Private Benefits in Public Offerings: Tax Receivable Agreements in IPOs

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Historically, an initial public offering ("IPO") was a process whereby a company sold all of its underlying assets to the public. A new tax innovation, the "tax receivable agreement" ("TRA"), creates private tax benefits in public offerings by allowing pre-IPO owners to effectively keep valuable tax assets for themselves while selling the rest of the company to the public.

Prior to 2005, TRAs were almost never used in IPOs. Today they have become commonplace, changing the landscape of the IPO market in ways that are likely to become even more pronounced in the future. This Article traces the history of various iterations of TRAs and shows that a new generation of more aggressive TRAs has recently developed. Although TRAs were historically used only for a small subset of companies with a certain tax profile, the new generation of innovative and aggressive TRAs can be used by virtually any company conducting an IPO, greatly expanding the potential use of TRAs.

TRAs have been described by a few critics as "bizarre" and "underhanded," yet the economic and tax consequences of the different types of TRAs have gone mostly unexplored in the literature. This Article explores whether critics' comments regarding TRAs have merit, or whether TRAs are simply an efficient contract between pre-IPO owners and public companies. It examines TRAs within the larger landscape of financial transactions, showing that the way TRAs are used in the public market deviates from similar private transactions in ways that are likely detrimental to public shareholders. This Article also shows how the Up-C, a type of IPO transaction where TRAs are most commonly used, allows pre-IPO owners to take money that should be earmarked for

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public shareholders in undisclosed ways and proposes remedies for this problem.

INTRODUCTION

Traditionally, an initial public offering ("IPO") was a relatively straightforward transaction: pre-IPO owners sold shares of a company to the public, turning a privately held company into a publicly held company. In these traditional IPOs, the interests that the pre-IPO owners sold to the public represented shares in the whole publicly traded company. Recently, pre-IPO owners have found a way to *keep a part* of the value of the company for themselves through a new tax innovation, the tax receivable agreement ("TRA"), allowing pre-IPO owners to extract billions of dollars from newly public companies.[1]

1. *See* Victor Fleischer & Nancy Staudt, *The Supercharged IPO*, 67 VAND. L. REV. 307, 307 (2014) ("A new innovation on the IPO landscape has emerged in the last two decades, allowing owner-founders to extract billions of dollars from newly public companies."); Howard Jones & Rüdiger Stucke, *A Cheaper Way to Do IPOs*, HARV. BUS. REV., Nov. 2013, https://hbr.org/2013/11/a-cheaper-way-to-do-ipos [https://perma.cc/9JCP-QRGU] (showing an additional $1 billion of gain for pre-IPO owners in just five IPOs that used TRAs); Vistra Energy Corp., Registration Statement (Form S-1/A) (May 1, 2017), https://www.sec.gov/Archives/edgar/data/1692819/000119312517152235/d312912ds1a.htm [https://perma.cc/HX48-LVZA] [hereinafter Vistra

Commentators have described TRAs as "underhanded,"[2] "a one-sided relationship,"[3] "a tax scheme . . . that does not pass the smell test,"[4] and a "bizarre siphoning of cash,"[5] and have stated that a TRA "drains money out of the company that could be used for purposes that benefit all the shareholders."[6] When Hostess recently used a TRA in its IPO, commentators aptly described the transaction as "selling your Twinkie and eating it too."[7]

TRAs have steadily and rapidly become an integral part of the IPO market. Prior to 2005, TRAs were used in less than one percent of IPOs. The use of TRAs has steadily increased, and companies now use TRAs in over eight percent of IPOs.[8] Although TRAs have received some media attention, and a few scholars have discussed TRAs in articles that more broadly focus on "supercharged" IPOs, no article has critically examined the various kinds of TRAs in depth.[9] This lack of critical

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Energy Corp. Registration Statement] ("The aggregate amount of undiscounted payments under the TRA is estimated to be approximately $2.1 billion . . . ."). To the extent an IPO involves a "step up" in basis, economically, some of the value that the pre-IPO owners receive under a TRA comes from the federal government. *See infra* Part I.

2. Amy S. Elliott, *IPO Agreements that Shift Basis Step-Up to Sellers Proliferate*, 132 TAX NOTES 334, 334 (2011) (quoting Robert Willens).

3. *Blackstone Partners May Avoid Tax on IPO Gains*, REUTERS (July 13, 2007, 8:23 AM), http://www.reuters.com/article/2007/07/13/us-blackstone-tax-idUSN1325038320070713 [https://perma.cc/RAE5-E39Q] [hereinafter *Blackstone Partners*] (quoting Lee Sheppard).

4. Yves Smith, *Another Private Equity Scam—Tax Receivable Agreements*, NAKED CAPITALISM (Aug. 3, 2014), http://www.nakedcapitalism.com/2015/08/another-private-equity-scam-tax-receivable-agreements.html [https://perma.cc/GXU8-GMQS].

5. *Carlyle's "Cash Tax Savings" Won't Go to Unit Holders*, PEU REP. (May 5, 2012), http://peureport.blogspot.com/2012/05/carlyles-cash-tax-savings-wont-go-to.html [https://perma.cc/WJ2J-ZT7C] [hereinafter *Carlyle's "Cash Tax Savings"*].

6. Lynnley Browning, *Squeezing out Cash Long After the I.P.O.*, N.Y. TIMES: DEALBOOK (Mar. 13, 2013, 6:26 PM), https://dealbook.nytimes.com/2013/03/13/private-equity-squeezes-out-cash-long-after-its-exit/ [https://perma.cc/JKJ9-P8E5] (quoting Robert Willens).

7. *See* Alan S. Kaden & Michael J. Alter, *Selling Your Twinkie and Eating It Too*, LAW360 (July 18, 2016, 10:55 AM), https://www.law360.com/articles/818198/selling-your-twinkie-and-eating-it-too [https://perma.cc/6AQ2-X3FU] (discussing Hostess's recent use of a TRA).

8. In 2017, 153 companies went public in an IPO, and thirteen (i.e., 8.5 percent) of those companies used TRAs. *See infra* Figure 1; *see also* Tom Zanki, *Up-C IPOs Quietly Gaining Traction During Market Lull*, LAW360 (Feb. 23, 2016, 6:26 PM), https://www.law360.com/articles/761721/up-c-ipos-quietly-gaining-traction-during-market-lull [https://perma.cc/W9FC-V7C2] (showing that Up-C IPOs, which almost always use a TRA but are not the only type of IPO to use a TRA, accounted for over five percent of the IPO market in 2013, 2014, and 2015).

9. *See* Gladriel Shobe, *Supercharged IPOs and the Up-C*, 88 U. COLO. L. REV. 913, 941 (2017) ("Although tax receivable agreements are an important and controversial aspect of most supercharged IPOs . . . their mechanics and normative desirability are complicated enough to warrant a separate discussion, and thus are not central to the focus of this Article."); *see also* Ian Fontana Brown, *The Up-C IPO and Tax Receivable Agreements: Legal Loophole?*, 156 TAX NOTES 859 (2017) (discussing the use of the Up-C for IPOs); Fleischer & Staudt, *supra* note 1, at 307 (analyzing TRAs within the context of supercharged IPOs); Christopher B. Grady, Note, *Finding the Pearl in the Oyster: Supercharging IPOs Through Tax Receivable Agreements*, 111 NW. U. L. REV. 483, 484 (2017) (discussing TRAs in the context of supercharged IPOs); Alexander Edwards

attention to TRAs has allowed both innovative and troubling aspects of these transactions to go undetected by the media, the government, and scholars.[10]

By taking the first deep dive into TRAs, this Article brings to light inventive and aggressive uses of TRAs. It explores the evolution of TRAs through what this Article calls three "generations" of TRAs, showing how each generation significantly expanded the ways in which pre-IPO owners can take value from public companies. As part of this analysis, it brings to light an important new category of TRA—the "third generation" TRA that very recently appeared on the IPO market. This new type of TRA is unlike its predecessors, which could only be used for companies with a specific tax profile, in that it can be used in virtually any IPO. This new development marks a turning point in the IPO landscape and greatly expands the potential use of TRAs in the IPO market.[11] Because scholars have almost exclusively discussed TRAs in the context of supercharged IPOs, they have missed this new and expansive way that TRAs have been used outside the context of supercharged IPOs.[12]

How do TRAs work? As the name "tax receivable agreement" implies, a TRA is a contract between a public company and its pre-IPO owners that shifts tax assets from the newly public company to its pre-IPO owners, allowing pre-IPO owners to "keep" certain tax assets for themselves as the company goes public.[13] The way this works is that tax assets reduce the amount of tax the public company owes each year that the public company has taxable income. Under a TRA, each year the public company uses certain tax assets to reduce its tax bill, the

et al., *The Pricing and Performance of Supercharged IPOs* (Rotman Sch. of Mgmt., Working Paper No. 2725531, 2017), https://papers.ssrn.com/sol3/Papers.cfm?abstract_id=2725531## [https://perma.cc/KJA4-M6SD] (examining TRAs and offering prices); Gregg D. Polsky & Adam H. Rosenzweig, *The Up-C Revolution* (Univ. of Ga. Sch. of Law Legal Studies Research Paper No. 2016-40, 2016), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2851872 [https://perma.cc/E2YX-GM9M] (critiquing TRAs within the context of the Up-C, the most common type of supercharged IPO).

10. *See infra* Part III (discussing issues with double tax distributions); *see also infra* notes 98–103 (discussing innovative aspects of the SkinnyPop and Vistra IPOs).

11. *See infra* Section I.B (discussing the origin and evolution of TRAs).

12. *See infra* Section I.B.3 (discussing new uses of TRAs outside the scope of supercharged IPOs). There has been a general trend toward using TRAs independently of supercharged IPOs. In the past eighteen months, five companies—The Simply Good Foods Co., Vistra Energy Corp, Foundation Building Materials, Inc., AdvancePierre Foods Holdings, Inc., and Forterra, Inc.—have used TRAs in non-supercharged IPOs. *See, e.g.*, Foundation Building Materials, Inc., Registration Statement (Form S-1) (Jan. 13, 2017), https://www.sec.gov/Archives/edgar/data/1688941/000119312517009960/d264719ds1.htm [https://perma.cc/86VT-XMXK] (discussing the corporation's use of a TRA).

13. *See* MARTIN D. GINSBURG ET AL., MERGERS, ACQUISITIONS, AND BUYOUTS ¶ 405 (Mar. ed. 2016) (discussing IPOs and tax implications).

public company pays the amount of that benefit (or some portion of that benefit) to the pre-IPO owners.[14] Although the tax assets technically stay with the public company, in substance, a TRA shifts the value of the tax assets to the pre-IPO owners by requiring the public company to pay the pre-IPO owners for the value of the tax assets as they are realized over time.[15]

What is the controversy over TRAs? Critics argue that TRAs transfer significant amounts of wealth from public companies to pre-IPO shareholders in ways that the public may not be able to understand because TRAs are complicated and involve "opaque secretive financial engineering."[16] However, those who defend TRAs claim that *without* a TRA, public shareholders actually "rip off" pre-IPO owners because, the argument goes, the public does not pay full value for tax assets in an IPO.[17] In other words, the argument in favor of TRAs is that they are an efficient means of "assuring [pre-IPO owners] receive a fair price for their business."[18] This Article considers the merits of these claims and analyzes whether TRAs help owners achieve a "fair" price, or whether it causes them to receive something more.[19] Although it is impossible to reach definitive conclusions regarding market efficiencies (or, in this case, arguable inefficiencies), the fact that pre-IPO owners almost always include TRAs for certain types of IPOs, and have recently begun to use TRAs in other types of IPOs, clearly shows that many pre-IPO owners believe that public shareholders do not perfectly price in TRAs.[20] This is true because if public investors perfectly adjusted the IPO price to account for the presence of a TRA, the TRA would serve no purpose other than to increase the administrative and legal expenses of the IPO.

14. *See infra* Section I.A (explaining the mechanics of TRAs).

15. Deborah L. Paul & Michael Sabbah, *Understanding Tax Receivable Agreements*, PRAC. L.J., June 2013, at 74, 74–75.

16. Matt Levine, *Supercharged IPOs: Like Regular IPOs, but Slower*, DEALBREAKER (Mar. 14, 2013, 4:53 PM), http://dealbreaker.com/2013/03/supercharged-ipos-like-regular-ipos-but-slower/ [https://perma.cc/M57A-N6QK].

17. Practitioners claim that tax assets are not priced into IPOs because public company valuations are often based on earnings before interest, taxes, depreciation, and amortization ("EBITDA"), which excludes both tax assets and tax liabilities. *See infra* notes 130–131 and accompanying text.

18. Fleischer & Staudt, *supra* note 1, at 324.

19. *See infra* Section II.A (analyzing whether TRAs help owners achieve a "fair" price).

20. *See* Robert Willens, *How IPO Founders Keep Their Taxes Low*, CFO (July 26, 2011), http://ww2.cfo.com/tax/2011/07/how-ipo-founders-keep-their-taxes-low/ [https://perma.cc/4TMP-9FUV] ("TRAs may be fully legal; however, the entire import of these agreements in the price of an IPO might not be fully appreciated by all investors. To the extent the TRAs are not taken into account by such shareholders, they may lead to market inefficiencies.").

This Article also presents a novel way to analyze whether TRAs underhandedly take money from public shareholders or whether they are necessary to ensure that IPOs are "fair" to pre-IPO owners by comparing TRAs to how private parties buy and sell tax assets outside the IPO context.[21] For example, when parties negotiate the sale of a company in the private sector, it is not uncommon for buyers to agree to make payments to the sellers for pre-sale tax assets as they are realized, in much the same way a TRA does. TRAs therefore may not be so bizarre, but may just be the public sector's extension of what parties were already doing in the private sector.[22] Because deals in the private sector are heavily negotiated between private parties, while TRAs are drafted solely by owners as part of the offering process of an IPO, private sector deals provide a comparison point to help determine whether the terms of TRAs are what public buyers would agree to if they were in the position to negotiate.

One important difference between TRAs and private sector deals is the reciprocity of their terms. Under a TRA, the public company is required to make payments to the pre-IPO owners for tax assets, but the pre-IPO owners have no continuing obligations to the public company for pre-IPO tax liabilities.[23] This is different from what private parties typically agree to, where buyers generally agree to pay sellers for pretransaction tax assets only if the sellers agree to indemnify the buyers for pretransaction tax liabilities.[24] If public investors do not price tax assets into an IPO, which is the common justification for a TRA, then it seems likely that public investors would not price tax liabilities into an IPO.[25] If public investors also do not adjust for the presence of a TRA, as is commonly believed, then a TRA that strips the

21. *See infra* Section II.B (comparing TRAs and private sector deals).

22. *See* Paul & Sabbah, *supra* note 15, at 75 ("Through the TRA, the IPO corporation pays for a valuable tax attribute . . . just as a buyer of assets would normally pay more than a buyer of stock because of the [tax assets] that a buyer obtains in an asset sale.").

23. *See id.* ("Under a TRA, the corporation agrees to make payments to the historic equity owners in an amount equal to a percentage of the benefit the corporation derives from certain specified tax attributes, if, as and when realized.").

24. For discussions of the negotiation process and provisions lawyers typically negotiate in private sector deals, see Evan L. Greebel, *Key Priorities for Buyers and Sellers in Acquisitions of Public and Private Companies*, *in* STRATEGIES FOR NEGOTIATING MERGERS AND ACQUISITIONS 31 (Robin V. Foster et al. eds., 2011); and Jeffrey Manns & Robert Anderson IV, *The Merger Agreement Myth*, 98 CORNELL L. REV. 1143 (2013).

25. In other circumstances, tax liabilities are also not priced into the value of securities. *See* ANDREI SHLEIFER, INEFFICIENT MARKETS: AN INTRODUCTION TO BEHAVIORAL FINANCE 23 (2000) (explaining that in mutual funds, the values of the securities are calculated based on net asset value, which does not include liabilities for capital gains tax on unrealized appreciations); Nicholas C. Barberis & Richard H. Thaler, *A Survey of Behavioral Finance*, *in* 1B HANDBOOK OF THE ECONOMICS OF FINANCE 1096 (George M. Constantinides et al. eds., 2003) (discussing pricing closed-ended funds and the effect of tax liabilities).

new public company of its pre-IPO tax assets is not just an innocent "correction" for a market inefficiency.[26] It only corrects for the market inefficiency that hurts the pre-IPO owners without accounting for the market inefficiency that hurts the public company. In light of this disparate treatment of pre-IPO tax assets and liabilities, this Article proposes ways to make TRAs better align with what parties would typically agree to in negotiated deals.

Although TRAs have generated some controversy, there is more amiss in the details of these transactions than scholars, policymakers, and the media have noticed. Thus far, public discourse regarding TRAs assumes that all the material risks associated with these transactions are disclosed to the public, and that therefore the main issue is whether the public is sophisticated enough to understand the disclosed risks.[27] This Article shows that a key material risk is not disclosed to the public in Up-C IPOs, which is the type of IPO in which TRAs are most commonly used.[28] Commentators have failed to notice that the Up-C structure allows pre-IPO owners to receive certain tax benefits *twice* at the expense of public shareholders: once in their capacity as pre-IPO owners, and then again in their capacity as public shareholders once they exchange their pre-IPO interests for shares in the public company. This Article illustrates how the Up-C can result in significant wealth transfers from public shareholders to pre-IPO owners.[29] It argues that because public companies' Securities and Exchange Commission ("SEC") filings do not disclose this wealth transfer, it is impossible for public shareholders to accurately assess the value of these public companies, and that nondisclosure of this wealth transfer from the public to pre-IPO owners therefore creates a market inefficiency that is detrimental to public shareholders.[30]

26. *See generally* Lucian A. Bebchuk, *Letting Shareholders Set the Rules*, 119 HARV. L. REV. 1784 (2006) (calling into question whether the market is able to price in available public information and stating that there is little empirical work to test whether the market accurately prices in legal arrangements).

27. *See* Elliott, *supra* note 2, at 339 ("[T]here's nothing nefarious about it. It's all disclosed." (quoting Robert Willens)).

28. *See infra* Section III.A (explaining that the Up-C structure, which is the most common type of IPO to use a TRA, almost always uses a TRA, and therefore evaluating the Up-C structure is necessary in order to thoroughly analyze the effect TRAs have on the public market).

29. *See infra* Section III.B (discussing this wealth transfer and its effects on the value of a public company).

30. *See* John C. Coffee, Jr., *Market Failure and the Economic Case for a Mandatory Disclosure System*, 70 VA. L. REV. 717, 722 (1984) (arguing in favor of mandatory disclosure in order to "improve the allocative efficiency of the capital market," which "in turn implies a more productive economy"); Merritt B. Fox et al., *Law, Share Price Accuracy, and Economic Performance: The New Evidence*, 102 MICH. L. REV. 331, 367–68 (2003) (finding that mandatory disclosure of material information improves accuracy in share pricing); Ronald Gilson & Reinier R. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 551 (1984) (discussing how accuracy in share

This Article proceeds as follows. Part I explains the basic mechanics of TRAs, explores the evolution of the three generations of TRAs, and introduces a new type of TRA that can be used in virtually any IPO. Part II analyzes whether TRAs are an underhanded tax scheme that allows pre-IPO owners to siphon money from public shareholders, or whether TRAs are a necessary tool to ensure pre-IPO owners receive fair value for their interests in a public company. It explores this question by comparing TRAs to how parties typically sell tax assets in the private sector. Part III argues that in Up-C IPOs, which almost always use a TRA, pre-IPO owners should disclose the material risk that pre-IPO owners can take funds that should have been earmarked for public shareholders.

I. TRAS 101

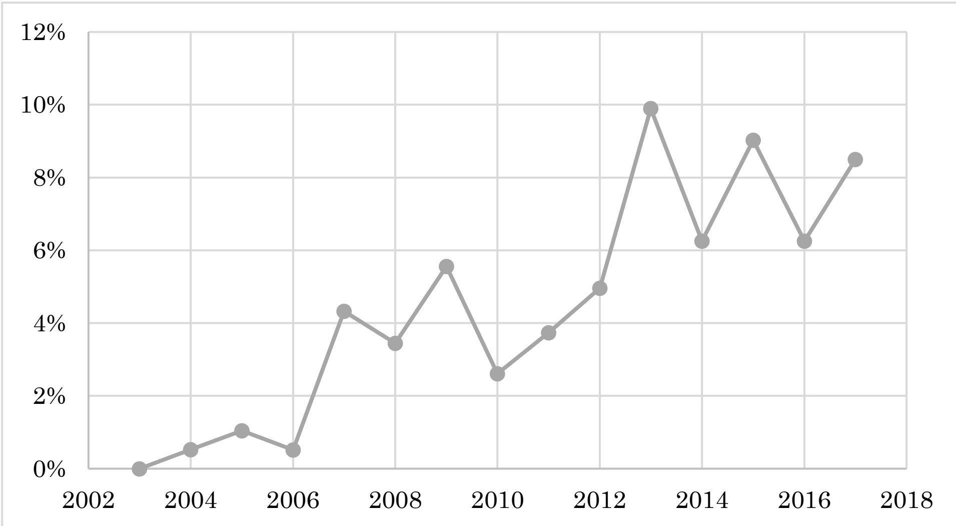
At its simplest, a TRA is a contract between pre-IPO owners and a public company that requires the public company to pay the pre-IPO owners for the tax assets covered by the TRA. The public company makes those payments over time, and the payments are based on how much the tax assets actually reduce the public company's tax liability each year. In other words, in IPOs that use TRAs, the pre-IPO owners sell everything to the public *except* for certain tax assets, and the public company ends up "paying back" the pre-IPO owners for those tax assets over time.[31]

This Part begins by discussing the basic mechanics of TRAs. It then analyzes the evolution of TRAs, which were originally used only in connection with supercharged IPOs. It shows that since 2004 TRAs have spread from less than one percent to over eight percent of the IPO market, and it presents a new "third generation" of TRAs, which can be used in virtually every IPO and which will likely contribute to the continuing popularity and spread of TRAs.

prices creates more efficient financial markets); Marcel Kahan, *Securities Laws and the Social Costs of "Inaccurate" Stock Prices*, 41 DUKE L.J. 977, 988 (1992) (discussing how securities regulation and mandatory disclosure protect market integrity and ensure more accurate share pricing).

31. *See* Jeffrey J. Rosen & Peter A. Furci, *Monetizing the Shield: Tax Receivable Agreements in Private Equity Deals*, DEBEVOISE & PLIMPTON PRIV. EQUITY REP. (Debevoise & Plimpton LLP, New York, N.Y.), Fall 2010, at 9, 9 ("[I]n a number of public offerings in recent years the pre-IPO shareholders have devised ways of retaining for themselves the economic benefits of identified tax attributes . . . with the result that the company is effectively taken public ex those attributes.").

FIGURE 1: TRAS AS A PERCENTAGE OF OVERALL IPOS[32]



A. Basic Mechanics of TRAs

To understand the purpose of a TRA, you first have to understand what pre-IPO owners are "selling" to the public in an IPO. Companies typically sell common stock to the public in an IPO, and until the invention of TRAs, common stock represented a fraction of the entire public company, including all of the public company's assets and liabilities.[33] TRAs revolutionized IPOs by splitting up the value of

32. The TRA percentage was calculated by comparing all IPOs since 1999 that used TRAs in their S-1 filings to the total population of IPOs during the same time frame. The search for the TRA population was conducted by using a custom web scraper to search the SEC's Edgar archives for all historical S-1s containing the term "tax receivable agreement." The author also used personal knowledge of the TRA market to locate additional TRAs that used terms other than "tax receivable agreement" (which appears to only have occurred in a few of the very early TRAs, before the market adopted a standardized term for these agreements). The total IPO population is derived from the Field-Ritter dataset, a spreadsheet compiled by Professor Jay Ritter from the University of Florida containing IPO data since 1975. *Founding Dates for Firms Going Public in the U.S. During 1975–2017*, https://site.warrington.ufl.edu/ritter/files/2018/01/FoundingDates.pdf (last updated Jan. 2018) [https://perma.cc/SBT7-EUQT] (link to "Excel Dataset 1975–2017" available at the bottom of the page).

33. The majority of stock issued in an IPO is common stock. However, companies often have other classes of stock (e.g., preferred stock) that differ from the common stock. Typically, the difference between the common stock and any other class of stock is that the other stock will possess different voting and economic rights. *See* Ronald J. Gilson & David M. Schizer, *Understanding Venture Capital Structure: A Tax Explanation for Convertible Preferred Stock*, 116 HARV. L. REV. 874 (2003) (explaining common stock, convertible preferred stock, and other types of stock). One could claim that the fact that companies have different classes of stock means that there are other scenarios where certain public companies sell less than the entire company. However, IPOs with TRAs are economically different than IPOs with multiple classes of stock

companies immediately before an IPO, essentially allowing pre-IPO owners to siphon off certain assets that the pre-IPO owners do not want to sell to the public. The rationale for "not selling" the entire company is that investment bankers, who help pre-IPO owners throughout the IPO process,[34] believe that one certain type of asset—the company's tax assets—is undervalued by public shareholders.[35] As discussed in Part II, investment bankers believe that public shareholders undervalue tax assets because tax assets reduce a company's tax liability in future years, and therefore it is difficult for the public to accurately value them in the year of an IPO.[36]

What are tax assets, and why are they valuable in future years?[37] Tax assets are credits, exemptions, and deductions that companies generate when they incur a capital expense rather than an immediate expense.[38] Tax assets are valuable because they allow a company to reduce its future tax liability by prorating the cost of an asset over the life of the asset.[39] For example, if an asset has a useful life of ten years, then the company will be able to depreciate or amortize that asset each year for ten years (and, accordingly, the company will be able to offset some of its taxable income each year for ten years).[40]

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because TRAs involve siphoning off one particular type of asset—a company's tax assets—rather than splitting up the economics or voting rights of the company as a whole.

34. *See infra* note 129 and accompanying text (discussing the roles of investment banks in the IPO process).

35. *See infra* Part II (analyzing whether public shareholders pay for tax assets in IPOs).

36. *See infra* Part II; *see also infra* note 123 and accompanying text (suggesting that the public market does not properly value tax attributes).

37. For an example of how tax assets created value over several years (in an IPO that used a TRA), see Robert Cyran, *Supercharged IPO Tax Spoils Need Splitting*, REUTERS (July 8, 2014), http://blogs.reuters.com/breakingviews/2014/07/08/supercharged-ipo-tax-spoils-need-splitting/ [https://perma.cc/8YBV-C3DA], which explains that "GoDaddy's PubCo equivalent has about $2.4 billion of goodwill and intangible assets. Assuming 15-year amortization and a 40 percent tax take at the federal and local level, that's a potential tax reduction of more than $60 million a year altogether . . . ."

38. If a company incurs an immediate expense, then the expense reduces a company's taxable income for the current year. For example, if a company spends $15,000 on maintenance (which is generally an immediate expense) in Y1, then the company will reduce its taxable income in Y1 by $15,000. However, if the Code requires the company to capitalize the expenditure (because it provides value to the company beyond the current year), then the company must record the expenditure as a tax asset on its books. In that case, the company will reduce its taxable income over time, according to the "useful life" of the asset. I.R.C. § 179 (2012).

39. A company must depreciate or amortize under either a straight-line or accelerated method, depending on the type of asset. Under a straight-line method, a company must take the purchase or acquisition price of an asset and divide that amount by the asset's useful life. Under the accelerated method, a company is permitted to depreciate or amortize more of an asset in earlier years, and less in later years, providing the company a time-value-of-money benefit.

40. For a more detailed example of a deferred tax asset, when a company sells a product with a one-year warranty, there is an expectation that the company will have future return or repair expenses associated with that warranty. A company that sells $20 million in products in Y1, at a pretax profit margin of fifty percent, would therefore have pretax income of $10 million in that

When a company uses tax assets to reduce the amount of tax it owes, it is more profitable than it otherwise would be (because its profits increase by the amount it did not have to pay in taxes).[41]

What is a TRA, and how does it fix the fact that public shareholders are apparently not willing to pay for tax assets ex ante (at the time of an IPO)? A TRA is a contract between a new public company and its pre-IPO owners that requires the public company to pay the pre-IPO owners for the company's tax assets ex post.[42] Under a TRA, the new public company agrees to pay the pre-IPO owners for a portion of the value of the company's tax assets as those tax assets result in a reduction in the public company's tax liability in the post-IPO period, whether or not the pre-IPO owners continue to own an interest in the company.[43] So although the public company technically still owns its

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year. If that same company expected that its warranty expense would be five percent of the $20 million in sales in today's dollars, its expected warranty expenses would be $1 million. Therefore, the company would have expected net income of $9 million in the current year. However, the Code does not allow companies to deduct expenses for warranties until the warranty expense actually occurs, so if the one-year warranty was sold in Y1, but the company realized all of the expected $1 million in warranty expenses in Y2, then the Code would require the company to pay tax on the full $10 million of pretax earnings in Y1, which, calculated at a rate of twenty-one percent, would equal $2.1 million. The $1 million expense, which reduces the company's taxes by $210,000 (in other words, $1 million times 0.21), is recorded on the company's balance sheet as a deferred tax asset in Y1, and therefore only reduces the company's tax liability by the $210,000 (to the extent the company in fact has taxable income) in Y2. *See* Rev. Rul. 2012-1, 2012-2 I.R.B. 255 (clarifying the treatment of certain liabilities under the recurring item exception to the economic performance requirement).

41. If deferred tax assets were not amortizable, companies would not be able to recognize their losses until they experienced a "realization" event, which typically occurs when a company sells the asset to an unrelated buyer. I.R.C. § 1001 (2012).

42. TRA payments for basis are generally treated as additional consideration for the sale of the pre-IPO owners' interests in the historic company. Because these payments are made over several years, pre-IPO owners are generally able to report their income under the installment method of reporting. *See* I.R.C. § 453 (2012) (explaining the installment method of reporting); Paul & Sabbah, *supra* note 15, at 78 (discussing the installment method of reporting). From the public company's perspective, these TRA payments are generally characterized as additional purchase price, which gives the public company additional basis in its assets. John C. Hart, *The Umbrellas of Subchapter K*, SIMPSON THACHER & BARTLETT LLP 1, 46 n.64 (Jan. 2016), http://www.stblaw.com/docs/default-source/related-link-pdfs/umbrellas-of-subchapter-k.pdf?sfvrsn=6 [https://perma.cc/H9F2-CED4]. Because companies make TRA payments over a period of several years, a portion of the TRA payments may be recharacterized as unstated interest under I.R.C. § 483, and would therefore be deductible by the public company and includible in income to the pre-IPO owners. *Id.* The tax treatment of TRA payments for the value of a company's net operating losses is more variable, and depends on the particular facts and circumstances of the IPO. One possibility is to treat the implementation of the TRA as a distribution to the pre-IPO owners. Paul & Sabbah, *supra* note 15, at 79. Alternatively, if the parties recapitalize the stock held by the pre-IPO owners, entering into a TRA could qualify as a tax-free reorganization, and TRA payments to the pre-IPO owners would likely be taxable distributions. *Id.*

43. Tax assets create savings as a public company uses the assets to offset the amount of tax that the public company owes each year that the public company has taxable income. *See* GINSBURG ET AL., *supra* note 13, ¶ 1602.10.2:

tax assets after the IPO, economically, a TRA shifts the value of the public company's tax assets to the pre-IPO owners.[44]

Under a TRA, a public company contracts to pay its pre-IPO owners the value of the company's tax savings each year the company uses its tax assets to reduce its tax liability.[45] This means that public investors generally pay for tax assets over time, if and when a public company realizes a benefit. TRAs calculate the payments to the pre-IPO owners using a "with and without" approach by comparing the public company's actual tax liability to the tax liability it would have incurred without the tax assets.[46] The public company bases its annual payment to the pre-IPO owners on the excess of the hypothetical tax liability over the actual tax liability for each year the TRA is in effect.[47] Interestingly, TRA payments themselves are generally characterized as additional purchase price, and therefore TRA payments themselves also create tax assets (in the form of additional tax basis), creating an iterative effect where the public company makes TRA payments on TRA payments.[48]

The recently enacted tax reform act lowered the corporate tax rate from thirty-five percent to twenty-one percent beginning in 2018.[49] This reduction in the corporate tax rate accordingly reduced the value of tax assets—prior to 2018, $100 of tax assets reduced corporate tax liability by $35, whereas beginning in 2018, $100 of tax assets will only reduce corporate tax liability by $21. It seems probable that this change,

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> Newco-C often agrees (in a so-called tax receivables agreement) to pay to the old partnership/LLC's selling equity owners a percentage (e.g. 85%) of any tax benefits Newco-C realizes from the asset basis step-up produced by these sales of old partnership/LLC common units to Newco-C, with such payments made as tax benefits are realized.

44. *See* Paul & Sabbah, *supra* note 15, at 74 (explaining that TRAs "[shift] value from the corporation to its historic equity owners").

45. The TRA generally requires the public company to produce a schedule showing the computation of the realized tax benefits for the year. The schedule and supporting documentation are generally subject to dispute resolution. Hart, *supra* note 42, at 45.

46. *See* Paul & Sabbah, *supra* note 15, at 77 ("TRAs typically calculate payments using a 'with and without' approach. In other words, the actual tax liability of the corporation is compared to a hypothetical tax liability computed as if the relevant tax benefit . . . did not exist.").

47. *See id.* at 77 (discussing possible TRA tax liabilities).

48. TRA payments from the public company to the pre-IPO owners also generally constitute additional consideration, which increases the public company's tax basis in the historic partnership by a corresponding amount. Therefore, the TRA payments themselves have an interactive effect and result in additional TRA payments since each time the public company makes a TRA payment, that payment itself results in additional TRA payments. *See* Phillip W. DeSalvo, *The Staying Power of the Up-C: It's Not Just a Flash in the Pan*, 152 TAX NOTES 865, 867 (2016) (explaining the potential "iterative effect" of TRA payments); Hart, *supra* note 42, at 47 n.64 (TRA payments "serve to further increase the basis of the partnership's assets (sometimes referred to as 'step-up on the step-up')").

49. Tax Cuts and Jobs Act of 2017, Pub. L. No. 115-97, § 13001, 131 Stat. 2054, 2096 (codified as amended at I.R.C. § 11 (West 2018)).

which reduces the overall value of TRAs to pre-IPO owners, will affect companies' decisions to enter into TRAs. However, it is too soon to tell what the overall impact of the reduction in the corporate tax rate will be on the market for TRAs, especially in light of recent innovations that significantly expand potential uses for TRAs.[50]

The vast majority of TRAs require the public company to pay the pre-IPO owners eighty-five percent of any tax savings, with the public company retaining the remaining fifteen percent.[51] Industry experts explain that there is "no magic"[52] to the eighty-five percent standard, "It was something that was developed in the early deals that has stuck."[53] Although the public company does retain fifteen percent of the benefit, it also incurs additional expenses because of the TRA, including tax and accounting fees to calculate and execute the TRA payments[54] and costs associated with a more complicated corporate structure.[55] Therefore, public companies will generally reap less than fifteen percent of the overall tax savings.

Payments from the public company to the pre-IPO owners usually continue until the relevant tax benefits have been used or expired. Since goodwill is typically a public company's most valuable tax asset, TRAs will generally remain in effect for at least fifteen years, since goodwill is amortizable over fifteen years.[56] However, TRAs

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50. *See infra* notes 98–103 (discussing innovative aspects of the SkinnyPop and Vistra IPOs).

51. *See, e.g.*, Cyran, *supra* note 37 ("GoDaddy is using one typical split of the benefits, 85 percent for sponsors and 15 percent for new investors, achieved through contractual payments as the tax deductions happen."). Although the vast majority of TRAs adhere to the eighty-five percent standard, some supercharged IPOs use a different formulation. *See, e.g.*, Spirit Airlines, Inc., Registration Statement (Form S-1) (Sept. 17, 2010), http://www.sec.gov/Archives/edgar/data/1498710/000119312510212371/ds1.htm [https://perma.cc/UGU9-EBEX] [hereinafter Spirit Airlines Registration Statement] (containing a TRA with a ninety percent standard); Virgin Mobile USA Inc., Registration Statement (Form S-1) (May 1, 2007), https://www.sec.gov/Archives/edgar/data/1396546/000119312507097779/ds1.htm [https://perma.cc/7H5B-WGHN] (containing a TRA with a one hundred percent standard).

52. Elliott, *supra* note 2, at 338 (quoting Phillip Gall).

53. *Id.*

54. *See* Hart, *supra* note 42, at 60 (discussing the additional expenses of TRAs).

55. As discussed in Part III, TRAs are almost always used in the Up-C structure. The Up-C structure, which involves a C corporation as the parent to a partnership, is typically more complicated and expensive to maintain than a structure that simply uses a C corporation. *See* Shobe, *supra* note 9, at 947 ("[A]n Up-C requires setting up and maintaining multiple entities, which entails additional accounting and legal expenses."). Because the ability to use a TRA is one of the primary reasons to use the Up-C structure, a material portion of the additional expenses associated with the Up-C can be primarily attributed to the TRA.

56. *See* I.R.C. § 197(a), (d)(1)(A) (2012) (explaining that certain intangibles, including goodwill, are ratably amortizable "over the 15-year period beginning with the month in which such intangible was acquired"). TRA payments may extend well beyond fifteen years from the date of the IPO, since pre-IPO owners may sell their partnership interests to the public company several years after the IPO. *See, e.g.*, Vistra Energy Corp. Registration Statement, *supra* note 1:

typically have provisions that accelerate the TRA payment obligations at the election of the public company or when certain events occur, including material breaches by the public company or a merger or acquisition of the public company.[57] If the TRA payments are accelerated by one of these events, the public company will be forced to pay for tax benefits under the assumption that the public company is able to fully utilize all of its future tax assets, which in many cases may not be true and would force the public company to pay the pre-IPO owners more than the value the public company actually receives from the tax assets.[58]

B. The Origin and Evolution of TRAs

While most TRAs operate under the same basic mechanics described above, TRAs differ based on the type of tax assets governed by the TRA and whether the pre-IPO owners took any additional steps to create new tax assets in the IPO. This Section analyzes the evolution of the three generations of TRAs and discusses proposed bills that would have eliminated many of the benefits of early TRAs. It discusses how first generation TRAs originated as a companion to supercharged IPOs, which make up only a small fraction of the total IPO market, and explores the development of second generation TRAs. Additionally, this Section presents a new generation of TRAs that, unlike their

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> The aggregate amount of undiscounted payments under the Tax Receivable Agreement is estimated to be approximately $2.1 billion, with more than 90% of such amount expected to be attributable to the first 15 tax years following Emergence, and the final payment expected to be made approximately 40 years following Emergence (assuming the Tax Receivable Agreement is not terminated earlier pursuant to its terms).;

see also supra note 48 and accompanying text.

57. In practice, public companies will not usually elect to terminate a TRA because this would force the company to pay out the benefits under the TRA calculated under the assumption that the company would have had sufficient income to fully utilize all of the potential future tax benefits, which may cause a public company to pay more to pre-IPO owners than if the public company had taken the "wait and see" approach of calculating the TRA payments on a year-to-year basis. *See, e.g.*, Switch, Inc., Registration Statement (Form S-1) (Sept. 8, 2017), https://www.sec.gov/Archives/edgar/data/1710583/000119312517280759/d393780ds1.htm [https://perma.cc/WVN3-K4MW]:

> [I]f we elect to terminate the Tax Receivable Agreement early, we would be required to make an immediate cash payment equal to the present value of the anticipated future tax benefits that are the subject of the Tax Receivable Agreement, which payment may be made significantly in advance of the actual realization, if any, of such future tax benefits.

58. *See, e.g.*, Shake Shack Inc., Registration Statement (Form S-1) (Jan. 20, 2015), http://www.sec.gov/Archives/edgar/data/1620533/000104746915000292/a2222777zs-1a.htm [https://perma.cc/YCW6-8WV3] [hereinafter Shake Shack Inc. Registration Statement] ("In certain cases, payments under the Tax Receivable Agreement to the Continuing SSE Equity Owners may be accelerated or significantly exceed the actual benefits we realize in respect of the tax attributes subject to the Tax Receivable Agreement." (emphasis omitted)).

predecessors, can be used in virtually every IPO, greatly expanding the potential use of TRAs in the IPO market. Expanded use of earlier generations of TRAs and the creation of a new generation of TRAs make it likely that IPOs that use TRAs will continue to be an integral and increasingly important aspect of the IPO market.[59]

1. First Generation TRAs

First generation TRAs appeared on the market in 1993 and were invented to operate in conjunction with supercharged IPOs.[60] The earliest use of TRAs occurred when companies started taking additional steps in connection with IPOs to create additional tax assets. IPOs that took these additional steps were catchily coined "supercharged IPOs."[61] Because supercharging an IPO increases the value of a public company, and because supercharging an IPO only happens if pre-IPO owners choose to supercharge the IPO, pre-IPO owners wanted to reap the benefit of the additional value they created for the public company (even though supercharging an IPO typically does not cost the pre-IPO owners anything extra beyond de minimis administrative expenses).[62]

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59. *See* Grady, *supra* note 9, at 515 ("[G]iven the benefits TRAs provide to pre-IPO owners, the public market's apparent disregard for the transfer of capital associated with TRA payments, and the low compliance costs associated with the transactions, their use is likely to increase in the future."); Zanki, *supra* note 8 ("There is not an IPO we do for a company, where it's a partnership pre-IPO, where we don't think about whether an Up-C makes sense . . . . Everyone is considering it." (internal quotation marks omitted) (quoting Joshua Korff)); *see also supra* notes 49–50 and accompanying text (discussing how recent tax reform changes may affect the IPO market's use of TRAs).

60. *See* Elliott, *supra* note 2, at 334 (TRAs "have been a feature of IPOs since at least 1993 when Cooper Industries Ltd. entered into one in connection with the IPO of . . . Belden, Inc."); Shobe, *supra* note 9, at 921 ("The Section 338(h)(10) supercharged IPO, the earliest of the three types of supercharged IPOs, was first seen in 1993.").

61. *See* Elliott, *supra* note 2, at 334 (stating that Robert Willens coined the term "supercharged IPOs").

62. It should be noted that some scholars claim that pre-IPO owners who supercharge an IPO incur additional expenses in the form of an immediate tax liability, and that therefore TRAs compensate pre-IPO owners for this additional expense. *See* Fleischer & Staudt, *supra* note 1, at 371 ("If the parties pursue a supercharged IPO, Founders Co. will be viewed as having sold the company to Public Co. for $10 million (the value of the asset) and thus will pay an immediate up-front tax of $1.5 million (a 15% rate) or $3.5 million (a 35% rate)."). However, pre-IPO owners only incur an immediate tax liability in supercharged IPOs that use a Section 338(h)(10) election, which represents a small subset of supercharged IPOs, so the vast majority of TRAs cannot be justified by the argument that the public company should compensate the pre-IPO owners for additional expenses. *See* Shobe, *supra* note 9, at 945–47 (explaining that only supercharged IPOs that involve a Section 338(h)(10) election cause the pre-IPO owners to incur an immediate tax liability, and that pre-IPO owners in other supercharged IPOs do not incur a greater tax liability than they would in a traditional IPO); Polsky & Rosenzweig, *supra* note 9, at 27 ("Another common myth is that TRAs compensate the legacy owners for the tax burden they incur in connection with the creation of tax assets subject to the TRA."). There is perhaps an argument that in an Up-C the sellers deserve to be paid for the time and expense they put in to structuring the Up-C and creating additional tax assets, but the pre-IPO owners have other reasons to structure an IPO as an Up-C,

TRAs were invented to meet the pre-IPO owners' demand,[63] and the first generation of TRAs became the means whereby the pre-IPO owners ensured that they, and not the public, received the benefits of the additional value.[64] In other words, supercharging an IPO increases the size of the IPO "pie," and first generation TRAs were created as a means to make sure pre-IPO owners got to keep the extra pie for themselves.

The latent value that pre-IPO owners unlock by supercharging an IPO, and capture via first generation TRAs, lies in the fact that goodwill, which is often a company's most valuable asset, has a basis of zero until the company "sells" the goodwill.[65] The trick to creating new basis (that the pre-IPO owners can then require the public company to pay them for via a TRA) is for the pre-IPO owners to "sell" their goodwill to the public company in the IPO process, which allows the public

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so they do not necessarily need further incentive to create these tax assets. *See* Shobe, *supra* note 9, at 942–48 (exploring the additional tax benefits of structuring a supercharged IPO as an Up-C).

63. *See* Kaden & Alter, *supra* note 7 ("TRAs are viewed as a means for compensating those who are responsible for creating the tax assets . . . .").

64. For an example of how supercharging an IPO can create significant value for a public company (that the pre-IPO owners can then take back via a TRA), see David Cay Johnston, *Blackstone Devises Way to Avoid Taxes on $3.7 Billion*, N.Y. TIMES (July 13, 2007), http://www.nytimes.com/2007/07/13/business/worldbusiness/13iht-blackstone.4.6652202.html?_r=0 [https://perma.cc/E4WQ-EAV2].

65. Goodwill is amortizable and thus reduces a company's tax liability over fifteen years. *See* I.R.C. § 197(c)(2) (2012) ("The term 'amortizable section 197 intangible' shall not include any section 197 intangible . . . which is created by the taxpayer. This paragraph shall not apply if the intangible is created in connection with a transaction . . . involving the acquisition of assets constituting a trade or business . . . ."). For example, if a company has self-developed goodwill worth $100 million and sells that goodwill to a new entity in the process of going public, then, since goodwill is deductible over fifteen years, the deduction would reduce the purchaser's tax liability by $1.4 million per year, assuming a twenty-one percent tax rate, for a total tax benefit of $21 million over fifteen years. If the goodwill remained with the company, and was therefore nondepreciable, the company would never be able to access this $21 million tax benefit. This calculation assumes that a company has sufficient taxable income to fully offset the tax deductions. For an example of the benefits of "selling" goodwill in an IPO (a.k.a. supercharging the IPO), see Cyran, *supra* note 37:

> [A] partnership like the one used to control GoDaddy sells assets to a new company which the partner-sponsors and IPO investors own – call it PubCo. Because the assets are sold at a higher price than their cost, the difference becomes a combination of goodwill and intangible assets on PubCo's books. These items can be amortized over time, a deduction from profit that reduces taxable income. . . . GoDaddy's PubCo equivalent has about $2.4 billion of goodwill and intangible assets. Assuming 15-year amortization and a 40 percent tax take at the federal and local level, that's a potential tax reduction of more than $60 million a year altogether, with $10 million annually going to IPO investors.;

see also Shobe, *supra* note 9, at 929–38 (discussing the three different ways that companies create additional tax basis by "supercharging" an IPO); Johnston, *supra* note 64 (describing the Blackstone supercharged IPO and noting that "[i]ndividuals who create goodwill through their skill at running a business cannot deduct it. But when goodwill is sold to someone else, the new owners get to deduct it because its value is assumed to erode").

company to deduct the basis ratably against its future tax liability. Scholars and practitioners nicknamed this "supercharging" the IPO because the new tax basis significantly increases the value of the new public company by reducing its future tax liabilities.[66]

There are three types of supercharged IPOs, and therefore there are three types of first generation TRAs, each one tied to a certain type of supercharged IPO.[67] Each of the three types of supercharged IPOs creates the supercharge (i.e., the additional basis) through a different structure and different provisions of the Internal Revenue Code.[68] The Up-C structure, discussed in Part III, and the corresponding Up-C TRA, is by far the most common and relevant way in which pre-IPO owners create new basis in an IPO.[69] A second type of supercharged IPO is an IPO of a partnership that meets the publicly traded partnership ("PTP") requirements. This type of IPO is rare because it is only available in very limited circumstances where a partnership meets certain passive-income requirements.[70] The third type of supercharged IPO is where a company makes a Section 338(h)(10) election in connection with an IPO, which forces the pre-IPO owners to incur additional costs and therefore only makes sense in very limited circumstances.[71]

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66. For a list of articles that discuss the supercharged IPO, see *supra* note 9.

67. The details of the three types of supercharged IPOs have been discussed in the literature, and therefore will not be a focus of this Article. *See* Shobe, *supra* note 9, at 929–38 (discussing Section 338(h)(10) IPOs, Up-Cs, and publicly traded partnership IPOs).

68. The primary differences among the three types of first generation TRAs stem from different ways that companies sell (and thus step up the basis) of the company's goodwill. Which structure a company is able to use depends on whether the company has been historically operated as a corporation or a partnership and, if the company is a partnership, whether it meets certain rules governing publicly traded partnerships. If the historic company is a corporation, then only the Section 338(h)(10) IPO is available. If the historic company is a partnership, then it can step up the basis of the company's assets through an Up-C or a publicly traded partnership IPO. *See* Shobe, *supra* note 9, at 929–38 (discussing these two types of supercharged IPOs).

69. *See* J. LYNETTE DEWITT, DELOITTE CTR. FOR FIN. SERVS, POSITIONING FOR SUCCESS IN PRIVATE EQUITY: THE UP-C ADVANTAGE 1 (2015), https://www2.deloitte.com/content/dam/Deloitte/us/Documents/financial-services/us-fsi-positioning-for-success-in-private-equity.pdf [https://perma.cc/2AC7-PXSX] (explaining that between 2005 and 2015, approximately fifty companies had gone public using the Up-C structure, representing an aggregate deal value of $30 billion); Brown, *supra* note 9 (discussing whether the Up-C and TRAs create a "legal loophole"); Shobe, *supra* note 9 (discussing rise in popularity of the Up-C); Polsky & Rosenzweig, *supra* note 9, at 28–29 (discussing the "Up-C Revolution" and the Up-C's importance in the IPO market); Zanki, supra note 8 (showing that Up-C IPOs accounted for over five percent of the IPO market in 2013, 2014, and 2015).

70. Perhaps the most famous example of a PTP IPO is the Blackstone IPO. *See* Emily Cauble, *Was Blackstone's Initial Public Offering Too Good to Be True?: A Case Study in Closing Loopholes in the Partnership Tax Allocation Rules*, 14 FLA. TAX REV. 153 (2013); Victor Fleischer, *Taxing Blackstone*, 61 TAX L. REV. 89 (2008).

71. In a Section 338(h)(10) IPO, pre-IPO owners are forced to incur an immediate tax liability on their interests in the historic company when they make the Section 338(h)(10) election in connection with supercharging the IPO. *See* I.R.C. § 338(h)(10) (2012).

In 2007, negative publicity surrounding a few prominent supercharged IPOs and their corresponding first generation TRAs generated sufficient controversy to prompt Congress to propose legislation that would have eliminated some of the benefits of using a TRA.[72] Specifically, the legislation would have required that TRA payments always be characterized as ordinary income.[73] This would have been detrimental to pre-IPO owners because TRA payments are almost always characterized as additional purchase price in exchange for goodwill that is taxed at the lower capital gains rate rather than at the ordinary income rate.[74] In 2009, Congress introduced, but again chose not to pass, similar legislation aimed at TRAs.[75] Despite the controversy surrounding these prominent TRAs, the legislation was never enacted and Congress has not seriously reconsidered any legislation directly aimed at TRAs.

TRAs have dramatically increased in popularity since Congress last considered these transactions. Prior to 2005 (i.e., for over a decade after TRAs first appeared on the market), TRAs were used in less than one percent of IPOs. Since 2005, TRAs have steadily gained traction in the IPO market and are now used in over eight percent of IPOs.[76] Although some of this growth is due to the invention and growth of the second and third generation TRAs, first generation TRAs still play an important role in the IPO market.[77]

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72. H.R. 3970, 110th Cong. (2007). In particular, the proposed legislation would have used Section 1239 of the Code to eliminate "tax arbitrage" benefits for transactions containing a TRA. Under current law, Section 1239 of the Code taxes the sale of property at ordinary income rates if the property is depreciable or amortizable in the hands of the purchaser. I.R.C. § 1239. For example, if a parent sells a family business to his or her child, then Section 1239 causes the parent to recognize ordinary gain on the sale of the business to the extent the assets of the business are depreciable or amortizable, even though the gain on the sale would otherwise have been taxable as capital gain (except to the extent of any "hot" assets under I.R.C. § 751).

73. *See* H.R. 3970 § 1204:

> In the case of a sale or exchange of property, directly or indirectly, between related persons, any gain recognized to the transferor shall be treated as ordinary income if . . . such property is an interest in a partnership, but only to the extent of gain attributable to unrealized appreciation in property which is of a character subject to the allowance for depreciation provided in section 167.

74. I.R.C. § 197.

75. H.R. 1935, 111th Cong. (2009).

76. *See supra* note 8 and accompanying text.

77. Eight recent examples of first generation TRAs include the Carvana Co., Five Point Holdings, Hamilton Lane, Solaris Oilfield, Ranger Energy Services, Switch, Funko, and Newmark Group IPOs. *See, e.g.*, Carvana Co., Registration Statement (Form S-1) (Mar. 31, 2017), https://www.sec.gov/Archives/edgar/data/1690820/000119312517106717/d297157ds1.htm [https://perma.cc/58PM-4ABS]; Five Point Holdings, LLC, Registration Statement (Form S-11) (Apr. 7, 2017), https://www.sec.gov/Archives/edgar/data/1574197/000119312517116314/d302947ds11.htm [https://perma.cc/K2HV-H6MD].

2. Second Generation TRAs

Whereas first generation TRAs only require a public company to pay its pre-IPO owners for tax assets created by the process of supercharging an IPO (value which the pre-IPO owners essentially created), "second generation" TRAs require a public company to pay its pre-IPO owners for the value created in a supercharged IPO *plus* something more.[78] The "something more" includes historic tax assets that existed before the IPO, which would otherwise have belonged to the public shareholders.

Second generation TRAs first appeared on the market in 2007, almost fifteen years after companies started using first generation TRAs.[79] Perhaps the reason it took the market longer to implement second generation TRAs is that the "something more" cannot be justified by the argument that the pre-IPO owners should be compensated for creating additional value.[80] Therefore, second generation TRAs can only be justified by the argument that public shareholders do not properly value tax assets, and that therefore providing any tax assets, including preexisting tax assets, would result in a windfall to the public company.[81] The fact that second generation TRAs rest on fewer justifications has not gone unnoticed.[82]

There are essentially two types of second generation TRAs, each of which requires public companies to pay pre-IPO owners for the value created in a supercharged IPO *plus* the company's "historic" basis, net operating losses ("NOLs"), or sometimes both.[83] Historic basis second generation TRAs, first appearing in 2007, require a public company to pay its pre-IPO owners for the basis created via the supercharge, plus basis that the company created prior to the IPO.[84] Historic basis TRAs

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78. Fleischer & Staudt, *supra* note 1, at 323.

79. *See infra* notes 84 and 86 (discussing the first two second generation TRAs).

80. *See supra* note 63 and accompanying text.

81. *See* Elliott, *supra* note 2, at 339 (quoting Phillip Gall) ("[I]f investors value stock based on EBITDA, the investors wouldn't have taken into account any tax benefits from existing basis either."); *infra* note 123 and accompanying text.

82. Professors Fleischer and Staudt describe this "second generation of supercharged IPOs" as "fishier." Fleischer & Staudt, *supra* note 1, at 323, 324 n.66; *see also* Elliott, *supra* note 2, at 337 (explaining how recently, "the terms of some TRAs have gotten even sweeter").

83. *See* Hart, *supra* note 42, at 50 (discussing "new basis" and "historic basis" TRAs). Although it is theoretically possible that a company could create additional tax assets in the process of an IPO and still only use a TRA that governs preexisting tax assets, in practice that never happens.

84. This type of TRA first appeared in 2007 when Duff & Phelps Co. went public and entered into a tax receivable agreement for the step up attributable to supercharging the IPO plus "the initial basis in our proportionate share of [the company's] assets." *See* Duff & Phelps Corporation, Registration Statement (Form S-1) (Aug. 27, 2007), https://www.nasdaq.com/markets/ipos/filing.ashx?filingid=5395133 [https://perma.cc/ZB22-

create value when companies purchase assets and receive a "cost" basis in the purchased assets.[85] Therefore, historic basis is different than basis created in a supercharged IPO because it is typically created over the life of a company (rather than all at once in the IPO itself).

Second generation TRAs for NOLs, which also first appeared in 2007, require a public company to pay pre-IPO owners for the basis created in a supercharged IPO, plus any NOLs that a public company generated prior to an IPO.[86] NOLs are a type of tax asset that a company "creates" when it has more losses in a year than it can use to offset its income for that year.[87] When this occurs, the Code allows the company to preserve its losses in the form of an "NOL carryforward" that the company can use to offset its taxable income in future years.[88] Second generation TRAs for NOLs and second generation TRAs for historic basis are similar because both require a public company to pay its pre-IPO owners for value that was created outside the IPO process that would otherwise belong to the public shareholders. In other words, in a second generation TRA the pre-IPO owners are essentially saying "we're already taking this so we'll take some of that too."

Predictably, some pre-IPO owners have found a way to maximize the potential payout under a TRA by requiring the public company to pay them for basis created in the supercharged IPO, historic basis, *and* any NOLs.[89] These hybrid second generation TRAs have been used at

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VQ5U]. The second TRA of this type appeared in 2010. Elliott, *supra* note 2, at 338; Hart, *supra* note 42, at 52 n.71.

85. For example, if a company purchased a computer for $3,000, then its basis (and its starting point for depreciating the computer) would be $3,000.

86. *See* Virgin Mobile USA, Inc., Registration Statement (Form S-1) (Oct. 10, 2007), https://www.sec.gov/Archives/edgar/data/1396546/000119312507215529/ds1a.htm [https://perma.cc/SXJ6-VFJC]. For a recent example this type of second generation TRA, see Select Energy Servs., Inc., Registration Statement (Form S-1) (Mar. 2, 2017), https://www.sec.gov/Archives/edgar/data/1693256/000104746917001192/a2231067zs-1.htm [https://perma.cc/25BG-6GEB].

87. A net operating loss is created when a company experiences a loss in a tax year that it is unable to use to reduce its taxable income. That loss can be carried forward to subsequent tax years, creating a valuable deduction against future income. *See* INTERNAL REVENUE SERV., PUBLICATION 542: CORPORATIONS 15 (2012).

88. An IPO may limit the public company's use of its NOLs following a "change of control," which may reduce (but not eliminate) the value of the public company's NOLs. *See* I.R.C. § 382 (2012). Unless a company is fully subject to the § 382 limitations, it can use its NOLs in future years to offset its taxable income. For a simplified example, if a company had $20 million losses in Y1 and only $5 million in taxable income, then it would have $15 million "extra" in NOLs that would carry over to Y2. If the company had $20 million in taxable income in Y2, then it would use the full $15 million of NOLs to offset $15 million of its income. Therefore, in Y2 the company would only have $5 million of taxable income.

89. *See* Artisan Partners Asset Mgmt. Inc., Registration Statement (Form S-1) (Nov. 1, 2012), https://www.sec.gov/Archives/edgar/data/1517302/000119312512445221/d429881ds1.htm [https://perma.cc/B8K6-K8K2]; Norcraft Cos., Inc., Registration Statement (Form S-1) (Oct. 7,

least twice and transfer the most value away from the public company and public shareholders to the pockets of the pre-IPO owners.[90]

3. Third Generation TRAs

After operating only in conjunction with supercharged IPOs for almost twenty years, TRAs broke free from that limited universe in 2010 by beginning to appear in "regular" IPOs, thereby creating a new generation of TRAs.[91] Third generation TRAs—TRAs that are used in non-supercharged IPOs—allow pre-IPO owners to take tax assets from newly public companies, despite the fact that the pre-IPO owners did not create additional tax assets in the IPO. The market has swiftly adopted third generation TRAs, and since 2010 they have appeared in fourteen IPOs,[92] including five in the past eighteen months.[93] This recent and increasingly popular use of TRAs outside the supercharged IPO context accounts for a significant portion of the recent growth of TRAs.[94]

Initially, third generation TRAs only required public companies to pay pre-IPO owners for the company's NOLs.[95] Much like with second generation TRAs, the inclusion of only NOLs *or* historic basis did not

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2013), https://www.sec.gov/Archives/edgar/data/1582616/000119312513393037/d566832ds1.htm [https://perma.cc/U7RX-QAMS].

90. *See* statements cited *supra* note 89.

91. In 2010, Spirit Airlines became the first company to use a TRA entirely independent of a supercharged IPO by requiring Spirit Airlines to pay its pre-IPO owners for the value of the company's NOLs. *See* Spirit Airlines Registration Statement, *supra* note 51 ("We will be required to pay our Pre-IPO Stockholders for 90% of certain tax benefits related to federal net operating losses . . . ."); Robert Willens, *Is an NOL "Personal" to the Shareholders?*, WILLENS BULL., Oct. 8, 2010, at 1 (discussing Spirit Airlines' TRA for $142.6 million in available NOLs and stating that "we have never seen [a TRA] premised on the corporation's NOLs but we do expect to see more of these types of arrangements in the future").

92. *See infra* note 97. This number was calculated by adding the Berry Plastics IPO (*see infra* note 95), the Ply Gem Holdings IPO (*see infra* note 96), and SkinnyPop (*see infra* note 98) and Vistra (*see supra* note 1) IPOs to the IPOs listed in footnote 97.

93. *See supra* note 12.

94. *See supra* note 8 and accompanying text.

95. The Spirit Airlines, Inc. IPO in 2010 and the Berry Plastics, Inc. IPO in 2012 both used TRAs that only governed NOLs. *See* Cyran, *supra* note 37:

> More worrisome are cases where the benefit-sharing agreement covers profit offsets that would normally be claimed by the company alone. One such was the Berry Plastics IPO in 2012, where sellers led by Apollo Global Management claimed 85 percent of the tax savings resulting from net operating losses sustained prior to its float. In Berry's case, that means it will pay about $80 million to former owners over the next year. The firm could have used the cash to reduce debt.;

see also Levine, *supra* note 16 (discussing the Berry Plastics IPO and stating, "[N]ot all supercharged deals involve this sort of step-up transaction that *creates* new tax assets: Berry's tax receivables agreement, for instance, covers pre-existing net operating losses, not amortization benefits created by the IPO.").

last long, and soon after pre-IPO owners expanded third generation TRAs to require the public company to pay its pre-IPO owners for the company's NOLs *and* historic basis.[96] Interestingly, this twist instantly became the norm, and since then, eight out of ten third generation TRAs followed suit.[97] This evolution within third generation TRAs shows, unsurprisingly, that pre-IPO owners favor TRAs that maximize the amount they can take from newly public companies through TRAs. Importantly, this trend toward paying pre-IPO owners for historic basis (outside the context of supercharged IPOs) paved the way for a brand new application of TRAs.

In 2015, pre-IPO owners of the parent company of SkinnyPop invented a new, "generation 3.1" TRA.[98] Vistra Energy Corp. followed suit in 2017 with a similar TRA.[99] These new, more expansive TRAs have thus far gone unnoticed in the literature. Like all third generation TRAs, these TRAs were implemented in non-supercharged IPOs. However, these TRAs warrants their own category because they are the

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96. In 2013, Ply Gem Holdings, a building products manufacturer, became the first company to use a TRA entirely independent of a supercharged IPO to require the public company to pay its pre-IPO owners for the value of its NOLs plus the value of its historic basis. *See* Ply Gem Holdings, Inc., Registration Statement (Form S-1) (May 13, 2013), https://www.sec.gov/Archives/edgar/data/1284807/000119312513215370/d483013ds1a.htm [https://perma.cc/N43Z-C4KB].

97. The eight IPOs that used TRAs for both NOLs and historic basis include The Simply Good Foods Company; Vince Holding Corp.; Sabre Corporation; El Pollo Loco; OM Asset Management; AdvancePierre Foods Holdings, Inc.; Forterra Inc.; and Foundation Building Materials, Inc. The two IPOs since 2013 to use TRAs only for NOLs include VWR Corporation and Surgery Partners, Inc. *See, e.g.*, El Pollo Loco Holdings, Inc., Registration Statement (Form S-1) (June 24, 2014), http://www.sec.gov/Archives/edgar/data/1606366/000119312514282217/d714963d424b4.htm [https://perma.cc/K78V-LR97]:

> We will enter into an income tax receivable agreement with our existing stockholders that will provide for the payment by us to our existing stockholders of 85% of the amount of cash savings . . . as a result of the utilization of our net operating losses and other tax attributes attributable to periods prior to this offering . . . .

It should be noted that the OM Asset Management IPO called its TRA a "deferred tax asset deed," but in substance the deed operated the same as a TRA. *See* OM Asset Mgmt., Registration Statement (Exhibit 10.4) (Oct. 8, 2014), https://www.sec.gov/Archives/edgar/data/1611702/000104746914008363/a2221809zex-10_4.htm [https://perma.cc/F3TF-KZYD] (" 'Deed' means this deferred tax asset deed.").

98. The SkinnyPop TRA requires the public company, Amplify Snack Brands, to pay its pre-IPO owners for tax assets that were generated upon the acquisition of SkinnyPop. *See* Amplify Snack Brands, Inc., Registration Statement (Form S-1) (June 26, 2015), https://www.sec.gov/Archives/edgar/data/1640313/000119312515237198/d893087ds1.htm [https://perma.cc/8VFN-C79K]:

> Pursuant to the tax receivable agreement, we will be required to make cash payments to the former holders of units of Topco equal to . . . % of the tax benefits, if any, that we actually realize, or in some circumstances are deemed to realize, as a result of certain tax attributes that were generated when SkinnyPop was acquired by affiliates of TA Associates in July 2014.

(omission in original).

99. *See, e.g.*, Vistra Energy Corp. Registration Statement, *supra* note 1.

first to require the public company to pay its pre-IPO owners *only* for the company's historic basis or other basis created independently of a supercharged IPO.[100] Therefore, these TRAs are unlike other third generation TRAs, which were limited to IPOs of companies that had NOLs.[101] This change is significant because it greatly expands the potential use of TRAs: when TRAs were only used in IPOs that created new basis via supercharging (i.e., first and second generation TRAs) *or* had NOLs (i.e., previous third generation TRAs), their use was limited to the relatively small number of IPOs that fit one of those fact patterns. But essentially every company that goes public in an IPO has historic basis in at least some of its assets, so this new category of third generation TRAs has almost universal application, and will be especially attractive to pre-IPO owners when a company has a material amount of historic basis.[102]

If other companies follow in the SkinnyPop and Vistra paths, which seems likely given how quickly the market has adopted each new iteration of TRA, TRAs could eventually be used in nearly every IPO.

What now? It appears that the SkinnyPop and Vistra Energy Corp. TRAs filled the last gap for potential use of TRAs in the IPO market. So a fourth generation of TRAs seems unlikely, not because the market would not be open to more aggressive TRAs, but because pre-IPO owners seem to have exhausted the possible ways in which they can extract tax assets from public companies.[103] Therefore, the future TRA narrative will most likely be a story of growth and expansion of the three generations of TRAs, and the main character in that story

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100. The Vistra TRA required the public company to pay the pre-IPO owners for historic basis and the basis step up attributable to the sale of certain preferred shares. Although the sale of the preferred shares was scheduled to occur after the IPO, this type of step up is distinguishable from the step up that occurs in first and second generation IPOs because it is unrelated to supercharging an IPO. *See id.*

101. Companies only generate NOLs when they operate at a loss, so TRAs that are exclusively used in conjunction with NOLs have limited application. *See* INTERNAL REVENUE SERV., *supra* note 87, at 11.

102. Although almost every company has at least some historic basis in its assets, the amount of historic basis will obviously vary in each IPO. In each case, pre-IPO owners will have to weigh whether the cumulative value they receive via the TRA payments is greater than the amount that public shareholders may discount the amount they are willing to pay for shares of the public company in an IPO. *See* Section II.A (discussing whether public shareholders pay less for companies with TRAs).

103. Although pre-IPO owners have occasionally required public companies to pay them for tax assets that were not a focus of this Section (e.g., foreign tax credits, alternative minimum tax credits, and deductions arising from the exercise of stock options), the tax assets that were the focus of this Section (i.e., basis and NOLs) are by far the most common and valuable tax assets governed by TRAs. For a discussion of one TRA that paid pre-IPO owners for deductions arising from the exercise of stock options, see Paul & Sabbah, *supra* note 15, at 77.

may be the most recent and universally applicable category of third generation TRAs.

4. Summary

In sum, for the first fifteen years of their existence, TRAs essentially served the same purpose—they paid pre-IPO owners just for the value of additional tax assets created in a supercharged IPO. Over the past ten years, TRAs have rapidly evolved, first by taking "more" than just the additional assets created in a supercharged IPO, and then by operating entirely independently of supercharged IPOs and requiring public companies to pay pre-IPO owners for assets that would otherwise have gone to the public shareholders. These new generations of TRAs have significantly contributed to the rapid spread of TRAs across the IPO market. Importantly, this Section has brought to light a brand new type of TRA that can be used in almost any IPO, significantly expanding the potential use of TRAs and making it likely that TRAs will continue to spread across the IPO market.[104]

Table 1 below illustrates the evolution of the three generations of TRAs and provides a snapshot of this Section. It breaks apart the three types of tax assets primarily at stake in an IPO, showing which year companies first created a TRA that transferred that type of tax asset (or combination of tax assets) from a public company to its pre-IPO owners.

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104. *See also supra* notes 49–50 and accompanying text (discussing how recent tax reform changes may affect the IPO market's use of TRAs).

TABLE 1: THE THREE GENERATIONS OF TRAS

<table>
<tr><th></th><th>Basis Created in a Supercharged IPO</th><th>Net Operating Losses</th><th>Historic Basis</th></tr>
<tr><td>First Generation TRAs</td><td>1993[105]</td><td></td><td></td></tr>
<tr><td rowspan="3">Second Generation TRAs</td><td colspan="2">2007[106]</td><td></td></tr>
<tr><td>2007[107]</td><td></td><td></td></tr>
<tr><td colspan="3">2012[108]</td></tr>
<tr><td rowspan="2">Third Generation TRAs</td><td></td><td>2010[109]</td><td></td></tr>
<tr><td></td><td colspan="2">2013[110]</td></tr>
</table>

Despite the fact that each generation of TRAs has been more aggressive than its predecessor, only first generation TRAs generated significant controversy or received the attention of Congress. Second and third generation TRAs have slipped by relatively unscathed from analysis and criticism by scholars and policymakers. The few scholars who have considered TRAs have remained focused on first and second generation TRAs, and therefore have missed important recent developments within third generation TRAs.[111] This Section has laid out, primarily in a descriptive manner, important developments in the

105. The first supercharged IPO, Belden, Inc., took place in 1993. *See supra* note 60 and accompanying text.

106. The first supercharged IPO to use a TRA for both the basis created in a supercharged IPO and NOLs of the public company was the Virgin Mobile USA, Inc. IPO, which took place in 2007. *See supra* note 86 and accompanying text.

107. The first supercharged IPO to use a TRA for both the basis created in a supercharged IPO and the public company's historic basis was the Duff & Phelps Co. IPO, which took place in 2007. *See supra* note 84 and accompanying text.

108. The first supercharged IPO to use a TRA for the basis created in a supercharged IPO, the NOLs of the public company, and the public company's historic basis was the Artisan Partners Asset Management Inc. IPO, which took place in 2012. *See supra* note 89 and accompanying text.

109. The first non-supercharged IPO to use a TRA was the Spirit Airlines IPO, which took place in 2010. The Spirit Airlines IPO TRA only covered NOLs of the public company. *See supra* note 91 and accompanying text.

110. The first non-supercharged IPO to use a TRA for NOLs of the public company and the public company's historic basis was the Ply Gem Holdings IPO, which took place in 2013. *See supra* note 96 and accompanying text.

111. *See, e.g.*, Fleischer & Staudt, *supra* note 1, at 323 (primarily discussing supercharged IPOs but noting that some TRAs do not "create new tax assets"); Polsky & Rosenzweig, *supra* note 9, at 24 (primarily discussing Up-Cs, but mentioning that "TRAs have also been used in situations that do not involve a [stepped-up basis]"). For further discussion of the various kinds of TRAs, see generally sources cited *supra* note 9.

evolution of TRAs, filling a gap that has prevented thorough analysis of TRAs by scholars and policymakers, and creating a foundation for Parts II and III of this Article to analyze the tax, policy, and efficiency concerns raised by TRAs.

II. TRAS: UNDERHANDED TAX SCHEME OR EFFICIENT TAX PLANNING?

TRAs have generated some controversy in the media, academic literature, and Congress.[112] Commentators have described TRAs as a "tax scheme . . . that does not pass the smell test,"[113] a "bizarre siphoning of cash,"[114] "underhanded,"[115] and "a one-sided relationship,"[116] and have stated that a TRA "drains money out of the company that could be used for purposes that benefit all the shareholders."[117] Others cast TRAs in a more positive light, describing them as the "pearl in the oyster,"[118] claiming that TRAs create a "win-win for all parties involved,"[119] and asserting that TRAs are the pre-IPO owners' way of "assuring they receive a fair price for their business."[120]

The controversy over TRAs comes down to whether public shareholders "rip off" the pre-IPO owners when there is not a TRA (by not paying full value for tax assets), or whether TRAs take value from public shareholders in ways that shareholders do not or are not able to accurately price into an IPO. As explained in Part I, tax assets increase the value of a company and *should* increase the amount shareholders pay for a public company's shares.[121] Although many people argue that public markets are efficient to the extent public companies fully disclose material information,[122] and therefore public shareholders act as they "should," "it has become conventional wisdom" that the market does not price tax assets or TRAs into the value of stock in an IPO.[123] In other

112. For a discussion of the legislative history surrounding TRAs, see Section I.B.1 (discussing proposals to strip parties of the tax benefits that accompany TRAs).

113. Smith, *supra* note 4.

114. *Carlyle's "Cash Tax Savings," supra* note 5.

115. Elliott, *supra* note 2, at 334 (quoting Robert Willens).

116. *Blackstone Partners*, *supra* note 3 (quoting Lee Sheppard).

117. Browning, *supra* note 6 (quoting Robert Willens).

118. Grady, *supra* note 9, at 488.

119. Brown, *supra* note 9, at 868.

120. Fleischer & Staudt, *supra* note 1, at 324.

121. *See supra* Section I.A (explaining the mechanics of TRAs).

122. *See, e.g.*, Zohar Goshen & Gideon Parchomovsky, *The Essential Role of Securities Regulation*, 55 DUKE L.J. 711 (2006) (discussing the role that securities regulation plays in enhancing market efficiency).

123. Paul & Sabbah, *supra* note 15, at 75; *see* GINSBURG ET AL., *supra* note 13, ¶ 405 ("A tax receivable agreement (a 'TRA') allows the person or persons transferring [tax assets] to Newco to

words, practitioners and investment bankers believe, and tell their clients, that shareholders do not pay more for a company with tax assets and do not pay less for a company with a TRA.[124] The belief that public investors do not pay more for tax assets, or pay less despite the presence of a TRA, is why IPOs that use TRAs have rapidly increased as a percentage of the IPO market[125] and why TRAs evolved from their original, limited use in supercharged IPOs to instruments that reach every type of tax asset.[126]

Previous scholarship has briefly considered whether public investors account for tax assets and TRAs in an IPO, but has focused on the economics of whether bankers include tax assets in their valuation of the company that is going public. This Part takes a different approach. Instead of getting into often intractable and thorny questions of economic valuation, this Part compares the way pre-IPO owners "sell" tax assets to public shareholders through a TRA to how parties buy and sell tax assets in the private sale of a company outside of the IPO context. This approach shows that TRAs differ from what parties would typically agree to in privately negotiated deals in ways that likely harm public shareholders.

A. Do Public Shareholders Account for Tax Assets and TRAs in IPOs?

Do TRAs fairly compensate pre-IPO owners for valuable tax assets that increase the profitability of public companies, or do TRAs rip off public shareholders? Answering that question requires separately analyzing the effect of (1) tax assets and (2) TRAs on the value of public companies.

First, in theory, public shareholders should be willing to pay more for a company with tax assets than they would for an identical

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capture most of Newco's [tax assets] that [are] not fully valued by the public markets."); Rosen & Furci, *supra* note 31, at 9 ("[P]ublic markets systematically undervalue tax assets of various sorts . . . ."); Polsky & Rosenzweig, *supra* note 9, at 21–22 ("[T]he market appears to ignore, or at least significantly undervalue, tax assets . . . ."); Hart, *supra* note 42, at 50 (noting that TRAs "are premised on the assumption that the public does not value such tax benefits and therefore would pay the same amount for shares of a company that did not own these attributes"); Kaden & Alter, *supra* note 7 ("TRAs are premised on the theory—generally accepted by underwriters—that the public markets do not properly value tax attributes."). *But see* Amy Foshee Holmes, Tax Receivable Agreements in Initial Public Offerings: An Analysis of the Innovation Incorporated in IPO Agreements 54 (Aug. 2014) (unpublished Ph.D. dissertation, University of Texas at Arlington) (on file with the central library, University of Texas at Arlington) (testing the effect of TRAs on IPO prices and showing a slightly negative association).

124. *See generally* sources cited *supra* note 123.

125. *See supra* note 8 and accompanying text.

126. *See* Section I.B (discussing the origin and evolution of TRAs).

company without such tax assets.[127] However, practitioners argue that in practice public shareholders do not pay, or at least do not pay full value, for tax assets of a company going public in an IPO.[128] One reason experts believe tax assets are not priced into IPOs is that investment bankers, who help public companies price their shares in an IPO,[129] typically base the offering price on "earnings before interest, taxes, depreciation, and amortization," commonly referred to as "EBITDA."[130] EBITDA specifically *excludes taxes*, including tax assets, from its calculation, so an offering price based on EBITDA would be the same for a company with tax assets as it would be for an identical company with zero tax assets.[131] Although the valuations are "based" on EBITDA, bankers describe IPO pricing as an "art,"[132] and will consider other factors, such as the current stock price of similar public companies, when setting the price per share.[133] Pricing tax assets is

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127. It is also possible that shareholders do not pay full value for tax assets in an IPO, but do pay for tax assets in secondary trading. However, since this question focuses on whether public shareholders compensate pre-IPO owners for tax assets, secondary trading is irrelevant to answering this particular question.

128. Paul & Sabbah, *supra* note 15, at 75 (explaining that although tax assets are recorded on a company's balance sheet and, theoretically, a company's valuation should increase in relation to the value of its tax assets, "[i]t has become conventional wisdom" that the market does not price tax assets into the value of stock in an IPO).

129. Although a company could theoretically sell shares on its own, in practice, companies almost always hire investment banks to fill a wide range of important roles in the process of going public. These roles include gauging public demand for the company, marketing the company's shares to potential buyers, and assisting in the company's compliance with complicated SEC rules. *See generally* Bernard S. Black, *The Legal and Institutional Preconditions for Strong Securities Markets*, 48 UCLA L. REV. 781 (2001) (describing the importance of investment banks' reputations and the various roles they play in the IPO process); Christine Hurt, *Moral Hazard and the Initial Public Offering*, 26 CARDOZO L. REV. 711 (2004) (describing the various and extensive roles investment bankers play in the IPO process).

130. Paul & Sabbah, *supra* note 15, at 75 (stating that "public company valuations generally are based on EBITDA (earnings before interest, taxes, depreciation and amortization) which disregards tax attributes because EBITDA does not take account of taxes"); Polsky & Rosenzweig, *supra* note 9, at 10 ("The conventional explanation relies on the public market's use of multiples of accounting metrics, such as EBITDA, EBIT, and earnings, in valuing businesses, rather than metrics such as deferred tax assets or book/tax differences.").

131. *See* GINSBURG ET AL., *supra* note 13, ¶ 405 ("[W]here (as is often the case) Newco's IPO price is based on estimates of Newco's future GAAP earnings (rather than estimates of Newco's future after-tax cash flows), structuring for asset [stepped-up basis] may produce little or no incremental sales proceeds for transferors . . . selling Newco stock in the IPO . . . .").

132. Shayndi Raice, *The Art of the IPO*, WALL ST. J. (Feb. 27, 2012), https://www.wsj.com/articles/SB10001424052970204740904577196792161567410 [https://perma.cc/68TC-FBL2] (IPO pricing "is more art than science" (quoting David Ludwig)).

133. Investment banks may look to several factors to determine the appropriate IPO price, including the amount of stock being sold in the IPO, the current profitability of the company, the potential growth of the company, the current stock price of similar public companies, and the company's assets and liabilities. It is important for an investment bank to set an appropriate offering price because a company that undervalues its shares forfeits capital it could have raised in an IPO, while a company that overvalues its shares may raise a lot of money but damage its shareholder relations and employee morale. *See* PATRICK J. SCHULTHEIS ET AL., THE INITIAL

further complicated by the fact that benefits derived from tax assets are generally realized over the course of at least fifteen years, and it is obviously impossible to predict whether a company will have taxable income ten to fifteen years down the road. So while it is possible for investment bankers to include tax assets in the offering price, it may be that they choose to leave tax assets out because they believe that tax assets are too difficult for public shareholders to understand and accurately price in.[134]

The "shareholders do not pay for tax assets" argument is the most persuasive in the context of first generation TRAs, which are only used in connection with supercharged IPOs, and which only require a public company to pay its pre-IPO owners for the "extra" basis created by supercharging.[135] The argument is relatively persuasive, especially for early supercharged IPOs, because supercharged IPOs are new and complicated transactions that are a significant change in structure from historic IPOs. Therefore, it seems plausible that many public shareholders would not understand that supercharging an IPO creates additional value for the public company, and that bankers would not want to deviate from their historic practices in valuing companies in an IPO. However, second generation TRAs require public companies to pay pre-IPO owners for assets created by the supercharged IPO *and* companies' historic tax assets, and third generation TRAs *only* target companies' historic tax assets. In those cases, the "shareholders do not pay for tax assets" argument cannot stand on the newness or complexity of the IPO; rather, in that case, the argument only holds true if shareholders do not pay for a company's historic (comparatively well understood and easy to value) tax assets. Companies going public have long had substantial historic tax assets without an accompanying TRA, so it is unclear why TRAs are needed now. Therefore, for second and third generation TRAs, it seems less likely that pre-IPO owners would get "ripped off" in the absence of a TRA and more likely that a TRA results in shareholders getting "less" value that they realize.

Because TRAs are prominently disclosed in public SEC documents,[136] we would expect public shareholders to pay less for a

PUBLIC OFFERING 187 (3d ed. 2008) (noting that "[a] higher price raises more money for the company" but that "[a]n unsustainably high price, however, can harm the company and the underwriters" and that a "[d]isappointing aftermarket performance may cause investors and analysts to lose interest"); *see also* Jonathan A. Shayne & Larry D. Soderquist, *Inefficiency in the Market for Initial Public Offerings*, 48 VAND. L. REV. 965 (1995) (discussing IPO overpricing).

134. *See* Moonchul Kim & Jay Ritter, *Valuing IPOs*, 53 J. FIN. ECON. 409 (1999) (describing the different IPO valuation processes).

135. *See* Grady, *supra* note 9, at 515 ("Ultimately, TRAs minimize inefficiencies in the I.R.C. and reward those who unlock value from tax benefits.").

136. *See infra* notes 186–191 and accompanying text.

company with a TRA than they would for an identical company without a TRA, and that the presence of a TRA would therefore cost the pre-IPO owners (in the form of a reduced share price) as much as they gained from payments under the TRA. However, practitioners claim that public shareholders do not adjust the price they are willing to pay for shares in a public company due to the presence of a TRA.[137] Furthermore, IPOs that use TRAs have increased from less than one to over eight percent of the IPO market since 2004, which indicates that pre-IPO owners believe that the market does not perfectly price in TRAs, perhaps because TRAs are so complicated that public shareholders are unable to understand the effect a TRA has on the value of a public company.[138] In fact, a TRA would never make sense if the public perfectly adjusted the price they were willing to pay per share to account for the presence of a TRA.[139] In that case, a TRA would serve no purpose other than to increase the administrative and legal costs of an IPO.

It is impossible in every circumstance to know whether TRAs help owners achieve a "fair" price or whether it causes them to receive something more. If it is true that public investors do not value the presence of tax assets when determining share price, then it would seem that TRAs are an effective means for pre-IPO owners to assure compensation for tax assets. On the other hand, if the share price reflects the presence of tax assets but public investors do not adjust downward to reflect a TRA, then the public investors are essentially paying twice for the same tax assets. The truth may also lie somewhere in the middle, with public investors paying something, but not full value, for tax assets. If that is the case, a justification exists for having

137. *See* Paul & Sabbah, *supra* note 15, at 74 (asserting that "TRAs do not appear to impact the valuation of a corporation in its IPO").

138. If pre-IPO owners know that SEC disclosures are so complex that TRAs get lost in the fine print, then critics' descriptions of these agreements as "underhanded" have merit. *See* Elliott, *supra* note 2, at 334 (quoting Robert Willens). Professors Fleischer and Staudt's empirical study analyzed the fine-print theory of TRAs by testing whether TRAs were more common in longer IPO public filings, under the theory that as the number of pages increases, owners will be more likely to include a TRA because a TRA will get lost in the details of a longer disclosure. Fleischer & Staudt, *supra* note 1, at 344–55. Their findings show that as the relevant SEC filings increase by ten pages, the likelihood that the parties include a TRA only increases by 0.01 percent, which is statistically insignificant. *Id.* at 354–55 ("Owner-founders, therefore, are not acting opportunistically, contrary to what many have argued.").

139. *See* Elliott, *supra* note 2, at 337 (" 'If there was a widespread belief that the public was pricing this agreement into the price they were willing to pay for the stock and that the existing owners were suffering dollar-for-dollar as regards to the public offering price, then there would no longer be an incentive for this' . . . ." (quoting Robert Willens)); Fleischer & Staudt, *supra* note 1, at 362 ("[I]f IPO pricing were perfect, and the new investors agreed to pay for all the underlying tax assets, the founders could simply supercharge the deal and accept a higher purchase price in lieu of a TRA, leaving the full value of the tax assets with the newly public company.").

a TRA with a division between the pre-IPO owners and the company—although whether the current standard, where the pre-IPO owners get eighty-five percent of benefits, is the correct division is an empirical question that depends on the circumstances of the particular IPO.

Although the traditional view is clearly that tax assets are not properly valued in an IPO and that TRAs do not impact IPO valuations, there has been a surprising recent shift in the market for one type of supercharged IPO, the Up-C, discussed in detail in Part III. For over a decade, every Up-C IPO included a TRA.[140] Although the vast majority of Up-Cs still include a TRA, since 2013, six companies have used the Up-C structure but have chosen not to implement a TRA.[141] The use of Up-Cs even without TRAs can be attributed at least in part to the fact that the Up-C structure inherently provides other benefits to the pre-IPO owners, including the fact that it allows pre-IPO owners to own interests in a partnership and thus avoid corporate-level tax.[142] This recent development could also mean that at least some recent pre-IPO owners believe that the market has learned to price in tax assets, including the assets created by the Up-C structure.[143] Although IPOs that use TRAs continue to increase as a percentage of the overall IPO market,[144] the recent nonuse of TRAs in Up-Cs potentially tells a story about the market's ability to learn to incorporate new information over time, although whether this trend will continue or accelerate, and why it has occurred now, is impossible to tell based on publicly available information. Either way, it is an interesting development that will merit further analysis in the coming years.

140. In 1999, barnesandnoble.com went public in the first Up-C but did not enter into a TRA in connection with the transaction. *See* Elliott, *supra* note 2, at 337. Although there is no record of their reasoning, it seems likely that the owners and their advisors thought that the market would account for the tax assets they created through the Up-C by increasing the amount paid in the IPO. Subsequent companies entering into a supercharged IPO apparently disagreed, and until 2013 every other supercharged IPO included a TRA.

141. The six companies to use the Up-C structure since 2013 without a TRA include TerraForm Global, Inc.; Black Knight Financial Services; Tallgrass Energy GP, LP; TerraForm Power, Inc.; NRG Yield, Inc.; and Taylor Morrison Home Corp. *See, e.g.*, TerraForm Power, Inc., Exchange Agreement (Exhibit, Form S-1) (May 28, 2014), http://www.sec.gov/Archives/edgar/data/1599947/000119312514262438/d672387dex105.htm [https://perma.cc/A828-K6GA].

142. *See* Shobe, *supra* note 9, at 941–47 (discussing the many benefits of the Up-C structure, including the fact that it allows pre-IPO owners to avoid corporation taxation).

143. Prior to these transactions, experts predicted that the market would learn to price tax assets into supercharged IPOs as people grew more accustomed to these transactions. The recent non-TRA Up-C IPOs indicate that their predications might be coming true. *See* Elliott, *supra* note 2, at 339 (explaining that experts expect "the market to become more sophisticated in its ability to price tax attributes into the offering price" (paraphrasing Warren P. Kean)).

144. *See supra* note 8 and accompanying text.

B. Comparing TRAs and Private Sector Deals

The existing literature on TRAs focuses on TRAs in isolation, ignoring the fact that in private sector deals,[145] commonly referred to as mergers or acquisitions, sellers explicitly and implicitly require buyers to pay for a company's tax assets.[146] This Section compares and analyzes how parties sell tax assets in the private sector to how pre-IPO owners sell tax assets to public shareholders through TRAs. It argues that to the extent TRAs and private sector deals treat tax assets similarly, TRAs should generally be uncontroversial because private parties heavily negotiate terms and have lower information asymmetries than investors in IPOs.[147] However, to the extent that TRAs subject public shareholders to less favorable terms than what private parties typically agree to, we should consider whether the less favorable terms are the type that public shareholders are able to accurately account for in the IPO share price.

145. Private sector deals most commonly include a sale to a buyer within the same trade or industry, or a sale to a financial buyer. Buyers within the same trade or industry are typically called "strategic buyers" and typically invest with the goal of integrating the purchased company into their overall business. Financial buyers, including private equity firms, venture capital firms, hedge funds, and ultrahigh net worth individuals, make investments in companies with the goal of realizing a return on their investment with a sale or an IPO—often within a few years of buying the company—and thus these buyers often become pre-IPO owners.

146. *See* WILLIAM CALLISON & MAUREEN A. SULLIVAN, PARTNERSHIP LAW AND PRACTICE § 4.15 (2012) (describing tax arrangements among partners in a partnership); Merle M. Erickson & Edward L. Maydew, *Implicit Taxes in High Dividend Yield Stocks*, 73 ACCT. REV. 435 (1998) (showing implicit tax sharing when certain tax-favored assets produce lower returns than other, non-tax-favored assets); Merle M. Erickson & Shiing-wu Wang, *Tax Benefits as a Source of Merger Premiums in Acquisitions of Private Corporations*, 82 ACCT. REV. 359 (2007) (examining how organizational form influences an acquisition's tax structure); Edward L. Maydew et al., *The Impact of Taxes on the Choice of Divestiture Method*, 28 J. ACCT. & ECON. 117 (1999) (discussing how the step up is an integral part of the acquisition price); Douglas A. Shackelford & Terry Shevlin, *Empirical Tax Research in Accounting*, 31 J. ACCT. & ECON. 321 (2001) (discussing implicit tax sharing, including in the context of the effect of taxes on asset prices); Dan S. Dhaliwal et al., *The Effect of Seller Income Taxes on Acquisition Price: Evidence from Purchases of Taxable and Tax-Exempt Hospitals*, J. AM. TAX'N ASS'N, Fall 2004, at 1 (empirically showing that purchase prices are higher when there is a step up in the basis of assets); Steven Henning et al., *The Effect of Taxes on Acquisition Price and Transition Structure*, J. AM. TAX'N ASS'N, Supp. 2000, at 1 (showing that target shareholders receive part of the benefits of goodwill deductibility through higher acquisition prices).

147. Many of the relevant terms of a purchase or merger agreement have a similar economic effect to what is commonly contained in TRAs. However, unlike purchase agreements, which govern most of the terms in a merger or acquisition, TRAs are narrowly drafted to cover only payments for specific tax assets. While a purchase agreement is much broader than a TRA, the relevant sections cover much of the same ground as TRAs. For a discussion of the terms parties typically negotiate in merger agreements, see Manns & Anderson, *supra* note 24.

1. TRAs and Private Sector Similarities

The premise behind TRAs stems from a concept that is already well accepted in the private sector: buyers should pay more for a company that has tax assets than for an identical company that does not.[148] In the private sector, parties execute this by explicitly requiring the buyer to pay a certain amount for tax assets (typically as a part of the overall purchase agreement[149]) or, alternatively, by discussing the value of tax assets and implicitly building tax assets into the lump sum purchase price. But in an IPO, there is no negotiation between the pre-IPO owners and the public: the pre-IPO owners entirely control the terms of a TRA because they draft and implement TRAs before selling any interests in the company in the public offering.[150] Because it is impossible for the pre-IPO owners to sit down and ask the public shareholders whether they implicitly build tax assets into the share price, TRAs are effectively the public market's equivalent of explicitly requiring a buyer to pay separately for tax assets.[151] Public shareholders simply have to accept the terms of a TRA as is or choose not to purchase shares of that company.

The fact that buyers in negotiated deals are generally willing to pay additional amounts for companies with tax assets means that the general premise (though not necessarily the execution) of requiring

148. *See supra* note 146; *see also* Merle Erickson & Shiing-wu Wang, *The Effect of Transaction Structure on Price: Evidence from Subsidiary Sales*, 30 J. ACCT. & ECON. 59 (2000) (empirically showing that purchase prices are higher in transactions where parties made a Section 338(h)(10) election in connection with private sector deals). Since a Section 338(h)(10) election creates additional value for the buyers, sellers will only agree to make the election if the buyers pay for the additional value created by the sellers. *See id.*

149. A contract between the buyer(s) and seller(s), typically referred to as either a purchase or a merger agreement (depending on the deal structure), is the primary document governing the business and tax deal between the parties. For a broad overview of merger and acquisition agreements, see RONALD J. GILSON & BERNARD S. BLACK, THE LAW AND FINANCE OF CORPORATE ACQUISITIONS 563–601 (2d ed. 1995); and THERESE H. MAYNARD, MERGERS AND ACQUISITIONS 307–12 (2d ed. 2009). Tax sharing agreements are also used by private parties, but provide a less relevant comparison point because they generally involve divvying up tax responsibilities and benefits (rather than one party paying the other for tax assets). Tax sharing agreements are often used when two companies that formerly had a relationship where tax responsibilities and benefits overlapped separate. For example, parties often enter into tax sharing agreements when a company leaves a consolidated group.

150. The result is that TRAs are fairly uniform. In contrast, the terms of purchase agreements vary significantly depending on the deal and the negotiating position of the buyer and seller.

151. To the extent private parties do not actually discuss the value of tax assets, it may be difficult to know in any one deal whether a buyer is in fact paying for tax assets. However, companies are usually sold in a competitive process, so if one potential buyer does not value the tax assets, there likely will be another who does, and generally, companies are sold to buyers who are willing to pay more for companies with tax assets.

public investors to pay for tax assets should be fairly uncontroversial.[152] Since private parties often explicitly pay for tax assets, TRAs seem less like a tax scheme and more like an extension of what parties already do in other contexts.[153] Pre-IPO owners saw that if they provided tax assets that increase the overall value of a company, they should, in theory, receive more in an IPO. Therefore, TRAs could be broadly viewed as a means of putting pre-IPO owners and private sellers on more equal footing, at least in terms of compensation for tax assets.

2. TRAs and Private Sector Differences

TRAs changed the relationship between the newly public company and the pre-IPO owners. Traditionally, after an IPO, pre-IPO owners had no ongoing obligations to the public company and the public company had no ongoing obligations to the pre-IPO owners, except in their capacity as employees.[154] The introduction of TRAs added continuing obligations from the public company to pre-IPO owners for tax assets without adding any continuing obligations from the pre-IPO owners to the public company for tax liabilities.[155] TRAs add a one-way, ongoing cash flow from the public company to the pre-IPO owners. But under no circumstances do the pre-IPO owners make payments to the public company.

TRAs typically provide some protection for the public company by reducing future payments to pre-IPO owners in cases where a tax asset that was already paid out is challenged and ultimately disallowed.[156] But this small protection to the public company merely

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152. TRAs almost always stipulate that the public investors will pay the pre-IPO owners eighty-five percent of the value of tax assets, *see supra* note 51 and accompanying text, whereas in private sector deals there is significant variation regarding whether and how much buyers will pay for tax assets. In some cases, private buyers will pay more than eighty-five percent, while in other cases they will pay much less. So, owners in a TRA may generally get a better deal than sellers in a private sector deal, but the general premise that buyers pay for tax assets in both cases remains true.

153. Elliott, *supra* note 2, at 337 ("Let's face it, every time you're selling assets, if you deliver a basis step-up to a buyer, you get paid more . . . . That's all [a TRA] is." (internal quotation marks omitted) (quoting Eric B. Sloan)); *see* Jones & Stucke, *supra* note 1:

> [P]rospective sellers should consider TRAs as a way to make IPOs feasible alternatives to M&A deals. In some cases they may find that TRAs make IPOs preferable to M&A deals—if, for example, there are too few bidders for a competitive auction, or if the firm being sold would benefit from independence.

154. *See* SCHULTHEIS ET AL., *supra* note 133.

155. *See* Paul & Sabbah, *supra* note 15, at 75.

156. *See, e.g.*, Shake Shack Inc. Registration Statement, *supra* note 58 (explaining the netting process and stating that pre-IPO owners will not be required to reimburse the company for tax assets that are disallowed, and that, instead, any disallowed amount will be netted against future payments to the pre-IPO owners).

demonstrates how big the potential problem is. Even where this protection exists, the public company is only permitted to reduce future payments once the challenge to the tax benefit is finalized. This may come many years after the original payment was made to pre-IPO owners, at which point the disallowed amount may exceed the future payments.[157] In this circumstance, the pre-IPO owners have no obligation to reimburse the public company for its overpayments, so the payments under the TRA could substantially exceed the tax savings the public company realized. This is particularly problematic for TRAs for pre-IPO tax assets, such as NOLs, where all of the assets may be realized shortly after the IPO, leaving no future stream of payments to reduce (as opposed to a basis step up, where the benefits are generally realized over at least fifteen years).

Not only do TRAs not require the pre-IPO owners to pay back all overpayments from the public company, they also do not require the pre-IPO owners to pay the public company for pre-IPO tax liabilities. An example illustrates how public shareholders could be liable for tax liabilities that the public company incurred in the pre-IPO period. If the company took an "uncertain tax position" in the pre-IPO period that created a potential tax liability of $50 million, and the year after the IPO the company ended up owing the IRS the full $50 million, the $50 million liability would be paid entirely by the public company. The TRA would not allow the public company to reduce future payments for tax assets to the pre-IPO owners or require repayment from the pre-IPO owners, even though that liability is attributable entirely to the period in which the pre-IPO owners owned the company.

The one-way nature of TRAs is a significant departure from how parties sell tax assets in private sector deals, where buyers generally only agree to ongoing obligations to sellers for pretransaction tax assets if the sellers agree to indemnify the buyers for pretransaction tax liabilities that arise after the sale. If the sellers do not agree to a pretransaction tax indemnity, the buyers generally will not agree to pay for pretransaction tax assets.[158] A TRA is therefore different from what private parties would typically agree to, since a TRA imposes an ongoing obligation on the company to pay the pre-IPO owners for the

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157. *Id.*

158. Purchasers in private sector deals often agree to pay sellers for the pre-IPO tax assets if and when buyers realize the benefit of those tax assets—though when sellers are in a strong bargaining position and the company possesses valuable tax assets, they may be able to successfully demand an upfront payment for the tax assets. Due to the burden of keeping track of and paying for tax assets, when tax assets are minor but sellers insist on being paid for them, a purchaser may pay for the assets upfront. However, if the tax assets are significant, a purchaser is less likely to want to take the risk that they may never receive the benefits they expect from the tax assets, and so are more likely to agree to pay for them if and when realized.

company's pre-IPO tax assets as they are realized without imposing a reciprocal obligation on the pre-IPO owners to pay for the company's pre-IPO tax liabilities as they are realized. In this respect, a TRA provides a worse outcome for the public in an IPO than buyers typically negotiate in a private sector deal.

This disparate treatment is potentially problematic because if public investors do not fully price in tax assets in an IPO, which is the basis for creating a TRA in the first place,[159] then there is also reason to expect they would fail to price in tax liabilities.[160] Although supporters of TRAs generally claim that a TRA is a tool to efficiently price deals by explicitly transferring the value of tax assets that would not otherwise be properly accounted for, the fact that TRAs do not include payments for tax liabilities means that they simply create a different kind of inefficiency in pricing, and one that always favors pre-IPO owners.[161] If public investors do not adjust for the presence of a TRA, as is commonly believed, then a TRA that strips the public company of its pre-IPO tax assets while not assuming the burdens of the pre-IPO tax liabilities is not just an innocent "correction" for a market inefficiency. It only corrects for the market inefficiency that hurts the pre-IPO owners without accounting for the market inefficiency that hurts the public company.[162]

If disclosure is meant to ensure proper market pricing, the SEC should at least require that companies specifically disclose the one-sided nature of TRAs by highlighting that TRAs pay pre-IPO owners for the value of tax assets but that the pre-IPO owners are not liable for certain pre-IPO tax liabilities that may arise. Alternatively, pre-IPO owners who use a TRA could indemnify the public company for tax liabilities attributable to the pre-IPO period. This could be done in a way that ensures fair treatment to both sides. For example, in a first generation TRA that only requires payments for tax assets created in connection with the IPO, it would be reasonable for pre-IPO owners not to indemnify the public company for all pre-IPO tax liabilities (since

159. *See supra* note 123 and accompanying text.

160. In other circumstances, tax liabilities are also not priced into the value of securities. *See* SHLEIFER, *supra* note 25, at 53–88 (explaining that in mutual funds, the values of the securities are calculated based on net asset value, which does not include liabilities for capital gains tax on unrealized appreciations); Barberis & Thaler, *supra* note 25, at 1096–97 (discussing pricing closed-ended funds and the effect of tax liabilities).

161. Public company valuations are often based on EBITDA, which excludes both tax assets and tax liabilities. *See supra* note 130 and accompanying text.

162. *See* Willens, *supra* note 20 ("TRAs may be fully legal; however, the entire import of these agreements in the price of an IPO might not be fully appreciated by all investors. To the extent the TRAs are not taken into account by such shareholders, they may lead to market inefficiencies.").

both pre-IPO tax assets and liabilities are left with the public company). However, recall from above that second and third generation TRAs include not only the tax assets created in the IPO but also, or even only, pre-IPO tax assets. For these types of TRAs, it would make sense to require the pre-IPO owners to indemnify the public company for all pre-IPO tax liabilities.

Although sellers could argue that being subject to ongoing obligations creates administrative burdens for them, this argument is not very persuasive where the pre-IPO owners are the ones choosing to change the nature of the IPO by including a TRA that creates ongoing financial and administrative obligations for the newly public company.[163] At the very least, sellers could be required to net pre-IPO tax liabilities against future payments for tax assets. Although liabilities could exceed future payments for tax assets, leaving the public company on the hook for something the pre-IPO owners should have paid, this would still be an improvement on the current TRA status quo and would not require any additional administrative burden on the pre-IPO owners.

III. UP-CS AND TRAS

Up-Cs are by far the most popular and relevant type of supercharged IPO, and the growth of the Up-C accounts for a significant portion of the increased use of first and second generation TRAs.[164] While TRAs are not synonymous with the Up-C structure, the majority

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163. In addition, if sellers do not want to deal with the administrative burdens that come with ongoing liability, they could purchase insurance to cover the pre-IPO tax liabilities, as is becoming increasingly common in the private sector. *See* George H. Wang, *Reps and Warranties—Keeping M&A Liabilities in Check*, LAW360 (May 1, 2015, 10:14 AM), https://www.law360.com/articles/650228/reps-and-warranties-keeping-m-a-liabilities-in-check [https://perma.cc/CDX5-2GBA] ("In recent years, representation and warranty insurance has gained popularity as a tool to decrease transaction liability exposure in mergers and acquisitions.").

164. *See, e.g.*, DeSalvo, *supra* note 48, at 865–66:

> [A]s more companies operate in entities treated as a partnership, there may be more companies eyeing public offerings that hold business operations in partnership form and are thus ripe for UP-C structures. . . . In fact, many private equity sponsors intentionally invest in operating companies through partnership structures to lay the foundation for an UP-C IPO to be considered as a potential exit strategy.;

see also Chelsea Naso, *Wilson Sonsini-Led GoDaddy Draws $460M in Upsized IPO*, LAW360 (Apr. 1, 2015, 10:33 AM), http://www.law360.com/articles/638102/wilson-sonsini-led-godaddy-draws-460m-in-upsized-ipo [https://perma.cc/89HM-8523]:

> The use of the Up-C structure has become more common as partnerships carving out business units look to get the most bang for their buck in an IPO, with GoDaddy's anticipated offering and the recent public debut of beloved burger chain Shake Shack Inc. drawing attention to the structure. Summit Materials Inc., a cement company backed by The Blackstone Group LP, also recently opted to list using the Up-C structure for its $400 million debut.

of TRAs are used in Up-Cs, the vast majority of Up-Cs use a TRA, and one of the main reasons pre-IPO owners use the Up-C structure is in order to implement a TRA.[165] So evaluating the Up-C structure is important in order to fully understand the effect TRAs have on the IPO market. I have written extensively about Up-Cs in a prior article,[166] so this Part just gives a brief overview of the Up-C structure. The purpose of discussing the Up-C in this Part is to a show a unique issue that arises with these complex transactions. It then brings to light a feature of Up-Cs that allows pre-IPO owners to take money from the public company in an Up-C that should have been earmarked for the public shareholders. This unjustified benefit to pre-IPO owners, which has never been discussed in the literature, is a material risk that is not disclosed to the public, making it impossible for public shareholders to accurately value Up-Cs.

A. The Up-C

The Up-C is the most common and increasingly popular form of supercharged IPO. Its quick rise to prominence is due to the fact that it creates significant benefits for pre-IPO owners, with very little downside. An Up-C structure is available when the pre-IPO owners own interests in a partnership (i.e., not a C corporation). One of the primary benefits of the Up-C is that the pre-IPO owners structure the IPO so that a new corporation,[167] which will become the publicly traded company, buys the pre-IPO owners' interests in the historic partnership, thus creating a structure where the public company is essentially a holding corporation for the operating partnership. Part of the "magic" of this structure is that when the public company purchases interests in the partnership (with the money it receives in the IPO), the corporation gets a stepped-up basis in the partnership's assets, thus creating valuable tax assets.[168] As discussed in Part I, the pre-IPO owners retain the value of these new tax assets, and in many cases,

165. There have been a few Up-Cs that have not used TRAs. The very first Up-C, barnesandnoble.com, did not use a TRA. *See* Elliott, *supra* note 2, at 337 ("[T]he online book retailer barnesandnoble.com was one of the first non-REITs to use the Up-C structure in its IPO."). In addition, a handful of recent Up-Cs have not used TRAs. *See supra* notes 140–144 and accompanying text.

166. *See generally* Shobe, *supra* note 9.

167. The new parent is a C corporation for tax purposes, but may be organized under state law as a corporation, a limited liability company, or a limited partnership. If the historic partnership itself had converted to a corporation and gone public, the public company would not receive a step up in the basis of the underlying partnership assets because the conversion would have been a Section 351 transaction and the public company would have taken a carryover basis in the partnership assets. *See* Rev. Rul. 84-111, 1984-2 C.B. 88.

168. GINSBURG ET AL., *supra* note 13, ¶ 1602.10.2 (explaining the mechanics of the Up-C).

other tax assets of the public company, by implementing a TRA requiring the public company to pay them for such assets.[169]

A second important benefit of the Up-C is that it allows pre-IPO owners to continue to hold their economic interests in the historic partnership rather than directly in the publicly traded C corporation, which is subject to corporate tax.[170] By holding their economic interests in a partnership, the pre-IPO owners get all the benefits of being publicly traded without having to pay two levels of tax.[171] A third benefit of the Up-C is that, unlike some other supercharged IPOs, owners do not have to pay tax any sooner than they would in a traditional IPO despite the benefits they receive from the Up-C structure.[172]

One other key feature of Up-Cs that is relevant to understanding the potential double benefit it creates for pre-IPO owners, as discussed in the next Section, is that the pre-IPO owners have the right to exchange their interests in the historic partnership for shares of the

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169. This allows the pre-IPO owners to pay tax on their sale at reduced capital gains rates (except to the extent of any "hot" assets), which generates an offsetting deduction for the corporation at higher corporate tax rates.

170. The historic partnership typically admits the new C corporation as the sole managing member of the partnership and gives this C corporation voting control over the partnership. The C corporation issues the Class A stock to public investors who subscribe in the IPO and issues Class B voting, noneconomic stock to the pre-IPO owners in accordance with their ownership in the historic partnership. The Class B stock acts as a mechanism for allowing the pre-IPO owners to effectively control the public company while maintaining the tax benefits of having their economic rights in the partnership. *See infra* Figure 2.

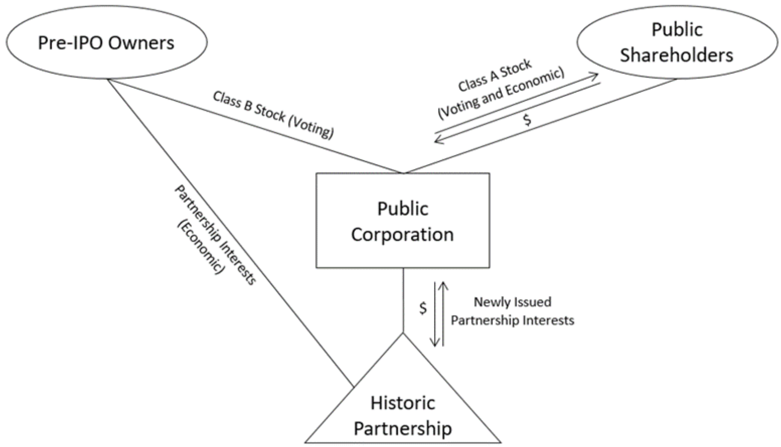
171. The recently enacted tax reform act reduced the benefit of holding interests in a partnership versus a corporation because the overall corporate marginal rate was reduced from 48 to 36.8 percent, whereas the overall pass-through marginal rate (assuming full benefit of the new twenty percent pass-through deduction, which many pre-IPO owners will likely not qualify for) was reduced from 39.6 to 29.6 percent. *See Tax Reform Act - Impact on Real Estate Industry*, BAKER BOTTS (Dec. 20, 2017), http://www.bakerbotts.com/ideas/publications/2017/12/tax-reform-act---real-estate [https://perma.cc/2M8C-JRYU] (describing effects of the tax reform act on marginal rates); *see also* GINSBURG ET AL., *supra* note 13, ¶ 1602.10.2:

> Two significant tax benefits can be achieved by using an Up-C structure as an alternative to simply incorporating the old partnership/LLC in a tax-free Code §351 transaction: (a) Newco-C obtains a stepped-up tax basis in its share of the old partnership/LLC's assets under Code §743(b) . . . [and] (b) The portion of old partnership/LLC's future taxable income allocated to its equity owners other than Newco-C is not subject to corporate-level tax and therefore is taxed only once at the old partnership/LLC equity owner level.

172. This is different than the Section 338(h)(10) supercharged IPO, which triggers an immediate tax liability for the owners even if they do not sell any of their interests in the IPO. *See* Willens, *supra* note 20 ("The Up-C structure enables companies to acquire assets by issuing operating partnership units. Those units may make it possible for the founding owners from whom the company acquires assets to defer recognizing taxable gains until the company disposes of those assets.").

public company on a one-for-one basis. This provides the pre-IPO owners liquidity like they would have in a traditional IPO.[173]

FIGURE 2: THE UP-C



B. Disclosure and Double Tax Distributions

In order for public shareholders to accurately value shares of a company, they need to understand the risks and liabilities of that company. Part II analyzed whether public shareholders understand the ways that certain "costs," including TRAs and tax liabilities, negatively affect the value of a public company. This Section furthers that discussion by showing that despite the fact that commentators assume that all material risks are disclosed in an Up-C, Up-Cs do not disclose the presence of a certain material risk—the risk that the Up-C structure allows pre-IPO owners to receive double tax distributions, which transfers value from the public to the pre-IPO owners without

173. *See* DeSalvo, *supra* note 48, at 866 ("Another significant advantage of the UP-C structure is that it provides equity owners in a private partnership a path to liquidity via the put right (often called a redemption right) provision of the amended partnership operating agreement."). One restriction on the pre-IPO owners' liquidity is that their exchange rights are limited to minimize the risk of triggering the PTP rules. For example, in many Up-Cs, the pre-IPO owners are only able to exchange their partnership interests for shares in the public corporation a few times per year. However, in other Up-Cs, the parties choose to impose minimal restrictions on the exchange rights of the pre-IPO owners. *See* Amy S. Elliott, *IRS Concerned by Aggressive Exchange Rights in Up-Cs, Up-REITS*, TAX NOTES TODAY (Dec. 4, 2015), https://www.taxnotes.com/tax-notes-today/partnerships/irs-concerned-aggressive-exchange-rights-cs-reits/2015/12/04/18112721 [https://perma.cc/8GV7-YC4M] (discussing aggressive exchange rights and quoting Clifford Warren, IRS Associate Chief Counsel (Passthroughs and Special Industries), as saying, "I think people may be straying—we're hearing—from some of the limitations . . . . [G]iven the spirit of C corp Up- structures, I think people should be conservative.").

any justification.[174] Tax distributions typically account for almost half of a partnership's revenue, so the amounts at stake are significant.[175]

Understanding the mechanics of how pre-IPO owners can receive double tax distributions, and why it should be disclosed, starts with gaining a basic understanding of the Up-C structure, explained above and illustrated in Figure 2. The Up-C is complicated, but the key takeaway for purposes of this Section is that *both* the public C corporation and the pre-IPO owners are partners in the historic operating partnership.

The next step in understating these double tax distributions requires an understanding of what tax distributions are and how they work in Up-Cs. Partnerships are taxed as flow-through entities, and each partner owes taxes on his or her allocable share of partnership income. Importantly, partners owe taxes on their allocable annual shares of partnership income even if the partnership does not distribute any cash to the partners, a scenario often referred to as "phantom income."[176] In other words, partners can potentially owe taxes but have zero cash on hand to pay those taxes.[177] To avoid this scenario, the Up-C requires that the partnership in the structure distribute cash to each of its partners.[178] These cash distributions are typically called "tax

174. *See* Elliott, *supra* note 2, at 339 ("[T]here's nothing nefarious about it. It's all disclosed." (quoting Robert Willens)); Telis Demos, *Shake Shack Files for Initial Public Offering*, WALL ST. J. (Dec. 29, 2014, 7:32 PM), https://www.wsj.com/articles/shake-shack-files-for-initial-public-offering-1419870904 [https://perma.cc/LN8W-VH9E] (noting that if TRAs and other material risks of the IPO are "fully disclosed and . . . reflected in the IPO price, it's probably not that objectionable" (quoting Robert Willens)).

175. As discussed later in this Section, partnerships typically make pro rata distributions to their partners at the highest rate applicable to any partner in the partnership. Typically, at least one partner's federal, state, and local combined tax rate totals approximately forty-five percent; therefore, partnerships typically distribute approximately forty-five percent of their income to the partners in the partnership. *See, e.g.*, Switch, Ltd., Fifth Amended and Restated Operating Agreement (Exhibit 10.3) (2017), https://www.sec.gov/Archives/edgar/data/1710583/000119312517280759/d393780dex103.htm [https://perma.cc/3V7H-5UQ7] [hereinafter Switch Operating Agreement]:

> [T]he Company shall be required to make a Distribution to each Member of cash in an amount equal to the excess of such Member's Assumed Tax Liability, if any, for such taxable period over the Distributions previously made to such Member pursuant to this Section 4.01(b) with respect to such taxable period (the "Tax Distributions").

176. For further discussion of phantom income, see Gregory L. Germain, *Avoiding Phantom Income in Bankruptcy: A Proposal for Reform*, 5 FLA. TAX REV. 249 (2001).

177. For example, if a historic partnership in an Up-C had $100 million in taxable income in 2016, and Leo, a pre-IPO owner, owned a fifty percent direct interest in the historic partnership, then Leo would be allocated $50 million in taxable income. If Leo's effective marginal rate was forty-five percent (with his federal and state taxes), then he would owe $22.5 million in tax, even if he had zero cash to pay the tax liability.

178. *See* Hart, *supra* note 42, at 59 ("As is the case with many partnership agreements, the operating agreements governing [Up-Cs] will feature a tax distribution provision to ensure that the partners have sufficient cash to pay their tax liabilities attributable to the partnership.").

distributions," since the purpose of the distributions is to ensure that each partner has enough cash to pay tax on his or her allocable share of partnership income.

How does the Up-C lead to double tax distributions to pre-IPO owners? The answer is best explained in three steps, which are also illustrated in the diagram below. First, Up-C agreements require that the partnership make *pro rata* tax distributions to each partner (including the pre-IPO owners and the public C corporation),[179] typically at the highest marginal effective tax rate that any one partner is subject to, regardless of any individual's actual tax liability. This means that partners subject to the highest marginal effective tax rate will have just the right amount of cash to pay their taxes, but partners subject to a lower marginal tax rate will receive more than they need to pay their taxes. Second, because the highest marginal corporate tax rate is lower than the highest individual tax rate, the C corporation in an Up-C (i.e., the entity that the public shareholders own shares in) receives *more* in tax distributions than it needs to pay its taxes. Although this outcome seems odd, parties in the Up-C intend for the C corporation to receive "extra" cash because it is unfair for one partner to receive a disproportionate amount of partnership revenue simply because of a difference in tax status.[180] Whether or not the pre-IPO owners are able to receive double tax distributions depends on what the public company does with its excess tax distributions. If it immediately distributes these amounts to its shareholders as dividends, then there is no potential windfall for the pre-IPO owners because all of the excess amount will go to the public shareholders who are rightly entitled to it.[181] It is more likely, however, that the company will retain these excess distributions for some period of time, which creates the potential for pre-IPO owners to receive a portion of these excess distributions

179. *See id.* at 59 ("[T]ax distributions, like any other distributions to be made by the umbrella partnership, are usually required to be made on a pro rata basis."); *see also* Switch Operating Agreement, *supra* note 175:

> To the extent a Member otherwise would be entitled to receive less than its Percentage Interest of the aggregate Tax Distributions to be paid pursuant to this Section 4.01(b) on any given date, the Tax Distributions to such Member shall be increased to ensure that all Distributions made pursuant to this Section 4.01(b) are made pro rata in accordance with such Member's Percentage Interest.

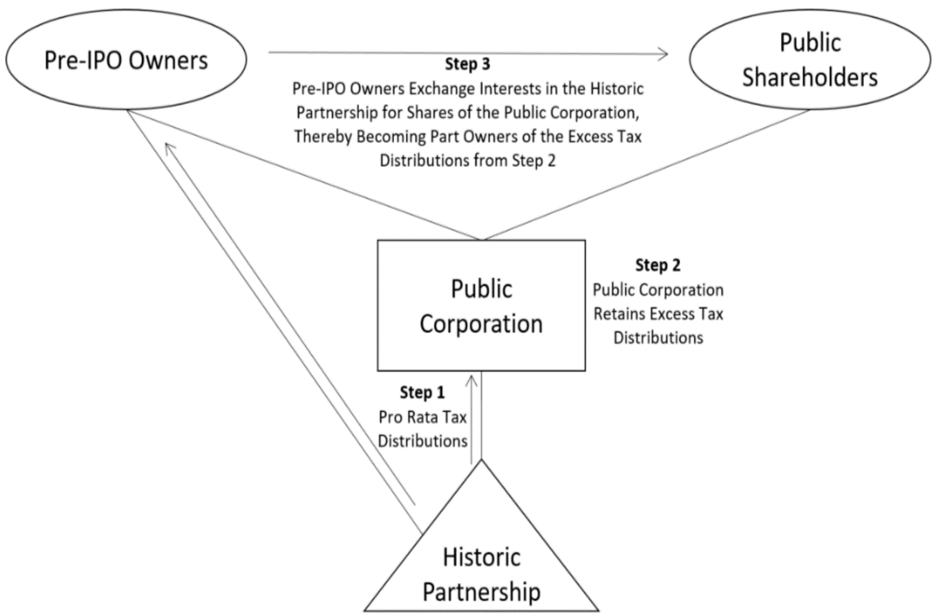
180. Tax distributions can either cover each partner's actual tax liability, or they can cover an assumed tax liability. If tax distributions cover each partner's actual tax liability, then some partners will receive more simply because of their tax status. Partners with lower marginal tax rates balk at the idea of subsidizing the more highly taxed partners.

181. The potential windfall to pre-IPO owners remains unless the public company is current in its distributions at the time the pre-IPO owners exchange their partnership interests for shares in the public company. To the extent the public company has only distributed part of its excess tax distributions as dividends, then a partial windfall remains.

(which should have been earmarked for the public shareholders). Third, pre-IPO owners realize a double benefit when they exchange their interests in the historic partnership for interests in the public company: the pre-IPO owners already received their *own* tax distributions as partners in the partnership, and upon exchange for an interest in the public company they own a portion of the company's excess tax distributions that should have been entirely attributed to the public shareholders at the time the excess tax distributions were paid. In other words, when the pre-IPO owners exchange their partnership interests for shares in the public company, their new shares in the public company have "extra" value built into them because the shares include a portion of the undistributed tax distributions that should have been attributable only to the public shareholders.[182] In fact, if a pre-IPO owner is aware that the public company retains the excess tax distributions, it could provide an incentive for a shareholder to hold its interest in the historic partnership and receive its full tax distributions while the public company accrues excess tax distributions. Once a pre-IPO owner trades its interest in the historic partnership for shares of the public company, it loses the ability to accrue this double benefit going forward.

182. Alternatively, if the public company does not distribute the excess tax distributions, then the parties could adjust the exchange ratio so that pre-IPO owners receive fewer shares in the public company to reflect the additional value they receive per share.

FIGURE 3: DOUBLE TAX DISTRIBUTIONS TO PRE-IPO OWNERS



This flaw in the Up-C structure can result in significant wealth transfers from public shareholders to pre-IPO owners. To illustrate how it works, using 2017 tax rates, suppose a historic partnership is owned eighty percent by a public company and twenty percent directly by a pre-IPO owner, Anna. Under the terms of a TRA, the partnership makes tax distributions to both the public company and to Anna at the highest marginal rate applicable to any partner. Anna's combined federal, state, and local effective marginal tax rate is forty-five percent, and the public company's combined federal, state, and local effective marginal tax rate is thirty-five percent (so the public company will receive more in tax distributions than it needs to pay its taxes). In 2016, the historic partnership had income of \$100 million and thus distributed \$45 million total in tax distributions to its partners: Anna and the public company. Because the public company owns an eighty percent interest in the historic partnership, it receives \$36 million of the \$45 million, with Anna receiving the remaining \$9 million. Because the public company had taxable income of \$80 million (it owns an eighty percent interest in a partnership that had taxable income of \$100 million), and is subject to a tax rate of thirty-five percent, it owes taxes of \$28 million even though it received \$36 million "to pay its taxes." The public company chooses to keep the \$8 million of excess tax distributions in the public company (rather than distributing it as dividends to the public shareholders). On January 1, 2017, Anna exchanges all of her interests in the historic partnership for shares of the public company and therefore owns twenty percent of the public company, *including* twenty percent of the $8 million excess tax distribution. This means that Anna has shares worth $1.6 million more than they would be if the public shareholders had rightly received all of the value of the excess tax distributions.[183] She can realize this unjustified windfall either by selling her shares (that are worth $1.6 million more than they would be without the double benefit) or by holding onto her shares until the public company pays the $8 million out as a dividend.[184] This is a simplified example, but it shows that even over the course of one year the effects of the double benefit to pre-IPO owners can be significant. The recently enacted tax reform act significantly lowered the corporate tax rate, which makes it much more likely that a corporation will receive excess tax distributions, and that those excess tax distributions will far exceed the corporation's actual tax liability. This will result in pre-IPO owners, such as Anna, potentially receiving an even greater windfall from double tax distributions.[185]

The SEC requires companies to prominently disclose any material risks in an S-1 registration statement, including risks that may affect a company's profitability, financial position, or other risk

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183. When Anna sells the shares or receives the dividend, she will pay shareholder-level tax on the $1.6 million.

184. The more likely scenario is that Anna will realize the benefit when she sells her shares. Since one of the main benefits of retaining her interests directly in a historic partnership is that she is only subject to one level of tax, it generally would not make sense for her to exchange her partnership interests for shares in the public company until she was ready to also sell her shares in the public company. A third alternative is that the public company may have the option to pay Anna cash for her partnership interests, in which case the public company would pay Anna the fair market value of her shares. In this case, Anna would realize the increased benefit of the $8 million from the increased fair market value of her shares.

185. The recently enacted tax reform act lowered the corporate tax rate from thirty-five percent to twenty-one percent, but lowered rates on individuals by less. *See* Tax Cuts and Jobs Act of 2017, Pub. L. No. 115-97, § 13001, 131 Stat. 2054, 2096. In particular, the tax rate for individuals who do not qualify for the twenty percent deduction for qualified business income was reduced from 39.6 to 37 percent, § 11001, 131 Stat. at 2057–58, and the types of shareholders who are pre-IPO owners in an Up-C are likely to fall into that category. Because tax distributions are based on the highest marginal tax rate that any one partner is subject to, it is very likely that tax distributions in Up-C structures will be distributed at thirty-seven percent plus any applicable state and local taxes, so the disparity between the corporate tax rate and the individual tax rate is now even greater. Because corporations have a much lower tax liability but will continue to receive tax distributions at high individual rates, corporations will have significantly more excess tax distributions. This results in potentially greater windfalls for pre-IPO owners, such as Anna, when they exchange their interests in the historic partnership for interests in the public corporation.

factors unique to the company or its industry.[186] For example, when a company uses a TRA, the company is required to disclose any material risks associated with the TRA.[187] To illustrate, the registration statement for the Shake Shack Up-C IPO prominently discloses that it uses a TRA[188] and explains many of the risks associated with its TRA, including the fact that pre-IPO owners are not required to reimburse the public company for tax benefits that are later disallowed,[189] that the payments under the TRA will be "substantial" and reduce the overall cash flow to the public company,[190] and that the public company could be required to make payments to the pre-IPO owners that are greater than the benefit it receives with respect to the tax assets.[191] Although Shake Shack's registration statement discloses these and many other material risks, it does not disclose any risks associated with excess tax distributions being paid to pre-IPO owners.

Although companies are supposed to disclose all material risks, in practice they never disclose the material risk that Up-Cs also create a unique opportunity for pre-IPO owners to receive an unjustified windfall from the public company's excess tax distributions. Nondisclosure of this risk creates a potentially significant market inefficiency that the SEC should fix by requiring Up-C IPOs to disclose the presence and effect of the wealth transfer from the public shareholders to the pre-IPO owners.[192]

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186. *See* Goshen & Parchomovsky, *supra* note 122 (discussing disclosure duties in an IPO). Interestingly, the SEC rules state that they do not want companies to disclose risks that apply to any issuer in any offering, implying that the SEC disclosure documents should highlight risks that are particular to the company filing the disclosure documents so that an investor is better able to compare risks among different companies. *See* 17 C.F.R. § 229.503(c) (2017) ("Do not present risks that could apply to any issuer or any offering.").

187. A public company is also required to include a copy of any TRA as an attachment to the company's SEC filings.

188. The Shake Shack Registration Statement prominently discloses the presence of its TRA. It uses the term "tax receivable agreement" or "TRA" ninety-seven times. *See* Shake Shack Inc. Registration Statement, *supra* note 58.

189. *Id.* at 42:

> We will not be reimbursed for any cash payments previously made to the Continuing SSE Equity Owners under the Tax Receivable Agreement in the event that any tax benefits initially claimed by us and for which payment has been made to a Continuing SSE Equity Owner are subsequently challenged by a taxing authority and are ultimately disallowed.

190. *Id.* at 41 ("The Tax Receivable Agreement with the Continuing SSE Equity Owners requires us to make cash payments to them in respect of certain tax benefits to which we may become entitled, and we expect that the payments we will be required to make will be substantial." (emphasis omitted)).

191. *Id.* at 41–42.

192. *See supra* note 30 and accompanying text; *see also* Eugene F. Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 J. FIN. 383 (1970) (emphasizing the importance of share price accuracy); Jeffrey N. Gordon & Lewis A. Kornhauser, *Efficient Markets, Costly Information, and Securities Research*, 60 N.Y.U. L. REV. 761, 802 (1985) ("[T]he law should

CONCLUSION

TRAs fundamentally change the nature of IPOs by transferring value from public shareholders to the pre-IPO owners. This Article shows that TRAs have rapidly risen in popularity and have very recently evolved in ways that make them universally available to any IPO. This Article analyzes the ways that TRAs transfer wealth from public companies to pre-IPO owners, presents previously overlooked economic and disclosure issues arising in these transactions, and argues that the SEC should require companies to publicly disclose these material risks.

select rules promoting the efficiency of financial markets relative to the optimal information set."). Public companies could avoid the SEC disclosure requirement by actually "fixing" the issue with tax distributions being unfairly paid to pre-IPO owners. One way the company could do this would be to amend its governing documents to require that it distribute any excess tax distributions as dividends prior to any pre-IPO owner exchanging his or her partnership interests for shares in the public company. Another option would be to amend the governing documents to adjust the exchange ratio. For example, typically, a pre-IPO owner in an Up-C could exchange ten partnership units for ten shares in the public company. *See* Shobe, *supra* note 9, at 936–37 ("The Up-C . . . [gives] the pre-IPO owners the right to exchange their (voting) Class B shares together with a corresponding number of (economic) partnership units on a one-for-one basis for (voting and economic) Class A shares."). However, if the public company has not distributed its excess tax distributions as dividends, then a pre-IPO owner who exchanged ten partnership units would receive fewer than ten shares in the public company.