FINDING INTELLECTUAL PASSION IN INITIAL PUBLIC OFFERINGS

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Early in my career I set my scholarly sights on the initial public offering (IPO)—the ultimate big-game trophy animal. As you may know, the IPO is, or at least used to be, a rite of passage for the small subset of corporations that grow beyond closely held firms to issue shares to the public and be listed on a national exchange.

Many, if not most, incoming law students would say that they are going to law school to help people, to make the world a better place, to fight for justice. But corporate law, tax law, and partnership law do not inspire and motivate many humanities majors to go to law school. So, what about my research inspires passion to the degree that I chose to title my remarks "Finding Intellectual Passion in Initial Public Offerings"? IPOs are definitely intellectually challenging and engrossing, but that is not enough to sustain a passion.

Over time I have realized that the beauty of the law is not only that the rule of law creates equals among men and, if dependable, can right the wrongs borne out of bigotry, corruption, and madness. The rule of law also creates an environment in which every citizen benefits from the almost invisible background of strong and true institutions, whether those institutions are law enforcement, systems of K–12 and higher education, an independent judiciary, an independent press, or yes, even sound financial institutions and capital markets. These are legal luxuries that we take for granted but that are definitely not found in every country around the world. My work has focused on the legal underpinnings of our financial markets, looking for strengths and weaknesses that we can build upon or rework in order to support that invisible background.

THREE IPO GATEKEEPERS

The purpose of an IPO is to give a firm access to the capital market. Raising capital by offering shares to the public strengthens the company and allows it to funnel that capital into various pursuits, such as research and development, marketing, supply chain management, and growth. Three gatekeepers stand between issuers and investors in the capital markets—attorneys, accountants, and investment banks—and corporations must enlist the help of all three in order to successfully navigate an IPO.

In 2002, as I moved from five years of private practice to academia, I began by studying and publishing about the gatekeepers I knew: attorneys. After that, I quickly realized that no one wanted to read an article about accountants (and I did not want to write one), so in 2004 I began focusing on the third capital market gatekeeper: investment banks.

I approached this topic by looking at federal regulation of IPO investment banking practices. That article was a bit tricky for me because I had practiced corporate finance, an area in which we assiduously sought to stay out of securities regulation, and I had not yet begun teaching securities law. However, the purpose of academic writing is to discover new approaches to interesting topics, so I went forward and immersed myself in the inertia of securities regulation.

In preparation for registering with the Securities Exchange Commission to sell its shares to the public, a company (referred to as a "firm") must hire a law firm, a public accounting firm, and an underwriter. In the world of IPOs, "the firm" or "the issuer" is identified with the individuals who control the firm, mainly the CEO and the board of directors.

Typically, the CEO during an IPO is the firm founder, unless the cofounders have ousted one or more of their compatriots and/or the firm has existed in Silicon Valley long enough for the venture capitalist shareholders to oust the founder and replace him or her with a professional manager as CEO. Often we refer to "the firm" but mean the founders, alongside large investors such as venture capital firms or angel investors.

The gatekeepers' function, then, is to ensure that the firm is not a fraud. The accountants audit the financials and provide "comfort letters" to the underwriter to make sure the books are not being cooked. The accountants will only sign the required comfort letter if they are satisfied that no fraud is being committed on the public, the intended consumer.

The investment banks act more like a sales force because they are usually obligated to purchase any unsold shares when the firm goes public. These banks are subject to liability for false statements in registration materials and selling documents, so they also theoretically have an incentive to ensure that the company is a straight—or at least not-too-crooked—arrow.

Finally, the law firms that take companies public counsel those companies regarding how to get their legal houses in order and how to be honest and straightforward in their registration materials. Because only a handful of law firms operate in the IPO industry, the theory is that they can charge high rates because of the reputation their names lend to unknown startup firms. My research questioned these gatekeeper theories as to the attorneys and investment banks.

THE ATTORNEYS

During the last (really) hot IPO market in the late 1990s, attorneys strayed away from their hourly IPO fee, which was thought of in the industry as their "reputational rent." During that time, many very young, unseasoned startups went public with little cash and before they had several quarters of profits.

To combat this, several law firms, mainly in the Bay Area, championed a fee innovation: law firms would be given pre-IPO shares in lieu of, or sometimes in addition to, an hourly fee.

In 1999, Silicon Valley law firms took 173 clients public and held IPO shares in 99 percent of these firms. The upside was that if an IPO went forward, the shares acted as a bonus—an enormous bonus. Instead of a legal fee of $250,000 or $500,000, firms were reaping 10 or 100 times that amount in IPO shares.

Because of the ways in which investment banks price IPO shares, those shares that are allocated before the opening bell are sold at the IPO price. Then, when the shares become available to the public, the price may rise relative to market demand. In a hot IPO market the shares could be worth much, much more by the end of the day. This "pop" is a huge advantage to those who are given pre-IPO shares, including law firms.

Now, nothing in the Model Rules prohibits lawyers from investing in their clients. Attorneys are not supposed to charge an "unreasonable" fee, but that is all the guidance that is given. What was the problem then? Was there a problem?

My theory was this: A deal lawyer's role is to tell the client when to slow down, walk away, or keep going. In an IPO, the lawyer finds the weak spots in the company and discloses these risks and weaknesses in the registration statement. If the attorney finds something that is not only material but extremely negatively significant, then the lawyer should counsel the firm to postpone the IPO. However, if an attorney is looking at an eight-figure "bonus" if the IPO closes and finds a hot audience, then the attorney may be tempted not to fully disclose weaknesses and definitely not to postpone or cancel an offering.

CRAIG FRAZIER

By the time I started my scholarly work on this issue, the hot IPO market of the late 1990s was over. A robust IPO market has not entirely returned, so the issue has drifted away for the most part. In addition, testing this theory is not easily done because the empirical data on which firms hired investor attorneys is not public. However, I have noted that many firms with known attorney investors are now in the trash bin of history.

THE INVESTMENT BANKS

The gatekeeper with the most control in the initial public offering is the investment bank—the underwriter. Back in the day, before the internet, before the online SEC portal EDGAR,[1] and before personal computers and cable television, the underwriter was the sole distributor of information about an upcoming IPO. Underwriters met personally with potential institutional investors and high-worth individual investors and tested the waters for how much they would be willing to pay for a share of the IPO firm, building a "book" of potential buyers. Because of SEC regulation of sales efforts leading up to an IPO, this book-building method remains central to the U.S. system even today.

Underwriters then get to choose which investors get the IPO shares at the IPO price. They also set the price, arguably because they have gained so much price information from the book-building process. However, IPO stocks in the United States on average gain 18 percent of their value during their first day of trading, enabling the lucky few who are allocated IPO shares to sell them the first day for a gain. During hot markets, such as the one we experienced in 1999, this 18 percent can be more like 65 percent, or even 100 percent for technology firms, resulting in quite a windfall for those who are able to purchase at the IPO price.

Raising capital by offering shares to the public strengthens the company and allows it to funnel that capital into various pursuits.

Surely the professional underwriters are not systematically estimating market demand this poorly. Imagine hiring a broker to sell your house and the broker sells it the next morning to a friend of his for $200K. Then that friend resells it in the afternoon for $236K or even $330K. You would probably feel a little suspicious. My initial reaction to the underpricing phenomenon was that the founders, or at least the firm, if the founders were cashing out, were getting ripped off. Remember, the firm, just like our home seller, only gets the money from the first sale, not the secondary transactions.

The underwriter is supposed to be out in the market discovering the market price but for some reason keeps mispricing the firm at 82 percent of the market price or less, shortchanging the founders. And, of course, the reason seems to be to grant favors to their own investment banking clients.

This activity was investigated in the early 2000s and became the subject of the Global Settlement between 10 investment banks, the SEC, the Department of Justice, and Eliot Spitzer as attorney general of New York. The banks did not admit or deny in the settlement that they were intentionally underpricing to line their friends' pockets. In fact, many have argued that underpricing is logical and good for all involved.

My solution in 2003 was to turn to the online auction IPO. In a Dutch Auction IPO, shares are sold online in a process in which would-be purchasers submit bids for a certain number of shares at a particular price. The clearing price, or IPO price, is the highest price at which all the IPO shares are sold. Theoretically, founders would then capture 100 percent of market demand, not 82 percent. In addition, online auctions "democratize" IPOs by theoretically allowing anyone to "get in" on an IPO, not just friends and family of the founder, institutional investors, and regular customers of the investment bank. Not coincidentally, shares issued in Dutch Auction IPOs generally have very low "pops" on the first day, confirming the theory that the firm was collecting the full market price with no underpricing.

As luck would have it, just as I was publishing my first paper on this topic, Google announced in 2004 that it would go public using an online IPO auction. Google's IPO was deeply flawed and did not show off the IPO auction to its best advantage, but something significant happened. The institutional investors stayed away. The smart money boycotted, or at least that was the rumor. The IPO auction that was supposed to bring this new technology into the mainstream all but buried it. But not because Google was a poor long-term investment.

I soon realized that the underwriters—and remember that there are only a handful of name-brand IPO underwriters—are necessary for creating or at least discovering market demand. It turns out that 100 percent of non-underwriter-backed IPO market demand is less than 82 percent of an underwriter-backed IPO market demand. Disintermediation is tougher than it looks.

The internet continues to inspire ways in which startup firms can raise capital without underwriter intermediaries, but of course they charge identically high fees for their own services.

Crowdfunding has been the 2010s' answer to the online IPO, with the same promises of disintermediation as well as democratization. However, I have also theorized in several articles that equity crowdfunding will carry the same stigma as the auction IPO for those firms that try to use crowdfunding as a step toward IPO. Sidestepping Wall Street is not easy.

PUBLICLY TRADED PARTNERSHIPS

Now, while much of my scholarship has been on initial public offerings, which almost always involve corporations, the business entity that is most interesting to me is the partnership. Five years ago Dean Gordon Smith and I became the lead authors on *Bromberg & Ribstein on Partnership* when our friend and mentor Larry Ribstein and then Alan Bromberg (the original authors) passed away. With as much work as we have put into the treatise, I am, as with IPOs, fascinated by the beauty and logic of partnership law.

The original partnership reflects core values of a society: individuals choosing a small number of others to create a firm and the partners working to further the enterprise and sharing control. Partners have duties to the entity and to each other. The entity and the partners are responsible to the outside world for debts of the partnership. The partnership is more valuable than the sum of its partners.

Limited partnerships, limited liability partnerships, and limited liability limited partnerships create more corporate-like entities several steps away from this ideal. The payoff for these types of formations is that the partnerships can be larger, attract more capital from dispersed investors without familial or community ties, and ensure management that they will be free from frivolous investor litigation.

My latest research focus—the publicly traded partnership—combines my interests in IPOs and partnerships with my interest in entity taxation. Master limited partnerships (MLPs), or publicly traded partnerships, are limited partnerships stripped of duties and control rights but with the liquidity of publicly traded units on a national exchange. And because of a specific exception in the tax code, they receive flow-through partnership taxation. MLPs are growing in number, and my research focuses on the opportunism created in these MLP agreements.

As I mentioned, I inherited in some part the law of partnership from my mentor Professor Ribstein. I have been appointed to the George Sutherland Chair, named in honor of Supreme Court Justice George Sutherland, who, like my mentor, was a staunch believer in the freedom of contract. Regarding MLPs, Professor Ribstein once wrote that they should benefit managers and unit holders alike from a governance aspect, even without fiduciary duties, if unit holders had certain contractual rights. Studies have shown that the latest MLPs do not contain those contractual safeguards. Because Professor Ribstein is not here to do so, I am passionate about highlighting that need.

Shortly before his unexpected death, I was talking to him about some experiences I had while trying to study microfinance in Malawi and how frustrated I would get with the lack of basic systems there that we rely on in the United States, this invisible background of institutions and infrastructure. I suddenly got quite emotional and blurted out, "Sometimes I think that the law can really get in the way of human flourishing."

Professor Ribstein, who was not a touchy-feely person, became equally emotional and replied, "Christine, that is what I have been writing about all my life."

I too am learning that all law, not just criminal law or constitutional law, can encourage or impede each child of God on their path to perfection.

NOTE

1 EDGAR is the commonly used acronym for the Electronic Data Gathering, Analysis, and Retrieval system. All companies that are required to file registration statements and other reports and forms with the SEC do so through EDGAR, and those filings are freely available and searchable by the public. *See* https://www.sec.gov/edgar/aboutedgar.htm.