Note

Winning Losses: Trading Injunctions and the Treatment of Net Operating Loss Carryovers in Chapter 11

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Bankruptcy judges routinely enjoin debt and equity trading during Chapter 11 proceedings in order to protect bankrupt corporations’ net operating loss (NOL) tax credits. These credits disappear if a corporation changes ownership. Firms and judges reason that Chapter 11’s automatic stay prohibits any trading that would imperil NOL credits by causing a change in ownership. The automatic stay protects a debtor corporation’s assets, and firms and judges argue that tax credits are assets protected by the stay. At first glance, this argument makes sense. However, a deeper analysis reveals serious legal and policy concerns with trading injunctions in Chapter 11. Prohibiting trading is an extreme step that lacks a clear foundation in previous legislative and judicial treatment of the automatic stay. In addition to imposing costs on shareholders and debtholders in a bankrupt corporation, trading injunctions provide a debtor corporation’s management with a powerful—and potentially coercive—tool to entrench its position. Furthermore, NOL credits for reorganized corporations make little sense from a tax policy perspective: NOL credits are meant to offset profits from the project that created the losses, but reorganized corporations use NOL credits to offset gains from reorganization. This Note critiques the treatment of NOLs during Chapter 11 from both bankruptcy and tax angles. Thus far, there has been almost no policy conversation surrounding NOLs in bankruptcy. After illustrating the problems with the current policy, this Note suggests several original solutions and evaluates these alternate policies.

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Introduction

Since the 1990s, bankruptcy judges have routinely issued injunctions halting trading in equity and debt during Chapter 11 bankruptcy proceedings.\(^1\) Corporations typically request these injunctions on the day they file for

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1. See, e.g., Official Comm. of Unsecured Creditors v. PSS S.S. Co. (In re Prudential Lines Inc.), 928 F.2d 565, 568 (2d Cir. 1991); In re Northwest Airlines, Case No. 05-17930 (Bankr. S.D.N.Y. Oct. 28, 2005); In re Delta Air Lines, Case No. 05-17923 (Bankr. S.D.N.Y. Sept. 16, 2005); In re Mirant Corp., Case No. 03-46590 (Bankr. N.D. Tex. July 22, 2003); In re WorldCom, Case No. 02-13533 (Bankr. S.D.N.Y. Mar. 5, 2003); In re Phar-Mor, Inc., 152 B.R. 924, 927 (Bankr. N.D. Ohio 1993). Often, injunctions do not freeze all trading but instead prohibit only those trades that would cause a change in ownership. See infra note 133.
bankruptcy, including them in the package of "first-day motions" that judges often quickly approve. Firms justify these requests by pointing out that debt and equity trading, if it triggers a "change in ownership" as defined by the Internal Revenue Code, threatens net operating loss (NOL) carryovers. These tax credits, which are based on losses the corporation incurred in previous years, disappear if the corporation changes ownership. Judges are generally convinced that carryovers are assets of the debtor estate and thus need to be protected through trading injunctions.

At first glance, this argument makes sense. Carryovers can be immensely valuable: major corporations in Chapter 11 may have accumulated billions of dollars in NOLs. If a corporation can deduct these losses from post-reorganization profits, the benefit to shareholders may be enormous. These shareholders—who may be the current creditors in a Chapter 11 case—need the bankruptcy judge's help to ensure that the corporation's assets, including its tax credits, do not diminish over the course of Chapter 11 proceedings. Indeed, the central purpose of Chapter 11 is to protect the debtor's value against collective action issues like individual investors' rush to dismember the debtor corporation in financial distress.

Upon closer examination, however, this standard Chapter 11 logic may not apply to NOL carryovers. Even if a corporation emerges from Chapter 11 and generates enough profits to use its carryovers—which is not necessarily the case—the rationale for issuing an injunction to protect the tax credits is questionable. First, the potential benefits of preserving the credits may not justify the significant costs that can result from a trading freeze: halting trading denies stakeholders valuable liquidity and may inhibit productive negotiations by trapping parties in their current ownership roles. Furthermore, an examination of the broad policy justification for carryovers reveals that maintaining carryovers in reorganized companies is not productive tax policy and may produce perverse incentives. Injunctions also give management an opportunity to freeze trading purely to prevent takeovers and remain in control. Finally, the legal foundation for trading injunctions is not as strongly rooted in the Bankruptcy Code as the judges and attorneys supporting these injunctions try to make it seem.

3. See I.R.C. § 382(b)(5) (Supp. 2009). I have used the general term "carryover" in this Note instead of the more specific "carryforward," which is the sort of credit generally at issue. I chose this approach because not all sources use the specific term consistently.
5. See, e.g., In re Phar-Mor, Inc., 152 B.R. at 927.
6. See, e.g., In re UAL Corp., 412 F.3d 775, 778 (7th Cir. 2005).
7. In many Chapter 11 reorganizations, existing equity is wiped out or reduced and creditors receive new equity in exchange for their debt.
8. If investors dismember a corporation by seizing collateral when the corporation appears distressed, going-concern value may be lost.
This Note examines these problems with NOL carryovers and the Chapter 11 injunctions that judges ostensibly use to protect them. Part I provides general background on carryovers. It begins by articulating a policy foundation for carryovers: without them, the annual tax period threatens to drive a wedge between private and social rates of return for some projects,\textsuperscript{9} discouraging some projects with positive net present values. The NOL carryover fixes this problem, but it is only effective if it is used to offset profits generated by the project that created the initial losses. After Congress introduced carryovers in 1918, corporations realized they could endow carryovers with independent value by merging with profitable corporations and using those loss carryovers to offset the profits. Starting in the 1930s, Congress and the courts responded by setting up a framework of limitations on carryovers when a corporation undergoes a change in ownership. The 1986 Tax Code provided a threshold to determine a change in ownership, and 2013 IRS regulations raised this threshold. Part II covers the treatment of carryovers during bankruptcy: the Bankruptcy Tax Act of 1980 specifically addressed carryovers in the Chapter 11 context, providing exceptions that allow corporations to retain carryovers even when a reorganization would otherwise trigger a change in ownership.

Part III identifies and evaluates critiques of the current approach to carryovers. This Part provides both legal and policy-based critiques of trading injunctions. Legal questions include whether carryovers are property of the debtor estate, whether the automatic stay should protect them,\textsuperscript{10} whether judges’ broader equitable powers can support injunctions, and whether injunctions violate the Fifth Amendment. Policy analysis suggests that the situation that justifies carryovers—namely, using losses to offset future profits directly generated by the same project—may be so rare in Chapter 11 that protecting NOLs has almost no basis in sound policy. Reorganization nearly always allows corporations to use carryovers to offset profits that do not directly result from the original corporation’s project.\textsuperscript{11} In addition to resting on questionable policy, trading freezes have immense costs and do not preserve carryovers indefinitely, since they do not typically persist after confirmation of a reorganization plan.\textsuperscript{12} Injunctions also provide a bankrupt corporation’s management with an anchor it can use to preserve its power.

Part IV proposes several solutions to the problems with the current treatment of carryovers. None is a perfect fix or fully achieves the policy

\textsuperscript{9} "Projects" as used in this Note simply refers to whatever business pursuits generate NOLs.

\textsuperscript{10} The automatic stay is an automatic injunction that prevents creditors from asserting claims against debtor assets during a bankruptcy proceeding. See 11 U.S.C. § 362 (2012).

\textsuperscript{11} See infra Part III.B.1.

\textsuperscript{12} However, the combination of injunctions and other aspects of bankruptcy law allows corporations to avoid losing NOLs by virtue of a reorganization, which makes it more likely that NOLs will survive long enough to offset gains from reorganization. See infra Part II.
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objectives of carryovers. All of the proposed strategies, however, would be preferable to the current system.

I. Congressional and Judicial Treatment of NOLs

A. Original Recognition of Net Loss Carryovers

The NOL carryover dates back to the Revenue Act of 1918, which allowed a one-year carryback and a one-year carryforward of losses. The justification for these provisions was simple: Congress wanted to eliminate the arbitrary impact of the annual tax period. Lawmakers were concerned with the “harshness” of this annual system and its disparate impacts on corporations with steady incomes versus those with fluctuating incomes. Without carryovers, a firm that makes $20 million one year and loses $10 million the next would owe twice as much in taxes as a firm that makes $5 million each year, even though the two firms generate the same total profits. With this in mind, Congress chose a policy that appeared more equitable to different types of taxpayers.

Broader efficiency considerations bolster the argument for NOL carryovers. Without carryovers, taxpayers may offset profits only with losses incurred during the same year. This accounting treatment discourages some projects with positive net present values: it taxes future revenue without offering any mitigating credit for losses in a different period. As an illustration, imagine a corporation that can generate profit of $100 million next year if it operates at a net loss of $80 million this year. If the discount rate is two percent, this project has a net present value of $18.04 million. However, if the corporate tax rate is 30% and the tax code does not allow carryovers, the corporation will reject the project: the project’s net present value to the corporation is -$11.4 million. If the corporation could use its $80 million loss this year to offset its profit next year, however, the project would offer a positive internal rate of return. The corporation then would be taxed on only

13. A carryback offsets profits from a previous year with current losses; a carryforward offsets current profits with losses from a previous year.
17. This assumes a flat corporate tax rate.
19. (100/1.02) = 80 = 18.04.
20. [+100*(1−0.3)]/1.02−80 = −11.4.
21. Net present value is the difference between the present value of cash inflows and the present value of cash outflows. The internal rate of return of a project is the discount rate that makes the net present value of cash flows from the project equal to zero. Due to capital constraints, corporations will not invest in every project with a positive internal rate of return. Still, carryovers
$20 million of its profit next year, producing a positive present value of $12.16 million.\footnote{\[20\times(1 - 0.3) + 80\]/1.02} - 80 = 12.16. Thus, the NOL carryover makes projects with overall positive net present values profitable to corporations: it removes the wedge that the annual tax period drives between private and social rates of return.

This analysis supports Congress’s “averaging” rationale for carryovers: smoothing out profits and losses over multiple years internalizes the value of a project.\footnote{Congress continually expanded the period in which corporations can offset profits: the most recent version of the Internal Revenue Code extends carryovers for twenty years and carrybacks for two years. I.R.C. § 172(b)(1)(A) (Supp. 2009).} However, the averaging justification depends on the assumption that the taxpayer benefiting from the carryover is the same one that incurred the losses: compensating one corporation for another’s losses does not improve incentives. Corporations quickly undermined this justification. As soon as Congress instituted carryovers, corporations realized that the carryovers could be tradable assets.\footnote{Michelle M. Arnopol, Why Have Chapter 11 Bankruptcies Failed So Miserably? A Reappraisal of Congressional Attempts to Protect a Corporation’s NOLs After Bankruptcy, 68 NOTRE DAME L. REV. 133, 139 (1992).} Loss corporations\footnote{The IRS defines a “loss corporation” as a corporation that has a NOL in a given year or is entitled to use a NOL carryover. See 26 C.F.R. § 1.382-2(a)(1)(i) (2010).} might never generate enough profit to take advantage of their tax credits, but these credits could be immensely valuable if transferred to a profitable corporation.\footnote{See Arnopol, supra note 24, at 139.} Profitable corporations began acquiring loss corporations purely to offset profit with the loss corporations’ NOLs.\footnote{Id.} This practice entirely derailed the policy justification for carryovers. It created a perverse incentive: it subsidized corporations for loss projects that never generated a profit.

When losses result in corporate assets, corporations may engage in risky projects with negative expected values. Consider, for instance, a corporation that can pursue a project that offers a 50% chance of an $80 million gain and a 50% chance of a $100 million loss. This project has an expected return of $-10 million.\footnote{80\times0.5 + (-100)\times0.5 = -10.} Assume that the corporate tax rate is 30%. In a regime in which buyers can assume all NOLs, the rational corporation will pursue this project. If the project fails, the corporation will have $100 million in NOLs, which are worth $30 million to a profitable corporation. In an auction setting, the corporation can sell itself for this amount, giving the project an ex ante expected value of $5 million to the firm.\footnote{80\times0.5 + (-70)\times0.5 = 5.} Tradable NOLs thus generate an inefficiency: corporations have an incentive to make losing bets when their losses are valuable to others.
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B. Judicial Intervention Limiting the Transferability of NOLs

By the 1930s, courts recognized this incentive problem and searched for a remedy. In *Woolford Realty Co. v. Rose*, the Supreme Court established a limit on the transferability of NOLs. *Woolford* involved the situation envisioned above: a profitable corporation acquired a loss corporation and used the NOLs to offset the profitable corporation's income, insisting that the Revenue Act allowed this practice. The Court was not impressed. Justice Cardozo wrote that Congress could not have intended to allow "mischief" through "juggling so facile and so obvious."
The Court established the principle that NOLs could be used only to offset income of the taxpayer that incurred the losses and never to offset the profits of a corporation that was separate when the initial corporation generated the losses. Any other interpretation, Justice Cardozo wrote, would be unreasonable and contrary to the purpose of the statute.

The Court soon clarified and expanded the limits on transferability of carryovers. In *New Colonial Ice Co. v. Helvering*, shareholders and creditors of a recently formed corporation negotiated to organize a new company after it became clear that the original business plan would not generate profits. These negotiations produced a plan that involved canceling all outstanding stock and replacing it with stock in a new corporation that would assume all assets and liabilities of the old corporation. The stockholders of the new corporation were the same as those of the old corporation. The creditors were also the same, although they received additional control over the management through a voting trust. Nevertheless, the Court held that the new corporation could not offset its profits with the old corporation's losses. It was irrelevant that the stockholders were the same in the original corporation and the new one because a corporation and its stockholders are separate entities. Since the corporation claiming the NOLs was formally a different corporation from the

31. *Id. at 328.*
32. *Id. at 329.*
33. *Id. at 330.*
34. *Id.; see also Planters Cotton Oil Co. v. Hopkins*, 286 U.S. 332, 333-34 (1932) (limiting NOL carryovers to the original taxpayer in a substantially similar situation).
36. The role of NOLs in this contractual effort to reorganize to an insolvent business provides an early preview of the importance of NOLs in Chapter 11.
38. *Id.*
39. *Id.*
40. *Id.*
41. *Id. at 442.*
42. *Id.; cf. Alprosa Watch Corp. v. Comm'r*, 11 T.C. 240, 246 (1948) (holding that transfer of stock does not make a corporation a new taxpayer since a corporation is a separate entity from its stockholders).
one that created them, it was by definition a separate taxpayer and was not entitled to these benefits. The Court thus held that maintenance of carryovers depended entirely on a corporation’s formal structure.

Ironically, this elevation of form over substance provided a foundation for widespread protection of carryovers in mergers. Lower courts treated Woolford and New Colonial Ice as if they prohibited only NOL transfers that took certain specific forms: the cases clearly prohibited the use of a carryover that a profitable corporation acquired when it bought a loss corporation, and they also prohibited the use of a carryover after explicit changes in corporate identity. Corporations argued that a large loophole remained: a profitable corporation could merge into a loss corporation and assume its carryovers so long as the merger formally left the loss corporation as the surviving corporate entity. In Helvering v. Pennsylvania Water & Power Co., the Supreme Court endorsed this loophole, holding that the surviving corporate entity in a merger is the same taxpayer as both of the pre-merger corporations. While this holding seems contrary to Woolford, the Court did not explicitly refer to Woolford in Pennsylvania Water. The cases are distinguishable in that the tax benefits in Pennsylvania Water were unamortized bond discounts that arose from debt assumed in the merger. The Court may have been drawing a distinction between incidental transfer of tax benefits in the course of a legitimate merger and deliberate purchase of net losses. However, many lower courts used Pennsylvania Water to open the floodgates for NOL transfers in mergers in general.

Lower courts likewise interpreted New Colonial Ice to allow transfer of tax benefits so long as firms maintained the legal fiction of a continuous entity. In Alprosa Watch Corp. v. Commissioner, for example, the Tax Court treated a corporation as the same legal entity for tax purposes even when its ownership, name, and area of business changed entirely. The Tax Court thus expanded on the formalism of New Colonial Ice. In New Colonial Ice, continuity of ownership and business plan was not enough to preserve tax benefits so long as firms maintained the legal fiction of a continuous entity.

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43. New Colonial Ice, 292 U.S. at 441-42.
44. Arnopol, supra note 24, at 141; see also Michael L. Schultz, Section 382 and the Pursuit of Neutrality in the Treatment of NOL Carryovers, 39 Kan. L. Rev. 59, 63 (1990) (claiming that courts interpreted New Colonial Ice to allow transfers of NOL carryovers "as long as the transaction took the proper legal form").
45. Arnopol, supra note 24, at 141.
47. Arnopol, supra note 24, at 141.
49. Arnopol, supra note 24, at 141. Lower courts split on this issue, but many allowed the transfer of tax attributes in broad contexts. See, e.g., Old Nat’l Bank in Evansville v. Comm’r, 256 F.2d 639, 644 (7th Cir. 1958); Adrian & James, Inc. v. Comm’r, 4 T.C. 708, 720 (1945). But see Jones v. Noble Drilling Co., 135 F.2d 721, 724 (10th Cir. 1943).
50. Arnopol, supra note 24, at 142.
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benefits when corporate form changed. In *Alprosa Watch*, continuous corporate form was the only requirement to establish taxpayer continuity.53

The Supreme Court entered the fray again in 1957 and provided more concrete limits on the transferability of NOLs. In *Libson Shops, Inc. v. Koehler*, a successor corporation in a merger relied on *Pennsylvania Water* to claim NOLs from several pre-merger corporations.55 The IRS argued that *New Colonial Ice* limited carryovers to the pre-merger corporation that created the losses.56 The Court did not explicitly resolve the tension between these cases; rather, it established a new test.57 Returning to the basic justification for carryovers, the Court held that the successor corporation could not deduct the losses because the business that would otherwise benefit from the deduction was not engaged in the same enterprise as the corporation that sustained the losses.58 “Continuity of business enterprise” was essential to carryovers’ fundamental purpose: the carryovers were designed not to become arbitrary tax assets but to permit averaging of a business’s profits and losses over a period longer than one year.59 The Court thus rejected the formalism and bright-line tests that lower courts had drawn from *Woolford, New Colonial Ice*, and *Pennsylvania Water*. Instead, it indicated that courts should follow a standard based on fundamental policy objectives when determining whether to allow transfers of carryovers.60

C. Statutory Constraints

The *Libson Shops* standard did not clarify precisely when NOLs would disappear, and Congress’s subsequent attempts at reform failed to develop a workable framework. After nearly thirty years of confused courts and ineffective statutes, the American Law Institute proposed an elegant approach to NOLs: cap a successor corporation’s ability to use NOLs at the value of the loss corporation immediately before the transaction.61 If this rule could be enforced, it would eliminate trafficking in carryovers: no corporation could

53. *Alprosa Watch*, 11 T.C. at 246. The Supreme Court did not address this converse situation in *New Colonial Ice*—the Court simply held that continuity of ownership and business activities did not trump corporate form. *New Colonial Ice*, 292 U.S. at 438.
54. 353 U.S. 382 (1957). *Libson Shops* was decided under the Internal Revenue Code of 1939. Id. at 382.
55. Id. at 390.
56. Id.
57. Id.
58. Id.
59. Id. at 386.
60. See id. at 389-90.
61. AM. LAW INST., FEDERAL INCOME TAX PROJECT, SUBCHAPTER C: PROPOSALS ON CORPORATE ACQUISITIONS AND DISPOSITIONS AND REPORTER’S STUDY ON CORPORATE DISTRIBUTIONS 204 (1982).
gain from another's tax benefits. Congress incorporated the proposal into the Tax Reform Act of 1986. The 1986 Act—which remains largely intact—limited carryovers after "ownership changes." According to the statute, a corporation experiences an ownership change if the aggregate value of increases in the stock held by shareholders who each own at least 5% of the corporation is more than fifty percentage points during a three-year period. Under this approach, shareholders who own less than 5% of the corporation are deemed to comprise together a "public group," which is effectively a single five-percent shareholder. Transfers of stock among these small shareholders do not count toward an ownership change, even if a large percentage of the value of the corporation is so transferred. However, certain "segregation events"—such as the issuance or redemption of stock or the sale of stock by a five-percent shareholder—can cause a loss corporation to have multiple public groups. Thus, under the 1986 Act, five-percent shareholders can quickly trigger changes in ownership when they sell stock to smaller shareholders. 2013 IRS regulations—discussed in the next Part—amended the segregation rules so that sales to small shareholders and small redemptions are generally not segregation events.

The 1986 Act caps carryovers if a corporation changes ownership. Corporations may deduct only losses equal to the value of the loss corporation at the time of the ownership change multiplied by the long-term, tax-exempt rate on federal obligations. The value of the loss corporation is determined by the market value of all of its outstanding stock. In principle, this statutory approach should effectively limit carryovers to the amount of income that the loss corporation could have generated independently, which is consistent with the policy rationale for carryovers.

62. See supra notes 23-27 and accompanying text.
64. Thus, to test for a change in ownership, subtract each five-percent shareholder's lowest percentage held during the testing period from that shareholder's percentage held on the testing date. Add all the resulting amounts: if the sum is over fifty percentage points, a change in ownership has occurred. For example, assume that there are two five-percent shareholders on the testing date: Shareholder A owns 45% of shares by value and Shareholder B owns 25%. If Shareholders A and B both owned 5% of shares at some point during the testing period, the aggregate increase in value is sixty percentage points, and a change in ownership has occurred. Non-voting stock is irrelevant. Assets similar to stock or assets that could become stock are governed by various specific provisions. Id.
65. Id.
66. Id.
67. Id.
69. The relevant rate is the one in effect when the ownership transaction occurs. I.R.C. § 382 (1986).
70. Id. Any capital contributions made in the two years prior to the ownership change are deducted from this value. See Amopol, supra note 24, at 167.
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D. Recent IRS Reforms

The IRS promulgated rules in 2013 that alter the segregation rules under Section 382.71 The new rules allow five-percent entities to transfer stock to small shareholders without creating a new public group. This new policy is a significant shift. Prior to the new rules, a transfer of stock from a five-percent entity to small shareholders would create a new public group comprised of those shareholders. Under the new rules, the transferred stock is treated as being acquired proportionately by all public groups in existence at the time of the transfer.72 The new rules also provide an exception to the segregation rules for small redemptions and a general exception for transfers of stock by five-percent entities that own less than 10% of the loss corporation’s stock.73

The 2013 rules thus raise the change-in-ownership bar for loss corporations, allowing corporations to maintain NOLs in the midst of more stock transactions. Taxpayers welcomed the new rules.74 It is too early to analyze judges’ reaction to the rules, but it seems likely that the rules will lead to fewer or narrower75 injunctions. While an end to broad injunctions against all trading is a plus, the 2013 reform falls far short of fixing the NOL regime. Many injunctions are issued largely or exclusively to prohibit trades that would still threaten NOLs under the new rules—the segregation rules are irrelevant when a new investor acquires 5% of a corporation or an existing shareholder’s stake doubles. Firms can still reasonably request injunctions to prevent trades not covered by the new rules. The types of trades covered by the new rules are by definition trades that could never allow outside investors to unseat management, so management can still use injunctions as an anchor to remain in power. Most importantly, the recent reforms do nothing to address the fundamental tax policy problem with NOLs in reorganized corporations: if anything, the new rules make it more likely that reorganized corporations will retain NOLs and thus use them to offset gains from reorganization rather than profits from the project that generated the losses.

II. NOL Carryovers in Chapter 11

Judicial and statutory limitations on NOL carryovers can play a particularly significant role in Chapter 11 bankruptcy cases. Since many corporations file for bankruptcy after sustaining losses, firms often have sizeable carryovers by the time they enter Chapter 11. Since the reorganization process offers a chance for a loss corporation to emerge from bankruptcy and

72. Id.
73. Id.
75. For example, injunctions that apply to fewer trades. See infra note 133.
generate profits, carryovers may be immensely valuable. However, reorganization threatens carryovers under the standard statutory framework: a significant adjustment of capital structure may trigger a change in ownership. Noting that this reduces prospects for successful reorganizations, Congress and the courts created exceptions that allow corporations in Chapter 11 to bypass the general limitations on carryovers.

A. The Bankruptcy Tax Act of 1980

The Bankruptcy Tax Act of 1980 addressed NOL carryovers in the context of Chapter 11 bankruptcy.\(^76\) Congress designed several provisions of the Act to allow reorganized companies to retain pre-bankruptcy carryovers.\(^77\) Significantly, the Act classified former creditors as shareholders if their claims became stock in the course of a reorganization plan.\(^78\) Thus, reorganizations did not trigger the change-in-control limitation by converting debt to equity.\(^79\) The Act also gave carryovers a prominent role in a reorganization plan’s discharge of debt.\(^80\) The IRS typically considers any discharge of debt to be taxable income.\(^81\) The Bankruptcy Tax Act, however, allowed a corporation in Chapter 11 to deduct discharged debt from its outstanding tax credits instead of declaring the discharged debt as income.\(^82\) The Act ranked tax assets in the order in which corporations had to use them to absorb discharged debt, and NOL carryovers were first in this ranking.\(^83\) This made carryovers particularly valuable in Chapter 11 proceedings. It also endowed carryovers with value as corporate assets that had nothing to do with the future profits that the corporation might earn.

B. The Tax Reform Act of 1986

The 1986 overhaul provided specific guidelines for the transfer of NOLs in Chapter 11 reorganizations.\(^84\) The standard rules outlined above would typically prevent a reorganized corporation from retaining carryovers: the value of a corporation’s stock immediately before reorganizing in bankruptcy


\(^77\) Id.

\(^78\) Id.

\(^79\) Id.

\(^80\) Id.


\(^82\) Discharged debt under this provision did not include any debt that the plan converted to equity. Bankruptcy Tax Act of 1980 § 2.

\(^83\) Id.

is usually very low. However, Congress created two avenues for corporations in Chapter 11 to preserve carryovers after Chapter 11 reorganizations.

The first route applies if the corporation’s original stockholders or creditors retain at least 50% ownership under the reorganization plan. “Fifty percent ownership” here requires ownership of both 50% of the value of outstanding stock and 50% of votes. Under these conditions, the IRS does not consider the corporation to have changed ownership. Thus, it can retain all of its carryovers in its reorganized form. To be considered an “original creditor,” a creditor must have held a corporation’s debt for more than eighteen months when the firm files for Chapter 11. Without this limitation, investors could simply purchase all of a corporation’s debt and the corporation could convert it to stock. If a corporation meets all of these requirements, it may maintain its carryovers after reducing their value through the use of a specified formula. There is one catch, however: if a corporation elects this approach and then changes hands again less than two years after the reorganization, all carryovers disappear.

If a corporation wants to avoid this risk, it can follow a second route: it can remain under the general rules governing limitations on NOLs and claim a special exception carved out for bankruptcy. Under this exception, a bankrupt firm can base its carryover ceiling on its value immediately after, rather than immediately before, its ownership change. This can be a tremendous advantage: if a reorganization plan cancels a large portion of a corporation’s debt, the corporation’s equity is likely to be much more valuable immediately after the plan takes effect.

85. See Arnopol, supra note 24, at 168.
86. The stockholders of the reorganized corporation must receive their stock in the reorganization plan based on the debt or equity they held in the original corporation. I.R.C. § 382(l)(3) (2012).
87. Id.
88. Id.
89. Id.
90. There is an exception for debts that arise through ordinary business proceedings in an effort to keep the corporation afloat. Id.
91. Id.
92. A corporation must deduct from its carryovers (1) half the debt discharged in the stock conversion and (2) the amount of interest paid, during the current taxable year and the three taxable years before it, on the debt that was converted to stock. See Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, § 1006(d)(18), 102 Stat. 3342, 3398 (codified at I.R.C. § 382(l)(5)(c)).
93. See Simmons, supra note 16, at 1051.
95. Id.
96. See Arnopol, supra note 24, at 173, for an extensive analysis of the two routes for dealing with NOL carryovers in bankruptcy and the choice between the two.
C. Bankruptcy-Specific Judicial Intervention

Congress intended the special provisions for carryovers in bankruptcy to promote successful reorganizations. In a broader sense, however, the reforms of the 1980s solidified carryovers as assets that had value independent of future profits. Reorganizing corporations could use carryovers to eliminate extensive tax liability for discharged debt. Furthermore, the bankruptcy exceptions in the 1986 Act allowed corporations to change ownership without triggering a reduction in carryovers. Carryovers thus became central to the reorganization process: in some cases, they became the peg on which a successful reorganization hung. However, there was one significant risk: if the original stockholders and creditors decided to sell their claims, NOLs might be gone forever. Firms tried to construct arguments to protect carryovers from this frightening fate.

In 1991, the Second Circuit provided a foundation for these arguments. The court in *In re Prudential Lines Inc.* classified NOL carryovers as property of a debtor’s estate. In that case, PSS Steamship Company attempted to claim a worthless stock deduction based on its interest in Prudential Lines, the debtor. If PSS had claimed this deduction, the debtor would have lost $74 million in carryovers. The court held that the carryover was the property of the bankruptcy estate and accordingly enjoined PSS from claiming the deduction. Claiming it, the court reasoned, would violate the automatic stay: by causing its bankrupt subsidiary to lose a tax asset, PSS would be exercising control over the debtor’s protected property.

Considering carrybacks to be the debtor’s property was not an entirely new idea. A quarter-century earlier, the Supreme Court had held that a debtor’s NOL carryback was property of the bankruptcy estate. In *Segal v. Rochelle*, a trustee in a voluntary bankruptcy proceeding acquired tax refunds by

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97. See id.
99. See id.
100. See id.
101. See, e.g., Arnopol, *supra* note 24, at 136 (“A financially troubled corporation is far more likely to reorganize successfully if it can offset its income earned after bankruptcy with its net operating losses incurred prior to bankruptcy.”).
103. If a security held as a capital asset becomes worthless, the IRS treats the resultant decline in value as a capital loss. I.R.C. § 165(g)(1) (2012). This allows the corporation to deduct a worthless security’s decline in value like a loss from selling a security. See I.R.C. § 1211(a) (2012).
104. Id.
105. Id. The worthless stock deduction would trigger an ownership change under I.R.C. § 382(g)(4)(d) (2012).
107. Id.
Winning Losses

applying NOLs to profits from previous years. The owners of the bankrupt business claimed that these refunds, which resulted from losses incurred prior to bankruptcy, remained their personal property and did not pass to the trustee. The Court disagreed: settling a circuit split, Justice Harlan reasoned that the refunds were "property" at the time the bankruptcy petition was filed, even though they were unclaimed. This meant that they belonged to the debtor, not the owners.

In Prudential Lines, the court expanded the Segal holding by applying it to carryforwards and to Chapter 11 bankruptcy. The court also protected carryovers more aggressively: rather than simply deciding which party should receive existing benefits, Prudential Lines endorsed the use of injunctions to prevent behavior that might jeopardize the carryovers. The court might have intended this holding to apply only to the specific situation in the case: a parent corporation effectively competing with its subsidiaries' creditors for a tax benefit. The Second Circuit likely was also motivated by other concerns specific to the Prudential Lines situation: PSS's threat to claim the stock deduction looked dangerously like a coercive maneuver to force the creditors' committee to back down and accept management's reorganization plan.

There is no indication that the court intended to endorse widespread injunctions in any Chapter 11 case involving NOLs.

Indeed, Prudential Lines did not immediately effect a broad change in Chapter 11 proceedings. At first, courts declined to apply its logic in other cases. Many commentators saw it as a dangerous ruling and criticized its reasoning. Throughout the early 1990s, most debtor corporations did not seek trading injunctions to protect tax assets. Indeed, the widespread forfeiture of carryovers during reorganization led some commentators to call for amendments to the Bankruptcy Code to protect the credits. These analysts

109. Id. at 376.
110. Id.
111. Compare Segal v. Rochelle, 336 F.2d 298 (5th Cir. 1964), aff'd, 382 U.S. 375, 380 (1966) (holding that carrybacks pass to the bankruptcy estate), with Fournier v. Rosenblum, 318 F.2d 525, 527 (1st Cir. 1963) (holding that loss-carryback refunds do not pass to the bankruptcy trustee), and In re Sussman, 289 F.2d 76, 77 (3d Cir. 1961) (holding the same as Fournier).
112. Segal, 382 U.S. at 378.
113. Id. The Segal Court explicitly declined to consider whether its reasoning would apply to carryovers generally. The Court mentioned the practical difference between carrybacks and carryforwards, pointing out that carryforwards' value depends on "earnings that might never eventuate at all." Carrybacks, on the other hand, have immediate and precise value. Id. at 381.
114. See Morris, supra note 2, at 288.
117. See, e.g., Arnopol, supra note 24, at 195 ("If the Chapter 11 goal of successfully rehabilitating financially troubled corporations is to be realized, section 382 must be amended so that corporations emerging from bankruptcy can use their pre-bankruptcy net operating losses to shelter their post-reorganization income from tax.").
argued that preserving carryovers would promote Chapter 11’s fundamental goals of preserving jobs and going-concern value. They need not have worried about forfeiture of carryovers. By the late 1990s, debtors and their attorneys had incorporated Prudential Lines into their Chapter 11 negotiation strategies. A request for a trading injunction became a commonplace feature of the “first-day motions” that attorneys bring before a bankruptcy judge when filing for Chapter 11. At the outset of a bankruptcy proceeding, debtors request trading injunctions alongside common, uncontroversial matters, such as permission to continue paying employees and arrangements for debtor-in-possession financing. In recent years, courts have become receptive to this approach and have cited Prudential Lines to defend rubber-stamping these orders to freeze debt and equity trading. Surprisingly, this routine practice is rarely contested. Almost no published opinions have wrestled with the implications of these broad injunctions.

There is one notable exception. During United Airlines’ 2002 bankruptcy proceeding, majority shareholders appealed a trading injunction and sought damages based on the decline in stock value that occurred while they were not allowed to trade. The Seventh Circuit ultimately held that no remedy was available, but Judge Easterbrook excoriated the bankruptcy judge in dicta for issuing the injunction. Judge Easterbrook attacked the bankruptcy judge’s reasoning that the injunction would not harm investors given that the stock market was just as likely to rise as to fall while the injunction was in effect. While this statement may be accurate in the sense that, according to the semi-strong form Efficient Market Hypothesis, all public information about a stock is incorporated into its current share price, it ignores the independent benefits of liquidity. Judge Easterbrook observed that investors suddenly held less

118. Id. On the policy goals of Chapter 11, see, for example, H.R. REP. NO. 95-595, at 220 (1978); Arnopol, supra note 24, at 134.
119. See Morris, supra note 2, at 285.
120. See, e.g., Max Barker, Claims Trading and the Automatic Stay: Revisiting In Re Prudential Lines and the Implications for Current Practice, 12 DEL. L. REV. 79, 79 (2010) (“The growing trend of debtors seeking first day orders pursuant to sections 105(a) and 362(a)(3) restricting trading in claims has added yet another motion to present to the bankruptcy judge on the first day of a new case.”).
121. See Morris, supra note 2, at 285.
122. Id.
123. Id. at 286.
124. Id.
125. In re UAL Corp., 412 F.3d 775 (7th Cir. 2005).
126. Judge Easterbrook reluctantly sided with United on grounds that parties injured by an erroneous injunction have no remedy. Id. (citing W.R. Grace & Co. v. Rubber Workers, 461 U.S. 757, 770 (1983) (“A person injured by the issuance of an injunction later determined to be erroneous has no action for damages in the absence of a bond.”)).
127. Id.
128. Id. at 777.
129. Id.
liquid, and therefore inherently less valuable, shares.\textsuperscript{130} He also noted that the injunction left investors forcibly undiversified at a time when United's future was highly uncertain.\textsuperscript{131}

Judge Easterbrook argued that depriving investors of liquidity was "both imprudent and unnecessary." \textsuperscript{132} He recommended several alternative approaches that would have protected both carryovers and investors.\textsuperscript{133} Pointing out that United's argument to protect its tax credits assumed that the corporation would generate significant post-bankruptcy profits,\textsuperscript{134} he asserted that the judge should have asked United to put its money where its mouth was: the company could have offered a bond to compensate its investors.\textsuperscript{135} A possible concern with this suggestion is that credit markets may not have been willing to underwrite such a bond. But Judge Easterbrook argued that United would have no trouble obtaining a loan if the company were actually going to generate a large profit after bankruptcy.\textsuperscript{136} It also probably would not owe damages to its investors in this case.\textsuperscript{137} If United were unable to borrow, this would indicate that United's "contentions [were] hot air" and its carryovers would never have value.\textsuperscript{138} In that situation, Judge Easterbrook believed that any injunction would be inappropriate.\textsuperscript{139}

As an alternative to a judicially imposed bond—a preferable alternative, in Judge Easterbrook's view—United and its Employee Stock Ownership Plan

\textsuperscript{130}. \textit{Id.}

\textsuperscript{131}. Judge Easterbrook conceded that the trust was intentionally undiversified but pointed out that shareholders put their investments in the hands of State Street, not the judiciary. The investment was less valuable when it was no longer managed by a fiduciary. \textit{Id.}

\textsuperscript{132}. \textit{Id.} at 778.

\textsuperscript{133}. Judges have in fact limited the scope of trading injunctions. Many courts—including the bankruptcy court in \textit{Prudential Lines} itself—have enjoined trading by only some shareholders (often shareholders that were or could become five-percent shareholders). Other courts have implemented notice-and-objection procedures for certain trades. \textit{See, e.g., In re Northwest Airlines}, Case No. 05-17930 (Bankr. S.D.N.Y. Oct. 28, 2005); \textit{In re Delta Air Lines}, Case No. 05-17923 (Bankr. S.D.N.Y. Sept. 16, 2005); \textit{In re WorldCom}, Case No. 02-13533 (Bankr. S.D.N.Y. Mar. 5, 2003). See Jeanne P. Darcey, \textit{Restrictions on Trading Claims in Bankruptcy: Preservation of the Debtor's NOLs}, \textit{AM. BANKR. INST.} (2009), http://www.abiworld.org/committees/newsletters/publicComp/vol6num1/Claims2.pdf, for a debtor-side practitioner's analysis of techniques to encourage courts to adopt narrower trading injunctions. For a practitioner's analysis of the costs and benefits of trading injunctions and the factors that courts should consider when designing them, see Mark A. Speiser \textit{et al.}, \textit{NOLs: The Policy Conflicts Created by Trading Orders}, \textit{COM. LENDING REV.}, May-June 2005.

\textsuperscript{134}. United had over $1 billion in NOL carryovers when it filed for bankruptcy. As discussed, judges rarely investigate the likelihood that tax credits have future value before granting injunctions. Judge Easterbrook argued (as addressed in Part III) that carryovers only have value—and therefore may only be protected as assets—if a corporation could generate future profits. \textit{In re UAL Corp.}, 412 F.3d at 778.

\textsuperscript{135}. In other words, United would put cash into (or credit behind) a security which could later be used to compensate shareholders harmed by the injunction. \textit{Id.} This approach, addressed in Part IV, is similar to the method employed in \textit{In re Kmart Corp.}, 359 F.3d 866 (7th Cir. 2004).

\textsuperscript{136}. \textit{In re UAL Corp.}, 412 F.3d at 778.

\textsuperscript{137}. \textit{Id.}

\textsuperscript{138}. \textit{Id.}

\textsuperscript{139}. \textit{Id.}
(ESOP) could have contracted outside of bankruptcy to require United to underwrite a bond in the context of a trading injunction. The bond could compensate investors harmed by a decrease in the stock price during the injunction. In the event of an increase in stock price—which would render the bond unnecessary—an adequate-protection agreement would have required stockholders to indemnify United for the cost of the bond. Judge Easterbrook argued that the parties would have wished to make this agreement prior to bankruptcy had they fully considered the benefits of preserving the carryovers. He therefore concluded that the bankruptcy judge should have issued an order to mimic the agreement the parties would likely have made.

In addition to noting the policy problems with the bankruptcy judge's injunction, Easterbrook questioned its legal merits. Easterbrook read Prudential Lines narrowly: he argued that the decision concerned only a parent's claim of a worthless stock deduction based on its interest in a subsidiary. Nothing in the opinion, he asserted, supported the broad proposition that any stock sale that forfeits tax credits constitutes an "exercise of control" over the credits in violation of the automatic stay. Judge Easterbrook also raised the possibility that carryovers may not even qualify as property under the Bankruptcy Code, although he declined to address this question because he felt that Prudential Lines was distinguishable on other grounds. Judge Easterbrook thus indicated that the legal reasoning in Prudential Lines itself may be questionable and asserted that its broad application to bankruptcy cases is clearly erroneous. Judge Easterbrook's discussion was a rare instance of a judge's analyzing and criticizing NOL-based trading injunctions on the record.

Judge Easterbrook's criticism notwithstanding, the generally accepted current law governing trading injunctions and NOLs in bankruptcy can be summarized as follows. An ownership change is determined based on the five-percent shareholder rules in the Tax Reform Act of 1986, subject to the 2013 amendments to the segregation rules. In bankruptcy, ownership changes are

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140. Id.
141. Id. Judge Easterbrook did not address why the parties did not, in fact, consider such an agreement. He simply noted that the parties could have made a "mutually beneficial" deal since "gains from trade" were available. Id. Judge Easterbrook concluded from this that the judge "should have crafted a mutual-protection covenant that mirrored the likely non-bankruptcy transaction." Id. While he did not grapple with the question of why the judge should have imposed an agreement that the parties did not make themselves, Judge Easterbrook surprisingly seemed to view a judicially created contract as an exercise in judicial restraint. In his formulation, a judge issuing an injunction imposes terms on the parties no matter what the judge chooses to do (if the parties did not expect or contract for a freeze in trading). The adequate-protection agreement, in Judge Easterbrook's view, was the fairest way to structure the injunction since it reflected the terms that reasonable parties would choose for themselves instead of "cramming one side's position down the throat of the other." Id.
142. Id.
143. Id.
145. In re UAL Corp., 412 F.3d at 778.
also subject to the bankruptcy exception to the change-in-control rule and the alternate valuation option provided by the Bankruptcy Tax Act of 1980. Segal and Prudential Lines establish that NOL carryovers are property of the bankruptcy estate and may be protected by trading injunctions.

III. Criticism of the Current Approach

Academic criticism of NOL policy under Chapter 11 has been surprisingly muted. The few commentators who have touched on the issue have focused almost exclusively on legal problems with Prudential Lines and its broad application in Chapter 11. The policy considerations that Judge Easterbrook began to unearth in UAL Corp. remain largely unventilated. Potential solutions have garnered almost no attention. This Part first examines legal critiques of the Prudential Lines doctrine and then begins to consider the deep policy concerns implicated by injunctions in Chapter 11 cases.

A. Legal Critiques

1. NOL Carryovers Do Not Qualify as Bankruptcy-Estate Assets

While most jurists and corporations consider the issue settled law, some commentators still question whether loss carryovers are property of a bankruptcy estate. Max Barker frames this question by asking whether a carryover resembles the type of property right that contains inherent limitations or instead is the type that automatically continues until a superior interest is asserted. An example of the latter would be a debtor’s rights to the assets it uses to secure a loan: the creditor’s interest limits the debtor’s interest, but only because it is superior in the event that the debtor defaults. This type of interest is clearly protected by the automatic stay: recall that the automatic stay is designed to prevent creditors from dismembering a corporation by seizing collateral. An example of the former type is a debtor’s interest in a leased warehouse or an insurance policy: it contains clear limitations and a built-in expiration date. The practical difference for bankruptcy purposes is that the automatic stay does not create any obligation for a landlord or an insurance

146. The treatment of NOLs under Chapter 11 has been discussed more frequently in practitioner circles, but these discussions have focused mostly on techniques to persuade courts to adopt injunctions (or not). See, e.g., Thomas W. Avent, Jr. & John F. Simon, Preserving Tax Benefits in Troubled Companies—Navigating Mostly Uncharted Waters, 102 J. TAX’N 176 (2005).

147. See, e.g., Segal v. Rochelle, 382 U.S. 375, 381 (1966); Official Comm. of Unsecured Creditors v. PSS S.S. Co. (In re Prudential Lines Inc.), 928 F.2d 565 (2d Cir. 1991); Objection of Wells Fargo Foothill, LLC at 8, In re Foothills Texas, Inc., 408 B.R. 573 (Bankr. D. Del. Feb. 11, 2009) (No. 09-10452), 2009 WL 4078882. As discussed above, Segal does not actually address whether carryovers are the property of the debtor estate, so there is a reasonable argument that the issue is not actually settled. See supra note 113. Note that Congress did provide that NOL carryovers are property of an individual debtor’s bankruptcy estate. See 11 U.S.C. § 346 (2012).

148. See, e.g., Morris, supra note 2; Barker, supra note 120.
company to renew its contract with the debtor. Barker believes that carryovers more closely resemble the first type of interest: they exist only until a change in ownership occurs. In Barker’s formulation, this creates a “natural expiration date” akin to the end of a lease or an insurance policy. Barker thus reasons that carryovers do not qualify as assets of the bankruptcy estate: the estate has no interest in maintaining carryovers after their “expiration date.”

Barker’s argument is not persuasive. Forfeiture of carryovers during a change in control does not resemble the “natural expiration” of a lease. Carryovers “naturally expire” after twenty years: this time limit is analogous to a lease’s expiration date. This is not the type of expiration at issue, however: no one has argued that the bankruptcy estate has a property interest in extending the statutory time limit on carryovers. The harm to the estate occurs when tax assets are impaired before that date, just as harm occurs when a valuable leasehold is canceled early. Carryovers are valuable assets because they can offset any profits that a corporation generates within the specified timeframe—unless the corporation’s ownership changes. But an ownership change is not an inevitable (or even necessarily likely) event. A carryover more closely resembles a stock option that may not turn out to have any value: potential worthlessness does not inherently limit a property interest.

The nature of a debtor’s property interest in carryovers thus strongly indicates that carryovers qualify as assets of a bankruptcy estate. Courts have long interpreted Section 541 of the Bankruptcy Code, which defines estate property, to include “contingent interests and future interests.” Many courts have gone farther, holding that “every conceivable interest of the debtor, whether future, non-possessory, contingent, speculative, or derivative, is within the reach of the concept of ‘property of the estate.’” An interest does not cease to be property of the estate “simply because it is novel or contingent or [because] enjoyment must be postponed.” Courts have consistently construed Section 541 to cover lost profits, potentially refundable rental deposits, and various types of tax refunds. While the Bankruptcy Code

149. Barker, supra note 120, at 8.
150. A stock option’s expiration date resembles the time limit on the use of carryovers: both types of assets are potentially valuable until this final date.
explicitly excludes several types of assets from its definitions of estate property, it never mentions carryovers.\textsuperscript{155} Carryovers thus remain well within the broad category of assets that has traditionally constituted estate property.\textsuperscript{156}

At least one commentator has attempted to exclude carryovers from estate property by simply arguing that the speculative nature of a carryover prevents it from being "property" pursuant to the Bankruptcy Code.\textsuperscript{157} This analysis considers Prudential Lines a mistake and contends that treating a "potential deduction" as estate property runs counter to traditional judicial and administrative policy.\textsuperscript{158} This rationale is even less convincing than Barker's framework since the Code specifically includes contingent interests in the estate. The fact that carryovers have no clear value until they offset profits means only that the value of a carryover is contingent, not that a carryover is not an asset at all.\textsuperscript{159} Like most "contingent interests and future interests"—indeed, like many concrete and present interests—the value of a carryover is uncertain. This does not mean that it is not an asset.

2. Congress Did Not Intend the Automatic Stay to Protect Carryovers From a Change in Ownership Caused by Trading

While it is difficult to argue that carryovers are not assets of a bankruptcy estate, there is a persuasive case to be made that the automatic stay should not be construed to protect a corporation from losing its carryovers due to a change in ownership. In the language of the Bankruptcy Code, the stay prohibits "any act to obtain possession of the property of the estate or property from the estate or to exercise control over the property of the estate."\textsuperscript{160} Historical analysis and logical consideration of this language reveal that Congress probably did not intend for this category of behavior to include trading in a corporation's stock or debt.\textsuperscript{161}

Several courts have contemplated Congress's intent in adding the "exercise control" provision quoted above, which did not appear in the

\begin{itemize}
  \item \textsuperscript{155} See 11 U.S.C. § 541(b) (2012).
  \item \textsuperscript{156} Id.
  \item \textsuperscript{157} See Joni Larson, The Bankruptcy Court Overlooks Tax Laws in In Re Prudential Lines, Inc.: An NOL Should Not Be Property of a Bankruptcy Estate, 29 WILLAMETTE L. REV. 23, (1993); Morris, supra note 2, at 291 n.26 (describing Larson’s argument and analyzing whether carryovers are estate property).
  \item \textsuperscript{158} See Larson, supra note 157, at 35; Morris, supra note 2, at 291 n.26 (describing Larson’s argument).
  \item \textsuperscript{160} 11 U.S.C. § 362 (2012).
  \item \textsuperscript{161} Even the cases often invoked to support trading injunctions do not assume that this was Congress's intent. Recall that Prudential Lines explicitly states only that a parent's claim of a worthless stock deduction at the expense of its subsidiary's carryover constitutes an "exercise of control" over this asset of the debtor. This conclusion itself may be debatable. More importantly—as Judge Easterbrook argued in UAL Corp.—it is distinguishable from the proposition that trading of debt and equity during bankruptcy is an exercise of control over a debtor's assets. See supra Part II.
\end{itemize}
Bankruptcy Code until the 1984 amendments. A common interpretation is that Congress simply meant to broaden the automatic stay to prohibit actions similar, but not technically equivalent, to "possession." The Sixth Circuit, for instance, concluded that Congress likely intended to broaden the concept of possession to include "control" through voting trusts or shareholder agreements. The court also speculated that Congress may have wanted to clarify that the automatic stay applies to property of the estate that the debtor does not possess or directly control. Other courts have similarly decided that the "exercise control" wording does not significantly expand the automatic stay: most courts have applied the phrase only to behavior that approximates possession. Under this interpretation, the automatic stay does not apply to trading that might endanger a corporation's tax credits, as the traders do not take possession of the carryovers.

Even under a broader interpretation of Congress's language, common sense suggests that the automatic stay should not apply to the behavior of traders. The traders wish to exercise their own property rights for their own benefit. Any effect this may have on the corporation's assets is incidental. It cannot be that any action that risks reducing the value of a corporation's assets should be deemed to violate the automatic stay. Indeed, it would be preposterous to prohibit certain actions whose effects on a corporation's assets are far more concrete and predictable than the effects of trading in the debtor corporation's securities. For instance, consider a factory being built near a debtor corporation's headquarters that may decrease the value of the debtor's real estate. Should courts halt construction in the name of the automatic stay? For that matter, why should judges not enjoin competing companies from producing new product lines that may devalue a debtor's intellectual property?

One might counter that the Prudential Lines holding refers to behavior that eliminates a debtor's property, not behavior that devalues property. This distinction is not as clear as it sounds, however. An action that incidentally eliminates an asset's value is not different in kind from one that merely reduces it. Returning to the previous examples, it would be perfectly possible for a new patent to reduce the value of a corporation's intellectual property to zero. Any number of third-party actions might reduce the value of a stock option to zero, but courts would never enjoin behavior that might drive down the market price of a company's stock simply because a bankrupt corporation owned stock.

162. See, e.g., Javens v. City of Hazel Park (In re Javens), 107 F.3d 359, 368 (6th Cir. 1997); see also Morris, supra note 2, at 295.
163. See Morris, supra note 2, at 295.
164. Javens, 107 F.3d at 368; see also Morris, supra note 2, at 295.
165. See Javens, 107 F.3d at 295.
166. See, e.g., Beker Indus. Corp. v. Fla. Land & Water Adjudicatory Com'n (In re Beker Industries Corp.), 57 B.R. 611, 626 (Bankr. S.D.N.Y. 1986); see also Morris, supra note 2, at 295.
167. See Barker, supra note 120, at 86.
168. See id.
options in that company at a higher price. Injunctions against trading make even less sense if they do not surgically target trades that cause changes in control.

If the proposition that equity trading violates the automatic stay is difficult to defend, the assertion that debt trading violates the automatic stay is almost impossible to justify. It is impossible for any debt transaction to have a direct effect on a corporation's carryovers. A subsequent reorganization plan that exchanges the debt for equity may trigger a change in ownership, but the cause of the change in ownership is the plan itself: it is always possible to design a plan that does not cause such a change. Of course, such a plan may not be viable: the state of the corporation may demand conversion of most or all debt to equity in the reorganized company. Thus, it may be easier to reorganize if debtholders cannot trade since all reorganization options are on the table (without endangering tax assets) if debtholders remain the same. However, the fact that debt traders may make the reorganization process more challenging does not mean that these traders exercise control over a property right. While Max Barker argues that restricting a debtor's reorganization options may amount to exercising control over the debtor's exclusive right to propose a reorganization plan,169 this assertion is quite a stretch: not only is it unclear whether the right to propose a plan is a property interest, but the debtor retains its exclusive right to propose a plan no matter how many debtholders sell their claims. The Bankruptcy Code never guarantees the debtor a smooth and easy route to reorganization.

3. Bankruptcy Judges' More General Equitable Powers Do Not Authorize Trading Injunctions

In addition to providing for the automatic stay, the Bankruptcy Code empowers judges to "issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of [Chapter 11]."170 If a debtor asks the bankruptcy judge to issue a preliminary injunction based on this clause, the judge must evaluate whether the debtor is likely to succeed on the merits, whether it will suffer irreparable damage if the injunction is denied, and whether the injunction will harm others or instead serve the public interest.171 While courts have invoked this provision consistently in granting injunctions, debtors' motions usually go unchallenged, and judges almost never analyze these issues on the record.172 Commentators have argued that injunctions based on this broad provision are especially suspect when they are included in the

169. Id. at 87.
171. See Morris, supra note 2, at 298.
172. See id. at 286.
package of first-day motions. This argument is strong: it seems highly improbable that a debtor could show that a successful reorganization and significant future profits are both likely. It would be even harder to establish that a carryover would be lost in the absence of an injunction. Yet these showings are necessary to establish the likelihood of irreparable harm and of success on the merits. Thus, judges’ general equitable powers provide little support for injunctions.

4. Trading Injunctions Violate the Fifth Amendment

The Supreme Court has established that the Takings Clause applies not only to the direct seizure of property but also to unfair redistribution of burdens among individuals. This vague standard takes into account the economic impact of redistribution and its consistency with parties’ plans and expectations. Jean Morris has invoked this reasoning to argue that trading injunctions are unconstitutional if they deny liquidity to security-holders. Not only does the loss of liquidity represent a significant economic cost in its own right, but the prevention of trading also seriously undermines investors’ reasonable expectations and plans. Since investors receive nothing in return for this loss, injunctions may qualify as a “taking” of private property “without just compensation.”

On its face, Morris’s analysis is appealing. Her argument highlights one of the fundamental concerns with trading injunctions in Chapter 11: the constitutional analysis is grounded in the costs created by trading injunctions. Morris makes a compelling case that Fifth Amendment precedent demands protection of the property right enjoyed by holders of liquid securities during a bankruptcy proceeding. However, this argument may be more academic than

173. See id. at 285 (commenting that the inclusion of injunctions in first-day motions is “remarkable”).
174. See id. at 299.
175. “[N]or shall private property be taken for public use, without just compensation.” U.S. CONST. amend. V.
177. See Morris, supra note 2, at 301.
178. Id. Morris draws a distinction between the Takings Clause’s application to injunctions based on § 105 and injunctions based on the automatic stay. While she believes that § 105 injunctions may be unconstitutional, she points out that § 362 requires judges to grant relief from the automatic stay if a nondebtor party’s interests are not “adequately protected.” She therefore argues that the automatic stay, while it may constitute a taking, is not an unconstitutional taking according to the language of the statute because the Bankruptcy Code requires compensation for affected investors. Id. Of course, judges have not actually provided this compensation in Chapter 11 cases involving injunctions to protect carryovers. See, e.g., In re UAL Corp., 412 F.3d 775 (7th Cir. 2005) (criticizing the decision below for failing to require a bond to compensate investors for a trading injunction). Morris’s argument implies that injunctions based on the automatic stay violate § 362 if investors receive no compensation.
179. See Morris, supra note 2, at 301-03.
practical: security-holders have yet to mount a significant constitutional challenge to a trading injunction in a Chapter 11 case and, as Morris notes, management would likely respond to such a challenge by insisting that the risk of liquidity loss in bankruptcy is factored into security prices.\textsuperscript{180}

B. Policy Critiques

The legal problems with trading injunctions in Chapter 11 are numerous and troublesome. However, even if injunctions fit clearly within the law, they would still raise important policy concerns. While commentators have devoted little attention to the policy questions surrounding trading injunctions, these issues deserve deep consideration and broad ventilation. The potential evils of injunctions do not stop at their harsh consequences for investors. Injunctions also create dubious incentives for the parties in a bankruptcy proceeding and provide management with a powerful—and unjustified—weapon to entrench its position.\textsuperscript{181} This Section briefly develops a policy critique of the broader NOL regime. It then outlines specific problems with the handling of carryovers in Chapter 11, building on several critiques that include some of the concerns Judge Easterbrook began to uncover in \textit{UAL Corp.}

1. The Incentive-Based Argument for Carryovers Is Particularly Unlikely to Apply in Chapter 11 Cases

Recall that the policy justification for NOL tax credits is correcting the undesirable incentives that the one-year tax period creates for corporations that must incur long-term losses to produce eventual profit. For this justification to hold water, the tax credit must go to a corporation whose managers consciously consider a risky project over a multi-year horizon. Additionally, the risky project must fall in the range of profitability in which its social rate of return is positive but the one-year tax period would reduce its internal rate of return below that of an alternate investment. Otherwise, the tax credit does not improve incentives.\textsuperscript{182}

Congress and the IRS have attempted to protect these policy goals by limiting carryovers when a merger or significant change in ownership might combine income-producing assets with a loss corporation.\textsuperscript{183} However, the

\textsuperscript{180}. This assertion may be questionable, however: this type of injunction is a relatively recent phenomenon and does not apply equally to all shareholders.

\textsuperscript{181}. \textit{See infra} Part III.B.3.


\textsuperscript{183}. \textit{See supra} Part I.
NOL structure makes no attempt to differentiate corporations that incur incidental losses from those that deliberately pursue projects with interim losses. By basing the value of retained carryovers on a corporation’s post-reorganization stock value, the Bankruptcy Code has strayed even farther from the goal of limiting carryovers to profit realized by the loss entity.\(^{184}\)

If the incentive-based benefits of NOL carryovers are questionable in many cases, they are especially suspect in the Chapter 11 context. As discussed previously, many commentators question trading injunctions because they doubt that a corporation in Chapter 11 will both successfully reorganize and manage to generate enough profits to take advantage of carryovers. Even if a new corporation does generate profits, the very fact that it does so through reorganization makes it unlikely that the incentive structure from the original project will hold. A corporation’s insolvency indicates that the original project that produced the NOLs did not, in fact, generate adequate future profits. The loss credits would incentivize a poor business decision.

In fact, the projects that tend to precede Chapter 11 reorganizations are exactly the types of projects that tax law should discourage.\(^{185}\) The ideal candidate for Chapter 11 reorganization is a corporation that cannot service its debt but can cover its variable costs if it is restructured. By canceling old equity and converting debt to new equity, the corporation may be able to generate a healthy profit in the future. Consider, for example, the railroad paradigm: a railroad cannot make its debt payments, but it would be able to make a profit if it did not have to make these payments. Reorganization can fix this problem by wiping out equity and giving the company to the creditors. This preserves the corporation, but it does not make the original project profitable: the project appears profitable only once the debt used to finance it disappears. There is no incentive-based justification for allowing this corporation to offset its profits with NOLs from the original project: the project was not, in fact, profitable.\(^{186}\) The NOLs do not offset profits from the original project but rather offset gains from reorganization. Insolvent corporations do not fit the mold that justifies carryovers.

The managers of a debtor corporation would likely respond that the corporation is not, in fact, insolvent: it may have simply faced a liquidity crisis and filed for Chapter 11 to prevent creditors from dismembering it. Perhaps the

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184. After a significant change in capital structure, the stock value (and subsequent profit) is likely no indicator whatsoever of the profitability of the original project that caused the losses. See infra Part III.B.2.

185. Of course, the tax benefits will not give equity holders an incentive to choose projects that will make the firm insolvent; they will never get to use the credits anyway if they are wiped out. They will, however, decrease the cost of debt for risky projects, as discussed below, and generally incentivize risk.

186. There may be good reasons to subsidize railroads: transportation infrastructure likely generates significant positive externalities. However, projects like these should be encouraged through direct subsidies (including specific tax credits) or government funding, not through broad provisions of the tax code that apply to all loss corporations.
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corporation is in the middle of the project that would justify carryovers: maybe it has incurred more losses than expected and has depleted its capital but still expects to make profits in the future. A firm in this situation has the best case for protection of carryovers in Chapter 11, but problems with its argument remain. The incentive foundation for carryovers still fails if the corporation reorganizes: the carryovers will offset gains from reorganization. Retaining carryovers for a corporation in the midst of a multi-year project might actually be justified if the carryovers' value were limited to the value of the corporation before reorganization. However, since the 1986 Code allows reorganized firms to base their credits on the post-reorganization value, the incentive structure falls apart as NOLs will offset gains from reorganization rather than gains from the project that generated the losses.

Another counterargument is that carryovers should remain with the reorganized corporation to protect the creditors, who become the new stockholders. This approach, however, endows creditors with a dubious moral high ground. As Judge Easterbrook noted in UAL Corp., creditors invest in corporations—they investigate the projects they underwrite and adjust their interest rates to compensate for the risk of default.187 Creditors are entitled to a priority claim on the corporation's assets and nothing more.188 There is no reason to treat tax credits as sacrosanct because they might benefit creditors, and there are excellent reasons not to do so. Providing tax credits for reorganized corporations that were insolvent artificially lowers the interest rate for risky ventures, including ventures that may have negative expected values.189 This is a perverse ex ante incentive, and it is not the incentive that justifies carryovers. Carryovers are useful if they encourage corporations to pursue positive-net-present-value projects they would otherwise avoid. When carryovers instead subsidize negative-net-present-value projects, the carryovers are harmful: they encourage corporations to take on a greater-than-optimal level of risk.190 All of this suggests that there is very little policy justification for protecting NOL carryovers during Chapter 11.

2. Freezing Trading Can Significantly Harm Investors

The illiquidity that results from a trading injunction clearly harms stockholders and debtholders. As Judge Easterbrook observed in UAL Corp., loss of liquidity is an “immediate and independent injury” that leaves investors vulnerable if they want—or need—to sell. Moreover, the loss of liquidity introduces uncompensated risk by preventing investors from diversifying their

187. In re UAL Corp., 412 F.3d 775, 778 (7th Cir. 2005).
188. See the legal discussion above about the status of tax credits as debtor assets—while they are assets, they are likely not the type of assets that the automatic stay is meant to protect for creditors.
189. See supra Part I.
190. See id.
portfolios and leaves them with a type of security that is not what they paid for, planned for, and owned. These are the most obvious costs to weigh when considering a trading injunction, and they are the ones that Judge Easterbrook and other judges tend to consider. Even if the merits of freezing the market were not questionable, these costs may exceed the value of the potential tax credit in many, or even most, situations.

The greatest costs of a trading freeze, however, may lie beyond these direct costs to investors. By forcing original creditors—who wanted to invest in a solvent firm—to ride out the bankruptcy process, an injunction denies the entire reorganization effort the extensive and well-documented benefits of claims trading. By allowing experienced distressed-debt investors to replace a firm's original creditors at the negotiating table, claims trading can streamline the reorganization process. While a trading injunction freezes institutional creditors whose business model assumes a steady return on investments—creditors who are likely eager to walk away—claims trading brings in speculative investors who specialize in distressed debt investing. These investors are more likely to bring enthusiasm, energy, and innovative solutions to the table. They are also more likely to have the expertise and desire to run and grow a reorganized firm should they exit Chapter 11 as controlling shareholders. Their presence offers clear benefits for the debtor corporation itself, and it also offers broader benefits for all parties: as a result of the liquidity they enjoy, parties are able to specialize in the investments that define their business models. Claims trading thus promotes efficiency on an industry-wide—and economy-wide—level. Investors can concentrate their expertise in particular areas and run effective businesses accordingly.

It is important to note that distressed-debt investors almost always purchase debt with the intention of acquiring control of the debtor corporation post-reorganization. As mentioned above, this goal gives such investors an entirely different perspective from institutional creditors who expect a fixed return on a loan. Significantly, distressed-debt investors' pursuit of control also

191. See In re UAL Corp., 412 F.3d at 778.
192. See Morris, supra note 2, at 300 (describing the costs and benefits of injunctions).
194. See id. at 256 (describing the differing negotiation goals of bank lenders and distressed debt funds). Goldschmid also notes that regulatory issues limit institutional creditors' options in bankruptcy: banks must write down distressed debt to below potential recovery value, and bank holding companies must dispose of shares of non-banking institutions acquired in bankruptcy within two years. These factors direct banks' goals toward quick retrieval of capital, not long-term growth. Id. at 258.
195. Id. at 259.
196. Id. at 261.
197. See id.
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puts them at odds with the debtor’s management, indicating that issuing injunctions to protect debtor assets does not protect the interests of creditors but rather protects the interests of the debtor’s management. Investors often pay a premium to acquire enough debt to obtain a controlling equity stake in a reorganized company. These investors hope that the reorganization plan will convert debt to equity. Assuming distressed-debt investors do not make blind decisions without researching a target company’s financials, such investors know that the firm will lose its carryovers if the bid is successful and the reorganization plan is confirmed.\(^{198}\) The fact that investors are willing to pay a premium for a stake in the reorganized firm, knowing the firm stands to lose its carryovers, indicates that the investors believe they can run the firm better than current management can. Allowing the investment thus should be beneficial from an efficiency standpoint. Claims trading thus should benefit every party involved,\(^ {199}\) with the exception of the current management that wishes to maintain control.

3. In Practice, Trading Injunctions Anchor Management’s Position in a Failing Firm

A trading injunction provides a remarkably powerful way for management to defend itself against a takeover attempt. Bankrupt firms are ripe for takeover, and management’s position is in jeopardy no matter what happens: unless management can find a handle to hold onto control, it may not remain at the helm when the reorganization process ends. Any tool to prevent a change in control—even temporarily—will be attractive to management. This is exactly what trading injunctions do: they provide a bulletproof vest for management under the false pretense of protecting the firm’s carryovers.

One need only look to the reactions of management to Judge Easterbrook’s dicta in \(U\&L\) Corp. to find convincing evidence of this view. Judge Easterbrook’s dicta frightened management-side attorneys: they worried that their powerful entrenchment device might disappear.\(^{200}\) Law firms thus

198. Admittedly, one common argument for trading injunctions is that buyers and sellers cannot know when their transaction will jeopardize tax credits. See, e.g., Morris, supra note 2, at 297 (discussing issues with “transfers by other unrelated shareholders or claimholders over whom the transferring shareholder or claimholder has no control (and concerning which the transferring shareholder or claimholder may have no knowledge)”). However, this argument rings hollow when an investor seeks to acquire a controlling interest: after all, anyone seeking to acquire 50% of a firm’s equity through claims trading knows that the carryovers will disappear if the reorganization proceeds as planned.

199. In addition to the overall efficiency benefits from allowing trading—which should benefit equity-holders—claims trading benefits debt-holders who wish to sell and investors who wish to buy. While management might benefit from the overall efficiency gain of allowing trading, it would likely lose more from its loss of control.

sought new ways to protect their clients from takeover attempts. Some even suggested that firms prepare poison pills in case courts stopped issuing injunctions. Noting that “restrictions on stock and/or claims trading has become almost routine in large [C]hapter 11 cases involving public companies on the basis that such restrictions are vital to prevent forfeiture of favorable tax attributes,” Jones Day attorneys Brad B. Erens and Mark G. Douglas commented that “the possibility that trading injunctions will be harder to obtain begs the question whether other means of preventing significant shifts in equity ownership are available.” They went on to analyze the efficacy of poison pills as techniques for preventing changes in control during Chapter 11.

The thrust of the attorneys’ analysis was an attempt to prevent changes in ownership. While they framed their discussion in terms of the general goal of preserving carryovers, avoiding changes in ownership offers such clear independent benefits for management that the mere conflict raises a concern even without evidence of misused injunctions. The reality of bankruptcy procedure deepens this concern: it is difficult for anyone to challenge management’s decision to request an injunction. If a debtor’s management asserts on the first day of bankruptcy that the debtor’s carryovers are a valuable asset and are likely to disappear quickly without an injunction, it is unlikely that another party will have the information or the sophistication to challenge this claim. Management’s inside access gives it leverage and presents a substantial risk of misuse of this authority.

4. Since Trading Injunctions Do Not Last Forever, Their Value Is Often Illusory

Even if none of the above concerns apply, trading injunctions’ capacity to protect tax assets is questionable. It is indeed possible to imagine a situation in which a corporation takes on a risky project with the expectation of interim losses on the way to an eventual profit, declares Chapter 11 due to a temporary liquidity crisis, still generates profits that greatly exceed the costs of the trading freeze, and is run by saintly management who seek an injunction purely to protect tax assets on behalf of investors. Even in this idealized scenario, however, there is no guarantee that an injunction would preserve carryovers

201. See id.
202. See, e.g., id. para. 15.
203. Id. para. 1.
205. This is a well-documented problem in many stages of the bankruptcy process: both information asymmetry and coordination problems among stakeholders tend to give management—and sometimes some select stakeholders—considerable leverage.
206. Of course, the legal and policy concerns of freezing trading would still apply—this is a situation in which an injunction accompanied by a bond might be appropriate.
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long enough for them to offset profits.\textsuperscript{207} When the injunction is lifted after the reorganization, stockholders will naturally start trading again—anyone who wanted to trade and was frustrated by the injunction will offload shares as soon as possible.\textsuperscript{208} If this trading creates a change in control before the corporation realizes enough profits to use its carryovers, the injunction’s benefits would evaporate. The injunction rests on particularly shaky legal ground in this case: it is almost impossible to justify a claim of “irreparable harm” to a debtor based on the loss of an asset that will disappear later anyway.\textsuperscript{209}

IV. Potential Improvements to the Current Approach

The current bankruptcy approach to carryovers creates numerous problems, both from legal and policy perspectives. While there is no single solution to these problems, many alternatives exist that would improve the status quo. The ideal policy would allow corporations to use NOL carryovers to offset only those profits generated by projects that the original corporation undertook with the expectation of interim losses. The policy would deny carryovers in all other situations. This would prohibit the retention of carryovers in most Chapter 11 cases. This perfect policy is impossible to achieve directly in practice, but the strategies below would all be closer to this perfect policy than blanket injunctions in Chapter 11 cases. This Part briefly offers several options.

The most modest option would be to continue issuing injunctions to prevent some transactions that would trigger changes in control, but to provide a mechanism to identify situations in which injunctions are inappropriate. Alternatively, judges could allow one side to continue behaving as it would like but force it to compensate the other side for resultant losses. This is the idea behind both injunction bonds and trading taxes. These remedies are the least comprehensive: they do little to address the fundamental policy problems with carryovers in bankruptcy. More radical approaches, such as making carryovers contingent on later approval, might be more difficult to implement but could reform tax policy to realign incentives. The most radical approach of all may be the simplest: bankruptcy judges would simply stop issuing trading injunctions and let the chips fall where they may.

\textsuperscript{207} Several commentators have mentioned this wrinkle in the justification for injunctions. \textit{See, e.g.}, Morris, \textit{supra} note 2, at 299.

\textsuperscript{208} This would be particularly likely because stockholders who suffer from a loss of liquidity during the injunction may grow in number as the injunction drags on, leading to a larger need for liquidity on the day it is lifted. \textit{See generally In re UAL Corp.}, 412 F.3d 775 (7th Cir. 2005).

\textsuperscript{209} Admittedly, the uncertainty regarding the end status of the credit gives it some value from an ex ante perspective, but broad policy justifications become thin if credits disappear before realization in a significant number of cases.
A. Stop Issuing Injunctions in Chapter 11; Leave the Rest of the Tax Regime in Place

The simplest solution to most of the legal and policy critiques outlined above is to end the practice of issuing injunctions to protect tax credits. Investors in bankrupt firms could trade at will, and debtors would lose their carryovers if a change in control resulted. This Note argues that this approach would be good tax policy in most Chapter 11 cases: the fact that a corporation needed to reorganize likely means that the project that generated the losses will not create net profits. Only losses from eventually profitable projects should become tax credits. This proposal would eliminate the other concerns about injunctions; all legal and policy problems would disappear.

A potential—and legitimate—criticism of this approach is that it enables groups of investors to threaten coercive trading. Large stockholders or major creditors could threaten to cause a change in control in order to gain leverage in Chapter 11 negotiations. They would effectively be holding carryovers hostage in order to seize a larger-than-deserved slice of the bankruptcy pie. Such behavior is not unique to bankruptcy or to the protection of tax assets: it resembles the corporate greenmail situation in which a major shareholder threatens a takeover in order to coerce a favorable buyout. However, manipulative tactics might be particularly difficult to prevent in Chapter 11: the changes in statutory and contractual requirements for buybacks that have helped temper greenmail would not be a viable solution for the carryover problem.

On the other hand, the role of the bankruptcy judge in Chapter 11 negotiations might provide an opportunity to rein in coercive behavior on an ad hoc basis. Chapter 11 proceedings present numerous opportunities for such coercion, and to prevent such coercion, bankruptcy judges must attempt to ensure the general fairness of the process. Thus, the Chapter 11 framework may help guard against manipulative maneuvers in the carryover context.

If investors truly value the protection afforded by injunctions, this proposal would not be harmful, as contractual protections could take the place of injunctions. Courts have upheld contractual prohibitions against alienability in the corporate context as long as they are precise and clearly articulated. Creditors who consider carryovers an asset in case of bankruptcy

210. And it certainly means that the full post-reorganization profits will not be net gains from the project. See supra Part III.B.2.
211. Notably, there is a 50% tax on income from greenmail, I.R.C. § 5881 (2012), and many corporate charters now contain anti-greenmail provisions that prevent management from unilaterally approving large buybacks, see Ronald J. Gilson, Drafting an Effective Greenmail Prohibition, 88 COLUM. L. REV. 329 (1988).
212. See generally Gilson, supra note 211.
213. That is, contractual restrictions on sale or transfer.
would adjust their interest rates to reward corporations for restrictions on
equity trades. Investors would pay a premium for unrestricted stock based on
how much they value the ability to trade freely. A corporation would impose
trading restrictions if it believed that this premium would be greater than the
increased cost of credit for a corporation without restrictions.\footnote{\textsuperscript{215} If all parties
have adequate information, this mechanism should ensure that corporations
choose trading restrictions only when benefit exceeds cost: if creditors value
restrictions more than stockholders value uninhibited trading, corporations
have an incentive to impose restrictions. If the analysis in this Note is correct,
however, most corporations would not choose this route.}

\textbf{B. Eliminate the 1986 Act’s Alternate Valuation Option for Bankrupt Firms}

A parallel policy adjustment to ending the injunction habit would be to
eliminate the 1986 Act’s alternate valuation option for bankrupt firms.\footnote{\textsuperscript{216} While
this proposal would not directly address the injunction problem, it would help
keep the treatment of NOLs in line with policy objectives. The 1986 Act’s
general NOL rules wisely limit carryovers to the value of a corporation
immediately before a change in control. If applied correctly, this standard
should prevent trafficking in carryovers and tie them directly to the profits
created by the project that generated the losses. There is no reason to depart
from this framework in bankruptcy. It is no coincidence that the value of a
corporation’s shares tends to be very low immediately before reorganization:
the low share price reflects that the project that created the firm’s carryovers
did not generate—and is not expected to generate—a large profit. The typical
approach of limiting the value of carryovers to the corporation’s value before
the change in control is appropriate in this situation: allowing a corporation to
maintain carryovers equal to its post-reorganization value enables the
corporation to offset profits created by the reorganization, not to offset profits
generated by the original project.

From a strict tax-policy perspective, the standard bankruptcy exception to
the change-in-control rule—which allows corporations to treat creditors as
owners for change-in-control purposes—is also questionable. This provision is
the linchpin that allows companies to maintain their tax credits during most

\footnote{Loan Ass’n, 482 S.W.2d 841 (Tex. 1972). Most alienability provisions are found in the context of
closely held corporations—indeed, the purpose of such restrictions is often to keep a firm in a family’s
control or to prevent a firm from accumulating enough shareholders to necessitate SEC registration.
However, these provisions can be used in public corporations’ stock as well. For examples of
contractual trading restrictions in public corporations, see \textit{In re Topps Co. S’holders Litig.}, 926 A.2d 58
(Del. Ch. 2007).

\textsuperscript{215} In making this decision, the corporation would have to predict the aggregate
increased cost of credit in the absence of trading restrictions and the aggregate premium that all
stockholders would pay to trade freely, so the determination would depend on capital structure. This
makes sense: the cost and benefit of trading restrictions vary according to how many creditors benefit
and how many stockholders suffer.

\textsuperscript{216} \textit{See supra} Part II.}
reorganizations: carryovers would otherwise disappear whenever creditors received at least a 50% stake in a reorganized firm. The previous Part explains why allowing carryovers to survive reorganization violates the policy foundation on which carryovers rest. The provision that makes this survival possible demonstrates where law diverges from policy: treating creditors as stockholders divorces carryovers from the behavior that created the losses. The provision severs initial losses from eventual profits by ignoring shifts in capital structure and effectively operating as if debt that was converted had never existed. This mechanism allows carryovers to offset profits that are actually gains from restructuring: it is no surprise that a project will often seem profitable when the debt used to finance it is ignored. Congress intended the bankruptcy exception to prevent the change-in-control rule from extending beyond its purpose: the rule was meant only to prevent mergers that facilitate trafficking in tax attributes, not to limit carryovers in reorganizations. From a policy standpoint, however, a reorganization is not entirely different from a merger: the corporation that uses the carryovers is not the same one that incurred the losses, and the profits that a reorganized corporation generates may exceed the value of the original corporation’s project.

Proponents of the current policy would likely argue that the alternate valuation option and the bankruptcy exception to the change-in-control rule are essential for successful reorganizations. If reorganizations universally destroyed tax assets, parties might be less willing to contemplate them. From a policy perspective, proponents of the status quo would argue that reorganization is designed to maximize the size of the debtor-corporation “pie”—in other words, the point of bankruptcy is to prevent dismemberment of firms by creditors and maximize the value of assets. It would seem that destroying tax credits runs counter to this policy goal. However, bankruptcy policy’s perspective must be broader than that of an individual firm. If the general goals of bankruptcy run counter to fair and efficient tax policy, tax concerns may demand less robust protections in bankruptcy. The special rules for bankruptcy amount to a tax subsidy rather than a logical piece of the overall NOL regime. While some might insist that subsidizing reorganizations is good policy, the numerous costs discussed in this Note suggest that this particular subsidy is counterproductive. As discussed, a decision to subsidize reorganizing corporations also threatens to encourage businesses to take on overly risky projects.

217. If the creditors owned stock before the reorganization or if other five-percent shareholders had increased their holdings during the three-year test period, the reorganization could trigger a change in control even if creditors received less than 50% of the reorganized firm. See supra Part I.C.

218. The retroactive treatment of this debt as equity for tax purposes adjusts taxes to “pretend” that creditors were, in fact, stockholders all along.

219. Based on the above analysis, the carryovers will exceed the profits from the original project whenever the reorganization cancels or converts debt.
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C. Limit Corporations' Ability to Use NOL Credits

An aggressive attempt to align the tax regime with its policy objectives might involve taxpayer-specific approval for the deduction of carryovers from income. In the Chapter 11 context, such a policy would require the post-reorganization firm to demonstrate that it deserves the tax credits. At the very least, this would entail proof that the reorganization did not result in the purchase or transfer of these credits to a profitable corporation. A better approach would require the corporation to demonstrate that the profits were the direct result of the project that incurred the losses. This reform theoretically could fix the overall policy problems with the NOL regime by denying carryovers whenever they are inconsistent with policy objectives.

However, the proposal is probably too cumbersome to be successful in practice. The approach would require an administrative agency—probably the IRS—to review thousands of applications for ratification of tax credits. This volume of adjudications would overwhelm an agency, and the efficacy of the process would also be questionable. The administrative law judge—or whoever reviews the applications—would be unlikely to have specific knowledge about the financials and decision-making details of the taxpayer in question. Management’s informational advantage would perhaps become a problem, as many corporations would be able to selectively produce facts to justify use of the credit.

A more modest way to institute taxpayer-specific approval of carryovers in Chapter 11 cases would be to require reorganized corporations to justify the reinstatement of carryovers at the conclusion of the Chapter 11 process. This is an attractive approach, and it is much more workable than the broad conversion of carryovers into contingent credits. Bankruptcy judges would freeze carryovers on the first day of bankruptcy. The carryovers would not be lost due to a change in control or any other reason, and investors could continue to trade. After plan confirmation, the bankruptcy judge would determine—in consultation with the various parties—whether reinstatement of the carryovers is consistent with legal and policy objectives. This approach would promote flexibility in deciding when firms can retain carryovers: judges would not be bound by strict, and often arbitrary, rules about changes in ownership.

While taxpayer-specific approval shares some of the other proposals’ informational difficulties, it offers the important benefit of removing negotiation about carryovers from the Chapter 11 process. This addresses

220. In a sense, however, almost all reorganizations do. See supra Part IV.B.
221. Or, depending on how stringent a standard the agency employs, most requests might be denied. In either case, this approach seems unlikely to separate accurately the corporations that should be able to use the credits from those that should not.
222. To make this an adversarial proceeding, the bankruptcy judge could invite the IRS to participate. See infra note 225 and accompanying text.

several of the policy concerns identified above.\textsuperscript{223} Management would not be able to use carryovers as opportunistic tools, and coercive threats to cause changes in control would no longer haunt Chapter 11 negotiations. Additionally, the frantic nature of the injunction request would disappear: judges would no longer find themselves in an impossible position in which they must either grant an injunction and risk being accused of endorsing management’s coercion or deny it and risk destroying a debtor’s value.\textsuperscript{224} Instead, parties would have time to present evidence, and the judge would have time to review it. The informational asymmetry would not disappear, but the problem would abate if injunctions were not pushed through in a time-pressured situation. The court also would have the chance to conduct an ex post analysis of the bankruptcy process, rather than trying to guess whether or not an injunction was essential to protect value.\textsuperscript{225}

To avoid the administrative difficulties associated with all regimes that attempt to allow certain credits, a policy regime could instead make trading costly or make \textit{stopping} trades costly. Pricing trades would acknowledge the external costs that justify injunctions in the first place; pricing injunctions would acknowledge the cost of halting trades. An injunction bond would discourage frivolous injunctions and compensate parties harmed by trading freezes, while a trading tax during Chapter 11 would discourage trading and make a change in control less likely.

A mandatory injunction bond, which Judge Easterbrook proposed in \textit{UAL Corp.}, would elegantly protect investors and encourage debtors to request injunctions only when they are justified. It is also not a novel idea: judges commonly require injunction bonds, including in bankruptcy cases.\textsuperscript{226} In fact, the Federal Rules of Civil Procedure instruct federal judges to require such bonds in some contexts.\textsuperscript{227} In bankruptcy, injunction bonds would force a

\textsuperscript{223} Note, however, that this proposal creates a double standard by including only bankruptcy cases. Corporations outside of bankruptcy would not have the opportunity to demonstrate that they deserved to keep carryovers after a change in ownership. Of course, corporations currently have the opportunity to freeze trading to prevent a change in ownership only in Chapter 11. Thus, to some extent, the same double standard already exists.

\textsuperscript{224} As mentioned, almost all judges choose the former option. See supra Introduction, Part III.A.2.

\textsuperscript{225} One problem with this proposal is that no party to the bankruptcy case would have any reason to oppose the reinstatement of carryovers after reorganization. While the proposal strives to allow situation-specific approval of tax credits, it could effect universal approval in practice. Making carryovers bulletproof would be directly contrary to the policy goals the solution was designed to achieve. To solve this dilemma, the IRS could review bankruptcy cases involving carryovers and decide to contest reinstatement if it seemed suspect. For this to work, the bankruptcy judge would have to invite the IRS to participate in the hearing: the IRS is not otherwise a party to the case, but the hearing would not be adversarial without its participation. This would raise the same concerns with administrative burden as the previous solution; however, the burden would be smaller since only bankruptcy cases would be involved.

\textsuperscript{226} See, e.g., President Casinos, Inc. v. Columbia Sussex Corp. (\textit{In re President Casinos, Inc.}), 360 B.R. 262 (B.A.P. 8th Cir. 2007). Bonds are strikingly rare in cases producing published opinions on trading injunctions.

\textsuperscript{227} See \textit{FED. R. CIV. P. 65(c)}. 

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debtor to put its money where its mouth is, reducing the likelihood that the debtor would use an injunction for coercive or abusive purposes. If the costs of a trading freeze were truly low—as debtors usually claim—a debtor would want to prove this to minimize the cost of the bond. If the cost of a trading freeze were likely to be higher than the benefit of preserving carryovers, a debtor would not be willing to pay the high cost of the bond. These incentives would encourage injunctions only when a trading freeze would create an overall surplus, and the parties would share this gain: tax credits would remain, and investors would either see their securities increase in value or receive compensation from the bond.

Bonds thus represent a vast improvement over the current practice, under which investors bear substantial costs. Bonds are not entirely satisfying from a policy standpoint, however. Fundamental concerns remain when carryovers survive reorganization. The hope that debtors will request injunctions only when carryovers are actually likely to have value lessens policy problems but does not eliminate them: as extensively discussed, a reorganized firm can use carryovers to offset significant gains that do not result from the initial losses. Furthermore, management’s massive informational advantage might allow it to get away with smaller-than-necessary bonds. It would be difficult for anyone to evaluate or challenge management’s assessment of the costs and benefits of an injunction, particularly if the injunction request were part of a package of first-day motions.

Trading taxes should appeal even to someone who buys none of this Note’s skepticism about the motives and policy benefits of injunctions in Chapter 11. It is uncontroversial that trading freezes injure stockholders. Any approach that allows trading, therefore, is desirable. Taxation of trades would cause buyers and sellers to internalize some of the costs of their trades. Tax revenue could be placed in a fund to compensate the debtor if the trading did cause carryovers to be forfeited. This is essentially a reverse of the injunction-bond approach: while the injunction bond would forbid trading and require the debtor to compensate investors for their loss of liquidity, trading taxes would allow trading but require parties who trade to compensate the debtor for the costs of trading.

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228. This bond should combat management’s agency problem by providing a market check: the debtor-in-possession lender will finance the bond only if the lender believes that the reorganization will produce a profitable corporation.

229. Of course, it is likely that the value of a corporation’s stock would increase if a trading freeze were beneficial, since this would probably mean that the corporation is expected to generate large profits after reorganization. Bonds thus might not significantly alter the situation in which injunctions are actually beneficial. Their principal value would be as a deterrent for frivolous injunctions and as protection for investors if stock prices were to decline (which would likely indicate that the injunction was a mistake).

230. See supra notes 130-131 and accompanying text.

231. See, e.g., In re UAL Corp., 412 F.3d 775 (7th Cir. 2005) (describing the manner and extent of the costs of trading freezes to investors).
The problem with the tax solution—in addition to the fundamental concerns surrounding any policy that allows reorganized corporations to maintain carryovers—is that it would be difficult to determine the right amount of tax. One of the main causes of the entire carryover dilemma is that carryovers' value is uncertain. It therefore would be difficult to calculate the appropriate tax to impose on buyers and sellers based on the risk of a change in ownership that their trades create. If an effective method could be created for estimating the right tax, however, this solution might be preferable to injunction bonds since it avoids the efficiency costs of a trading freeze.

Conclusion

The policy goal that best justifies NOL carryovers—remedying the arbitrariness of the annual tax year system—is challenging to pursue in practice. Both inside and outside of bankruptcy, it is difficult to confine the application of carryovers to profits that result from the project that produced the original losses. Congress's attempt to do this—by limiting the value of carryovers after a change in control to the value of the corporation before the change in control—232—is laudable from a policy perspective. In practice, however, it is difficult to apply. In the bankruptcy context, Congress deliberately allowed an end-run around this provision, permitting corporations that reorganize to retain carryovers despite a change in control. This end-run often divorces carryover credits from the losses that produced them.

This separation permits carryovers to offset gains from reorganization, producing perverse incentives and undermining the rationale for injunctions to protect carryovers. Furthermore, the draconian results and unclear benefits of trading freezes demand a new approach. The dangers of trading freezes do not stop at their harsh consequences for investors. Injunctions also enable managers to prevent takeovers in order to remain in power. To fix this problem, judges must first depart from the status quo: the routine and indiscriminate use of first-day trading injunctions needs to end. Various policies could take injunctions' place: Congress could reform the 1986 Act's special rules for bankruptcy or new rules could limit corporations' ability to use NOLs. Alternatively, judges could simply stop issuing injunctions to protect NOLs.

None of these solutions offers a perfect fix for the deeply flawed Chapter 11 carryover regime. Each approach, however, addresses important problems with the current system. These are problems that demand attention. For Chapter 11 bankruptcy to achieve its objectives, it must be a forum in which parties have the opportunity to negotiate on an even playing field to allocate assets and devise a plan to restructure a troubled corporation. Bankruptcy

232. This value is multiplied by the long-term, tax-exempt rate on government obligations. See I.R.C. § 382(b)(1) (2012).
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courts also must protect debtor assets from threats caused by collective-action problems. Any attempt to protect assets, however, should be carefully tailored, strongly justified, and fairly implemented. If courts hand parties weapons that can be used to hijack negotiations and coerce adversaries, reorganization disintegrates into repression.