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BANKRUPTCY'S CORPORATE TAX LOOPHOLE

*Diane Lourdes Dick**

Imagine you are a company with a failing business that is drowning in debt. On the bright side, you also possess a very valuable asset. This asset is unique because, unlike most assets, if you liquidate the business through a Chapter 7 bankruptcy, it will be extinguished and its value will not be realized by any shareholders or creditors. On the other hand, even if you substantially liquidate the business using Chapter 11, you can, thanks to an extraordinary ambiguity in the law, preserve this valuable asset. Even better, you can direct the value of this asset to your preferred stakeholders—whether they are shareholders or creditors—rather than have the asset's value allocated among stakeholders according to bankruptcy's absolute priority rule. You can do this because you have the most information about this valuable asset and because bankruptcy law and courts effectively ignore its existence, leaving you to allocate its value as you see fit. What is this unique asset? Valuable tax attributes, including net operating losses and credit carryovers. This scenario is not purely hypothetical; Solyndra and Washington Mutual, among others, have effectively used Chapter 11 to divert the value of tax losses and credits to a select group of shareholders and creditors in contravention of bankruptcy's distributional norms. This Article recommends statutory revisions to the tax and bankruptcy laws to remove the unintended tax advantage and thus neutralize the tax consequences of corporate restructuring decisions.

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INTRODUCTION

In September 2011, the financially troubled solar cell manufacturing company Solyndra LLC and its parent, 360 Degree Solar Holdings, Inc., filed voluntary petitions for bankruptcy protection in U.S. Bankruptcy Court for the District of Delaware.¹ By generally accepted financial and accounting conventions, Solyndra² was insolvent.³ In preliminary disclosures made to the court, the privately held company reported assets of \$854 million and liabilities of \$863 million.⁴

Solyndra's difficulties were not merely financial. By most accounts, the company failed because of fundamental deficiencies in its business model.⁵ The company produced solar panels made from innovative materials that became increasingly difficult to market as commodity price shifts and

1. Voluntary Petition, *In re Solyndra LLC*, No. 11-21799 (Bankr. D. Del. Sept. 6, 2011); Voluntary Petition, 360 Degree Solar Holdings, Inc., *In re Solyndra*, No. 11-21799.

2. Unless the context indicates otherwise, "Solyndra" refers to Solyndra LLC and 360 Degree Solar Holdings, Inc., together.

3. Under bankruptcy law, a company is insolvent when "the sum of such entity's debts is greater than all of such entity's property, at a fair valuation." 11 U.S.C. § 101(32)(A) (2012).

4. Schedules of Assets & Liabilities of Solyndra LLC (Second Amended) at 1, *In re Solyndra*, No. 11-21799 (Feb. 14, 2012).

5. See, e.g., Yulia Chernova, *Loan Was Solyndra's Undoing*, WALL ST. J., Sept. 16, 2011, at B1.

governmental subsidies drove down the cost of competitor products.⁶ Additionally, Solyndra became embroiled in political controversy and fraud accusations arising out of the U.S. Department of Energy's guarantee of a \$535 million loan to the company.⁷ The morning after the company filed for bankruptcy, the FBI raided the company's facilities in search of documents and electronic files that might evidence any wrongdoing in the company's dealings with the Department of Energy.⁸

According to conventional wisdom, companies that suffer financial difficulties may be resuscitated via debt restructuring, while companies that also struggle with deeper economic problems, such as outmoded business models, should be liquidated.⁹ But despite falling into the latter category, Solyndra did not pursue liquidation under Chapter 7¹⁰ of the U.S. Bankruptcy Code.¹¹ Instead, Solyndra filed under Chapter 11,¹² which is often cited as a source of rehabilitative relief, enabling debtors to reorganize and emerge from bankruptcy with a fresh start.¹³

Were Solyndra's stakeholders overly sanguine about the company's long-term prospects and drawn to Chapter 11 as the "optimist's valhalla"?¹⁴ Probably not. Although Chapter 11 is more commonly associated with its rehabilitative relief mechanisms, it also offers tools to liquidate a business.¹⁵ And in Solyndra's case, it seems that from the outset, the company's insiders intended to use Chapter 11's liquidation mechanisms rather than its rehabilitative devices.¹⁶ Almost immediately after filing for

6. *Id.*

7. Eric Morath, *Lawmaker Seeks Solyndra Examiner*, WALL ST. J., Sept. 20, 2011, at A2.

8. Thomas Catan & Deborah Solomon, *FBI Raids Solar-Panel Maker*, WALL ST. J., Sept. 9, 2011, at B1.

9. See, e.g., Michael Bradley & Michael Rosenzweig, *The Untenable Case for Chapter 11*, 101 YALE L.J. 1043, 1050-51 (1992).

10. 11 U.S.C. §§ 701-784 (2012) (providing for liquidations of bankrupt persons).

11. All references herein to the Bankruptcy Code are to the Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549 (codified as amended at 11 U.S.C.).

12. 11 U.S.C. §§ 1101-1174 (providing for reorganizations and liquidations of bankrupt persons).

13. This purpose of Chapter 11 was articulated at the time of its adoption in 1978: "Chapter 11 deals with the reorganization of a financially distressed business enterprise, providing for its rehabilitation by adjustment of its debt obligations and equity interests." S. REP. NO. 95-989, at 9 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5795. "The purpose of a business reorganization case, unlike a liquidation case, is to restructure a business's finances so that it may continue to operate, provide its employees with jobs, pay its creditors, and produce a return for its stockholders." H.R. REP. NO. 95-595, at 220, *reprinted in* 1978 U.S.C.C.A.N. 5963, 6179.

14. *In re Maxim Indus., Inc.*, 22 B.R. 611, 613 (Bankr. D. Mass. 1985).

15. Liquidation can be accomplished by selling all or substantially all of the company's assets in a sale conducted during the pendency of the case or pursuant to a confirmed Chapter 11 plan. Asset sales may be conducted under 11 U.S.C. § 363(b)(1), which provides that, in the course of a Chapter 11 case, a debtor in possession, "after notice and a hearing, may . . . sell . . . other than in the ordinary course of business, property of the estate" Moreover, 11 U.S.C. § 1123(b)(4) permits the sale of all of the property of the estate and the distribution of the proceeds to creditors pursuant to a liquidation plan. See 11 U.S.C. § 1123(b)(4).

16. See *infra* notes 17-18.

bankruptcy, the company sought approval to sell substantially all of its assets.¹⁷ In pleadings before the court, stakeholders argued the classic economic case for liquidation: that the company's assets were worth more either in the hands of a higher-valuing end user or in an alternative use.¹⁸

Solyndra's pursuit of liquidation under Chapter 11 is not exceptional. As other commentators observe, business debtors increasingly conduct liquidations under Chapter 11 rather than Chapter 7.¹⁹ For one thing, Chapter 11 allows a debtor's incumbent management team to command the liquidation process,²⁰ whereas Chapter 7 requires management to relinquish control to a trustee.²¹ Similarly, some bankruptcy scholars reason that Chapter 11 liquidations are faster and less expensive and may generate higher payouts to creditors.²²

But Solyndra's case differs from the typical Chapter 11 liquidation²³ in a very important respect. Although Solyndra *also* sold substantially all of its assets during the pendency of its Chapter 11 case, it pursued a vaguely styled "Joint Chapter 11 Plan" (the Solyndra Plan),²⁴ claiming to effectuate both a reorganization *and* a liquidation.²⁵ In particular, the Solyndra Plan contemplated that the parent would be reorganized and would continue to exist, while the operating subsidiary would be dissolved.²⁶ Following a

17. Motion of Solyndra LLC Pursuant to Sections 105(a) and 363 of the Bankruptcy Code for Authority to (A) Conduct an Auction for Core Assets, and (B) Sell Assets to the Successful Bidders at an Auction Free and Clear of all Encumbrances at 1, *In re Solyndra LLC*, No. 11-12799 (Bankr. D. Del. Nov. 22, 2011).

18. *Id.* at 17. Solyndra's stakeholders sought to sell the company's assets to a turnkey buyer. *Id.* at 3. However, they also solicited court approval to sell the assets separately if necessary. *Id.* at 17.

19. See, e.g., H. Jason Gold & Dylan G. Trache, *Liquidation of Troubled Businesses: Chapter 11 Liquidations Increasing*, METROPOLITAN CORP. COUNS., Apr. 2009, at 10; Michael Cooley, *How To Succeed at Chapter 11 Without Really Reorganizing*, J. CORP. RENEWAL (Aug. 27, 2008), <http://www.turnaround.org/Publications/Articles.aspx?objectID=9654>.

20. The debtor in possession "generally has the authority to exercise the same powers as a trustee." *Weingarten Nostat, Inc. v. Serv. Merch. Co.*, 396 F.3d 737, 742 n.4 (6th Cir. 2005) (discussing and citing 11 U.S.C. §§ 1107(a), 1108).

21. 11 U.S.C. §§ 701-702.

22. See, e.g., Arturo Bris et al., *The Costs of Bankruptcy: Chapter 7 Liquidation Versus Chapter 11 Reorganization*, 61 J. FIN. 1253, 1301 (2006); Stephen J. Lubben, *Business Liquidation*, 81 AM. BANKR. L.J. 65, 81 (2007); see also 9C AM. JUR. 2D *Bankruptcy* § 2818 (2006); BEN BRANCH ET AL., *LAST RIGHTS: LIQUIDATING A COMPANY* (2007). Not all bankruptcy scholars, however, agree that Chapter 11 offers a more efficient method of achieving any outcome. See generally Diane Lourdes Dick, *The Chapter 11 Efficiency Fallacy*, 2013 BYU L. REV. 759 (highlighting Chapter 11's inherent structural inefficiencies).

23. Consider, for instance, the recent Chapter 11 liquidation of the beleaguered bookseller Borders. The debtor in possession proposed and sought court approval of a "Chapter 11 Plan of Liquidation," which contemplated that the debtor would sell its assets and then dissolve. See First Amended Joint Plan of Liquidation Pursuant to Chapter 11 of the Bankruptcy Code Proposed by the Debtors and the Official Committee of Unsecured Creditors at 15, *In re Borders Grp., Inc.*, No. 11-10614 (Bankr. S.D.N.Y. Nov. 2, 2011).

24. Debtors' Amended Joint Chapter 11 Plan at 1, *In re Solyndra LLC*, No. 11-12799 (Bankr. D. Del. Sept. 7, 2012).

25. *Id.* at sec. I.

26. *Id.*

series of sales to liquidate the assets of the subsidiary,²⁷ the parent bore little resemblance to its previous incarnation as the holding company to a solar cell manufacturer. With no operating subsidiary, no manufacturing assets, no significant employee base and no active business,²⁸ the "reorganized" parent was arguably a mere shell. The Solyndra Plan's preservation of the parent was especially perplexing given that the company adopted a parent-subsidiary structure just seven months prior to the bankruptcy filing.²⁹

In terms of economic substance, the Solyndra Plan clearly contemplated liquidation of Solyndra's historic business enterprise of manufacturing solar panels. But in terms of legal form, the Solyndra Plan also devised a reorganization of the parent. The company's shareholders, led by two private equity firms,³⁰ exploited the disconnect between substance and form to extract a noteworthy economic privilege: the future ability to use nearly \$1 billion of Solyndra's tax losses and credits.³¹ These valuable tax attributes came to rest on the books of the corporate parent because the operating subsidiary was an unincorporated flow-through entity with only one corporate member, and therefore disregarded for tax purposes.³² While not disclosed as assets at the time of the company's bankruptcy filing,³³ these losses and credits have substantial value because they can be used to reduce federal income tax liabilities on future earnings.³⁴

27. See Michael Kanellos, *Failed Solar Company's Auction Draws Bargain Hunters*, N.Y. TIMES, Nov. 1, 2011, at B1; Michael Bathon, *Solyndra Wins Court Approval To Sell Manufacturing Plant*, BLOOMBERG.COM (Sept. 24, 2012, 1:05 PM), <http://www.bloomberg.com/news/2012-09-24/solyndra-wins-court-approval-of-manufacturing-facility-auction.html>.

28. The company terminated operations and laid off virtually all of its employees prior to its bankruptcy filing. Declaration of W.G. Stover, Jr., Senior Vice President and Chief Financial Officer, in Support of First Day Motions at 13, *In re Solyndra*, No. 11-12799 (Sept. 6, 2011).

29. Stakeholders reorganized the company in February 2011. *Id.* at 6–11.

30. See Solyndra, Inc., Amendment 1 to Form S-1 (Form S-1), at 2, 98 (Mar. 16, 2010) (noting that Argonaut Ventures I, LLC, and its affiliates (Argonaut) beneficially owned approximately 35.7 percent of the company's outstanding common stock, and Madrone Partners, L.P., (Madrone) beneficially owned 11 percent of the company's outstanding common stock). The remaining investors were other equity funds, officers, and directors of the company. See *id.* However, pursuant to the February 2011 restructuring, the company issued equity warrants that would revert ownership of 99.9 percent of the company's outstanding common stock to Argonaut and Madrone. See *The Solyndra Memorial Tax Break*, WALL ST. J. (Oct. 17, 2012, 12:01 AM), <http://online.wsj.com/news/articles/SB10000872396390444799904578050803545600588>; see also Solyndra, Inc., Notice of Exempt Offering of Securities (Form D) (Mar. 10, 2011).

31. See Michael Bathon, *Solyndra Lenders Ahead of Government Won't Recover Fully*, BLOOMBERG.COM (Oct. 17, 2012, 5:53 PM), <http://www.bloomberg.com/news/2012-10-17/solyndra-lenders-ahead-of-government-won-t-recover-fully.html>.

32. Treas. Reg. § 301.7701-3(a) (2006).

33. The tax attributes are not disclosed on the company's schedules of assets and liabilities filed with the court. See Schedules of Assets & Liabilities 360 Degree Solar Holdings (Amended), *In re Solyndra LLC*, No. 11-12799 (Bankr. D. Del. Jan. 19, 2012); Schedules of Assets & Liabilities Solyndra LLC (Second Amended), *In re Solyndra*, No. 11-12799 (Feb. 7, 2012).

34. See *infra* Part I.B.

Because Solyndra's parent emerged from bankruptcy with no active business, its managers immediately set out to raise capital and conduct acquisitions of profitable businesses to realize the tax benefits. Once utilized, these tax attributes may generate up to \$350 million of federal income tax savings³⁵ for any investments "stuffed" into the parent, thereby enhancing the company's cash position and giving shareholders a sizable investment advantage.³⁶ To place these amounts in perspective, Solyndra's unsecured creditors—including the Department of Energy—received approximately \$3.8 million under the Solyndra Plan: an estimated three cents on the dollar for their claims.³⁷

With the exception of rules that apply to consolidated enterprises,³⁸ the tax laws generally³⁹ do not allow a corporation taxed under Subchapter C⁴⁰ to transfer its tax attributes to another person, whether in bankruptcy or otherwise.⁴¹ Thus, in order to retain the future ability to use its valuable tax attributes, a debtor company must emerge from bankruptcy intact. Of course, Solyndra would not have been able to exit bankruptcy if it had been liquidated under Chapter 7.⁴² Congress specifically prohibits the continued existence of business entities following bankruptcy liquidation in an effort to prevent "trafficking in corporate shells."⁴³ For the same reasons, Solyndra's stakeholders would not have retained the company's tax attributes if they pursued a pure plan of liquidation in Chapter 11.⁴⁴ In both

35. These figures assume a 35 percent federal income tax rate on corporate income. The corporate income tax is imposed pursuant to I.R.C. § 11(B)(1)(D), based upon the statutory rates set forth in that section.

36. See *The Solyndra Memorial Tax Break*, *supra* note 30.

37. See Debtors' Amended Joint Chapter 11 Plan, *supra* note 24, at 18, 38.

38. Under I.R.C. § 1501, an affiliated group of corporations may file a consolidated return. Consolidated enterprises are subject to extensive regulations promulgated under § 1501. See I.R.C. § 1501 (2012).

39. There are, of course, some highly specific exceptions. See, e.g., Alvin C. Warren, Jr. & Alan J. Auerbach, *Transferability of Tax Incentives and the Fiction of Safe Harbor Leasing*, 95 HARV. L. REV. 1752, 1768 (1982) (providing an early critique of the continuing practice of "safe harbor leasing," whereby taxpayers lease the tax benefits of ownership of an asset to another party who can use them). Similarly, to the extent we think of tradable pollution credits as tax attributes, then these would also exemplify a departure from the general rule. See Richard F. Kosobud et al., *Tradable Environmental Pollution Credits: A New Financial Asset*, 1 REV. ACCT. & FIN. 69 (2002).

40. Unless the context indicates otherwise, the term "corporation" refers to entities taxed under Subchapter C of the Tax Code and not to corporations governed by Subchapter S of the Tax Code. The former are taxpaying entities while the latter are generally treated as "pass through" entities, with shareholders responsible for paying taxes on income. See sources cited *infra* note 149.

41. See *infra* Part I.B.3.

42. Unlike individual debtors, business debtors are not entitled to discharge debts in a Chapter 7 bankruptcy. 11 U.S.C. § 727(a)(1). Instead, Chapter 7 debtors must distribute all property in full or partial satisfaction of claims against the estate. *Id.* § 726. Debtors who are not individuals are then dissolved. See *infra* note 43 and accompanying text.

43. H.R. REP. NO. 95-595, at 384-85 (1977); S. REP. NO. 95-989, at 98-99 (1978), reprinted in 1978 U.S.C.A.N. 5787.

44. Chapter 11 liquidating plans typically contemplate that the debtor will sell its assets and remit the proceeds to a liquidating trust. Under federal income tax regulations, liquidating trusts are permitted to exist solely for the purpose of satisfying claims and

cases, any excess tax benefits would have expired with the then defunct parent and subsidiary entities.⁴⁵

Although Chapter 11 offered Solyndra's stakeholders the best opportunity to keep the company intact and therefore preserve its valuable tax attributes, Chapter 11 carries its own restrictions. Most notably, debtors are not permitted to discharge debts and exit bankruptcy pursuant to a plan that essentially achieves liquidation rather than reorganization.⁴⁶ For these reasons, Chapter 11 bankruptcy only became economically attractive to Solyndra following its February 2011 adoption of a parent-subsidiary structure. Then, the company could enter Chapter 11 as two separate debtors and creatively sidestep these confirmation requirements.

Predictably, the evidence presented by the Solyndra Plan's opponents strongly suggests that the company's path through Chapter 11 was tax driven. The Solyndra Plan was designed to take advantage of an ambiguity in the law that allows a company to liquidate its business under Chapter 11 and preserve valuable tax attributes for future use by reorganizing only the corporate parent.⁴⁷ Solyndra has not been the only company to employ this strategy in recent years. Among others,⁴⁸ Washington Mutual followed a similar path through Chapter 11, liquidating its business assets and reorganizing the parent to preserve nearly \$18 billion in valuable tax attributes.⁴⁹

Nonetheless, the bankruptcy court endorsed the Solyndra Plan in October 2012⁵⁰ over the objections of the Internal Revenue Service⁵¹ (IRS) and the

otherwise effectuating the plan of liquidation. Treas. Reg. § 301.7701-4(d) (as amended in 1997).

45. See *supra* notes 43–44.

46. Section 1141(d)(3) expressly proscribes the granting of a discharge if “(A) the plan provides for the liquidation of all or substantially all of the property of the estate; (B) the debtor does not engage in business after consummation of the plan; and (C) the debtor would be denied a discharge . . . if the case were a case under chapter 7.” See 11 U.S.C. § 1141(d)(3); *Borsdorf v. Fairchild Aircraft Corp.* (*In re Fairchild Aircraft Corp.*), 128 B.R. 976, 982 (Bankr. W.D. Tex. 1991) (describing the purpose of this provision). What is more, a Chapter 11 plan may not be confirmed unless it complies with the provisions of 11 U.S.C. § 1129(a). A plan must be feasible, demonstrating that the debtor will generate profits from future business operations. See *Fin. Sec. Assurance v. T-H New Orleans Ltd. P’Ship* (*In re T-H New Orleans Ltd. P’ship*), 116 F.3d 790, 801–02 (5th Cir. 1997). The proponent of a Chapter 11 plan bears the burden of proof with respect to each element of 11 U.S.C. § 1129(a). See *In re Genesis Health Ventures, Inc.*, 266 B.R. 591, 610 (Bankr. D. Del. 2001).

47. See sources cited *infra* notes 51–52.

48. See Order Confirming First Amended Plan of Reorganization, *In re PMI Grp., Inc.*, No. 11-13730 (Bankr. D. Del. July 25, 2013), ECF No. 1015 (confirming a Chapter 11 plan pursuant to which a corporate parent reorganized to preserve valuable tax attributes).

49. Peg Brickley & Mike Spector, *WaMu Gets Closer to Bankruptcy Exit*, WALL ST. J. (May 25, 2011, 12:01 AM), <http://online.wsj.com/news/articles/SB10001424052702303654804576343803438618670>. The tax attributes are discussed in greater detail in *In re Wash. Mut., Inc.*, 461 B.R. 200, 225–26 (Bankr. D. Del. 2011), *vacated in part*, No. 08-12229 (MFW), 2012 WL 1563880 (Bankr. D. Del. Feb. 24, 2012).

50. Order Confirming Debtors’ Amended Joint Chapter 11 Plan, *In re Solyndra LLC*, No. 11-12799 (Bankr. D. Del. Oct. 22, 2012).

51. Objection of the United States of America, on Behalf of the IRS, to Confirmation of Debtors’ Amended Joint Chapter 11 Plan, *In re Solyndra*, No. 11-12799 (Oct. 10, 2012).

U.S. Trustee.⁵² The government argued that the principal purpose of the Solyndra Plan was tax avoidance, as evidenced by the fact that the parent would emerge from bankruptcy with valuable tax attributes and no active business.⁵³ In approving the Solyndra Plan, the court reasoned that the parent's business purpose was merely to serve as a holding company and that the valuable tax attributes would motivate the parent to continue its historical line of business of investing in companies.⁵⁴

Yet this "pseudo-reorganization" tax avoidance strategy, as I call it in this Article, arguably cannot withstand a closer reading of tax and commercial law.⁵⁵ But it would miss the mark to focus only on the dubious merits of this particular deal structure. The pseudo-reorganization is just one of many recent and high-profile attempts to circumvent Chapter 11's distributional norms by exploiting ambiguity in the corporate tax and bankruptcy laws. Thus, whether one agrees or disagrees with the *Solyndra* court's reasoning, the case invites one to explore the relatively uncharted junction between these two areas of the law,⁵⁶ and to give deeper theoretical consideration to various provisions of the U.S. Tax Code⁵⁷ that benefit bankrupt companies.

A central claim of this Article is that bankruptcy-specific exceptions in the tax laws transform the debtor's valuable tax attributes into marketable property that, in many cases, gives the estate its intrinsic value. Yet the bankruptcy laws leave these tax assets vulnerable to siphoning by dominant stakeholders who are in a position to extract excess returns.⁵⁸ The problem arises because one of the Bankruptcy Code's most important safeguards instructs courts to evaluate the fairness of nonconsensual Chapter 11 plans against a hypothetical Chapter 7 liquidation.⁵⁹ But because under the tax

52. U.S. Trustee's Objection to Confirmation of the Debtors' Amended Joint Chapter 11 Plan, *In re Solyndra*, No. 11-12799 (Oct. 10, 2012).

53. *See id.* at 5-6.

54. *See supra* note 50 and accompanying text. A similar decision was more recently rendered in the PMI Group, Inc.'s Chapter 11 case. *See* Order Confirming First Amended Plan of Reorganization at 10, *In re PMI Grp., Inc.*, No. 11-13730 (Bankr. D. Del. Jul. 25, 2013), ECF No. 1015.

55. *See infra* Part III.C.

56. There is a relative dearth of legal scholarship at the confluence of tax and bankruptcy. There are, however, some recent exceptions. *See, e.g.*, Michelle Arnopol Cecil, *Abandonments in Bankruptcy: Unifying Competing Tax and Bankruptcy Policies*, 88 MINN. L. REV. 723 (2004); Frances R. Hill, *Toward a Theory of Bankruptcy Tax: A Statutory Coordination Approach*, 50 TAX LAW. 103 (1996); Shu-Yi Oei, *Taxing Bankrupts*, 55 B.C. L. REV. 375 (2014); Katherine Pratt, *Shifting Biases: Troubled Company Debt Restructurings After the 1993 Tax Act*, 68 AM. BANKR. L.J. 23 (1994); Jack F. Williams, *Bifurcation for Claim Filing Purposes of a Corporate Tax Year That Straddles the Petition Date*, 9 AM. BANKR. INST. L. REV. 463 (2001).

57. All references herein to the Tax Code are to the Internal Revenue Code of 1986 (codified as amended at 26 U.S.C.).

58. Such excess returns are the very essence of economic rents. *See* LUCIAN BEBCHUK & JESSE FRIED, *PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION* 62 (2004) (referring to economic rents as "extra returns that firms or individuals obtain due to their positional advantages"). *See generally* GORDON TULLOCK, *THE RENT SEEKING SOCIETY* (2005).

59. 11 U.S.C. § 1129(a)(7) (2012).

laws, the debtor's valuable tax attributes do not survive liquidation, they are overlooked.⁶⁰ The problem is exacerbated by the fact that these tax attributes are often omitted from the debtor's asset disclosures.⁶¹ This amounts to a perfect storm, where some of bankruptcy's most vital protective devices neglect to take into account what is often the debtor's most valuable asset. As I argue in this Article, this extraordinary ambiguity at the intersection of federal tax and bankruptcy law not only facilitates inequitable allocations of economic benefits and burdens in Chapter 11 but also causes a much broader, systematic misallocation of resources. In particular, it contributes to an overall reduction in social welfare, as parties in a position to exploit the information asymmetry and control the restructuring are able to monetize the tax assets as excess returns and then use them to shelter income from unrelated assets.⁶²

This ambiguity and its negative collateral consequences should be addressed now because both the Tax Code and the Bankruptcy Code are the subject of major reform efforts. President Obama has expressed interest in corporate tax reforms, with policymakers in both political parties studying proposals.⁶³ At the same time, the American Bankruptcy Institute recently convened the Commission to Study the Reform of Chapter 11, laying the groundwork for a comprehensive rewriting of Chapter 11.⁶⁴ As policymakers work to reshape the corporate tax system and the commercial bankruptcy framework, special attention must be given to the areas of overlap.

This Article proceeds as follows. Part I offers those new to the literature a short overview of commercial bankruptcy under Chapter 11. Part I also contains a discussion of various bankruptcy-specific provisions of the Tax Code. Part II revisits the *Solyndra* case and others to understand the role of valuable tax attributes in large commercial bankruptcies. This Part reveals how these tax attributes not only give the bankruptcy estate its intrinsic value, but also become a source of excess returns for persons in a position to exploit the restructuring. Part III proposes a new legal framework for the

60. See *supra* notes 43–44.

61. See *supra* note 33. In the *Solyndra* case, the government complained about this very issue. See Objection of the United States of America, on Behalf of the Department of Energy and the IRS, to Debtors' Motion for an Order at 4, *In re Solyndra LLC*, No. 11-12799 (Bankr. D. Del. Aug. 24, 2012) ("Nowhere does the Disclosure Statement describe, quantify, or estimate the potential value [of] these net operating losses, which [Solyndra]'s equity owners intend to take out of this bankruptcy under the Plan."). Debtors typically decline to disclose valuable tax attributes in preliminary asset disclosures, only later describing them in subsequent disclosures buried in hundreds of pages of material submitted at the plan confirmation stage of the case. See *infra* note 257 and accompanying text.

62. On the relationship between excess returns and overall social welfare, see TULLOCK, *supra* note 58.

63. See, e.g., John D. McKinnon, *Obama's Budget Seeks Overhaul of Business-Tax Codes*, WALL ST. J. (Mar. 4, 2014, 7:53 PM), <http://online.wsj.com/news/articles/SB10001424052702304360704579419073375887800>.

64. Katy Stech, *Bankruptcy Leaders Call for Chapter 11 Overhaul*, WALL ST. J. (Apr. 19, 2012, 5:30 PM), <http://blogs.wsj.com/bankruptcy/2012/04/19/bankruptcy-leaders-call-for-chapter-11-overhaul/>.

treatment of valuable tax attributes in commercial bankruptcies, based on the arguments developed in Part II.

I. BACKGROUND: THE INTERSECTION OF CHAPTER 11 BANKRUPTCY AND TAX LAW

Chapter 11 bankruptcy is frequently described as a legal process that offers debtors much-needed “breathing room” from the demands of creditors.⁶⁵ The filing of a bankruptcy petition creates an estate that includes “all legal or equitable interests of the debtor in property.”⁶⁶ Although, under this broad definition, all of the debtor’s assets are deemed property of the bankruptcy estate,⁶⁷ the debtor typically retains possession and may continue to operate its business.⁶⁸ Meanwhile, the commencement of a bankruptcy case also imposes an automatic stay, which enjoins creditors from enforcing pre-petition obligations or exercising remedies against the debtor’s property.⁶⁹

With creditors barred from pursuing collections during the pendency of the case, attention quickly shifts to negotiating the debtor’s exit from bankruptcy on terms that will allow maximum repayment of claims. A Chapter 11 debtor emerges from bankruptcy by obtaining judicial confirmation of a Chapter 11 plan.⁷⁰ A plan ordinarily classifies claims against the estate, delineates the debtor’s future as a going concern, and identifies any cash or property distributions to be made to each class of claimants.⁷¹

Traditionally, Chapter 11 plans contemplate reorganization of the debtor.⁷² Under these so-called plans of reorganization, claimants may receive equity interests in the debtor or in a newly formed company in exchange for all or part of their claims.⁷³ Alternatively, under a “plan of liquidation,” the debtor may propose to sell its assets, distribute proceeds to

65. See, e.g., 5 COLLIER ON BANKRUPTCY ¶ 541.01 (Alan N. Resnick & Henry J. Sommer eds., 16th ed. 2013) (noting as a “fundamental purpose[] of the Bankruptcy Code” the “breathing room given to a debtor that attempts to make a fresh start”); *Local Loan Co. v. Hunt*, 292 U.S. 234, 244 (1934) (“[Bankruptcy] gives to the honest but unfortunate debtor . . . a new opportunity in life and a clear field for future effort, unhampered by the pressure and discouragement of preexisting debt.”).

66. 11 U.S.C. § 541(a) (2012). As this expansive language suggests, Congress intended a wide range of property to be included in the bankruptcy estate. See *United States v. Whiting Pools, Inc.*, 462 U.S. 198, 203 (1983).

67. “The scope of [§ 541(a)(1)] is broad. It includes all kinds of property, including tangible or intangible property, causes of action . . . and all other forms of property currently specified in section 70a of the Bankruptcy Act.” H.R. REP. NO. 95-595, at 367 (1977); S. REP. NO. 95-989, at 82 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5868, 6323.

68. 11 U.S.C. §§ 1107(a), 1108.

69. See *id.* § 362. The court can grant relief from the automatic stay only under certain specified conditions or for cause. See *id.*; see also FED. R. BANKR. P. 4001.

70. 11 U.S.C. § 1141.

71. *Id.* § 1123.

72. See *supra* note 13.

73. For instance, in the General Motors bankruptcy, creditors received equity security interests in a newly formed company. *Parker v. Motors Liquidation Co.* (*In re Motors Liquidation Co.*), 430 B.R. 65, 72 (S.D.N.Y. 2010).

creditors in satisfaction of their claims, and then dissolve.⁷⁴ While the latter plan achieves substantially the same outcome as a Chapter 7 bankruptcy, the debtor is able to manage the sale of its assets under Chapter 11.⁷⁵

Broadly speaking, the Chapter 11 plan is a distributional exercise, detailing how and to what extent economic benefits and burdens will be borne by various constituents. Acknowledging the significance of the plan to the bankrupt company, the Bankruptcy Code gives the debtor the exclusive right to file a Chapter 11 plan for a period of 120 days.⁷⁶ In addition to its draft plan, the debtor must also prepare adequate financial and nonfinancial disclosures.⁷⁷

Once proposed, the Chapter 11 plan is subject to a vote by classes of the bankrupt company's creditors and equity security holders.⁷⁸ In some cases, the debtor and its creditors are able to negotiate a Chapter 11 plan that all classes either affirmatively accept or are deemed to accept because they will be paid in full, such that their interests are not impaired.⁷⁹ In cases of this sort, the bankruptcy court must confirm the plan unless the plan proponent is unable to meet its burden of proving certain additional requirements.⁸⁰ For instance, the plan must be feasible, proposed in good faith, and not violate any applicable laws.⁸¹

Typically, however, a Chapter 11 plan faces opposition from one or more classes. In these cases, at least one class of impaired claims must vote in favor of the plan.⁸² Additionally, with respect to each impaired class of claims or interests, under the plan each holder must receive property equal to or greater than the amount that such holder would so receive if the debtor were liquidated under Chapter 7.⁸³ In other words, the claimants should be

74. See *supra* note 44. For an example of a plan of liquidation, see *supra* note 23.

75. See *supra* note 20.

76. 11 U.S.C. § 1121(b).

77. With respect to plans of reorganization, the debtor must also provide an estimate of the value of the debtor as a going concern. See *id.* § 1125. Reorganization value, or "enterprise value," is used to determine value received or retained in the form of equity security interests in the debtor. Under GAAP, enterprise value is the "fair value" of the company before liabilities. Fair value refers to "the price that would be received to sell [an] asset . . . in an orderly transaction between market participants . . . at the measurement date." FIN. ACCOUNTING STANDARDS BD., STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 157 (2006) (effective Nov. 15, 2007), available at <http://www.fasb.org/summary/stsum157.shtml>.

78. 11 U.S.C. § 1126. Consent thresholds are explored in greater detail in David Arthur Skeel, Jr., *The Nature and Effect of Corporate Voting in Chapter 11 Reorganization Cases*, 78 VA. L. REV. 461, 467 (1992).

79. For a discussion of a recent uncontested Chapter 11 plan, see Peg Brickley, *GateHouse Media Wins Confirmation of Chapter 11 Restructuring*, WALL ST. J. (Nov. 6, 2013, 3:36 PM), <http://online.wsj.com/article/BT-CO-20131106-713150.html>.

80. 11 U.S.C. § 1129(a).

81. See *id.* (setting forth the remaining elements of plan approval).

82. *Id.* § 1129(a)(10). "Insiders" are not taken into account for the purposes of satisfying this requirement. *Id.* In bankruptcy law, the term "insider" includes a person in control of the debtor, as well as any person so closely related to the debtor as to suggest that any transactions were not conducted at arm's length. *Id.* § 101(31)(B)(iii).

83. *Id.* § 1129(a)(7).

given at least what they would receive if the debtor were liquidated.⁸⁴ Finally, the bankruptcy court may “cramdown”⁸⁵ the plan over the objections of a dissenting class only if certain additional statutory requirements are satisfied.⁸⁶ Chief among these is the condition that a plan be “fair and equitable” with respect to dissenting classes.⁸⁷ A plan is fair and equitable if members of the dissenting class receive property equal in value to their permitted claims or, to the extent the class receives less than this amount, no creditor of lesser priority (or any equity security holder)⁸⁸ receives any distribution under the plan.⁸⁹ This requirement, which is a core tenet of bankruptcy law, is known as the “absolute priority rule.”⁹⁰ It serves as an important safeguard for creditors by ensuring that, unless their claims are paid in full or they agree otherwise, the Chapter 11 plan will—with limited exceptions⁹¹—respect the relative collection rights of creditors under state law.⁹²

As this brief overview reveals, Chapter 11 principally functions to preserve all potential sources of economic value that can be used to satisfy the debtor’s obligations, while setting legal parameters on the distribution of such wealth. By imposing these protective distributional norms, Chapter 11 allows debtors to continue their business operations while negotiating with creditors to restructure their financial obligations. Against this backdrop, the following sections consider how the tax laws not only facilitate a firm’s use of federal bankruptcy process to resolve financial

84. *Id.* This test is commonly known as the “best interests of creditors” test. See generally Jonathan Hicks, Note, *Foxes Guarding the Henhouse: The Modern Best Interests of Creditors Test in Chapter 11 Reorganizations*, 5 NEV. L.J. 820 (2005).

85. This term does not appear in the Bankruptcy Code, but is used to refer to judicial confirmation of a plan notwithstanding the objections of dissenting impaired classes. See generally Charles D. Booth, *The Cramdown on Secured Creditors: An Impetus Toward Settlement*, 60 AM. BANKR. L.J. 69, 69 (1986).

86. 11 U.S.C. § 1129(b).

87. *Id.*

88. *Id.* But see *infra* note 91 (discussing the “new value exception” to the absolute priority rule).

89. See Booth, *supra* note 85.

90. The doctrine, presently codified at § 1129(b)(2)(B)(ii), originated in judicial opinions. See, e.g., *Case v. L.A. Lumber Prods. Co.*, 308 U.S. 106 (1939); *N. Pac. Ry. Co. v. Boyd*, 228 U.S. 482 (1913); see also Douglas G. Baird & Thomas H. Jackson, *Bargaining After the Fall and the Contours of the Absolute Priority Rule*, 55 U. CHI. L. REV. 738 (1988); Walter J. Blum & Stanley A. Kaplan, *The Absolute Priority Doctrine in Corporate Reorganizations*, 41 U. CHI. L. REV. 651 (1974); Ralph Brubaker & Charles Tabb, *Bankruptcy Reorganizations and the Troubling Legacy of Chrysler and GM*, 2010 U. ILL. L. REV. 1375, 1391 (referring to the absolute priority rule as “one of the most central, fundamental distribution-value protections of a chapter 11 plan”).

91. See *infra* notes 210–12 and accompanying text.

92. The rights of secured and unsecured creditors are determined under state law, in statutes and case law governing contracts, debtor-creditor relations, as well as liens in real and personal property. For instance, the relative priority of secured creditors and other lien holders are set forth in the Uniform Commercial Code as adopted in each state. See, e.g., U.C.C. § 9-317 (2000) (setting forth the basic rule governing priority between lien creditors and secured parties); *id.* § 9-322(a)(1) (setting forth the basic rule governing priority among conflicting security interests).

distress, but also unexpectedly generate additional value for the bankruptcy estate.

A. Bankruptcy-Related Tax Provisions

Certain tax laws are designed to work in conjunction with the Bankruptcy Code, enabling companies to resolve financial distress via the bankruptcy process without harsh tax consequences. For instance, bankruptcy-related provisions of the Tax Code extend nonrecognition treatment to certain transactions entered into by bankrupt companies⁹³ and permanently exclude some of a debtor's income from taxation.⁹⁴ Whether we view these provisions as necessary and legitimate exceptions that allow for a truer picture of the debtor's income⁹⁵ or as preferential departures from the normal taxing system that amount to "tax expenditures"⁹⁶ of governmental

93. See *infra* notes 98–103 and accompanying text.

94. See *infra* notes 104–11 and accompanying text.

95. The normal taxing system assigns tax consequences to realization events, such as dispositions of assets. This generally means that less income is taxed than would be under a pure economic definition of income. See, e.g., HENRY C. SIMONS, *INCOME TAXATION* 50 (1938) (setting forth what is now known as the Haig-Simons definition of income: "the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value of the store of property rights between the beginning and end of the period in question"); see also Charlene Luke, *What Would Henry Simons Do?: Using an Ideal To Shape and Explain the Economic Substance Doctrine*, 11 *HOUS. BUS. & TAX L.J.* 108, 127 (2011) (providing a thorough discussion of the Haig-Simons definition of income). However, the normal taxing system can also result in the imposition of the income tax even where there is no income in an economic sense. Nonrecognition rules are an attempt to bring the normal taxing system into better alignment with the economic definition of income.

96. Tax expenditures are defined under the Congressional Budget and Impoundment Control Act of 1974 as "revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability." Congressional Budget and Impoundment Control Act of 1974, Pub. L. No. 93-344, § 3(3), 88 Stat. 297. Tax expenditure analysis was famously introduced by Stanley Surrey and further developed by Surrey and Paul McDaniel. See generally STANLEY S. SURREY, *PATHWAYS TO TAX REFORM* (1973); STANLEY S. SURREY & PAUL R. MCDANIEL, *TAX EXPENDITURES* (1985); Stanley S. Surrey & Paul R. McDaniel, *The Tax Expenditure Concept: Current Developments and Emerging Issues*, 20 *B.C. L. REV.* 225 (1979); Stanley S. Surrey & Paul R. McDaniel, *The Tax Expenditure Concept and the Budget Reform Act of 1974*, 17 *B.C. INDUS. & COM. L. REV.* 679 (1976); Stanley S. Surrey, Assistant Sec'y, U.S. Dep't of the Treasury, *Excerpts from Remarks Before the Money Marketeers on the U.S. Income Tax System—the Need for a Full Accounting* (Nov. 15, 1967), in *U.S. DEP'T OF THE TREASURY, DOC. NO. 3245, ANNUAL REPORT OF THE SECRETARY OF THE TREASURY ON THE STATE OF THE FINANCES FOR THE FISCAL YEAR ENDED JUNE 30, 1968*, at 322 (1969). As a conceptual framework, tax expenditure analysis first assumes a normal income tax, based upon "the definition of net income, the specification of accounting rules, the determination of the entities subject to tax, the determination of the rate schedule and exemption levels" which comprise the "revenue-raising aspects of the tax." SURREY & MCDANIEL, *supra*, at 3. Then, the concept invites analysts to identify any deviations from the normal revenue-raising structure of the income tax system, in the form of exemptions, exclusions, deductions, credits, deferral, and preferential tax rates. These deviations are assessed as a form of government spending, albeit through forgone tax revenue rather than direct expenditures.

resources,⁹⁷ in either case, they function to protect the interests of bankrupt companies and their stakeholders.

For example, as noted above, the Tax Code extends nonrecognition treatment to certain acquisitions of a debtor's assets.⁹⁸ "Nonrecognition treatment" means that the transaction will be tax-free to the parties if certain other requirements are met.⁹⁹ At least one party to the acquisition must be under bankruptcy court jurisdiction and the court must approve the transfer of assets.¹⁰⁰ As a deviation from broader provisions of the Tax Code that impose the income tax on wealth realized through dispositions of assets,¹⁰¹ nonrecognition treatment is provided to transactions that demonstrate continuity of investment and continuity of business enterprise.¹⁰² This treatment is premised on the belief that while the form of an investment has changed, its economic substance remains the same: qualifying transactions are merely adjustments of continuing interests in property under a new corporate form.¹⁰³

The Tax Code also offers favorable treatment to insolvent persons through an exception to cancellation of indebtedness rules. Under the normal income tax structure, cancelled debt is considered income.¹⁰⁴ Although the borrower does not receive cash at the time a debt is discharged, the borrower's net worth improves in an amount equal to the forgiven obligation.¹⁰⁵ However, a taxpayer may exclude cancelled debt from gross income if the taxpayer is insolvent at the time of the debt

97. As the staff of the Joint Committee on Taxation explains, the distinction is not always clear: "The determination of whether a provision is a tax expenditure is made on the basis of a broad concept of income that is larger in scope than 'income' as defined under general U.S. income tax principles. The Joint Committee staff uses its judgment in distinguishing between those income tax provisions (and regulations) that can be viewed as part of normal income tax law and those special provisions that result in tax expenditures." JOINT COMM. ON TAXATION, ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 2012-2017, at 2 (2013).

98. I.R.C. § 368(a)(1)(G) (2012). The acquisition of a debtor's assets will be a nonrecognition event if the stock or securities of the acquiring corporation are distributed in a transaction that qualifies under §§ 354, 355, or 356 of the Internal Revenue Code. *Id.*

99. *Id.*

100. *See Id.* § 368(a)(3)(B)(ii). For instance, a debtor's equity security holders would not recognize gain or loss if they exchanged their equity interests for stock or securities of either the corporation acquiring the debtor's assets or a corporation controlled by the acquiring corporation. *Id.* §§ 354, 355. However, gain must be recognized to the extent of any money or other property received. *Id.* § 356.

101. *See supra* note 95. Under normal income tax law, dispositions of property are taxable pursuant to the calculation described in I.R.C. § 1001.

102. To receive nonrecognition treatment for reorganizations described in I.R.C. § 368, transactions must also satisfy nonstatutory requirements set forth in accompanying regulations. The principal tests are the continuity of interest and continuity of business enterprise requirements, which are described in Treasury Regulations § 1.368-1 (2011) and § 1.368-2 (2010).

103. *See* Treas. Reg. § 1.368-1(d) (2011).

104. I.R.C. § 61(a)(12); *United States v. Kirby Lumber Co.*, 284 U.S. 1, 2 (1931); Treas. Reg. § 1.61-12 (as amended in 1997).

105. *See* Treas. Reg. § 1.61-12.

discharge.¹⁰⁶ This exception codifies a longstanding view that the insolvent debtor does not have income, as a definitional matter.¹⁰⁷

Yet in a quiet departure from these established principles of taxation, the Tax Code *also* permanently excludes cancellation of indebtedness income where the discharge occurs pursuant to a bankruptcy case,¹⁰⁸ regardless of the debtor's solvency at the time of the discharge.¹⁰⁹ Although the latter provision is not identified as a tax expenditure,¹¹⁰ it functions as such by extending a special exclusion from the broad concept of income. However, the benefits are not without some limitations; under both the insolvency and bankruptcy exception, the taxpayer's valuable tax attributes must be reduced in an amount equal to the cancelled debt excluded from gross income.¹¹¹

Through bankruptcy-specific tax provisions of this sort, the government declines to impose the federal income tax on certain transactions entered into by bankrupt companies. While these provisions seem to reflect a legislative intent to capture a truer picture of the debtor's income, and thus were probably not intended to function as tax expenditures, they may be overbroad as codified. In a world where companies can use Chapter 11 for strategic¹¹² and even abusive purposes,¹¹³ rather than merely as a vehicle for reorganizing financially troubled companies, it may not be appropriate to extend beneficial tax treatment to all bankrupt debtors.¹¹⁴ I return to this point in subsequent sections. In the meantime, the following section draws upon the concept of tax expenditures to identify a type of favorable tax treatment that goes even further, effectively transforming certain of the debtor's tax attributes into marketable property.

106. I.R.C. § 108(a)(1)(B).

107. The distinction highlights the difference between definitional income and economic income. *See, e.g.,* Hirsch v. Comm'r of Internal Revenue, 115 F.2d 656, 657 (7th Cir. 1940) ("In determining what constitutes income, substance rather than form is to be given controlling weight."). Although the discharge of indebtedness causes an accession to wealth, the insolvent debtor who receives a discharge does not enjoy "gain from capital and labor, or from either of them, or in profit gained through the sale or conversion of capital." *Bowers v. Kerbaugh-Empire*, 271 U.S. 170, 175 (1926). Thus, the transaction does not lead to income; rather, as the Supreme Court noted, such a transaction results in a loss. *Id.* The Court's holding was later codified into a predecessor statute to § 108. *See* Act of June 29, 1939, Pub. L. No. 76-155, 53 Stat. 862, 875 (codified at I.R.C. § 22(b)(9) (1939)).

108. I.R.C. § 108(a)(1)(A) (2012).

109. *Id.* § 108(a)(2)(A) (clarifying that the requirement that a taxpayer be insolvent at the time of the discharge is not applicable where the discharge occurs in a bankruptcy case).

110. JOINT COMM. ON TAXATION, *supra* note 97, at 5.

111. *See* I.R.C. § 108(b)(1). The taxpayer's tax attributes are reduced in the order provided in the statute. *Id.*

112. *See* Dick, *supra* note 22, at 778; *see also infra* note 199 and accompanying text.

113. *See In re S. Beach Sec., Inc.*, 606 F.3d 366, 376 (7th Cir. 2010) (rejecting a debtor's abusive Chapter 11 plan).

114. This point will be discussed in future sections. *See infra* Part III.A.

B. Tax Law's Treatment of a Debtor's Tax Attributes in Bankruptcy

One need only scan bankruptcy-related news stories to appreciate the importance of tax attributes, such as net operating losses (NOLs), in Chapter 11.¹¹⁵ They carry significance because, under federal tax law, certain tax attributes of a bankrupt debtor are deemed transferred to its bankruptcy estate.¹¹⁶ For instance, property that is part of the bankruptcy estate maintains its historical adjusted basis, holding period, and character.¹¹⁷ Similarly, NOL carryovers,¹¹⁸ capital loss carryovers,¹¹⁹ and tax credit carryovers¹²⁰ are transferred to the estate.¹²¹

In Chapter 11, the debtor is expected to identify and allocate economic value pursuant to a fair and equitable plan; tax attributes introduce a number of conceptual challenges. Although at first glance tax attributes are mere bookkeeping entries, many such attributes are subjectively valued by stakeholders and also capable of objective appraisal.¹²² To gain a better sense of how they function as assets, the following sections consider tax attributes from both an accounting and legal perspective.

1. Tax Attributes As Assets Under Generally Accepted Accounting Principles

Because bankruptcy necessarily requires an inventory of the debtor's assets and liabilities, a preliminary question is whether valuable tax attributes are bankruptcy "assets." Under generally accepted accounting

115. See, e.g., Marie Beaudette & Jacqueline Palank, *Kodak Files Plan To Exit Bankruptcy Protection*, WALL ST. J. (May 1, 2013, 5:00 PM), <http://online.wsj.com/news/articles/SB10001424127887324266904578457030412008730> (noting sizable NOLs in Kodak's bankruptcy estate); Erik Holm & Eric Morath, *Ambac Files for Chapter 11*, WALL ST. J. (Nov. 9, 2010, 12:01 AM), <http://online.wsj.com/news/articles/SB10001424052748703514904575602911478916800> (noting substantial NOLs in Ambac's bankruptcy estate).

116. I.R.C. § 1398.

117. *Id.* § 1398(g)(6).

118. Companies accrue NOLs when deductions exceed gross income during the tax year. *Id.* § 172. Once accrued, NOLs can be used to offset income in a different tax year. *Id.* § 172(b)(1)(A). Specifically, NOLs may be carried back and applied against income in previous years, or carried forward and applied against income in subsequent years. *Id.* § 172(b)(2).

119. Individual taxpayers are permitted to deduct a maximum of \$3,000 of net capital losses (total capital losses less total capital gains) in any given tax year. *Id.* § 1211(b). Net capital losses in excess of \$3,000 may be carried forward to subsequent tax years, subject to the same limitation of being deductible only to the extent of capital gains plus a maximum additional deduction of \$3,000. See *id.* § 1212(b). Corporate taxpayers do not have the benefit of the additional \$3,000 and have greater restrictions on the number of years carryforwards are permitted. However, corporate taxpayers are permitted a limited carryback, which is not available to noncorporate taxpayers. *Id.* § 1212(a).

120. For instance, certain unused business and investment credits may be carried forward to subsequent years. See, e.g., *id.* § 39 (allowing for the carryforward of unused general business credits); *id.* § 904(c) (allowing for the carryforward of unused foreign tax credits).

121. See *id.* § 1398(g).

122. Conflicting approaches to the appraisal of tax attributes are considered in *In re Washington Mutual, Inc.*, 461 B.R. 200, 231–32 (Bankr. D. Del. 2011), *vacated in part*, No. 08-12229 (MFW), 2012 WL 1563880 (Bankr. D. Del. Feb. 24, 2012).

principles (GAAP),¹²³ an asset is any “probable future economic benefit[] obtained or controlled by a particular entity as a result of past transactions or events.”¹²⁴ Flowing from this broad definition, certain tax attributes, such as loss and credit carryovers, are recorded on a company’s balance sheet as “deferred tax assets.”¹²⁵ This designation reflects the fact that these tax attributes have the potential to reduce a subsequent period’s income tax expense and can therefore be presently valued.¹²⁶ For instance, NOLs may generally be carried back two years to generate tax refunds and forward twenty years to reduce future taxable income.¹²⁷

Tax attributes are often the most sizable asset of a struggling company,¹²⁸ with a face value that can exceed the company’s market capitalization.¹²⁹ For this reason, whether inside or outside of bankruptcy, companies take great pains to protect their valuable tax attributes.¹³⁰ But while tax attributes are consistently treated as assets under accounting principles, they are not generally disclosed to the bankruptcy court in the debtor’s initial asset disclosures.¹³¹ From a formal perspective, the requisite disclosure form does not expressly call for disclosures of tax attributes.¹³² Further, as

123. GAAP are uniform standards of, and guidelines to, financial accounting and reporting. See *Frequently Asked Questions*, AM. INST. CPAS, <http://www.aicpa.org/About/FAQs/Pages/FAQs.aspx> (last visited Mar. 25, 2014). The Financial Accounting Standards Board and the Governmental Accounting Standards Board are authorized by the Securities and Exchange Commission to establish these principles. See *id.*

124. FIN. ACCOUNTING STANDARDS BD., STATEMENT OF FINANCIAL ACCOUNTING CONCEPTS NO. 6: ELEMENTS OF FINANCIAL STATEMENTS 16 (1985).

125. Under GAAP, deferred tax assets represent the increase in taxes refundable (or saved) in future years as a result of deductible temporary differences existing at the end of the current year. FIN. ACCOUNTING STANDARDS BD., FASB INTERPRETATION NO. 48: ACCOUNTING FOR UNCERTAINTY IN INCOME TAXES 2 (2006).

126. FIN. ACCOUNTING STANDARDS BD., STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 109, at 5 (1992).

127. I.R.C. § 172(b)(1)(A) (2012).

128. See, e.g., Bill Rochelle, *Harrisburg, Madoff, Ambac, Old GM, Friendly: Bankruptcy*, BLOOMBERG BUSINESSWEEK (Oct. 14, 2011), <http://www.businessweek.com/news/2011-10-14/harrisburg-madoff-ambac-old-gm-friendly-bankruptcy.html> (noting that a commercial debtor declared that its NOLs were its most valuable asset); Robert Willens, *CIT Moves To Protect Its NOLs*, CFO.COM (Dec. 28, 2009), <http://www2.cfo.com/accounting-tax/2009/12/cit-moves-to-protect-its-nols/> (describing the steps taken by CIT Group Inc. to protect its NOLs as a vitally important asset).

129. Such was the case in *Selectica, Inc. v. Versata Enterprises, Inc.*, No. 4241-VCN, 2010 WL 703062 (Del. Ch. Feb. 26, 2010), discussed *infra* notes 260–66 and accompanying text.

130. Outside of bankruptcy, the “poison pill” is becoming an increasingly common planning device to protect NOLs. This strategy has been given scholarly attention recently. See, e.g., Michael R. Patrone, Case Note, *Is the “Tax Poison Pill” the Last Stand for Protecting NOLs After Health Care Reform?*, 1 HARV. BUS. L. REV. ONLINE 11 (2010).

131. For instance, Judge Posner notes that although NOLs were the only asset of Chapter 11 debtor South Beach Securities, Inc., they were not disclosed as assets in the company’s initial asset disclosures. *In re S. Beach Sec., Inc.*, 606 F.3d 366, 373 (7th Cir. 2010); see also *supra* note 33; *infra* note 133.

132. See B 6B (Official Form 6B), Schedule B—Personal Property, available at http://www.uscourts.gov/uscourts/RulesAndPolicies/rules/BK_Forms_1207/B_006B_1207f.pdf. The debtor’s valuable tax attributes could potentially come under item 18, “Other liquidated debts owed to debtor including tax refunds.” *Id.* However, most debtors do not

a matter of customary practice, debtors do not typically disclose valuable tax attributes under any asset categories, even going so far as to omit them expressly as “excluded assets.”¹³³

While there is no legislative or rulemaking history clarifying this omission,¹³⁴ there are two possible explanations. On the one hand, the oversight may be traced to a blurred distinction between an asset and its valuation; alternatively, the oversight may reflect deeper uncertainty as to whether these assets qualify as property of the estate.¹³⁵ These potential explanations are considered in greater detail in the following sections.

2. Assigning Value to Tax Attributes Under GAAP

Under GAAP, deferred tax assets are subject to valuation rules that reduce their carrying value to what the company might reasonably realize in the future, taking into account any impairment costs.¹³⁶ These rules, which were designed to prevent companies from overstating their financial position, require companies to consider the totality of evidence, both positive and negative, when assigning value to assets.¹³⁷ With respect to deferred tax assets, a company must take into account a “valuation allowance” if it is more likely than not that all or part of the tax asset will not be realized on future tax returns.¹³⁸ While the analysis naturally relies heavily upon subjective judgments, companies are required to give greater weight to evidence that can be objectively verified.¹³⁹

In accordance with these requirements, companies that are experiencing severe economic difficulties generally take a full valuation allowance for any deferred tax assets.¹⁴⁰ This conservative stance reflects an assumption that the company’s poor past performance strongly suggests that it will not

fully disclose valuable tax attributes here or elsewhere in their disclosures; this is likely a function of the valuation principles discussed *infra* Part I.B.2.

133. See, e.g., Schedule of Assets and Liabilities for Eastman Kodak Co. at 5, Eastman Kodak Co. v. Apple Inc. (*In re* Eastman Kodak Co.), No. 12-10202 (ALG) (Bankr. S.D.N.Y. Apr. 18, 2012) (noting as a disclaimer that the asset disclosures exclude tax accruals).

134. Bankruptcy law is unique in that statutory interpretation and policymaking resides almost entirely with the courts rather than with administrative agencies. See Rafael I. Pardo & Kathryn A. Watts, *The Structural Exceptionalism of Bankruptcy Administration*, 60 UCLA L. REV. 384, 391 (2012).

135. For a more detailed discussion of the distinction between an asset and its valuation, see *infra* note 146 and accompanying text.

136. See FIN. ACCOUNTING STANDARDS BD., *supra* note 126, at 5–6.

137. See *id.*

138. *Id.* at 6.

139. See *id.*

140. For instance, the struggling oil and gas company Ultra Petroleum took a full valuation allowance against its deferred tax assets in 2012. Ultra Petroleum Corp., Annual Report (Form 10-K), at 42–43 (Dec. 31, 2012); see also Zoltek Cos., Quarterly Report (Form 10-Q), at 13 (June 30, 2012) (“The Company has recorded a full valuation allowance against its deferred tax assets in Hungary, the United States and Mexico because it is more likely than not that the value of the deferred tax assets will not be realized.”); The Spectranetics Corp., Quarterly Report (Form 10-Q), at 12 (Mar. 31, 2012) (“Due to the Company’s history of losses and the lack of sufficient certainty of generating future taxable income, the Company has recorded a full valuation allowance against its deferred tax assets.”).

generate profits in the near future. When a company takes a full valuation allowance, its deferred tax assets are reflected with zero value on financial statements.¹⁴¹

Of course, companies that are suffering economic difficulties are often the very companies that eventually file for bankruptcy. For instance, Solyndra's financial statements leading up to its bankruptcy filing reflect zero value for its deferred tax assets, accompanied by the following notation: "Due to its history of operating losses, the Company has recorded a full valuation allowance against its deferred tax assets."¹⁴² Because of this, the company's initial asset disclosures to the bankruptcy court—which do not contain any reference to tax attributes—are facially consistent with financial statements that recorded zero value for deferred tax assets.¹⁴³ Thus, it seems that the interaction of accounting rules and federal bankruptcy procedure yields a peculiar result: one of the debtor's most important assets is not disclosed at the outset of the bankruptcy case. But there is another possible explanation for the lack of disclosure: although tax attributes are "assets," they may not be consistently thought of as "property" of the estate. The following section considers this theoretical question in the context of tax and bankruptcy law.

3. Transferability of Tax Attributes: General Rules

Tax attributes are undeniably an important source of value to most bankruptcy estates, even after taking into account any reductions caused by anticipated cancellation of indebtedness.¹⁴⁴ Thus it is not surprising that, as the previous section articulates, they are recognized as assets under modern accounting principles. But with respect to their treatment in bankruptcy law, a wider question remains: Are valuable tax attributes *property* of the estate? Or are they merely legal entitlements, reflecting the debtor's future and highly contingent ability to receive value by operation of the tax laws? The question implicates a principal distinction in property law: "not only is there valueless property, but there is also propertyless value [I]n short, property is not wealth."¹⁴⁵ Thus, what amounts to an "asset" under modern accounting principles may not be "property" in a legal sense.¹⁴⁶

141. See *supra* note 140.

142. Consolidated Financial Statements of Solyndra, Inc., (Amendment No. 1 to Form S-1), at 168 (Mar. 16, 2010).

143. See sources cited *supra* note 33.

144. See *supra* note 111 and accompanying text.

145. Felix S. Cohen, *Dialogue on Private Property*, 9 RUTGERS L. REV. 357, 364 (1954).

146. As a legal concept, private property is defined as "a right vested in individuals thought of as set over against one another, . . . requir[ing] the recognition and protection of society for its existence." ALEXANDER LINDSAY, *ESSAY IN PROPERTY: ITS DUTIES AND RIGHTS* 70 (2d ed. 1922); see also *RESTATEMENT OF PROP.* ch. 1 intro. note (1936); Cohen, *supra* note 145, at 363–64. The question of whether an asset is "property" has received scholarly attention in other contexts. See, e.g., Darian M. Ibrahim, *The Unique Benefits of Treating Personal Goodwill As Property in Corporate Acquisitions*, 30 DEL. J. CORP. L. 1, 5 (2005) (considering personal goodwill as property rather than the present value of future earnings potential).

Generally speaking, tax attributes are a difficult asset to convey or monetize. In this way, they behave more like a legal entitlement than private property. Although the debtor's tax attributes are deemed transferred to the bankruptcy estate in a Chapter 11 case,¹⁴⁷ they do not survive the debtor's liquidation¹⁴⁸ and cannot be passed directly to stakeholders pursuant to a Chapter 11 plan. These limitations on direct transfers reflect the nature of the corporate income tax generally: to the extent an entity is taxed as a corporation under Subchapter C of the Tax Code, its gains and losses do not flow through to its shareholders.¹⁴⁹ Accordingly, with the exception of corporations that elect either to file a consolidated return¹⁵⁰ or to be taxed under Subchapter S of the Tax Code,¹⁵¹ there is generally¹⁵² no mechanism in the tax laws—whether in bankruptcy or otherwise—for a corporation to distribute valuable tax attributes, such as NOLs or tax credits, to any other persons, including the corporation's shareholders.¹⁵³

Moreover, the tax laws also impose restrictions on the *indirect* transfers of valuable tax attributes. Although such limitations technically expand the future tax liabilities of certain taxpayers, they are not characterized by the government as “*negative* tax expenditures,”¹⁵⁴ but rather as compliance and enforcement provisions that prevent abuse.¹⁵⁵ In the case of NOLs, Congress was especially concerned about “exploit[ation] by persons other than those who incurred the loss.”¹⁵⁶ This is because, while loss carrybacks and carryforwards are theoretically necessary to temper the economic distortions that arise when a business cycle fails to fall neatly within the

147. See *supra* note 116 and accompanying text.

148. See *supra* notes 42–45 and accompanying text.

149. I.R.C. § 11 (2012) (imposing a tax on the taxable income of every corporation). In contrast, the Tax Code provides that entities taxed as partnerships, “shall not be subject to the income tax imposed by this chapter. Persons carrying on business as partners shall be liable for income tax only in their separate or individual capacities.” *Id.* § 701. Thus, while the Tax Code creates a flow through regime for partnerships, it directly taxes corporations. Therefore, with the exception of those corporations that elect either to file a consolidated return or to be taxed under Subchapter S of the Tax Code, gains and losses of the corporation are used to calculate income tax liability at the entity level.

150. See *id.* § 1501.

151. The election is made pursuant to I.R.C. § 1362 by eligible corporations. See *id.* § 1362. Upon so electing, “[e]xcept as otherwise provided . . . an S corporation shall not be subject to [federal income taxes].” *Id.* § 1363(a). Thus, gains and losses flow through to the shareholders, who are liable for income tax only in their individual capacities.

152. For examples of highly specific exceptions to this general rule, see *supra* note 39.

153. All corporations other than those qualified corporations who make the election to be taxed as S Corporations are subject to taxation under Subchapter C of Chapter 1 of the Internal Revenue Code of 1986 as amended. See Treas. Reg. § 301.7701-2(c) (as amended in 2012) (the “check the box” entity classification regulations).

154. By “*negative* tax expenditures,” I mean “[t]ax provisions that provide treatment less favorable than normal income tax law and are not related directly to progressivity.” JOINT COMM. ON TAXATION, *supra* note 97, at 3.

155. *Id.*

156. H.R. REP. NO. 83-1337, at 42 (1954). The same concerns motivated more recent amendments to the Tax Code. See, e.g., STAFF OF THE JOINT COMM. ON TAXATION, 100TH CONG., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, at 294 (Comm. Print 1987).

taxable year,¹⁵⁷ it would violate the important principle of tax neutrality to allow loss carryovers to be used to offset income earned by a *different* taxpayer via indirect transfers, such as through a change in ownership of a corporate taxpayer.

Advancing this legislative intent, broad anti-abuse rules thwart taxpayers from acquiring unprofitable companies to harvest their mounting tax losses and use them to shelter income.¹⁵⁸ For example, a longstanding anti-abuse provision of the Tax Code states, in pertinent part, "If any person or persons acquire . . . control of a corporation, . . . and the principal purpose for which such acquisition was made is evasion or avoidance of Federal income tax . . . then the Secretary may disallow such deduction, credit, or other allowance."¹⁵⁹

Due to the evidentiary challenges associated with a standards-based approach of this sort,¹⁶⁰ Congress subsequently enacted a bright-line rule to limit the ability of a company to indirectly transfer its valuable tax attributes to other persons through a change of ownership.¹⁶¹ Under this rule, a change of ownership occurs if the percentage of a corporation's shares held directly or indirectly by one or more of its 5 percent stockholders increases by more than fifty percentage points over the lowest percentage of shares owned by those shareholders at any time during a three-year period.¹⁶² In other words, if enough of a company's stock changes hands, the corporation will face restrictions on the use of its prior losses to offset future income.

157. The Joint Committee staff explains that "normal income tax law would provide for the carryback and carryforward of net operating losses [T]he general limits on the number of years that such losses may be carried back or forward were chosen for reasons of administrative convenience and compliance concerns and may be assumed to represent normal income tax law." JOINT COMM. ON TAXATION, *supra* note 97, at 8. Theoretical justifications for NOLs have been discussed in the academic literature. See Michelle M. Arnopol, *Why Have Chapter 11 Bankruptcies Failed So Miserably? A Reappraisal of Congressional Attempts To Protect a Corporation's Net Operating Losses After Bankruptcy*, 68 NOTRE DAME L. REV. 133, 138 (1992); Daniel L. Simmons, *Net Operating Losses and Section 382: Searching for a Limitation on Loss Carryovers*, 63 TUL. L. REV. 1045, 1057 (1989); J. Henry Wilkinson, Jr., *The Net Operating Loss Deduction and Related Income Tax Devices*, 45 TEX. L. REV. 809, 855 (1967).

158. Some of the legislative concerns are highlighted in H.R. REP. NO. 83-1337 (1954).

159. I.R.C. § 269(a)(1) (2012).

160. Section 269(a)(1) is so rarely used to defeat transactions because, for the principal purpose of a transaction to be tax avoidance, the purpose of tax evasion has to clearly overshadow any other purpose. See *U.S. Shelter Corp. v. United States*, 13 Cl. Ct. 606, 621 (1987) (discussing evidentiary challenges).

161. I.R.C. § 382 was initially enacted over fifty years ago. The section was substantially overhauled in the Tax Reform Act of 1986. See BORIS I. BITTKER & LAWRENCE LOKKEN, *FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS* § 95.5.1 (2003).

162. I.R.C. § 382(g). A "5 percent stockholder" is a shareholder who held at least 5 percent of the company's shares during the test period. *Id.* All shareholders who do not own at least 5 percent of the company's shares are aggregated and treated as a single 5 percent stockholder. *Id.* Transfers between such stockholders are disregarded for purposes of determining whether an ownership change has occurred. *Id.* Thus, so long as 50 percent or more of the shares is owned by less than 5 percent equity holders throughout the three-year testing period, there will be no change in control. *Id.* § 382(g)(4)(A). These limitations are also triggered by certain tax-free reorganizations. See *id.* §§ 368(a)(1), 382(g)(1).

The restrictions on use of these tax assets are quite severe. Generally speaking, where a change of ownership has occurred, the corporation's ability to use its NOLs to reduce future income is capped at an annual rate equal to the value of the corporation immediately before the ownership change¹⁶³ multiplied by the highest adjusted long-term tax exempt bond rate for that month and the two prior months.¹⁶⁴ For example, if a company has \$1,000 of NOLs and the fair market value of the company on the date of the change of ownership is only \$500, then the available NOLs are reduced to \$500. Assuming a 3 percent bond rate at the time of the change of ownership, the annual usable value of the NOLs would be reduced to a meager \$15. If the corporation does not continue its historic business, its available NOLs generally are reduced to zero.¹⁶⁵ These rules apply to the corporate merger, acquisition, and recapitalization context and were designed to neutralize the tax consequences of corporate investments.¹⁶⁶ With respect to other forms of valuable tax attributes, the same statute limits a corporation's recognition of built-in losses during the five-year period following a change of ownership,¹⁶⁷ while a successive statute limits indirect transfers of certain tax credit or capital loss carryovers.¹⁶⁸

Taken together, these rules effectively proscribe direct *and* indirect transfers of a corporation's valuable tax attributes. Thus, at least outside of bankruptcy,¹⁶⁹ tax attributes are reminiscent of the "propertyless value" that courts must occasionally grapple with in cases under Article 9 of the Uniform Commercial Code.¹⁷⁰ Like liquor licenses,¹⁷¹ Federal Communications Commission (FCC) licenses,¹⁷² and other governmental permits that figure prominently in such cases, tax attributes are generally treated as creatures of statutory law, subject to direct and indirect transfer restrictions.¹⁷³ Similarly, their future economic benefits are theoretically revocable by the government at any time, through revisions to federal tax laws, regulations, or interpretations thereof.¹⁷⁴ Accordingly, while they

163. In determining the value of the corporation, I.R.C. § 382(l)(1) generally disregards any capital infusions received within two years of the ownership change. *Id.* § 382(l)(1).

164. *Id.* The rate is published monthly by the U.S. Treasury. See, e.g., Rev. Rul. 2014-1, 2014-2 I.R.B. 263 (providing the adjusted long term rates for January 2014).

165. I.R.C. § 382(c)(1); Treas. Reg. § 1.368-1(d) (2012).

166. BITTKER & LOKKEN, *supra* note 161, § 95.5.1 ("Congress sought a limitation that would make NOL carryovers a relatively neutral factor in acquisitions.").

167. I.R.C. § 382(h).

168. *Id.* § 383.

169. See *infra* Part I.B.4.

170. See, e.g., *Jackson v. Miller (In re Jackson)*, 93 B.R. 421, 423 (Bankr. W.D. Pa. 1988) (stating that a purported security interest in a liquor license was void and of no effect because the license was classified as nonproperty under state law). The issue of whether an asset constitutes "property" is important in cases of this sort, because Article 9 applies only to transactions "intended to create a security interest in personal property." U.C.C. § 9-110 (2010).

171. *In re Jackson*, 93 B.R. at 424.

172. See *Thacker v. FCC (In re Magnacom Wireless, LLC)*, 503 F.3d 984, 990 (9th Cir. 2007); *Kidd Commc'n v. FCC*, 427 F.3d 1, 5 (D.C. Cir. 2005).

173. See *supra* notes 148-62 and accompanying text.

174. See, e.g., *In re Jartran, Inc.*, 44 B.R. 331, 380 (Bankr. N.D. Ill. 1984) ("[T]he realization of the tax savings [from use of NOLs] is subject to a number of contingencies,

may be regarded as assets, they usually function more like legal entitlements and less like property.¹⁷⁵ But as the following section explores, special provisions in the Tax Code lift the restrictions on indirect transfers of certain tax attributes by corporate debtors in Chapter 11. These rules have the effect of reversing any potential expansion of future tax liability caused by the compliance and enforcement rules described in this section. Even more, they effectively transform the debtor's valuable tax attributes from a legal entitlement to an item of property that can be monetized through a Chapter 11 bankruptcy case.

4. Transferability of Tax Attributes in Bankruptcy

As the previous section explained, tax attributes are ordinarily subject to onerous restrictions on direct and indirect transfers. With respect to the latter, the Tax Code imposes severe annual limitations on the future use of a corporation's valuable tax attributes following a change of ownership. In the bankruptcy context, these limitations would be especially burdensome: assuming that a bankrupt company has zero equity value as determined under GAAP,¹⁷⁶ the requisite calculation for limiting the annual use of the company's NOLs following a change of ownership would consistently return zero, thereby effectively eradicating *all* of the debtor's NOLs.¹⁷⁷

In part to prevent this harsh outcome, drafters of the Tax Code crafted special rules to apply to changes of ownership that take place pursuant to a confirmed Chapter 11 plan. These rules are quite generous, allowing a company to emerge from bankruptcy without *any* limitation on its future use of NOLs,¹⁷⁸ and without the ordinarily applicable continuity of business enterprise requirement.¹⁷⁹ To qualify for this preferential treatment, some

including continuation in effect of relevant tax provisions . . ."). Likewise, the government can take steps to *enhance* the economic benefits associated with tax attributes. *See, e.g.,* J. Mark Ramseyer & Eric B. Rasmusen, *Can the Treasury Exempt Its Own Companies from Tax? The \$45 Billion GM NOL Carryforward*, 1 CATO PAPERS PUB. POL'Y 1, 3–5 (2011) (describing the government's issuance of a series of notices permitting General Motors to engage in a § 363 sale in Chapter 11 without subsequently running afoul of the Tax Code's § 382 NOL limitations).

175. This principle is reflected in Revenue Ruling 74-175, wherein the Internal Revenue Service declined to allow a decedent's estate to deduct his losses, on the grounds that "only the taxpayer who sustains a loss is entitled to take the deduction." Rev. Rul. 74-175, 1974-1 C.B. 52.

176. Of course, this valuation would typically not assign value to the debtor's tax attributes. *See supra* Part I.B.2.

177. This perverse outcome is noted in Kelly Kogan, *Solyndra: Now It's IRS's Turn*, 217 DAILY TAX REP. 1, 3 (2012).

178. I.R.C. § 382(l)(5) (2012).

179. *See* Treas. Reg. § 1.382-9(m)(1) (as amended in 1994) ("If section 382(l)(5) applies to an ownership change of a loss corporation, section 382(c) and the regulations thereunder do not apply with respect to the ownership change."). However, there is a limited continuity of business enterprise requirement under the more broadly applicable § 269. *See* Treas. Reg. § 1.269-3(d) (as amended in 1992) ("Absent strong evidence to the contrary, a requisite acquisition of control or property in connection with an ownership change to which section 382(l)(5) applies is considered to be made for the principal purpose of evasion or avoidance of Federal income tax unless the corporation carries on more than an insignificant amount of an active trade or business . . .").

combination of historic shareholders and creditors of the bankrupt company must receive at least 50 percent of the reorganized debtor's equity interests in full satisfaction of their claims against the debtor.¹⁸⁰ In this way, the rule permits a change of ownership of the bankrupt company, and thus an indirect transfer of its valuable tax attributes.¹⁸¹ Relying on this provision, many Chapter 11 plans contemplate that creditors will receive equity interests in the debtor in exchange for all or part of their debt claims.¹⁸² It is important to note, however, that to the extent a second change of ownership occurs within two years of the Chapter 11 plan, the available NOLs will be effectively reduced to zero.¹⁸³

By allowing companies in Chapter 11 to retain the benefit of NOLs that can be used to shelter future income notwithstanding a change of ownership, the tax laws improve the economic position of bankrupt companies relative to similarly situated nonbankrupt companies.¹⁸⁴ These rules reflect a departure from the otherwise applicable compliance and enforcement provisions described in the previous section and lead to forgone governmental revenues: in this case, the taxes that would have been due on the future income sheltered by the losses.¹⁸⁵ But these provisions go far beyond the typical tax expenditure provision,¹⁸⁶ as the value enhancements they deliver do not merely take the form of a reduced overall tax liability. By easing transfer restrictions, they enable one of the bankruptcy estate's most sizable assets to function less like a legal entitlement and more like an item of property. This metamorphosis is more than a mere mincing of legal terms; by allowing tax attributes in effect to be transferred to the corporation's new owners (such as a select group of

180. The 50 percent threshold must be satisfied by "old and cold" holdings, meaning that relevant stakeholders have kept their interests for at least eighteen months. See I.R.C. § 382(l)(5)(E)(i).

181. However, recall that NOLs (and certain other valuable tax attributes) are subject to reduction in an amount equal to any cancellation of indebtedness income excluded by the debtor from taxable income. See *supra* note 111 and accompanying text. The reduction is made after calculating the tax for the year in which the cancellation of indebtedness occurs. I.R.C. § 382(l)(5)(B). Additionally, NOLs must be reduced for certain interest payments made within the past three years to creditors that receive equity interests in the debtor under the Chapter 11 plan. *Id.* Finally, if an "ownership change" occurs in the two years following the debtor's emergence from bankruptcy, the NOLs must be reduced to zero. See *id.* § 382(l)(5)(D).

182. See *supra* note 73 and accompanying text.

183. See I.R.C. § 382(l)(5)(D).

184. Strategic planning opportunities are described by Mark Gelfeld & Karen Lobl, *Tax Planning Opportunities for Debtor Corporations in Title 11 Proceedings*, 91 COM. L.J. 417, 429 (1986).

185. Rules that allow taxpayers to retain valuable tax attributes, such as NOLs, have been characterized as tax incentives elsewhere. For example, the Joint Committee on Taxation notes that any extensions in the time limits for carrybacks and carryforwards constitute tax expenditures. JOINT COMM. ON TAXATION, *supra* note 97, at 3; see also Ramseyer & Rasmusen, *supra* note 174, at 8-9 (using the term "tax breaks" to describe the government's issuance of notices exempting the § 363 sale of General Motors from § 382 restrictions); Julie Tennyson, *Tax Incentives for the Biotechnology Industry: Should Tennessee Offer Sales Tax Exemptions and Net Operating Loss Extensions?*, 70 TENN. L. REV. 567, 578 (2003) (analyzing extensions in the time limits for NOL carryovers as tax expenditures).

186. See *supra* note 96.

former creditors and/or shareholders), the tax laws allow these assets to be monetized by corporate stakeholders in a way that makes Chapter 11 bankruptcy especially appealing.

*C. Discussion: Valuable Tax Attributes As
Property of the Bankruptcy Estate*

As the previous sections articulate, modern accounting principles recognize valuable tax attributes as “assets,”¹⁸⁷ while at the same time imposing valuation rules that have the practical effect of obscuring them on a bankrupt company’s financial statements. Meanwhile, an intricate web of compliance and enforcement provisions of the Tax Code normally ensures that tax attributes function more like revocable, nontransferable legal entitlements and less like private property. However, these special provisions ease the restrictions for debtors in Chapter 11 cases. In doing so, the tax laws allow the debtor’s valuable tax attributes to become marketable property for a certain subgroup of privileged stakeholders.¹⁸⁸

This property view of tax attributes clearly manifests in bankruptcy law, where judges regularly treat certain valuable tax attributes—such as NOLs and tax credit carryovers—as property interests of the bankruptcy estate for certain purposes. For instance, bankruptcy judges take proactive measures to protect valuable tax attributes for the benefit of the estate.¹⁸⁹ To this end, courts routinely bar any action by shareholders that has the potential to adversely affect the debtor’s future ability to use its valuable tax attributes.¹⁹⁰ In a 1991 decision, the Second Circuit held that a debtor’s sole shareholder’s taking of a worthless stock deduction violated the automatic stay to the extent it would eliminate the value of NOLs by triggering a change of ownership under the tax laws.¹⁹¹ Acknowledging the contingent nature of these assets, the U.S. Bankruptcy Court for the Northern District of Ohio explained, “What is certain is that the NOL has a potential value, as yet undetermined, which will be of benefit to creditors and will assist Debtors in their reorganization process.”¹⁹² Reflecting this view, many bankruptcy courts enjoin, as a matter of course, stock trading by significant shareholders during the pendency of the case.¹⁹³

187. See *supra* Part I.B.1.

188. The notion that the tax laws can cause tax attributes to function as marketable property is explored in Simmons, *supra* note 157, at 1057–58.

189. See *infra* notes 191–93 and accompanying text.

190. See, e.g., sources cited *infra* note 193.

191. *In re Prudential Lines Inc.*, 928 F.2d 565, 573–74 (2d Cir. 1991). If a change of ownership were to occur, the tax attributes would be restricted due to the annual limitation imposed by the Tax Code. *Id.* at 574.

192. *In re Phar-Mor, Inc.*, 152 B.R. 924, 927 (Bankr. N.D. Ohio 1993).

193. See, e.g., Jean Morris, *Imposition of Transfer Limitations on Claims and Equity Interests During Corporate Debtor’s Chapter 11 Case To Preserve the Debtor’s Net Operating Loss Carryforwards: Examining the Emerging Trend*, 77 AM. BANKR. L.J. 285, 285–86 (2003); see also Final Order Pursuant to Sections 105(a) and 362 of the Bankruptcy Code Establishing Notification Procedures and Approving Restrictions on Certain Transfers of Interests in the Debtors’ Estates at 2, *In re Wash. Mut.*, No. 08-12229 (Bankr. D. Del. Nov. 19, 2008), ECF No. 315 (recognizing that the NOLs were property of the bankruptcy

Of course, this judicial treatment of tax attributes is consistent with Congress's intention to "bring anything of value that the debtors have into the estate."¹⁹⁴ In the words of the influential U.S. Bankruptcy Court for the Southern District of New York, "It is beyond peradventure that NOL carrybacks and carryovers are property of the estate of the loss corporation that generated them."¹⁹⁵ The Eighth Circuit advanced a similar view of tax attributes, noting that the "right to carry forward the [debtor's] NOLs" constituted a "property interest" of the estate.¹⁹⁶

To be sure, these fairly routine declarations that valuable tax attributes are property of the estate bring us back full circle. Against this backdrop, it is difficult to find any legal support for the routine omission of a debtor's valuable tax attributes from preliminary asset disclosures. But the problem of inconsistent legal treatment of valuable tax attributes extends much further. As the following sections explain, the debtor's tax attributes are also not consistently taken into consideration as a source of value that can be distributed to creditors under a Chapter 11 plan. This oversight derives from an ambiguity at the junction of tax and bankruptcy law.

II. THE LOOPHOLE

As Part I describes, the Tax Code contains numerous bankruptcy-specific provisions designed to facilitate resolutions of corporate financial distress via Chapter 11 bankruptcy.¹⁹⁷ Most notably, the tax laws allow bankrupt companies to preserve valuable tax attributes for future use without limitation, even where a change of ownership has taken place.¹⁹⁸ By easing indirect transfer restrictions on a valuable asset, this latter tax provision effectively transforms a legal entitlement into marketable property. Of course, while the tax laws allow indirect transfers of the debtor's valuable tax attributes, these transfers must take place pursuant to a confirmed Chapter 11 plan and are therefore—at least theoretically—subject to bankruptcy law's broader limitations on transfers of the debtor's wealth. In

estate and that substantial equity trades would violate the automatic stay); Revised Final Order Pursuant to 11 U.S.C. §§ 105(a) and 362 Establishing Notification Procedures for Substantial Claimholders and Equity Security Holders and Approving Restrictions on Certain Transfers of Interests in the Debtors' Estates at 2, *In re AMR Corp.*, No. 11-15463 (Bankr. S.D.N.Y. Apr. 11, 2013), ECF No. 7591 (stating that NOL carryforwards were property of the debtors' estates and approving notification procedures and restrictions on transfers of claims against and interests in the debtors to protect tax credits).

194. H.R. REP. NO. 95-595, at 176 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6136.

195. *Nisselson v. Drew Indus., Inc.* (*In re White Metal Rolling & Stamping Corp.*), 222 B.R. 417, 424 (Bankr. S.D.N.Y. 1998).

196. *Gibson v. United States* (*In re Russell*), 927 F.2d 413, 417-18 (8th Cir. 1991). While courts do not classify NOLs as any particular type of property, these assets would presumably qualify as general intangibles as the term is defined in the Uniform Commercial Code. Under U.C.C. § 9-102(42), "general intangibles" is a catch-all term, referring to "any personal property, including things in action, other than accounts, chattel paper, commercial tort claims, deposit accounts, documents, goods, instruments, investment property, letter-of-credit rights, letters of credit, money, and oil, gas, or other minerals before extraction. The term includes payment intangibles and software." *See* U.C.C. § 9-102(42) (2001).

197. *See supra* Part I.A.

198. *See supra* Part I.B.

other words, while the tax laws may function to bolster the value of the bankruptcy estate, it ought to be squarely within the domain of bankruptcy law to account for and distribute this value to satisfy claims against the estate. The very purpose of bankruptcy is to provide for the fair and orderly distribution of the debtor's property in accordance with established legal and equitable principles.¹⁹⁹

An expectation that bankruptcy law provides a distributional framework may explain why legal scholars were not troubled by the initial adoption of the tax laws that allow debtors to indirectly transfer valuable tax attributes through Chapter 11.²⁰⁰ Scholars, much like the judges tasked with construing these provisions, largely assumed that Chapter 11 would function to efficiently and fairly reallocate the value of these newly monetized assets to the company's true residual owners.²⁰¹ Reflecting this view, Professor Michelle Arnopol Cecil noted in a 1992 article that the bankruptcy-specific rules on transferability of tax attributes rest upon the "sound assumption that historic creditors of a loss corporation are its true owners and should be treated as equity holders for tax purposes."²⁰² According to Professor Arnopol, this would "effectuat[e] the policy of tax neutrality by allowing only the owners of the loss corporation to have unfettered use of its net operating losses."²⁰³

Of course, implicit within this reasoning is an expectation that Chapter 11 in fact functions to allow the true residual owners of a corporation to succeed to its remaining assets, including its valuable tax attributes. In other words, the argument rests upon an assumption that tax attributes, like all other potential sources of value, are accounted for in bankruptcy. Further, the logic assumes that any indirect transfers of valuable tax attributes that take place pursuant to a confirmed Chapter 11 plan merely vest the future economic benefits in the persons who have borne the corresponding economic losses, such that they would be entitled to distributions from the debtor's estate in the first place. But, as we shall see, this reasoning assumes too much about the manner in which valuable tax attributes are disclosed, appraised, accounted for, and indirectly transferred in Chapter 11.

199. See, e.g., *Rine & Rine Auctioneers, Inc. v. Douglas Cnty. Bank & Trust Co.* (*In re Rine & Rine Auctioneers, Inc.*), 74 F.3d 854, 860 (8th Cir. 1996).

200. See, e.g., Martin M. Van Brauman, *The Carryforward of Net Operating Losses and Other Tax Attributes After Bankruptcy Reorganizations*, 23 ST. MARY'S L.J. 461, 489 (1991) ("[T]he ability to currently structure an acquisition solely for the carryover of tax attributes from a non-affiliated corporation is somewhat comparable to Sir Galahad's quest for the Holy Grail."); see also William M. Davidow, Jr., *Limitations Imposed by the Tax Reform Act of 1986 on a Corporation's Use of Net Operating Loss Carryovers After an Ownership Change*, 17 U. BALT. L. REV. 331, 353-59 (1988) (thoroughly critiquing § 382 and the regulations promulgated thereunder, but expressing no concerns about the bankruptcy-specific exceptions).

201. Judge Posner identifies this expectation regarding § 382's bankruptcy-specific exception in *In re South Beach Securities, Inc.*, 606 F.3d 366, 374-75 (7th Cir. 2010).

202. Arnopol, *supra* note 157, at 195.

203. *Id.*

*A. How Valuable Tax Attributes Escape
Bankruptcy's Distributional Norms*

A central claim of this Article is that the debtor's valuable tax attributes function as marketable property and escape Chapter 11's distributional norms. To be sure, it would violate fundamental principles of tax law to distribute a corporate debtor's tax attributes directly to parties in bankruptcy.²⁰⁴ But because the tax laws allow *indirect* transfers of the debtor's tax attributes in Chapter 11,²⁰⁵ they essentially permit these valuable assets to be beneficially distributed to parties in bankruptcy via the debtor's equity security interests. Moreover, even where the tax attributes are not indirectly transferred in Chapter 11 plans pursuant to bankruptcy-specific tax laws, they are nonetheless distributed by the bankruptcy court to the extent their economic benefits are permitted to remain with shareholders notwithstanding the impairment of creditor claims.²⁰⁶ Parties who receive or retain valuable tax attributes may then use them to shelter income from unrelated assets and increase after-tax investment returns.

Chapter 11 debtors and their stakeholders routinely engage in the indirect transfer of valuable tax attributes through changes of ownership in the reorganized company. For instance, some Chapter 11 plans contemplate that the debtor's historic creditors will succeed to the equity interests of the reorganized company. In the recent Chapter 11 case of *In re PMI Group, Inc.*, the debtor's equity security interests were cancelled and new common stock was issued to creditors in exchange for their debt claims; this arrangement allowed creditors to enjoy the benefit of approximately \$1.2 billion of NOLs.²⁰⁷ At least on the surface, these restructurings seem to come the closest to vesting the future economic benefits of tax attributes in the parties who have borne the economic burdens of the underlying losses, as the indirect transfer of the tax assets at least seems to follow the absolute priority rule.

However, there are other instances where a Chapter 11 plan contemplates that shareholders will receive equity interests of the reorganized debtor even though creditors will receive minimal or no distributions. Indeed, as noted above, Solyndra's historic shareholders retained their equity interests under the Solyndra Plan,²⁰⁸ effectively stepping ahead of creditors who received

204. See *supra* notes 38–41 and accompanying text. Judge Posner notes this impossibility in *In re South Beach Securities, Inc.*, 606 F.3d at 376.

205. See *supra* Part I.B.4.

206. See *infra* notes 207–13 and accompanying text.

207. See First Amended Plan of Reorganization of the PMI Group, Inc. Pursuant to Chapter 11 of the U.S. Bankruptcy Code at 11, *In re PMI Grp., Inc.*, No. 11-13730 (Bankr. D. Del. June 3, 2013), ECF No. 882. An earlier example includes *In re Celotex Corp.*, 204 B.R. 586, 614 (Bankr. M.D. Fla. 1996) (allocating 50 percent or more of the stock of the reorganized company to asbestos claimants, as creditors of the debtor).

208. In this way, Solyndra's plan did not turn on application of I.R.C. § 382(l)(5), as any changes in equity ownership pursuant to the warrants would take place outside of the Chapter 11 plan. See generally Amy S. Elliott, *Setting the Record Straight on Solyndra's NOLs Post-bankruptcy*, 136 TAX NOTES 1493 (2012).

only three cents on the dollar for their claims.²⁰⁹ Solyndra's shareholders relied upon a limited, judicially created²¹⁰ exception to the absolute priority rule where shareholders are permitted to invest new capital in the reorganized debtor in exchange for the right to retain their equity security interests, even though creditors are not paid in full.²¹¹ To meet this "new value exception," investors must contribute new and substantial money or money's worth that is necessary for a successful reorganization and is reasonably equivalent to the interest received.²¹² Finally, creditors must either have a right to bid for the equity interests or the bankruptcy court must determine the market value of the new equity interests.²¹³ In the *Solyndra* case, the court found that an \$810,000 capital contribution,²¹⁴ coupled with a commitment to make secured financing available to the reorganized debtor,²¹⁵ was sufficient to allow shareholders to retain their equity security interests, thereby preserving their rights to nearly \$1 billion of the company's tax attributes. As these numbers suggest, restructurings of this sort pose a more obvious threat to the absolute priority rule.

But both types of restructurings have the potential to yield inequitable and inefficient allocations of value. This is because, astonishingly, whether the Chapter 11 plan vests beneficial ownership of a debtor's valuable tax attributes in creditors or shareholders, bankruptcy's most vital safeguards do not apply to the transfer. Indeed, the law fails to provide an efficient mechanism for both recognizing the value enhancements that these tax attributes bring to the debtor's corporate stock and ensuring that such value is subjected to Chapter 11's distributional norms.

The disconnect is caused by an ambiguity at the junction of tax and bankruptcy law. Recall that under bankruptcy law, a court must confirm a Chapter 11 plan before a debtor can exit bankruptcy.²¹⁶ Where there is controversy, such as where the debtor is attempting to obtain judicial confirmation over the objections of dissenting impaired classes, the court must ensure that the plan is "fair and equitable."²¹⁷ As noted above, this analysis requires, in pertinent part, that the court evaluate whether the plan provides each impaired and dissenting creditor with at least as much as it

209. See *supra* note 37 and accompanying text.

210. Some argue, however, that 11 U.S.C. § 1129(b)(2)(B)(ii) contemplates an exception of this sort; the statute bars any claimant from retaining equity "on account of" such person's junior interest. See 11 U.S.C. § 1129(b)(2)(B)(ii) (2012). Thus, to the extent the claimant has contributed new value to the reorganized debtor, such person is not retaining equity on account of a junior interest, but rather receiving them in consideration of a new capital contribution.

211. *Bank of Am. Nat'l Trust & Savs. Ass'n v. 203 N. LaSalle St. P'ship*, 526 U.S. 434, 445 (1999) (citing *Case v. L.A. Lumber Prods. Co.*, 308 U.S. 106, 121–22 (1939)); *Bonner Mall P'ship v. U.S. Bancorp Mortg. Co.*, 2 F.3d 899, 908–09 (9th Cir. 1993).

212. *Bonner Mall*, 2 F.3d at 907, 911.

213. *Bank of Am. Nat'l Trust & Savs. Ass'n*, 526 U.S. at 456–57.

214. Debtors' Amended Joint Chapter 11 Plan at 14, 51–54, *In re Solyndra LLC*, No. 11-12799 (Bankr. D. Del. Sept. 7, 2012).

215. See *id.* at 14, 17, 31.

216. See *supra* note 70 and accompanying text.

217. 11 U.S.C. § 1129(b)(1) (2012).

would have received in a hypothetical Chapter 7 liquidation.²¹⁸ But this analytical device is defective. Testing the Chapter 11 plan against a hypothetical liquidation naturally omits the debtor's valuable tax attributes from consideration, as they would be extinguished when the liquidated debtor is subsequently dissolved.²¹⁹ In effect, this means that the "fair and equitable" analysis ignores the presence of what may be the debtor's most valuable asset.²²⁰ For instance, disclosures accompanying the Solyndra Plan explained that the "[d]ebtor may have various other miscellaneous assets, including net operating loss carry-forwards and/or rights to tax refunds. No value has been ascribed to such other miscellaneous assets for purposes hereof."²²¹ Considering the substantial value placed on these tax assets, how can bankruptcy law's most important safeguard allow these assets to be relegated to an excluded, miscellaneous category? Indeed, the very asset that motivated Solyndra's restructuring was a mere footnote in the "fair and equitable" analysis used to test compliance with the absolute priority rule.²²²

In practice, this astonishing gap in the law means that impaired dissenting classes must rely on their relative bargaining power in private negotiations, without the benefit of statutory safeguards, to determine whether and how valuable tax attributes will be allocated. Disgruntled claimants who appreciate the magnitude of the debtor's tax attributes but are either unable to gain a seat at the negotiation table,²²³ or who wrestle their way into the negotiations but lack the power to bargain for better treatment, are left with only one recourse: they must challenge the plan's estimation of the debtor's enterprise value.²²⁴ In challenges of this sort, claimants essentially plead with the court to bring tax attributes within bankruptcy's distributional norms by demonstrating that certain classes of creditors or equity holders will receive or retain value under the plan in

218. *Id.* § 1129(a)(7)(A)(ii).

219. *See supra* notes 43–44 and accompanying text.

220. The practice of excluding valuable tax attributes from the liquidation analysis is widespread and longstanding. *See, e.g.,* Calpine Liquidation Analysis, Exhibit 11 to Supplement to Debtors' First Amended Joint Plan of Reorganization Pursuant to Chapter 11 of the U.S. Bankruptcy Code at 6, Calpine Corp. v. Nev. Power Co. (*In re* Calpine Corp.), No. 05-60200 (Bankr. S.D.N.Y. Aug. 27, 2007), ECF No. 5704 ("The Debtors' NOLs are assumed to offset federal taxes . . . expected to be incurred by the Trustee in a liquidation; any NOLs remaining are ascribed no value in the Liquidation Analysis because the remaining NOLs do not retain value in a chapter 7 liquidation."); Exhibit C, Consolidated Hypothetical Liquidation Analysis for Delta Air Lines, Inc., and its Subsidiaries at 5–6, *In re* Delta Air Lines, Inc., No. 05-17923 (Bankr. S.D.N.Y. Dec. 19, 2006), ECF No. 3906-3 ("The Liquidation Analysis assumes no recovery for deferred income taxes . . .").

221. Disclosure Statement in Respect of Debtors' Amended Joint Chapter 11 Plan, Exhibit 3 at 3 n.6, *In re* Solyndra, LLC, No. 11-12799 (Bankr. D. Del. Sept. 7, 2012).

222. *See supra* notes 220–21 and accompanying text.

223. The importance of assembling coalitions in order to gain a seat at the negotiation table is discussed in Michelle M. Harner & Jamie Marincic, *Behind Closed Doors: The Influence of Creditors in Business Reorganizations*, 34 SEATTLE U. L. REV. 1155, 1158–59 (2011).

224. Such was the case in *In re Washington Mutual, Inc.*, 461 B.R. 200 (Bankr. D. Del. 2011), *vacated in part*, No. 08-12229 (MFW), 2012 WL 1563880 (Bankr. D. Del. Feb. 24, 2012).

violation of the absolute priority rule, in the form of equity security interests in the debtor that either exceed the value of the holders' claims, or that exceed the value of any new money they intend to contribute to the reorganized debtor.

But these disputes are extremely costly and time consuming, often requiring expert testimony to consider how various tax attributes should be appraised under complex financial valuation models.²²⁵ And even the most comprehensive valuation models are ultimately based on multiple assumptions and subjective determinations.²²⁶ For instance, in the highly contested *In re Washington Mutual, Inc.* case, the consolidated debtors' expert applied a financial model that declined to take into consideration the likelihood that the reorganized company would receive new capital or debt infusions to acquire profitable businesses; accordingly, the plan's estimated reorganization value was quite conservative.²²⁷ Meanwhile, the expert for the plan's opponents speculated that the reorganized debtor could raise billions of dollars to realize more of the tax benefits.²²⁸ The court ultimately adopted a conservative valuation estimate, noting that "the Reorganized Debtor should be able to raise additional capital and debt over the next twenty years equal to twice the value of its current assets,"²²⁹ which the court found to be approximately \$140 million.²³⁰ Within months of exiting bankruptcy, the reorganized debtor had already executed debt instruments allowing it to borrow over \$250 million to acquire profitable businesses and utilize the tax benefits, thereby rapidly outpacing the court's ballpark figure.²³¹

Thus, while challenges to the debtor's reorganization value may provide a last resort for impaired dissenting classes, they do not offer meaningful safeguards. Moreover, much has changed in the decades following the initial adoption of Chapter 11 in 1978 and the revamping of the Tax Code in 1986.²³² As I have argued elsewhere, modern corporate restructurings are highly political processes, in which insiders, traditional bank lenders, hedge funds, distressed-debt investors, and other powerful stakeholders are able to engage in strategic conduct to acquire control of the process.²³³ In this environment, Chapter 11 enables parties with existing market power in the securities and capital markets to extract excess returns at the expense of other constituents.²³⁴ Negotiations often focus on the distribution of economic burdens, on one hand, and the exploitation of rent-seeking

225. *See id.* at 226–28.

226. *See generally* JAMES R. HITCHNER, FINANCIAL VALUATION 27–54 (3d ed. 2011).

227. *In re Wash. Mut.*, 461 B.R. at 228.

228. *Id.* at 230 n.24.

229. *Id.* at 236.

230. *Id.* at 226–28.

231. WMI Holdings Corp., Quarterly Report (Form 10-Q) at 26, 29 (Aug. 9, 2013).

232. The new reality is eloquently described in Harvey R. Miller, *Bankruptcy and Reorganization Through the Looking Glass of 50 Years (1960–2010)*, 19 NORTON J. BANKR. L. & PRAC. 193 (2010).

233. *See Dick, supra* note 22, at 762.

234. *Id.* at 765, 790.

opportunities, on the other.²³⁵ As the following section explores, some constituents are placed at a considerable disadvantage early in the process, where they must find the resources to overcome costly barriers to entry and significant collective action obstacles. Because bankruptcy law fails to appraise and account adequately for the debtor's valuable tax attributes, the tax attributes have become a principal source of excess returns in this deeply flawed process.

B. Chapter 11 As an Anticompetitive Environment for Negotiating Allocations of Valuable Tax Attributes

Theoretically, allocations of a bankrupt company's wealth are determined—or at least severely constrained—by the Bankruptcy Code. But for the reasons discussed in previous sections, the debtor's valuable tax attributes largely escape these constraints, leaving it to the parties to negotiate to receive the future benefits of the debtor's valuable tax attributes. What is more, Chapter 11 constructs an anticompetitive environment for these negotiations. For example, the omission of tax attributes from a debtor's preliminary asset disclosures leads to information asymmetries as to the nature and extent of what may be the debtor's most sizable asset. Additionally, not only does bankruptcy law fail to remedy the market failure, it also buttresses it through legal rules that impose barriers to entry and that effectively entrench the market power of certain parties, such as insiders, dominant lenders, hedge funds, and other institutional investors. Finally, principal-agent problems arise as these dominant stakeholders with superior information and market power use their negotiating positions to steer the case towards an outcome that allows them to extract the tax benefits to privilege future, unrelated investments. Each of these problems is considered in greater detail below.

First, the lack of adequate disclosure of valuable tax attributes early in the bankruptcy case causes an information asymmetry.²³⁶ This asymmetry rewards sophisticated stakeholders at the expense of other constituents and allows them to negotiate with more or better information as to the true value of the bankrupt company.²³⁷ Further, in light of the debtor's exclusive right

235. *Id.* at 822.

236. For further detail on the problem of information asymmetries, see Joseph E. Stiglitz, Professor, Columbia Bus. Sch., Nobel Prize Lecture: Information and the Change in the Paradigm in Economics (Dec. 8, 2001), available at http://nobelprize.org/nobel_prizes/economics/laureates/2001/stiglitz-lecture.pdf (detailing Stiglitz's contributions to the field). See generally George A. Akerloff, *The Market for "Lemons": Quality, Uncertainty and the Market Mechanism*, 84 Q.J. ECON. 488 (1970) (exploring the effect of information asymmetries in the used car market); Bruce C. Greenwald & Joseph E. Stiglitz, *Externalities in Economies with Imperfect Information and Incomplete Markets*, 101 Q.J. ECON. 229 (1986) (considering the role of the government in addressing market inefficiencies caused by information asymmetries).

237. To be sure, it is theoretically possible for anyone to reconstruct the debtor's tax attributes by parsing through its historical financial statements. But less sophisticated claimants, as well as those without professional representation, are less likely to engage in this discovery process.

to file a Chapter 11 plan during the first 120 days,²³⁸ those stakeholders who are in the best position to know the nature and extent of the debtor's tax attributes are also most likely to be tasked with preparation and advancement of the debtor's Chapter 11 plan. The resultant power imbalance infects the restructuring with strategic, rather than transparent and competitive, bargaining. And, ironically, because Chapter 11 relies on consensus- and market-based processes to reach case outcomes,²³⁹ these information asymmetries have the potential to thwart the efficient resolution of corporate financial distress.

This ambiguity in the law also manifests in a more subtle—yet equally troublesome—way: it weakens the negotiating power of certain parties from the outset of the case by obscuring the true enterprise value of the debtor. For instance, the debtor's failure to disclose the nature and extent of its valuable tax attributes early in the case can prevent common shareholders from gaining a seat at the negotiation table. The U.S. Trustee's power to appoint an official committee to represent equity security holders is discretionary, rather than mandatory, and the U.S. Trustee will only appoint a committee where shareholders prove that they are not already adequately represented.²⁴⁰ Courts reiterate that the appointment of an equity committee is extraordinary relief, and their formation "should be the rare exception."²⁴¹ Under the strictest standard, shareholders bear the burden of demonstrating "a substantial likelihood that they will receive a meaningful distribution in the case under a strict application of the absolute priority rule."²⁴²

Without early and meaningful disclosure of the debtor's assets, including its tax attributes, shareholders cannot meet this burden. In that event, the U.S. Trustee is likely to determine that the equity security holders have no reasonable expectation of a recovery and thus do not require the appointment of an equity committee.²⁴³ For precisely these reasons, shareholders in the recent *In re Eastman Kodak Co.* bankruptcy case had to "take matters into their own hands . . . [and were] forced to represent [themselves]."²⁴⁴ This creates both a substantial barrier to entry and a collective action obstacle in Chapter 11 negotiations.²⁴⁵

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

239. See Dick, *supra* note 22, at 766.

240. 11 U.S.C. § 1102(a)(1)–(2) (2012).

241. *In re Williams Commc'ns Grp., Inc.*, 281 B.R. 216, 223 (Bankr. S.D.N.Y. 2002).

242. *Id.*

243. Such was the case in the Eastman Kodak bankruptcy. See Jonathan Stempel, *Kodak Shareholders Won't Get Voice, Creditors Back Chapter 11 Exit*, REUTERS (Aug. 15, 2013, 5:58 PM), <http://www.reuters.com/article/2013/08/15/us-kodak-ruling-idUSBRE97E14N20130815>.

244. Motion in Support of an Order Approving the Appointment of an Official Equity Committee and Response to the Objection of the U.S. Trustee at 10, *Eastman Kodak Co. v. Apple Inc. (In re Eastman Kodak Co.)*, No. 12-10202 (Bankr. S.D.N.Y. July 31, 2013), ECF No. 4500.

245. Dick, *supra* note 22, at 822.

Along similar lines, the market for the debtor's tax benefits is further insulated from competition by legal barriers, such as the exclusivity rule,²⁴⁶ as well as strategic barriers, such as Chapter 11-plan proponents' frequent and deliberate creation of impaired classes to vote in favor of a controversial plan.²⁴⁷ Indeed, the enormous transaction costs associated with a plan-confirmation battle also serve as a legal barrier of sorts, particularly where only certain parties enjoy reimbursement of attorney's fees from the debtor's estate.²⁴⁸

These inefficiencies, in turn, lead to principal-agent problems. Chapter 11 relies on formal and informal grouping mechanisms, whereby persons designated as agents represent an aggregated grouping of similarly situated claimants. For instance, in a Chapter 11 case, similarly situated claimants may be recognized collectively in official committees comprising persons holding the largest claims.²⁴⁹ Yet within these agency structures, certain dominant stakeholders with superior information, as well as market power in the capital and securities markets, such as insiders, traditional bank lenders, hedge funds, and distressed debt investors, are able to lobby the agent to steer the case towards an outcome that allows them to extract excess returns.²⁵⁰ For instance, in the *Solyndra* case, dominant shareholders arguably took control of the case long before the company filed for bankruptcy by advancing the February 2011 restructuring and securing warrants to obtain additional equity in the debtor.²⁵¹ These same dominant shareholders also served as proponents of the company's Chapter 11 plan, advancing a plan that would enable them to use the tax attributes to privilege their future, unrelated investments.²⁵²

For these reasons, Chapter 11 creates an anticompetitive environment, in which the debtor's valuable tax attributes become economic rents for dominant stakeholders. In this manner, the muddled overlap of tax and bankruptcy law facilitates a bewildering result. Valuable tax attributes, which are routinely recognized by bankruptcy courts as "property" of the estate²⁵³ and are often a debtor's most substantial asset, are permitted to

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

247. See, e.g., *In re Mach. Menachem, Inc.*, 233 F. App'x 119, 121 (3d Cir. 2007) (addressing the problem of class gerrymandering).

248. Persons other than the debtor or trustee seeking payment of attorneys' fees from a bankruptcy estate must show that their actions constituted a "substantial contribution" to the debtor's reorganization. See 11 U.S.C. § 503(b)(3)(D) (2012).

249. 11 U.S.C. § 1102(a)(1)–(2) (authorizing the appointment of creditors' and equity security holders' committees). In some cases, claimants form unofficial committees. See *In re Wash. Mut., Inc.*, 419 B.R. 271, 279 (Bankr. D. Del. 2009) ("[C]ollective action by creditors through the use of *ad hoc* committees or groups allows creditors to utilize other group members' holdings to obtain a greater degree of influence in a bankruptcy case than single creditors acting alone.").

250. See Dick, *supra* note 22, at 816. The concerns I raise in my previous work to some extent echo early criticisms of Chapter 11's predecessor law. See generally SEC. & EXCHANGE COMM'N, REPORT ON THE STUDY AND INVESTIGATION OF THE WORK, ACTIVITIES, PERSONNEL AND FUNCTIONS OF PROTECTIVE AND REORGANIZATION COMMITTEES (1937).

251. See *supra* note 31 and accompanying text.

252. See *supra* notes 31–35 and accompanying text.

253. See *supra* Part I.C.

disappear down the proverbial rabbit hole, sidestepping bankruptcy's vital safeguards and falling to the mercy of monopolized negotiations, where they can be exploited as excess returns.

To be sure, valuable tax attributes are not the only assets that meet this fate. Other intangible assets, such as goodwill, intellectual property, and litigation claims arguably meet a similar fate and thus present the same challenges to bankruptcy practice. But the case of valuable tax attributes has especially profound legal implications, as it also calls into question the historical justifications for generous tax laws that facilitate Chapter 11 restructurings.²⁵⁴ If the goal of tax law, to the extent it intersects with bankruptcy law, is to enable economically efficient restructurings of business enterprises, then the tax consequences of the choice to pursue Chapter 11 bankruptcy ought to be neutral. But the ability to extract valuable tax attributes for future use substantially changes the incentive effects of the corporate income tax on financially distressed companies and their stakeholders. In this way, the law motivates stakeholders of distressed companies to engage in lengthy and expensive Chapter 11 cases²⁵⁵ and to pursue acquisitive investments that they would not otherwise pursue following emergence from bankruptcy. Meanwhile, the taxpayers essentially subsidize, via the Tax Code, unnecessary and economically inefficient reorganizations that reward dominant stakeholders.²⁵⁶ The following section considers various reform proposals to improve the overall efficiency and fairness of commercial bankruptcies under Chapter 11.

III. CLOSING THE LOOPHOLE

This Article has shown how an ambiguity at the intersection of the corporate tax laws and Chapter 11 of the Bankruptcy Code enables certain of a corporate debtor's most valuable assets to escape bankruptcy's distributional norms and serve as excess returns to dominant parties. The resulting inefficiencies implicate the fields of corporate taxation and commercial bankruptcy. Thus, to address the issues identified in this Article, policymakers must target reform efforts in three major policy areas: (1) reforming the bankruptcy laws to ensure that value created by the tax laws is adequately disclosed and fairly distributed in the course of a restructuring; (2) reforming the tax laws to prevent corporate debtors from receiving the benefit of specialized tax provisions unless they are actually reorganizing the business enterprise in substance rather than merely in form; and (3) redesigning the overlap of the tax and bankruptcy laws to

254. See, e.g., Arnopol, *supra* note 157.

255. Solyndra's decision to conduct its liquidation via bankruptcy process carried a substantial investment of time and resources: the company spent nearly fourteen months in Chapter 11, incurring costs of nearly \$8 million for professional advisors alone. See Certification of Counsel with Respect to Proposed Omnibus Order Approving Final Fee Applications of Professionals at Exhibit A, *In re Solyndra*, No. 11-12799 (MFW) (D. Del. Dec. 26, 2012).

256. See *supra* Part II.

ensure greater coordination and fewer opportunities for abuse. Each of these goals is discussed in greater detail below.

A. Revisions to the Bankruptcy Laws

Two principal reforms are needed to the bankruptcy laws: first, bankruptcy disclosure rules should be amended to require disclosure of a debtor's valuable tax attributes as assets early in the case; second, Chapter 11 must affirmatively bring the debtor's valuable tax attributes under bankruptcy's distributional norms. Each of these specific reforms is explained in the following subsections.

1. Modifications to Bankruptcy Disclosure Rules

As a preliminary matter, bankruptcy disclosure rules should be modified to require early and meaningful disclosure of a debtor's valuable tax attributes as assets. While bankruptcy law requires that a plan proponent disclose the material tax consequences of the reorganization,²⁵⁷ these disclosures come much later in the Chapter 11 case, when the collateral consequences of inadequate asset disclosures have already taken place. Early and meaningful disclosure can be facilitated by expressly including the debtor's valuable tax attributes as a separate category of the currently required "Schedule B—Personal Property" of the debtor's asset disclosure schedules.²⁵⁸ Alternatively, a new "Schedule K—Tax Attributes" can be created, with space for the debtor to list and describe its various tax attributes. Instructions accompanying the relevant form would require that, for disclosure purposes, the debtor must identify the face value of tax attributes rather than their carrying value as determined under GAAP.²⁵⁹

To be sure, richer asset disclosures promote the goals of bankruptcy and better protect the interests of creditors. What is more, an amendment of this sort reflects the principled approach adopted by the Delaware Court of Chancery in a 2010 corporate decision, which appreciates the economic significance of tax attributes even where they suffer full impairment under the accounting rules. In *Selectica, Inc. v. Versata Enterprises, Inc.*,²⁶⁰ the court approved a corporation's use of penalty provisions in stockholder rights plans to deter transactions that might jeopardize the corporation's future ability to use its NOLs.²⁶¹ In deciding that this NOL "poison pill"²⁶² was a valid exercise of the corporate board's authority, the court concluded

257. 11 U.S.C. § 1125(a)(1) (2012).

258. See B 6B (Official Form 6B), *supra* note 132.

259. The differences are described *supra* Part I.B.1.

260. No. 4241-VCN, 2010 WL 703062 (Del. Ch. Feb. 26, 2010).

261. *Id.* at *25.

262. The typical poison pill dilutes any stockholder who acquires shares in excess of a specified ownership threshold without prior board approval. For a more detailed discussion of poison pills specifically designed to protect a firm's NOLs, see Merle Erickson & Shane Heitzman, *NOL Poison Pills: Selectica v. Versata*, 127 TAX NOTES 1369 (2010); Peter B. Siegal, *Using Appraisal To Protect Net Operating Loss Carryforwards*, 106 NW. U. L. REV. 927, 929–30 (2012).

that NOLs were a “company asset worth protecting.”²⁶³ Responding to a claim that the NOLs did not constitute an asset because any value they had was highly contingent and subject to legal restrictions on their use, the court took great pains to separate the question of whether the NOLs were an asset from the calculation of their value under GAAP.²⁶⁴ To this end, it rejected the argument that the company’s decision to take a full valuation allowance for the NOLs in its recent financial statements suggested that they were not assets worth protecting.²⁶⁵ Notwithstanding the accounting write-down, the NOLs were subjectively valued by the firm’s stakeholders and had been assigned substantial economic value by the company’s professional advisors.²⁶⁶

Applying the *Selectica* court’s reasoning to bankruptcy law’s asset disclosure requirements, it seems that debtors ought to disclose fully tax attributes as potentially valuable assets at the outset of the bankruptcy case, regardless of their valuation as determined under GAAP.²⁶⁷ Of course, while enhanced asset disclosures would reduce information asymmetries, additional legal reforms are needed to bring valuable tax attributes within bankruptcy’s distributional norms. The following section considers a proposal to achieve this end.

2. Amendments to the Chapter 11 Plan Confirmation Tests

This Article has demonstrated how valuable tax attributes can be monetized and transferred through Chapter 11 bankruptcy. Yet this allocation process largely escapes bankruptcy’s distributional norms, occurring entirely via private negotiations that tend to be monopolized by dominant parties, such as insiders, hedge funds, and other powerful distressed-debt investors.

Thus, Chapter 11’s safeguards should take into account the debtor’s valuable tax attributes. To this end, the rules governing judicial confirmation of nonconsensual Chapter 11 plans should be modified. Courts may continue to evaluate the fairness of nonconsensual plans against a hypothetical Chapter 7 liquidation; however, the statutory test²⁶⁸ should be amended to expressly take into account the net present value of the debtor’s available tax attributes. The net present value calculation would assume (1) that all available valuable tax attributes will be utilized pro rata over a period not to exceed five years following the debtor’s reemergence from bankruptcy, and (2) in each such tax year, the debtor will be subject to the highest federal income tax bracket ever applied to the debtor and which

263. *Selectica*, 2010 WL 703062, at *17.

264. *Id.* at *19.

265. *Id.*

266. *Id.* at *19 n.161.

267. Arguably, to the extent companies are able to steer the Chapter 11 case to an outcome that preserves and maximizes valuable tax attributes for future use, companies should no longer take a full valuation allowance once they have entered Chapter 11 bankruptcy.

268. See 11 U.S.C. § 1129(a)(7) (2012).

is then in effect.²⁶⁹ Tax attributes would be valued as of the effective date of the plan, taking into account the time-value of money and any reductions mandated by the tax laws, such as the reduction for cancellation of indebtedness income excluded by the debtor from taxable income.²⁷⁰ That amount would be added to the total liquidation value as an additional, hypothetical, cash-equivalent asset. Then, with respect to each impaired class of claims or interests, each holder would receive under the proposed plan property equal to or greater than the amount that such holder would receive if the debtor company were liquidated under Chapter 7 and the debtor's assets, including the hypothetical cash-equivalent asset, were distributed to all claimants.²⁷¹

Of course, in many cases this calculation will be ill suited to the actual economic circumstances confronting the debtor. In situations of this sort, the court would set an evidentiary hearing to determine the value of the debtor's tax attributes. The debtor would bear the initial burden of proving by a preponderance of the evidence²⁷² that its tax attributes are worth *less* than the amount determined under the net present value calculation described above. Likewise, impaired classes of claimants would bear the initial burden of proving by a preponderance of the evidence that the debtor's valuable tax attributes are worth *more* than the amount determined under the net present value calculation. In either case, opponents would be required to prove the value of tax attributes using a discounted cash flows analysis.²⁷³ In these proceedings, the court would not be bound by the conclusions reached by expert witnesses and may make adjustments to arrive at a final judgment on the value of the debtor's tax attributes.

By forcing the Chapter 11 plan to take into account the value of the debtor's tax attributes to those persons who hold equity security interests in the debtor at the time it exits bankruptcy, this rule would make valuable tax attributes a neutral factor in Chapter 11 restructurings. At the same time, it

269. This framework assumes that the reorganized debtor will take steps to maximize its economic interests vis-à-vis the valuable tax attributes. This assumption is consistent with broader corporate jurisprudence. *See, e.g., Matsushita Elec. Indus. Co., Ltd. v. Zenith Radio Corp.*, 475 U.S. 574, 588–89 (1986) (assuming that firms behave in an economically rational manner).

270. *See supra* notes 111, 181 and accompanying text.

271. The proposed modification would be made to 11 U.S.C. § 1129(a)(7).

272. The Supreme Court has explained that the preponderance-of-the-evidence standard is appropriate for deciding most bankruptcy claims. *See Grogan v. Garner*, 498 U.S. 279, 286 (1991) ("Because the preponderance-of-the-evidence standard results in a roughly equal allocation of the risk of error between litigants, we presume that this standard is applicable in civil actions between private litigants unless 'particularly important individual interests or rights are at stake.'" (quoting *Herman & MacLean v. Huddleston*, 459 U.S. 375, 389–90 (1983))).

273. A discounted cash flows analysis would estimate the tax attributes' value by using forecasted future cash flows, and by applying an appropriate discount rate. *See* DAVID T. LARABEE & JASON A. VOSS, VALUATION TECHNIQUES: DISCOUNTED CASH FLOW, EARNINGS EQUALITY, MEASURES OF VALUE ADDED, AND REAL OPTIONS 108 (2013). Factors that would be relevant to the forecast include: (1) proposed or otherwise anticipated changes to the reorganized company's business enterprise, (2) forecasted revenue growth rates for such industry, and (3) estimated future expenses. *Id.*

would further advance the congressional intent to prevent the use of the bankruptcy process to traffic in corporate shells.²⁷⁴

B. Revisions to the Tax Laws

As a preliminary matter, the Tax Code should be amended to prevent corporate debtors from receiving the benefit of tax provisions that are designed to facilitate Chapter 11 restructurings unless they are actually reorganizing the business enterprise in substance rather than merely in form. Considering how these provisions are utilized in modern Chapter 11 proceedings, they essentially function as unintended tax expenditures to benefit dominant corporate stakeholders. Imposing additional limitations on these provisions would also bring them into greater harmony with sound tax policy and the economic realities of a particular transaction.²⁷⁵

Most importantly, the bankruptcy-specific tax law that allows debtors to preserve their valuable tax attributes, notwithstanding a change of ownership,²⁷⁶ should be amended to apply only to Chapter 11 plans that satisfy the more stringent business continuity requirements.²⁷⁷ The analysis would emphasize economic substance over legal form, taking into account the historic business that generated the tax attributes rather than the historic business of a mere holding company or other corporate entity presently possessing the tax attributes.

Amendments of this sort would allow the Tax Code's bankruptcy-specific provisions to more narrowly target troubled businesses that utilize Chapter 11 to rehabilitate and restructure in a way that preserves jobs and continues a productive business enterprise. At the same time, they would prevent the use of the bankruptcy process to cleanse a company of its unsecured debts and underperforming assets and restructure it as an investment vehicle with built-in, taxpayer-subsidized investment returns. In doing so, these amendments would help take valuable tax attributes from the position of being a driving force in Chapter 11 cases and relegate them to playing the incidental role that Congress envisioned.²⁷⁸ Further, these modifications would drive home the point that when companies pursue bankruptcy protection, they necessarily submit *all* of their assets to the court's jurisdiction, including their tax assets.

To this end, as an alternative to the revision I proposed above to bankruptcy's "best interest of the creditor's test,"²⁷⁹ the tax laws could also be modified to prevent stakeholders from using valuable tax attributes as a source of excess returns in bankruptcy. For example, Congress could clarify that, so long as historic shareholders and creditors receive at least 50 percent of the reorganized debtor's equity security interests, the debtor may retain only a share of its available tax attributes, calculated by applying the

274. See *supra* notes 43–44 and accompanying text.

275. See *infra* notes 283–89 and accompanying text.

276. See I.R.C. § 382(l)(5) (2012).

277. These requirements are set forth in Treas. Reg. § 1.368-1(d)(4)(ii) (2011).

278. See *supra* note 45.

279. See *supra* Part III.A.2.

ratio of (i) the allowable claims, as determined under bankruptcy law,²⁸⁰ of the historic shareholders and creditors that are deemed to be fully satisfied, because such persons will have received equity security interests in the reorganized debtor, to (ii) the total of all allowable claims against the debtor.²⁸¹ The amount of available tax attributes would take into account any reductions mandated by the tax laws, such as the reduction for cancellation of indebtedness income excluded by the debtor from taxable income.²⁸² For example, if a company with \$1,000 of NOLs reorganizes pursuant to a Chapter 11 plan that vests 100 percent of the reorganized debtor's equity security interests in historic creditors who together hold only 75 percent of the total allowable claims against the debtor, then the available NOLs would be reduced to \$750.

A rule of this sort takes into consideration the theoretical argument that creditors of an insolvent corporation are its true owners; however, it only allows such owners to receive their pro rata share of the tax benefits. Of course, from a tax policy perspective, this revision may not be sufficient to prevent tax-motivated Chapter 11 reorganizations. Dominant stakeholders would still have the ability to extract a large share of valuable tax attributes without regard for the interests of the debtor's other constituents. Accordingly, changes to the bankruptcy laws are still needed to address these distributional elements.

C. Reassessing the Intersection of Chapter 11 Bankruptcy and Tax Law

In addition to the specific reforms noted above, greater attention is generally needed at the crossroads where the tax and bankruptcy laws intersect. Modern commercial bankruptcies have grown ever more complex; meanwhile, the tax laws have increased in magnitude and difficulty. These trends create ample opportunity for sophisticated companies and their advisors to find and exploit ambiguities and inadequacies in the law.

These two intricate areas of law must be assessed to ensure seamless overlap. Presently, federal tax law largely defers to Chapter 11, affording valuable tax benefits with minimal restrictions. The problems identified in this Article appear to derive, at least in part, from a false assumption in the tax laws that companies in bankruptcy pursue *either* rehabilitative relief under Chapter 11 *or* liquidation under Chapter 7. But as corporate structures have grown more complex in the years following Chapter 11's initial enactment, and as Chapter 11 is increasingly used to engage in liquidations of all or part of a company's business assets,²⁸³ these tax laws rest upon an outmoded and incorrect assumption. Now that Chapter 11 is routinely used to liquidate some entities in the corporate structure and reorganize others, broad bankruptcy-related exceptions in the tax laws are

280. See 11 U.S.C. § 502.

281. See *id.*

282. See *supra* notes 111, 181 and accompanying text.

283. See, e.g., *supra* note 27 and accompanying text.

especially susceptible to abuse. Rather than relying on loose references to a “plan of reorganization,”²⁸⁴ the Tax Code ought to develop its own definitions of rehabilitative versus liquidating bankruptcies and invoke these definitions in bankruptcy-specific tax laws.

More broadly, greater coordination is needed between the IRS and the U.S. Trustee to combat abuse of Chapter 11 to harvest tax losses and use them to shelter income. For one thing, both agencies can appeal to the bankruptcy courts to use their judicial discretion to apply broad anti-abuse rules to questionable restructurings.²⁸⁵ Similarly, there are numerous judicial doctrines, stretching across both disciplines, that can be used to challenge Chapter 11 plans that seek to exploit the debtor's tax attributes in bankruptcy.²⁸⁶ For instance, the doctrine of substance over form is used in tax law to force a taxpayer to realize tax consequences in accordance with the economic substance of a transaction rather than its legal form.²⁸⁷ Meanwhile, the same doctrine has been applied in bankruptcy cases to determine the true nature of a debtor's interest in property.²⁸⁸ Similarly, the step transaction doctrine assigns legal consequences to an entire integrated event rather than a series of separate steps,²⁸⁹ while the sham transaction doctrine allows courts to unwind structures intended to avoid income tax liability.²⁹⁰ Finally, the business purpose doctrine challenges transactions that fail to be motivated by the exigencies of business and are instead devices for tax avoidance.²⁹¹

These doctrines could have been used to successfully challenge Solyndra's pseudo-reorganization. However, doing so would have required the IRS to look beyond the tax laws and the U.S. Trustee to look beyond the bankruptcy laws, such that each would appreciate the broader consequences of various steps taken by Solyndra and its stakeholders. For instance, the government could have argued that Solyndra's purported reorganization

284. For instance, Treasury Regulation § 1.382-9 refers repeatedly to a “plan of reorganization.” See Treas. Reg. § 1.382-9 (as amended in 1994).

285. I.R.C. § 269(a)(1).

286. Tax doctrines, including “substance over form,” were invoked by Judge Posner in a spirited opinion addressing an unsuccessful attempt by South Beach Securities, Inc., to use Chapter 11 to preserve valuable tax attributes in an uncontested Chapter 11 case involving only insiders as creditors. See *In re S. Beach Sec., Inc.*, 606 F.3d 366, 374 (7th Cir. 2010). Tax doctrines were also invoked by the IRS to find that an acquisition of a corporation with substantial NOLs did not satisfy the § 382 bankruptcy-specific rules, even though the transaction technically met statutory requirements. See I.R.S. Tech. Adv. Mem. 200915033 (Apr. 10, 2009), available at <http://www.irs.gov/pub/irs-wd/0915033.pdf>.

287. See, e.g., *Gregory v. Helvering*, 293 U.S. 465, 469–70 (1935).

288. See, e.g., *United Airlines, Inc. v. HSBC Bank USA, N.A.*, 416 F.3d 609, 614 (7th Cir. 2005).

289. *Comm'r v. Clark*, 489 U.S. 726, 738 (1989).

290. See, e.g., *Cohen v. Comm'r*, No. 110869, 1943 WL 9207 (T.C. Aug. 4, 1943). Judicial consideration of “corporate shams” was given recent empirical attention in Joshua D. Blank & Nancy Staudt, *Corporate Shams*, 87 N.Y.U. L. REV. 1641, 1659–65 (2012) (finding that the courts have produced a consistent body of law to identify abusive corporate sham transactions).

291. See, e.g., *Frank Lyon Co. v. United States*, 435 U.S. 561, 583–84 (1978); Treas. Reg. § 1.368-1(b) to (c) (2012).

was a sham, and that the Chapter 11 plan used the legal form of a reorganization to achieve the economic substance of a liquidation. To this end, the step transaction doctrine could have been used to collapse Solyndra's February 2011 adoption of a parent-subsidiary structure and the later Chapter 11 plan. Doing so may have demonstrated that the purported business purpose motivating the February 2011 restructuring was insufficient to disguise the true tax-driven character of the transaction, that the reorganization elements of the Chapter 11 plan lacked economic substance, and that the Solyndra Plan in substance contemplated only a liquidation of the business and a preservation of the future tax benefits to benefit future, unrelated investments. The U.S. Trustee, in its role as a "watchdog in bankruptcy proceedings,"²⁹² should be more proactively examining Chapter 11 cases for abuses of this sort, drawing upon bankruptcy *and* tax statutory law, as well as doctrinal principles.

Of course, sound application of these judicial doctrines to complex questions at the confluence of bankruptcy and tax law requires greater coordination from the bench. As modern commercial bankruptcies feature increasingly nuanced tax issues, presiding judges must be well versed in the tax laws. Thus, while bankruptcy jurisdiction may continue to reside in the bankruptcy judge,²⁹³ judges should be required—or at least strongly encouraged—to refer cases and proceedings to the U.S. tax court for guidance on the tax implications of decisions rendered in the bankruptcy case. Indeed, Congress should reconsider providing U.S. bankruptcy courts jurisdiction to resolve tax matters that arise in bankruptcy cases.²⁹⁴ A full discussion of the proper jurisdictional balance for tax and bankruptcy matters is outside the scope of this Article, but on the surface it seems that the traditional efficiency arguments that favor more streamlined case management cannot justify failures of the sort identified here.

Finally, while also beyond the scope of this Article, there is a deeper question that deserves thoughtful scholarly attention: should bankruptcy law continue to defer to GAAP as the primary way for parties to disclose their economic condition? Skeptics exist in the legal and accounting scholarly communities.²⁹⁵ Although modern accounting principles allow for the systematic reporting of assets and liabilities, the rules were designed to serve a different purpose and do not necessarily give the truest picture of a person's overall economic condition. Indeed, just as tax law strays from GAAP in computing a corporation's earnings and profits for the purposes of

292. *In re S. Beach Sec., Inc.*, 606 F.3d 366, 370 (7th Cir. 2010) (discussing the duties assigned to the U.S. Trustee under 28 U.S.C. § 586(a)(3) (2006)); *see also* 28 U.S.C. § 586(a)(3)(B) (authorizing the U.S. Trustee to monitor Chapter 11 plans and disclosure statements); *Morgenstern v. Revco D.S., Inc.*, 898 F.2d 498, 500 (6th Cir. 1990) (referring to the U.S. Trustee as a "watchdog").

293. *See generally* 28 U.S.C. § 1334.

294. Questions of this sort are raised in Steve R. Johnson, *The Phoenix and the Perils of the Second Best: Why Heightened Appellate Deference to Tax Court Decisions Is Undesirable*, 77 OR. L. REV. 235, 239–42 (1998).

295. *See generally* Mark J. Cowan, *A GAAP Critic's Guide to Corporate Income Taxes*, 66 TAX LAW. 209 (2012).

identifying taxable distributions to shareholders,²⁹⁶ so should bankruptcy law stray from GAAP in computing a debtor's economic condition. For instance, bankruptcy law might depart from GAAP by providing a method for debtors to value tax attributes during the pendency of a Chapter 11 case.

More broadly, continued diligence and thoughtful attention to the overlap of tax law and commercial bankruptcy are needed to maintain a fair, efficient, and tax-neutral system for restructuring financially distressed firms. This will require, in part, additional thoughtful exchanges between tax and bankruptcy scholars and practitioners. I hope that this Article, and the responses it generates, contribute richly to this enhanced dialogue.

CONCLUSION

Between tax law and bankruptcy law lies fertile ground for companies in financial distress to design abusive, tax-motivated restructuring transactions. For example, Solyndra's pseudo-reorganization takes advantage of Chapter 11's historic role as a rehabilitative device to cloak a corporate liquidation with some semblance of reorganization and exploit valuable tax attributes as excess returns. When troublesome ambiguities of this sort are exploited, taxpayers are left subsidizing economically irrational restructurings, while providing built-in investment returns for future, unrelated investments. Because these tax benefits manage to escape bankruptcy's distributional norms, the benefits largely accrue to insiders, traditional bank lenders, hedge funds, distressed-debt investors, and other powerful stakeholders. Meanwhile, the distressed company's other constituents—employees, unsecured creditors, or common shareholders, as the case may be—bear a disproportionate share of the company's losses without any of the accompanying tax benefits. Not only is this outcome inequitable and inefficient, but it fails to satisfy basic elements of sound tax and bankruptcy policy. Working together to advance meaningful legal reforms, tax and bankruptcy experts can eradicate abuses of this sort and help to restore the functionality of the commercial restructuring process.

296. The method of calculating a corporation's earnings and profits is set forth in regulations promulgated under 26 I.R.C. § 312. *See, e.g.*, Treas. Reg. § 1.312-6 (2012).

