given the extra time and energy spent analyzing documents or, alternatively, if they simply do not understand fully the agreement. The transaction costs associated with the TRA raise the question of why the owner-founders would risk market punishment in the form of a lower price paid for the shares in the IPO?

On the one hand, if the tax and accounting rules together make supercharged IPOs a good idea, then the owner-founders would reasonably pursue a TRA even if it increases transaction costs and leads to a lower price for the shares. This lower price is, once again, a possible reason for the uneven division of benefits between the parties. The owner-founders need to recover the tax costs associated with permitting Public Co. to have access to the tax benefits, but they also must be compensated if investors impose unreasonable punishment for assets that they do not fully comprehend but nonetheless ultimately own.

On the other hand, IPOs in general tend to be complex deals. If the investors have already taken a leap of faith despite this complexity, or have already discounted the price as a form of market punishment for the complexity, then adding an additional nuance in the form of a TRA may be rational on the theory that the owner-founders are not likely to suffer further penalty by way of an additional purchase price reduction. Imbedding a TRA into the deal, in short, may be an easy means for the owner-founders to extract money from Public Co. in the post-IPO period without further punishment—support for the critics’ view that the plan is “underhanded.”

5. *The Macroeconomy*

Up to this point in our analysis, we have considered factors that operate in unique ways on the specific parties involved in the transaction, but other macro-level variables beyond the parties control may also affect the choice to supercharge an IPO. Various scholars have argued that market factors are an important stimulus to financial innovation generally. They argue that a growing economy generates high profit levels along with high levels of *expected* profits, which then impels creative financing, new instruments, and an overall bubble of financial innovation to achieve those profits.⁷² Advocates of the

⁷¹ J.J. McConnell and E.S. Schwartz, *The Origins of LYONS: A Case Study in Financial Innovation*, 4 J. OF APP. CORP. FINANCE 40 (1992). Credit scoring is the process of assigning a single quantitative measure to a potential borrower representing an estimate of the borrower’s future loan performance. This innovation allows credits to lend and monitor loans without meeting the borrower and cheaper, better information will make it more likely that the lender will price loans based on expected risk rather than refusing to loan monies. 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. OF BUS. 577, 579-80 (2005); Tufano, at page 16 (ATMs, smart cards, and other examples).

⁷² See David A. Zalewski and Charles J. Whalen, *Incorporating Subsidiary into Macroeconomic Policy*, in FINANCIAL INSTABILITY AND ECONOMIC SECURITY AFTER THE GREAT RECESSION, CHARLES J. WHALER, ED (2011) (discussing rediscovery of early theorists such Hyman Minsky). HYMAN MINSKY, STABILIZING AN UNSTABLE ECONOMY (1986); Hyman Minsky, *Evolution of Financial Institutions*, 20 J. OF ECON. ISSUES 345 (1986); Irving Fisher, *The Debt Deflation Theory of Great Depressions*, 1 ECONOMETRICA 337 (1933); WESLEY C. MITCHELL, *BUSINESS CYCLES* (1913). For useful summaries and extensions of Minsky’s work, see Michael Carter, *Financial Innovation and Financial Fragility*, 23

theory argue that new inventions are necessary to generate the increased profits expected by investors, who themselves are willing take on greater and greater risks to achieve their goals and aims.⁷³ This would suggest that a growing market economy may have boosted the owner-founders incentive to find additional means to generate returns for their public investors—the supercharged IPO and its tax-efficient outcome accomplished just this.

Others argue that whether or not the business cycle is expanding or contracting, market participants will innovate in order improve performance and maintain a competitive advantage—a position that can only be maintained with ceaseless innovation and improvement of products and processes.⁷⁴ This theory implies that macroeconomy will not affect the pace of innovation and will have no affect on the parties' choice to pursue a conventional or supercharged IPO.

B. The Diffusion of Financial Discoveries

We now turn from the drivers of financial engineering, to its diffusion. Many scholars have noted that successful financial innovation tends to spread, and have offered theories for how and why this happens. Indeed, notwithstanding the drawbacks associated with their complexity and the criticisms they generate, Robert Willens notes that supercharged IPOs along with the attendant TRAs are becoming “almost standard procedure in these types of incorporations.”⁷⁵ In this section, we discuss the mechanisms by which the supercharged IPOs may have diffused since the first deal emerged in 1993.

1. Geographic Clusters

Firms that are located in close geographic proximity are well positioned to share, or simply observe, new and successful ideas and products. For this reason, scholars have noted that financial innovation tends to spread first in local markets, and later into

J. of ECON. ISSUES 779 (1989); Marc Jarsulic, *Financial Instability and Income Distribution*, 22 J. ECON. ISSUES 545 (1988). See also Michael D. Bordo, *An Historical Perspective on the Crisis of 2007-2008*, NBER Working Paper 1459 (Dec. 2008) (arguing that scholars as early as Wesley Mitchell in 1913 argued that business cycle upswings lead to financial innovation) available at <http://www.nber.org/papers/w14569.pdf>; see also Richard Bookstaber, *Fighting Demons: Addressing the Perils of Financial Innovation*, 29 MULTINATIONAL MONITOR 55, 57 (2008) (often hedge fund managers are faced with the choice of increasing leverage to meet target returns or see his business diminish. There are thus strong incentives to push leverage to the edge).

⁷³ Recently, theorists have argued that a economic expansion and the desire for continually increasing profits led individuals and firms to innovate in the banking industry causing the well-known savings and loans crisis in the 1970s and subprime mortgage in 2007-2008. See Janet L. Yellen, *A Minsky-Meltdown: Lessons For Central Bankers*, President's Speech to the 18th Annual Human P. Minsky conference on the state of the U.S. and World Economics available at <http://www.frbsf.org/news/speeches/2009/0416.html>. Some theorists suggest a feedback loop may exist: financial innovation responds to volatile markets, which then become less volatile because of the innovation. See Karen E. Dynan, Douglas Elmendorf and Daniel E. Sichel, *Can Financial Innovation Help to Explain the Reduced Volatility of Economic Activity?*, 53 J. OF MONETARY ECON. 123 (2006)

⁷⁴ Mahbrouk Abir and Mamoghli Chokri, *Dynamic Financial Innovation and Performance of Banking Firms: Context of an Emerging Banking Industry*, 51 INT'L RES. J. OF FINANCE AND ECON. 17, 18 (2010) (innovation necessary for competitive advantage); M.E Porter, *Competitive Strategy* (2004); P.W Roberts and R Amit, *The Dynamics of Innovative Activity and Competitive Advantage: The Case of Australian Retail Banking, 1981-1995*, 14 ORGANIZATION SCI. 107 (2003) (innovation key for competitive advantage).

⁷⁵ Robert Willens, "Up-C" Incorporations Feature "Tax Receivable Agreements," Vol. 5, Issue 135 (July 15, 2011).

national and global markets. This theory implies that the early adherents to the supercharged IPO are likely to be companies that are located within the same region as the company that first adopted the TRA. Cooper Industries, a company located in Houston, engineered the first supercharged IPO,⁷⁶ and thus we expect that various other companies in the South may also have been early adopters if geography in fact facilitates diffusion in the context of supercharged IPOs.

2. Industry Culture

Certain industries are known to be particularly innovative and to value financial engineering as a means to retain a competitive edge.⁷⁷ Private equity and asset management firms, for example, are widely viewed to be aggressive planners in both the tax and accounting spheres—and, indeed, the innovation spiral described in the last section was engineered with the help of private equity firms seeking to enhance the benefits of the supercharged IPO. The principals of these firms often have substantial experience structuring deals, and for this reason have a deep understanding of the stakes involved in the deal. Because of their chosen line of work, private equity and hedge fund managers exhibit a high level of tax sophistication and thus it is likely that irrespective of geography, they will be early adopters of good innovations in the IPO context.⁷⁸

3. Firm Organization

Individual firms must choose how they will organize for purposes of doing business. Historically, most firms organized as a corporate entity under state law, but more recently owner-founders have preferred to organize as partnership. There are numerous important differences to this choice, but for our purposes it useful to note that partnerships, while substantially more complex, are widely viewed as more flexible than corporations, and at the same time are thought to give rise to many more tax planning opportunities. Principals who run firms that are organized as partnerships may be more tolerant of complex deals and strategies, or they may have chosen to operate (and continue to operate) in partnership form in order to take advantage of tax planning opportunities. We predict this may be true regardless of geography and industry; partnerships exist all over the globe and operate in a wide range of industries including, private equity, real estate, oil and gas, and cleantech.

While seasoned domestic and multinational corporations certainly engage in complex planning activities, we expect these types of aggressive and risky activities are

⁷⁶ Amy S. Elliot, *IPO Agreements That Shift Basis Step-Up to Sellers Proliferate*, Tax Notes 334 (2011).

⁷⁷ Institutional and cultural constraints in general may also help explain why some companies adopt innovative tax structures and some do not. While measuring the precise impact of these factors is challenging, seasoned practitioners often point to variation in corporate culture or managerial sophistication to explain how different clients react to new tax ideas. Some academic research backs this common observation. When the Sarbanes-Oxley legislation changed internal auditing controls—and reined in Enron-style corporate culture—the use of corporate tax shelters declined significantly. Victor Fleischer, *Options Backdating, Tax Shelters, and Corporate Culture*, 26 VA. TAX REV. 1031 (2006). Managerial sophistication matters too: Private equity-backed companies tend to be more aggressive in their tax planning. See Sharon P. Katz, Brad Badertscher, *The Impact of Private Equity Ownership on Portfolio Firms' Corporate Tax Planning* — HBS Working Knowledge (August 28, 2009), <http://hbswk.hbs.edu/item/6259.html> (last visited August 29, 2011).

⁷⁸ This prediction is analogous to predicting that when a cutting-edge oncologist is a patient herself, she will tend to choose a more aggressive form of cancer treatment than the average patient would. [cite]

less common among start-up corporations that go public in the context of an IPO than the organizations operating as partnership. Finally, the partnership structure gives Public Co. the ability to take the basis step-up on a rolling basis as partners sell to the public over the course of time.⁷⁹ Although other deal structures enable corporations to take advantage of the basis step-up over time, the early supercharged IPOs required corporations to elect a taxable structure on an all-or-nothing basis, which may not have pleased founders who planned to hold their shares and would have preferred to defer unrealized gains indefinitely.⁸⁰

4. Elite Lawyering

TRAs are a legal innovation, coming into widespread use in 2007 after the tax and accounting reforms were firmly in place. The quality of the lawyers working on the deal may be a strong predictor for the presence of innovative deal structuring on the theory that this group closely tracks any and all reforms that could affect deals and deal structures. More specifically, we would expect that the more creative, sophisticated and experienced the practitioner, the more advanced the deal structure should be. Over time, of course, a useful innovation would be expected to diffuse more widely and become standard, as with poison pills and other anti-takeover devices, but the early adopters are likely to be elite lawyers who spend time and energy engineering the best deal possible for their clients.⁸¹

5. Media Attention

Supercharged IPOs have received substantial critical attention in popular journals, and extensive commentary on this new-style deal has also appeared in specialized legal, tax, and accounting outlets. This attention and interest, while both positive and negative, works to educate firms, lawyers, and financial intermediaries on the latest and most innovative deal structures. Whether or not the innovation is in fact advantageous to all the parties or solely to the owner-founders of the company, we expect

⁷⁹ If the sponsor is a partnership, historic partners can hold on to control of Public Co., and they trigger a basis step up (and pay tax on unrealized gains) if and only if they exchange their partnership interests for Public Co. stock. C Corps who have shareholders with heterogeneous preferences for continued investment in Public Co. may have trouble getting to agreement on a taxable deal, while in similar circumstances historic partnerships might not. Furthermore, regardless of the industry, managers who operate a partnership are likely to have greater tax sophistication. The variable *partnership* is coded equal to 1 if the operating company of the issuer is a partnership (for tax purposes) prior to the IPO, even if the issuer is incorporating as part of the IPO, and equal to 0 otherwise. For the reasons just explained, we expect this will correlate positively with the presence of a TRA.

⁸⁰ The increase in the number of companies that operate in partnership form prior to going public may have led more IPO issuers to think about taxable deals. Indeed, partnerships have become firmly integrated into the public capital markets—and in some contexts, such as the Blackstone deal—the parties literally succeed in taking a partnership vehicle public. See Eric Sloan, *Partnerships in the Public Space*, in PLI, THE CORPORATE TAX PRACTICE SERIES: STRATEGIES FOR ACQUISITIONS, DISPOSITIONS, 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*, in PLI, THE CORPORATE TAX PRACTICE SERIES: STRATEGIES FOR ACQUISITIONS, DISPOSITIONS, SPIN-OFFS, JOINT VENTURES, FINANCINGS, REORGANIZATIONS & RESTRUCTURINGS, VOL. 8 (2010) [hereinafter, *Thinking Outside the Box*].

⁸¹ [Cite to article about Cravath partner's innovation in the legal context.]

that as media attention increases—so too the use of the supercharged IPO along with the complex TRA.

IV. AN EMPIRICAL INVESTIGATION

We have explained how the supercharged IPO differs from the conventional IPO, we have investigated the rationales (both just and unjust) for choosing a complex TRA over a simply payout scheme, and now we turn to the empirical component of our project. In this section, we rely on the theories presented above to develop a statistical model in an effort to understand and explain the parties choice to pursue the supercharged IPO and the TRA, and describe the process by which this innovation spread across geographic areas, industries, and firms.

A. A Statistical Model

In order to can conceptualize our empirical investigation, consider the following statistical model:

$$\begin{aligned} \text{Pr}(\text{TRA}_i=1) = & b_0 + b_1\text{TaxArbitrage}_i + b_2\text{BigBasis}_i + b_3\text{Post2001}_i + b_4\text{HighRisk}_i + \\ & b_5\text{NeedlesslyComplex}_i + b_6\text{Macroeconomy}_i + b_7\text{Geography}_i + \\ & b_8\text{Industry}_i + b_9\text{FirmType}_i + b_{10}\text{EliteLawyer}_i + b_{11}\text{Media} + \\ & \sum b_j C_{ij} + e \end{aligned} \quad (1)$$

where TRA_i in equation (1) is the parties' decision to supercharge the IPO with a tax receivable agreement, and is coded equal to 1 if the TRA is present in the deal and equal to 0 otherwise. Imbedded in this model are eleven hypotheses, which we explain immediately below.

1. The Innovation Drivers: Six Hypotheses

Our first hypothesis relates to the parties' tax arbitrage opportunities. If the tax rate on the owner-founders is lower than that imposed on Public Co., then the value of the deductions taken by Public Co. will exceed the tax costs imposed on the owner-founders and, in these circumstances, we expect the parties to favor of a supercharged IPO.⁸² We test this theory with variable, *Arbitrage*_i, a continuous variable that reflects the tax rate gap, if any, between the capital gains rate imposed upon owner-founders and corporate rate imposed upon Public Co at the time of the IPO. Second, we hypothesize that the parties will not engage in complex tax planning unless the overall tax saving is significant. The specific tax benefits for each firm will vary depending on the size of the basis associated with the assets by Public Co., a number that we cannot directly

⁸² To test our theory of tax arbitrage, we will create the variable, *arbitrage*, reflecting the difference between corporate and capital gains taxation rates. We expect a large and positive difference in these rates (corporate rates are higher than individual capital gains rates) will generate an increase in the TRAs because the seller's cost of paying taxes will be low and the investors' benefit of a stepped up basis followed by large depreciation deductions will be high.

observe.⁸³ As a proxy, we created the variable *BigBasis_i*, which is continuous and measures the market value of the firm (based on post-IPO trading) less the net book value of the firm (book assets less book liabilities at the time of the IPO).⁸⁴ If the IPO were structured as a taxable deal, this amount would correlate well with the amount of the potential basis step-up attributable to goodwill, often the most valuable asset in an IPO.⁸⁵ Third, we expect that firms will be particularly motivated to utilize the supercharged IPO after the year 2001, when both the tax and accounting reforms are firmly in place. We investigate this theory with *Post2001_i*, a dichotomous variable equal to 1 if the date is equal to 2001 or later, and equal to 0 otherwise.

The parties will want to supercharge their IPO to gain access to valuable tax assets, but they will also want to avoid the risks associated with tax increases on the owner-founders as well as IRS scrutiny of large tax deductions taken by Public Co. As discussed above, the parties have structured the deal with the help of the TRA and the fifteen-year payout to insure against these risks. It is not possible, of course, to get into the parties' minds in order to empirically investigate whether the deal structure was in fact motivated by these threats, but we do know that tax rates and corporate audits tend to increase during Democratic administrations. Accordingly, we rely on *Risk_i*, a dichotomous variable equal to 1 if a Democratic president is in power and equal to 0 if the president is a Republican.

Our first four hypotheses forecast that b_1, b_2, b_3 , and $b_4 > 0$. If the coefficients on these variables are not positive, then these factors do not play the expected role in the parties' decision to adopt a supercharged IPO. Indeed, if b_1, b_2, b_3 , and $b_4 \leq 0$, the evidence may favor the critics' interpretation of these deals: owner-founders do not appear to be motivated by a desire to reduce taxes and save investors money, but perhaps the desire to extract large sums from Public Co. irrespective of the effect on investors. In an effort to dig deeper into this theory of potential misconduct, we created the variable, *NeedlesslyComplex_i*, which is continuous and measures the number of pages in the IPO public filings. As the page number increases, the temptation to execute a TRA will increase on the theory that public investors will neither observe nor understand the additional component imbedded in the deal. We expect a pre-existing complicated deal structure to enable owner-founders to add a TRA without incurring market sanctions associated with a decrease in the price paid for Public Co.'s shares. If this type of bad behavior is present, we expect $b_5 > 0$, if $b_5 < 0$, then complex deals actually discourage the use of the TRAs perhaps for fear of market punishment or perceived improprieties.

⁸³ Firms also vary in their expected marginal tax rate going forward. For firms that do not expect to have taxable income for a long time, a basis step-up is not worth very much. While NOLs can be carried forward, the discounted present value of such tax savings can be small, and is often assumed to be zero on the firm's financial statements. Specifically, the issuer must assess the likelihood that any deferred tax assets will be used and report a valuation allowance on the financial statements. Because a large number of firms use a valuation allowance of 100%—under the accounting rules, an indication that the value of the reported tax shield is not “more likely than not” to be realized—we use a dummy variable to indicate firms with a valuation allowance of 100%.

⁸⁴ Our measure of market capitalization is incomplete. We gathered data from the CRSP database (Daily Stock File) where possible, and from the website YCharts for firms where CRSP data was missing. Additionally, some firms in the sample withdrew their IPO offerings because of market conditions or other reasons, and so no measure of market value is available.

⁸⁵ We plan to check the accuracy of this proxy for the firms that use a TRA by looking at the firm's reported amount for deferred tax assets as a measure of the value of the basis step-up. We will then gross up that figure by dividing that amount by the percentage of the firm sold in the offering.

Finally, with respect to the incentives to innovate and discover in the financial context, our sixth hypothesis involves the variable economic growth. Some argued that growth will inspire financial innovation, but others argue market factors will have no affect at all given the desire to innovate in all market contexts. We test these views with the help of *Macroeconomy_i*, a dichotomous variable that measures whether the economy is growing or shrinking as assessed by the NBER. We expect $b_6 \geq 0$ given the two theories just noted, but do not expect that a contracting economy will promote financial innovation in the IPO context.

B. The Diffusion Process: Five Hypotheses

After 1993, supercharged IPOs became more prevalent and seemed to flourish after 2005. Indeed, as noted above, notwithstanding the drawbacks associated with their complexity and the criticisms they generate, Robert Willens notes that supercharged IPOs along with the attendant TRAs have become “almost standard procedure in these types of incorporations.”⁸⁶ In this section, we discuss the mechanisms by which the supercharged IPOs may have diffused since the first deal emerged in 1993.

Our first hypothesis relates to the role of geography. We expect that firms located in the southern part of the country will be early adopters of the supercharged IPO given their proximity to Cooper Industries, located in Houston and the first firm to eschew the conventional IPO. We rely on *Geography_i*, a dichotomous variable that is equal to 1 if the firm is located in the South and equal to 0 otherwise. We also expect that certain industries—those known to be particularly aggressive and innovative—will be early adopters of the supercharged IPO. The variable, *Industry_i*, is a dichotomous variable that is equal to 1 if the firm is a private equity firm and equal to 0 otherwise. We also expect that firms organized as a partnership, regardless of industry and geographic location, will also be more likely to adopt the supercharged IPO. The variable, *FirmType_i*, is dichotomous and equal to 1 if the firm is a partnership and equal to 0 otherwise. Elite lawyers, known for their innovative deal structures are also more likely to observed and adopt to deal structures. The variable *EliteLawyer_i*, is dichotomous and equal to 1 if the lawyer on the deal is from an elite firm and equal to 0 otherwise.⁸⁷ Finally, we expect that media attention will promote the use of the supercharged IPO. We test this hypotheses, with the variable *Media_i*, a continuous variable that measures the extent of media coverage in national journals (both popular and those geared to tax, accounting, and banking audiences) the supercharged IPOs. We expect b_7, b_8, b_9, b_{10} and $b_{11} > 0$.

3. Control Set

In addition to the explanatory variables just described, we have a series of control variables in our model. Our control set includes *net tax assets*, which is a continuous variable that captures an asset on the company’s balance sheet that may be used in the

⁸⁶ Robert Willens, "Up-C" Incorporations Feature "Tax Receivable Agreements," Vol. 5, Issue 135 (July 15, 2011).

⁸⁷ Chambers and Partners identified 5 law firms in the top tier: Cleary Gottlieb Steen & Hamilton; Davis Polk & Wardwell; Skadden, Arps, Slate, Meagher & Flom; Sullivan & Cromwell; and Wachtell, Lipton, Rosen & Katz. Chambers identified 6 law firms in the second tier: Cravath, Swaine & Moore; Debevoise & Plimpton; Kirkland & Ellis; Latham & Watkins; Simpson Thacher & Bartlett; and Weil, Gotshal & Manges. For the ranking methodology, please consult <http://www.chambersandpartners.com/Rankings-Explained>

future to reduce taxes. In some cases, a firm may have substantial deferred tax assets from NOLs, and a TRA may allow the IPO sponsors to capture that value. We include the variable as a means to capture the TRAs that are not associated with a basis step up but with NOLs. Net tax assets are revealed on the SEC form S-1 and can be negative, positive, or equal to 0. We also included controls for the size of the firm as measured by the *market capitalization* post-IPO, and a *time trend* based on the filing date of the first S-1.

C. The Data and the Empirical Findings

For purposes of our empirical investigation, we examined the IPOs that took place between January 1, 1990 and May 1, 2011. We selected this time period in part because the conventional wisdom holds that TRAs first emerged in force in 1993, and we wanted to be sure to capture as many early tax-sharing agreements as possible.⁸⁸ Moreover, if an environmental change (such as in the accounting, tax, or business context) sparked the use of TRAs in 2007, including earlier years in our dataset will enable us to observe relevant shifts.

To identify the population of interest, we obtained the registration statements under the Securities and Exchange Act of 1933, also known as the SEC form S-1, for each new securities offering.⁸⁹ Because we are interested in initial public offerings of equity securities where the investors implicitly price the assets and liabilities of the issuer (including tax assets and liabilities),⁹⁰ we excluded all debt offerings, secondary offerings, SPACs, offerings that would trade on OTCBB, Pink Sheets, penny stock offerings (\$1 or under), 401k plan offerings, and offerings of non-operating companies (mutual funds, ETFs, commodity pools). This process generated 1326 IPOs between the years 2004-2011.

Our goal is to understand and explain why some but not all IPOs include a TRA; thus, our dependent variable is the presence of a TRA. The SEC form S-1 requires companies to provide an array of information about the issuer, along with a complete description of the sale terms; TRAs are disclosed and attached as an exhibit to the form S-1. We examined each form and coded our binary variable, TRA, equal to 1 if the agreement was present and equal to 0 otherwise.⁹¹

[In this part, we plan to present summary statistics, our empirical findings, and analyses]

CONCLUSION

[In this part, we will summarize our theory and results]

⁸⁸ As noted above, however, the earliest TRA emerged in 2004. See discussion *supra*.

⁸⁹ We identified all S-1s from the Knowledge Mosaic database available at <http://www.knowledgemosaic.com/net/home/kmhome.aspx>

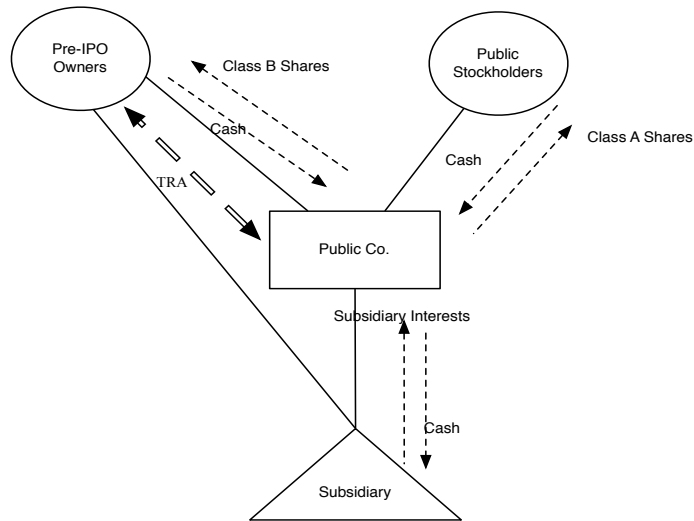
⁹⁰ We are not interested in secondary offerings, private or PORTAL offerings, and do not care whether the IPO was successful or not.

⁹¹ We searched each form S-1 for the specific terms: *tax receivable agreement*. This approach excluded similar economic arrangements styled “tax matters agreements” or “tax sharing agreements.” This approach also excluded one observation in which the issuer was a payee (AMC).

APPENDIX

[In this part we will provide details on the innovation spiral in the supercharged IPO context]

1. Supercharged IPO with TRA and Two Classes of Stock



2. Publicly Traded Partnership with TRA

