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Re-Examining First Day Trading Orders and Tax Status in Bankruptcy After Rodriguez

by

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How should a federal bankruptcy court decide which of a federally regulated thrift or an FDIC controlled bank gets a federal tax refund? The Supreme Court of the United States' answer in *Rodriguez*: Look to *state* law.[1] So unremarkable was this holding that it required approximately six pages of text and attracted no dissent or concurrence.

As the Supreme Court said, the decision was not really about tax refunds, but was instead an opportunity to instruct lower courts on making federal common law.[2] Indeed, the Tenth Circuit on remand reaffirmed its earlier decision almost entirely by citing to its earlier opinion.[3] But the Court's instructions and analysis cast serious doubt on the validity of a long-standing and critical aspect of many bankruptcy proceedings—the first day net operating loss trading order. It also requires re-evaluation of authorities related to preserving the non-taxpaying status of the debtor; a somewhat less common but related issue.

These authorities have generally analyzed the question of whether net operating losses or the tax status of a bankrupt entity is entitled to protection under the Bankruptcy Code by examining applicable provisions of the Internal Revenue Code ("I.R.C.") and relying on their own sense of fairness. The result is federal common law, in all but name, that largely protects net operating losses but not tax status. Examining these authorities reveals the precise concern *Rodriguez* identifies with the improper creation of federal common law—a body of law that is inconsistent and poorly grounded. Following *Rodriguez*, courts faced with these questions should more comprehen-

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[1]Rodriguez v. FDIC, 140 S. Ct. 713 (2020).

[2]*Id.* at 718 ("We took this case only to underscore the care federal courts should exercise before taking up an invitation to try their hand at common lawmaking.").

[3]Rodriguez v. FDIC (*In re* United W. Bancorp, Inc.), 959 F.3d 1269 (10th Cir. 2020).

sively analyze applicable state law in determining the treatment of net operating losses or the tax status in a bankruptcy proceeding. Moreover, relying on appropriate state law doctrines will allow private parties to rely on contract law to set forth their desired outcomes in bankruptcy. Ideally, this will all result in a firmer approach to these issues in bankruptcy.

That is what this Article is about.[4] First, it discusses the specific issue in *Rodriguez* and its history—the allocation of tax refunds in bankruptcy and the *Bob Richards* rule. Second, it discusses the legal history of first day trading orders to preserve net operating losses. Third, it re-examines these authorities in light of *Rodriguez*. Finally, it concludes by discussing the issues regarding the tax status of the debtor.

I. THE BOB RICHARDS "RULE" AND RODRIGUEZ

Congress permits closely affiliated, commonly controlled domestic corporations the privilege of filing consolidated federal income tax returns.[5] This is a meaningful administrative privilege as it generally permits numerous corporations to file, pay tax and engage with the IRS on a unitary basis, rather than separately and individually.[6] But it is also a substantive privilege, as the consolidated return rules generally work to disregard the separateness of each entity insofar as they interact with each other.[7] Thus, consolidated entities may engage in transactions with one another without the immediate tax consequences that would arise if they were required to report on a separate basis.[8] Consolidated entities may share tax attributes, whereby losses of one entity offset gains of another.[9] The net result is that in many ways, several separate legal entities appear to the tax system as a single entity if they consolidate.

The legal entities are still separate entities for other purposes, including

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[4]Other articles have addressed similar questions. The author is aware of two. Randolph J. Haines, *It's Time to Return to Our Roots: The Bankruptcy Common Law That Governs Insolvent Estates*, 95 AM. BANKR. L.J. 501, 521-35 (2021) (criticizing the *Rodriguez* holding severely, in part because it could be interpreted in the manner this Article discusses); Mitchell P. Reich, *A Swan Song for Federal Common Lawmaking in Bankruptcy Courts*, 39 AM. BANKR. INST. J. 20 (Sept. 2020) (brief article also indicating *Prudential Lines* is likely to fall).

[5]I.R.C. § 1501. Entities generally must be related by at least 80 percent ownership by vote and value. I.R.C. § 1504(a)(2). This Article requires references to two critically important statutes that practitioners in each space often simply refer to as the "Code." To avoid confusion, in this Article, references to the "I.R.C." are to the Internal Revenue Code of 1986, as amended (26 U.S.C. § 1 *et seq.*). References to the "Bankruptcy Code" are to the Bankruptcy Code (11 U.S.C. § 101 *et seq.*). References to specific sections of the Bankruptcy Code are noted as applicable sections "of the Bankruptcy Code."

[6]*See, e.g.*, Treas. Reg. § 1.1502-77. Many affiliated groups contain enormous numbers of corporations, and, as a consequence, the administrative convenience is considerable.

[7]*See, e.g.*, Treas. Reg. § 1.1502-13.

[8]*Id.*

[9]*See, e.g.*, Treas. Reg. §§ 1.1502-11, -12.

bankruptcy, and inevitably circumstances intrude upon the consolidation fiction. Suppose Subsidiary and Parent are consolidated, and suppose Parent is the "agent" for the group before the IRS—that is, the single entity authorized to interact with the IRS on behalf of all entities in the group.[10] Subsidiary generates substantial losses, which are carried back to offset income earned by Subsidiary in a prior year, thereby resulting in a refund. The refund is paid to Parent as agent for the group. Subsidiary files for bankruptcy but Parent does not.[11] Are Subsidiary, and indirectly, Subsidiary's creditors, entitled to the refund because it arose from Subsidiary's own losses?

A. Bob Richards and Its Progeny

This is the question the Ninth Circuit faced in *Bob Richards*.[12] The court began by acknowledging the parties could have allocated the refund however they wished as a matter of contract because there is no principle requiring a tax savings to inure to the benefit of the company sustaining the loss.[13] However, the parties did not have a contract, express or implied. So the court next moved to the equitable doctrine of unjust enrichment. The court concluded that Parent would be *unjustly enriched* were it to keep a refund that related entirely to the earnings history of Subsidiary.[14] The court observed the "basically procedural" aspect of payment to Parent and went to explicitly recognize that "the Internal Revenue Service is not concerned with the subsequent disposition of tax refunds."[15]

In other words, *Bob Richards* recognized there is no unique federal interest in the allocation of refunds, looked first to state contract law and found it unavailing, and then decided the matter on the basis of the state common law

[10]As the agent, Parent is the *only* entity authorized to transact with the IRS with respect to the taxes of *all* entities in the consolidated group. Treas. Reg. § 1.1502-77.

[11]Note that longstanding authority makes clear that tax consolidation is not terminated as a result of a corporation's bankruptcy or other circumstances that suggest the parent corporation no longer controls the subsidiary. *See* I.R.S. Priv. Ltr. Rul. 9246031 (Aug. 18, 1992); I.R.S. Priv. Ltr. Rul. 9014051 (Jan. 8, 1980); *see also* Rev. Rul. 78-119, 1978-1 C.B. 277 (temporary seizure of subsidiary stock by court does not result in deconsolidation). Tax consolidation typically terminates upon consummation of the plan of reorganization, assuming the creditors hold the stock of the post-emergence corporation.

[12]W. Dealer Mgmt., Inc. v. England (*In re* Bob Richards Chrysler-Plymouth Corp.), 473 F.2d 262 (9th Cir. 1973). The case was in fact driven by whether Parent was permitted to set off the refund against a separate unsecured claim it had against Subsidiary. By concluding that Parent was effectively an agent receiving the refund on Subsidiary's behalf, Parent could not retain the funds as a setoff against the separate unsecured claim.

[13]*Id.* at 264 (citing W. Pac. R.R. Corp. v. W. Pac. R.R. Co., 197 F.2d 994, 1004 (9th Cir. 1951), *rev'd on other grounds*, 345 U.S. 247).

[14]*Id.* at 265. The fact that the refund related entirely to the earnings history of Subsidiary (Bob Richards Chrysler-Plymouth, in this case) meant that Subsidiary itself would have independently recovered the same amount from the government in the absence of consolidation appeared to be a significant factor.

[15]*Id.*

doctrine of unjust enrichment. Thus, the court applied primarily equitable principles under state law to reach what is a sensible result.

Since *Bob Richards*, other courts have faced the same question. The Tenth Circuit followed *Bob Richards* on similar facts in *Barnes v. Harris.*[16] The Fifth Circuit did also.[17] The Eleventh Circuit addressed the issue in two cases.[18] Although both cases involved a tax sharing agreement that was ambiguous on its face, the court applied state law to determine that the clear intent of the parties was to establish an agency relationship between Parent and Subsidiary.[19] Although not expressly relying on *Bob Richards*, both decisions cited aspects of the *Bob Richards* decision favorably in footnotes.[20] Somewhere along the way, the *Bob Richards* decision began to be characterized as a federal common law "rule"—namely that Subsidiary is entitled to a refund unless the parties unambiguously allocate the refund to Parent.[21]

The Sixth Circuit faced an unusual circumstance in *FDIC v. AmFin Financial Corp.*[22] There, the trial court found the tax sharing agreement unambiguously provided that Parent was not an agent of Subsidiary with respect to the refund and instead could retain the proceeds of the refund for its own account.[23] The Sixth Circuit reversed, concluding that the tax sharing agreement was in fact ambiguous and that several terms the district court relied on for its conclusion did not in fact unambiguously create a debtor-creditor relationship.[24]

The Sixth Circuit then proceeded to discuss and dismiss the *Bob Richards* "rule." In particular, the court objected that the *Bob Richards* rule is an illegitimate creation of federal common law because there is no unique federal interest or policy that would conflict with the use of state law.[25] This odd attack on *Bob Richards* was noted in the concurring opinion of Judge Gilman,

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[16]783 F.3d 1185 (10th Cir. 2015). Here, too, Subsidiary generated the refund entirely out of its own operations, and here, too, there was no agreement regarding the allocation of the refund.

[17]Capital Bancshares, Inc. v. FDIC, 957 F.2d 203 (5th Cir. 1992).

[18]FDIC v. Zucker (*In re* Netbank, Inc.), 729 F.3d 1344 (11th Cir. 2013); Zucker v. FDIC (*In Re* BankUnited Fin. Corp.), 727 F.3d 1100 (11th Cir. 2013).

[19]*In re Netbank*, 729 F.3d at 1346; *In re BankUnited*, 727 F.3d at 1108-09.

[20]*In re Netbank*, 727 F.3d at 1347 n.3; *In re BankUnited*, 727 F.3d at 1102 n.2. *In re Netbank* specifically observed that the outcome would have been the same under the *Bob Richards* rule because it understood the contract interpretation standard under *Bob Richards* to be the same controlling factor as under Georgia contract law. *In re Netbank*, 727 F.3d at 1347 n.3.

[21]*See In re Netbank*, 727 F.3d at 1347 n.3.

[22]757 F.3d 530 (6th Cir. 2014).

[23]FDIC v. AmFin Fin. Corp., 490 B.R. 548, 553 (N.D. Ohio 2013). The Northern District of Ohio held the tax sharing agreement created a "debtor-creditor" relationship between Parent and Subsidiary with respect to the refund. Since Parent was also in bankruptcy, this meant Subsidiary was left to press its unsecured claim against Parent along with all others similarly positioned. In effect, it likely meant some other Parent creditor would receive the cash.

[24]*AmFin*, 757 F.3d at 535.

[25]*Id.* at 535-36.

who observed that the apparent dismissal of the *Bob Richards* rule was likely unnecessary and perhaps incorrect.[26] In particular, because it was not clear whether the contract was ambiguous or whether the intent of the parties could be determined, the court could have simply remanded the case for further consideration.[27] Indeed, the *Bob Richards* issue was probably not ripe in the absence of a final determination as to what the parties' tax sharing agreement actually intended.

The Tenth Circuit faced the issue again in *Rodriguez v. FDIC*, where the parties had entered into a tax allocation agreement.[28] The Tenth Circuit cited *Bob Richards* and *Barnes* as setting forth the federal common law basis on which it would rest its decision: did the agreement unambiguously allocate the refund to Parent?[29] After a detailed review, the Tenth Circuit concluded that the agreement indeed unambiguously provided that Subsidiary was entitled to the refund and Parent received the refund as a mere agent.[30] Happily, this was the same outcome as the default *Bob Richards* "rule." The trustee of Parent (it had also filed for bankruptcy in the meantime) appealed the decision to the United States Supreme Court.

B. RODRIGUEZ

This confusing array of cases, characterizations and pseudo-circuit splits set the stage for Supreme Court review. The Court took up *Rodriguez* for the explicit purpose of deciding the fate of *Bob Richards*.[31] In a unanimous opinion so brief it could almost be quoted in full, the Court held the *Bob Richards* rule to be an improper exercise in federal common lawmaking and instructed lower courts to decide such questions based on state law.

In particular, the Court emphasized that federal common lawmaking must be "necessary to protect uniquely federal interests."[32] And while the federal government may have an interest in how it treats taxes of a consolidated group and the manner in which it remits refunds to the group, it could not have any interest "in determining how a consolidated corporate tax refund, once paid to a designated agent, is *distributed* among group members."[33] The Court further refreshed its prior statements that Congress "generally left the

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[26]*Id.* at 540 (Gilman, J., concurring) ("I thus see no need for the lead opinion to opine on what it sees (wrongly in my view) as a purported conflict between state law and federal common law.")

[27]Indeed, the remaining portion of the opinion evaluates objections to the consideration of various Ohio state law doctrines that could be used to infer the intent of the parties to create an agency or trust relationship. *Id.* at 536-38.

[28]Rodriguez v. FDIC (*In re* United W. Bancorp, Inc.), 914 F.3d 1262, 1264 (10th Cir. 2019), *vacated*, 140 S. Ct. 713 (2020).

[29]*Id.* at 1269-70.

[30]*Id.* at 1274.

[31]Rodriguez v. FDIC, 140 S. Ct. 713, 717 (2020).

[32]*Id.* (quoting Texas Indus., Inc. v. Radcliff Materials, Inc., 451 U.S. 630, 640 (1981)).

[33]*Id.* at 718.

determination of property rights in the assets of a bankrupt's estate to state law"[34] and that the I.R.C. generally "creates no property rights."[35] Indeed, the Court regarded the putative federal nature of the tax refund as a red herring—just because it derives from a federal tax process, the refund itself is merely property in the form of a specified amount of money. Fundamentally, corporations are creatures of state law and state law is "well equipped to handle disputes involving corporate property rights."[36] Although admitting "special exceptions to these usual rules sometimes might be warranted," the Court provided no examples of such exceptions and clearly indicated the distribution of a federal tax refund among the members of a consolidated tax group was not one of them.[37]

It is conceivable that the Court chose the *Bob Richards* rule as a vehicle precisely because it would permit the Court to make a definitive statement on federal common law with minimal disruption. This is especially the case because parties have always been able to contract for the arrangement they wanted.[38] The *Rodriguez* court acknowledged as much, openly admitting that "some, maybe many, cases will come out the same way under state law or *Bob Richards*" and stating the Court took the case "only to underscore the care federal courts should exercise before taking up an invitation to try their hand at common lawmaking."[39]

C. Observations on the Rodriguez Decision

And so the Supreme Court interred the *Bob Richards* "rule." But what did the Court really accomplish?

In the first place, on remand the Tenth Circuit affirmed its earlier decision with virtually no new analysis. Instead, it repeated its earlier analysis that the tax sharing agreement was unambiguous.[40] This is not surprising because the earlier decision did not rely on the *Bob Richards* rule, notwithstanding its discussion of the case. Instead, it had ruled on the basis of its application of state contract law principles to the interpretation of the tax

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[34] *Id.* (quoting Butner v. United States, 440 U.S. 48, 54 (1979)).

[35] *Id.* (quoting United States v. Nat'l Bank of Com., 472 U.S. 713, 722 (1985)).

[36] *Id.*

[37] *Id.*

[38] Indeed, as a consequence of some of the cases discussed above, the FDIC released a policy statement specifically requiring banks to enter into tax sharing agreements that clearly provided that Parent was an agent of the subsidiary bank with respect to tax refunds (and indeed suggested specific language to that effect). *See* Federal Deposit Insurance Corporation, Addendum to Interagency Policy Statement on Income Tax Allocation in a Holding Company Structure, 79 Fed. Reg. 35229 (June 19, 2014). More recently, the FDIC issued a specific proposed rule regarding tax allocation agreements, likely in partial response to the *Rodriguez* decision. *See* Federal Deposit Insurance Corporation, Tax Allocation Agreements, 86 Fed. Reg. 24755 (May 10, 2021).

[39] *Rodriguez*, 140 S. Ct. at 718.

[40] Rodriguez v. FDIC (*In re* United W. Bancorp, Inc.), 959 F.3d 1269, 1273 (10th Cir. 2020).

sharing agreement.[41]

Indeed, the Court purported to reject *Bob Richards*, instructing courts to follow state law instead. But *Bob Richards* had already explicitly recognized there was no unique federal interest in the distribution of a federal tax refund and based its decision on unjust enrichment—a doctrine of state common law.[42] Notably, the Court favorably referenced unjust enrichment as one of the rules state law is "replete with" and "readymade" for the task of allocating a refund.[43] Thus, the Court effectively told lower courts to just do what *Bob Richards* did the first time around.

Second, it is not clear lower courts will be able to avoid what is effectively federal common law in this area. The reason is that state laws, no matter how comprehensive, are exceedingly unlikely to specifically contemplate the circumstance of a federal consolidated tax refund. This is not only because such laws are by and large generic by nature; it is also because federal tax consolidation is a unique creature of federal tax law that reflects the peculiar concerns of the federal income tax code. Although states and foreign jurisdictions often do permit unitary or consolidated filings, each set of rules is unique to the concerns of the tax law it is promulgated under.

The upshot is that courts will need to determine which of the generic concepts of unjust enrichment, trust, implied or express contract or other applicable state law ought to be relied upon in determining the allocation of a tax refund. Moreover, courts will then have to apply those principles in actually allocating the tax refund. This will not be a straightforward exercise since the law will not likely speak to the federal tax refund issue. Thus, the development of some sort of formalized pathway for analysis—whether called federal common law or not—seems inevitable.

And that analysis may not even get to a place all that different from *Bob Richards*. Recall that in *Bob Richards*, Subsidiary carried back its own losses against its own income. Although Parent was the agent for the group, it did not have an active business or any other subsidiaries. In the absence of a contractual arrangement, it is hard to see how any state law would permit Parent to retain the refund solely as a result of its role as agent before the IRS.

Of course, *Bob Richards* addressed the circumstance where no contract was in place. However, there are numerous court decisions addressing the

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[41]Rodriguez v. FDIC (*In re* United W. Bancorp, Inc.), 914 F.3d 1262, 1274 (10th Cir. 2019), *vacated*, 140 S. Ct. 713 (2020).

[42]W. Dealer Mgmt., Inc. v. England (*In re* Bob Richards Chrysler-Plymouth Corp.), 473 F.2d 262, 265 (9th Cir. 1973) ("Allowing the parent to keep any refunds from a subsidiary's losses . . . unjustly enriches the parent. . . . The Internal Revenue Service is not concerned with the subsequent disposition of tax refunds . . . .").

[43]*Rodriguez*, 140 S. Ct. at 716.

case where a contract was in place, and, in such cases, Parent has often been able to successfully retain a tax refund in reliance upon that contract.[44] Although predating *Rodriguez*, these decisions generally follow the Court's approach—they looked to state contract law to interpret the contract and concluded that Parent could keep the refund, subject to unsecured claims by Subsidiaries under the tax sharing agreement.

Several of the cases adopting that approach explicitly considered whether equitable doctrines such as unjust enrichment or constructive trust might override this result.[45] These arguments are intuitively appealing since Subsidiary might have been entitled to all or a portion of the refund had it filed a separate return. However, the cases did not find anything unfair about the retention of the refund by Parent. In many cases, the courts found Subsidiary had benefited from its relationship with Parent.[46] In addition, Parent may have had multiple business lines or other subsidiaries so that the effect of consolidation was much more complex than the *Bob Richards* facts.[47] Thus, the courts generally were not persuaded that state law equitable doctrines like unjust enrichment would supersede an unambiguous contract.

So, courts seem to have already been doing what the Supreme Court instructed when it rejected *Bob Richards.* The main change may be nothing more than that courts will simply stop referring to the *Bob Richards* rule.

D. Rodriguez in Broader Context

As a final observation, *Rodriguez* should be read together with other Supreme Court pronouncements on the application of equitable principles or doctrines in bankruptcy. Bankruptcy courts are undoubtedly courts of equity and must apply equity jurisprudence.[48] Although the full context of these

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[44]*See, e.g.*, Franklin Sav. Corp. v. Franklin Sav. Ass'n (*In re* Franklin Sav. Corp.), 159 B.R. 9 (Bankr. D. Kan. 1993), *aff'd*, 182 B.R. 859 (D. Kan. 1995); Superintendent of Ins. v. First Cent. Fin. Corp. (*In re* First Cen. Fin. Corp.), 269 B.R. 481 (E.D.N.Y. 2001), *aff'd*, 377 F.3d 209 (2d Cir. 2004); *see also* Team Fin., Inc. v. FDIC (*In re* Team Financial, Inc.), No. 09-10925, 2010 WL 1730681 (Bankr. D. Kan. 2010); FDIC v. Siegel (*In re* IndyMac Bankcorp Inc.), 554 F. App'x 668, 670 (9th Cir. 2014); Sharp v. FDIC (*In re* Vineyard Nat'l Bancorp), 508 B.R. 437 (Bankr. C.D. Cal. 2014); Giuliano v. FDIC (*In re* Downey Fin. Corp.), 499 B.R. 439 (Bankr. D. Del. 2013), *aff'd sub nom.* Cantor v. FDIC (*In re* Downey Fin. Corp.), 593 F. App'x 123 (3d Cir. 2015).

[45]*See, e.g.*, *In re Franklin Sav. Corp.*, 159 B.R. at 30; *In re First Cen. Fin. Corp.*, 269 B.R. at 500; *In re Downey Fin. Corp.*, 499 B.R. at 470.

[46]*In re Franklin Sav. Corp.*, 159 B.R. at 32 ("[Parent] forgave income tax receivables from [Subsidiary] . . . . This was an economic advantage to [Subsidiary].").

[47]*In re First Cen. Fin. Corp.*, 269 B.R. at 486 (Parent had two separate operating subsidiaries that filed on a consolidated basis).

[48]Young v. United States, 53 U.S. 43, 49-50 (2002) ("[Bankruptcy courts] appl[y] the principles and rules of equity jurisprudence." (quoting Pepper v. Litton, 308 U.S. 295, 304 (1939))); United States v. Noland, 517 U.S. 535, 539 (1996) ("[T]he bankruptcy court . . . is a court of equity . . . ." (quoting Andrew DeNatale & Prudence B. Abram, *The Doctrine of Equitable Subordination as Applied to Nonmanagement Creditors*, 40 Bus. L. 417, 428 (1985))).

principles is well outside the scope of this Article, the Court has engaged in several exercises in recent years to more precisely fashion the role of equity in bankruptcy.[49]

For example, in *United States v. Noland*, the Court rejected the subordination of tax penalties on post-petition taxes to claims of other creditors.[50] The lower court's rationale was reasonable: it was not fair to reduce the amount available to pre-petition creditors in order to pay penalties that were not pecuniary losses by the government and were not designed with bankruptcy in mind.[51] But the Supreme Court reversed the lower court because its approach would have the effect of overturning the statutory priority scheme with respect to a category of taxes (namely, penalties), thereby "swe[eping] away" the "distinction between characteristic legislative and trial court functions."[52]

Similarly, the Court rejected the effort of a lower court to impose an equitable surcharge on a debtor that intentionally defrauded the court and its creditors as inconsistent with the "meticulous—not to say mind-numbingly detailed—enumeration of exemptions and exceptions to those exemptions" of the statutory scheme.[53] Much earlier, and soon after the passage of the 1984 Bankruptcy Code, the Court unanimously rejected an effort to contravene the absolute priority rule to permit a debtor to retain its family farm because "whatever equitable powers remain in the bankruptcy courts must and can only be exercised within the confines of the Bankruptcy Code."[54]

The trend in these cases is to call upon bankruptcy courts to ground their equitable findings more clearly in a manner consistent with the statutory scheme or, as in *Rodriguez*, with more developed bodies of law (i.e., state law). The effect is to curtail broad exercises of equity jurisprudence in bankruptcy

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[49]The American Bankruptcy Law Journal devoted its Spring 2020 issue to a comprehensive examination of this topic. *See* 94 AM. BANKR. L.J. 189-355 (2020).

[50]*Noland*, 517 U.S. 535 (1996).

[51]United States v. Noland (*In re* First Truck Lines, Inc.), 48 F.3d 210, 218 (6th Cir. 1995), *rev'd*, 517 U.S. 535 (1996). Because the taxes (and related penalties) were post-petition, they had administrative priority over pre-petition claims.

[52]*Noland*, 517 U.S. at 540.

[53]Law v. Siegel, 571 U.S. 415, 424 (2014).

[54]Nw. Bank Worthington v. Ahlers, 485 U.S. 197, 206 (1988). In a similar vein, the Court has also carefully adjudicated any potential conflict between the structure of the bankruptcy court, bankruptcy proceedings and the powers conferred upon Congress and the courts pursuant to the Constitution. *See* Granfinanceria v. Nordberg, 492 U.S. 33 (1989) (Seventh Amendment guarantees jury trial for person sued by bankruptcy trustee to avoid fraudulent conveyance); Stern v. Marshall, 564 U.S. 462 (2011) (inconsistent with Article III to permit bankruptcy court judges to decide certain matters). The *Stern* decision has provoked significant criticism as overly formalistic. *See, e.g.*, Randolph J. Haines, *The Conservative Assault on Federal Equity*, 88 AM. BANKR. L.J. 451 (2014); Erwin Chemerinsky, *Formalism Without Foundation:* Stern v. Marshall, 2011 SUP. CT. REV. 183.

cases. Thus, *Rodriguez* may be viewed as an extension of this line of cases—now instructing courts to limit purported federal common law making also.

II. THE FIRST DAY NET OPERATING LOSS TRADING ORDER

Although acknowledged nowhere by the Court, the *Rodriguez* teaching demands a thorough re-examination of a much more critical area of bankruptcy practice: the preservation of a corporation's net operating losses in bankruptcy. Indeed, so fundamental is this issue that planning around net operating losses is a predominant tax-planning theme of most corporate bankruptcies. Yet, as discussed below, the bedrock cases in this area have always been shaky at best, and *Rodriguez* likely renders them obsolete. Understanding this consequence requires some background on the underlying tax issue and the key cases on first day trading orders.

A. Net Operating Losses and I.R.C. § 382

Any taxpayer that generates deductions in excess of income in a year will generate a "net operating loss" (often abbreviated to "NOL"), which can be carried forward to offset future taxes.[55] A bankrupt corporation often has substantial net operating losses, generally incurred as a result of the very same distress that led to the bankruptcy. Because of the potential to shield future taxes when the business becomes profitable again, these losses may be among the most valuable assets of an entity that is able to reorganize on a going concern basis. But there is a problem: I.R.C. § 382. It is intended to prevent "trafficking" in the net operating losses of a corporation.[56] The merits of the concept are debatable.[57]

Under I.R.C. § 382, a corporation's ability to use losses to offset future income is severely limited if so-called "five-percent shareholders"—shareholders that own 5% or more by value of the corporation's stock—have increased their ownership in a corporation by more than fifty percentage points over the lowest percentage held by those shareholders in the preceding three-year period.[58] If an ownership change occurs, the corporation's net operating

[55] I.R.C. § 172.

[56] *See, e.g.*, H.R. Rep. No. 99-426, at 258-59 (1985); S. Rep. No. 99-313, at 233 (1986); Staff of J. Comm. on Taxation, 99th Cong., General Explanation of the Tax Reform Act of 1986 296-97 (Comm. Print 1987).

[57] *See, e.g.*, Sam Dimon, *Limit My Practice Instead! Thoughts on Reforming Section 382*, 88 Tax Mag. 65 (Mar. 2010); Gordon D. Henderson, *Controlling Hyperlexis—The Most Important "Law And . . . "*, 43 Tax Law. 177 (1989).

[58] I.R.C. § 382(e), (g). Small public shareholders are generally aggregated and treated as one large "public" five-percent shareholder, with various segregation and aggregation rules for transactions involving stock issuances and other significant corporate transactions. *See* Treas. Reg. § 1.382-2T(j). The net effect is that even public issuances entirely to small shareholders have the potential to cause an ownership change.

losses available to offset income in any future year are limited to an amount equal to a small statutory interest rate multiplied by the fair market value of the corporation's equity at the time.[59]

An ownership change under I.R.C. § 382 can occur even if the corporation itself was not involved in any of the underlying transfers of its shares. It can also apply even if the various acquisitions by five-percent shareholders that resulted in a change of control were uncoordinated, were not otherwise part of the same plan or occurred on entirely different dates. Thus, unrelated transactions among a corporation's shareholders that are wholly outside the corporation's control (or without its knowledge) could, accidentally, eliminate a very valuable asset of the corporation. Bankrupt corporations are particularly vulnerable to I.R.C. § 382 because they are likely to have substantial net operating losses and also likely to experience significant turnover in their shareholders due to their deteriorating financial condition. Moreover, because the statutory formula is based on equity value, a change of control may result in a limitation amount of zero—i.e., wiping out the entire net operating loss.[60]

It has become standard practice to include among first day orders a restriction on trading in a bankrupt corporation's stock in order to avoid the application of I.R.C. § 382 prior to consummation of the plan of reorganization and therefore preserve potentially valuable NOLs.[61] These first day orders generally restrict further trading that would be expected to cause shareholders of the bankrupt corporation, and sometimes creditors, to increase their holdings beyond a specified threshold without approval of the court.[62] The threshold is typically 5% of the corporation's stock, or in the

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[59]I.R.C. § 382(b). The rationale is that a potential purchaser of the company would be indifferent between purchasing the company and investing at the risk-free rate, thereby ensuring that any purchase must provide value above the corporation's net operating losses. STAFF OF J. COMM. ON TAXATION, 99th CONG., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986 317 (Comm. Print 1987). Accordingly, the statutory rate is intended to reflect the interest rate on long-term municipal bonds. I.R.C. § 382(f). This rate is determined monthly and has hovered around 2-3% recently. *See, e.g.*, Rev. Rul. 2022-12, 2022-27 I.R.B. 1.

[60]This limitation may be increased by built-in gain in the bankrupt corporation's assets, if any, but the continuing availability of this uplift is subject to uncertainty. *See* I.R.C. § 382(h); I.R.S. Notice 2003-65, 2003-2 C.B. 747 (permitting the use of a method that increases the I.R.C. § 382 limitation by the amount of built-in gain in a corporation's assets, even if those assets are not disposed of); Prop. Treas. Reg. § 1.382-7, 84 Fed. Reg. 47455 (Sept. 10, 2019) (proposed regulations that would eliminate the method available in Notice 2003-65).

[61]As the name implies, first day orders are orders entered by the bankruptcy court on (or closely after) the filing of the bankruptcy petition and are generally critical issues related to preserving the business of the debtor. *See infra* note 94 and accompanying text.

[62]In general, only changes in *stock* ownership can trigger an I.R.C. § 382 limitation. However, as discussed *infra* at note 113, first day trading orders sometimes encompass creditors in order to retain flexibility for the bankrupt corporation to pursue a special exemption from I.R.C. § 382 for bankruptcy plans that result in the equitization of creditors.

case of pre-existing five-percent shareholders, their current ownership. This reflects the statute's focus on increases in ownership by five-percent shareholders. The typical first day trading order is much more complex because it must also incorporate the remarkably complex constructive ownership and attribution rules under I.R.C. § 382. The net, often intended, result, is an in terrorem order that effectively shuts down significant trading in the bankrupt corporation's stock.

First day trading orders are not explicitly authorized by any statutory provision of the I.R.C. or Bankruptcy Code. Instead, they are the product of a rather murky series of cases discussed next.

B. SEGAL

The story begins with *Segal v. Rochelle*.[63] An individual debtor had generated a net operating loss in the year leading up to his bankruptcy filing and would have been eligible to carry the net operating loss back to a prior year and obtain a refund of taxes already paid.[64] The question was whether the potential refund was "property" of the estate against which creditors could seek recourse.[65]

There were two difficulties, however. First, the claim for refund could not be filed until the individual's taxable year ended, which was after the bankruptcy petition had been filed and therefore the date at which the individual's interests in property were measured.[66] Second, the individual could generate additional income prior to the end of the taxable year that might reduce or eliminate the loss entirely. As a result, the refund was in some sense a potentiality that had not yet materialized at the time the individual filed for bankruptcy.

Although finding the question a "close" one, the Court concluded that

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[63]382 U.S. 375 (1966).

[64]*Id.* at 376. The debtor was a partner in a partnership that had also filed for bankruptcy and the losses appear to be related to the debtor's interest in the partnership. A second issue in the case not discussed in this Article was whether the claim was "transferable" as required by the Bankruptcy Code at the time and in the face of a statute prohibiting assignments of claims against the government. The Court concluded that the claim was transferable because the Texas (the jurisdiction of all relevant parties) court could compel the assignment of any refund received, which was sufficient to satisfy the requirements of the Bankruptcy Code. *Id.* at 381-85. Thus, on this issue, the Court relied on state law equity to (arguably) override federal statutory law.

[65]The filing for bankruptcy creates an "estate" comprised of all "legal or equitable interests of the debtor in property as of the commencement of the case," including all profits, proceeds and similar items from such property and all interests in property acquired after commencement of the case. *See* § 541 of the Bankruptcy Code (certain other items not listed are also included in the bankruptcy estate).

[66]At the time of *Segal*, property acquired post-petition was outside the estate and therefore could inure to the benefit of the debtors free and clear of pre-petition claims. The First and Third Circuits had ruled that the refund claim was not part of the estate and therefore could pass to the debtor. *See* Fournier v. Rosenblum, 318 F.2d 525 (1st Cir. 1963); *In re* Sussman, 289 F.2d 76 (3d Cir. 1961). As discussed further below, the modern Bankruptcy Code largely eliminates this distinction.

any refund attributable to the net operating loss carryback was property of the estate.[67] As to this point, the Court did not view the fact that the refund could not be claimed or received until after the petition date as presenting any issue because the term property had been interpreted "most generously" and an "interest is not outside its reach because it is novel or contingent or because its enjoyment must be postponed."[68] Instead, the principal concern for the Court was that the transfer of the refund to the estate would interfere with the "fresh start" policy of the Bankruptcy Code at that time. In other words, the Court was concerned the funds would be used to satisfy creditor claims and could not be used by the debtor post-confirmation. However, the Court found it "sufficiently rooted in the prebankruptcy past" so that it would not encumber the debtor's fresh start.[69]

As to the possibility that even the amount of the refund was not fixed and was in part dependent on post-petition earnings of the debtor, the Court concluded that "contingency in the abstract is no bar" and, returning to the fresh start theme, went on to say "the bankrupt without a refund claim to preserve has more reason to earn income rather than less."[70] The Court recognized there was an issue for net operating loss carry*forwards* but pointedly refused to rule on the matter and distinguished the current case because the loss carryback related to pre-petition income and loss.[71]

Thus, the refund claim arising out of the net operating loss carryback was property of the estate and would inure to the benefit of creditors. Noticeably absent from *Segal* is any discussion of state law.[72] As the Supreme Court would specifically instruct fifteen years later: "Property interests are created and defined by state law. Unless some federal interest requires a different result, there is no reason why such interests should be analyzed differently simply because an interested party is involved in a bankruptcy proceeding."[73] *Segal*, however, makes no mention at all of what state property interests existed in the right to receive a refund or how state law would have adjudicated the claim. Indeed, the *Segal* holding seems to be grounded entirely in a federal bankruptcy definition of "property."[74]

Congress explicitly endorsed *Segal* in enacting the modern version of the

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[67]*Segal*, 382 U.S. at 379.

[68]*Id.*

[69]*Id.* at 380.

[70]*Id.*

[71]*Id.* at 381.

[72]As discussed in note 64, *supra*, state law is mentioned in footnotes related to the transferability issue.

[73]Butner v. United States, 440 U.S. 48, 55 (1979).

[74]*Segal*, 382 U.S. at 379 ("Whether an item is classified as 'property' by the Fifth Amendment's Just-Compensation Clause or for purposes of a state taxing statute cannot decide hard cases under the Bankruptcy Act, whose own purposes must ultimately govern.").

Bankruptcy Code.[75] But Congress also limited one of the main issues in *Segal* by enacting § 541(a)(7) of the Bankruptcy Code, which provides that interests in property acquired by the estate after filing the petition are also property of the estate.[76] Moreover, the same legislative history substantially curtailed the notion of a "fresh start."[77] Finally, in the Bankruptcy Tax Act of 1980, Congress enacted I.R.C. § 1398, providing that an individual's bankruptcy estate would be a separate taxpayer and providing for an election to close the individual's taxable year as of the commencement of the case.[78]

The result of all of this is that *Segal* is an unusual case. Its analytical method is not consistent with the Court's later precedents, but it has not been overruled. Similarly, Congress explicitly approved of its result while at the same time eliminating the issue of the case and undercutting the policy rationale motivating its outcome.

C. Protecting Net Operating Losses-Prudential Lines and In Re Phar-Mor

Segal might just stand as a historical curiosity related to net operating loss carrybacks but for the fact that it is a basis for the holding in *Prudential Lines*.[79] *Prudential Lines* is the leading authority holding that net operating loss carry*forwards* of a debtor in bankruptcy are "property" of the debtor's estate.[80]

In *Prudential Lines*, Subsidiary was in bankruptcy, but Parent was not. Parent and Subsidiary filed on a consolidated basis and reported a consolidated $75 million net operating loss, of which $74 million was attributable to Subsidiary's prebankruptcy operations.[81] Parent wanted to claim a worthless

[75]H.R. Rep. No. 95-595, at 367-68 (1977); S. Rep. No. 95-989, at 82-83 (1978) ("The result of *Segal v. Rochelle*, 382 U.S. 375 (1966), is followed, and the right to a refund is property of the estate.").

[76]The Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, § 541, 92 Stat. 2594.

[77]H. Rep. No. 95-595, at 367-68 (1977); S. Rep. No. 95-989, at 82-83 (1978) ("Paragraph (1) has the effect of overruling *Lockwood v. Exchange Bank*, 190 U.S. 294 (1903), because it includes as a property of the estate all property of the debtor, even that needed for a fresh start.").

[78]Bankruptcy Tax Act of 1980, Pub. L. No. 96-589, § 1398(d), 94 Stat. 3397. This would effectively permit the estate to fix the amount of the refund and make a claim immediately. Note that so-called "wage-earner" bankruptcies—*i.e.*, individual bankruptcies under Chapters 12 and 13—do not result in the creation of a separate taxpayer, but as these relate to wage earners, they are unlikely to present issues related to NOLs. (Individuals who have NOLs typically do so because they earn income through self-employment or as partners in operating businesses organized as flow-through entities.)

[79]Off. Comm. of Unsecured Creditors v. PSS S.S. Co. (*In re* Prudential Lines, Inc.), 107 B.R. 832, 833 (Bankr. S.D.N.Y. 1989), *aff'd*, 119 B.R. 430 (S.D.N.Y. 1990), *aff'd*, 928 F.2d 565 (2d Cir. 1991).

[80]As the name implies, carryforwards are net operating losses that may offset *future* taxable income. In contrast, carrybacks are net operating losses that may reduce taxable income already earned and produce a refund of taxes already paid. Although the same set of circumstances gives rise to a net operating loss in a particular taxable year (deductions exceeding gross income), whether that net operating loss may be carried back to forward depends on the statutory rules in effect. *See* I.R.C. § 172.

[81]*In re Prudential Lines, Inc.*, 107 B.R. at 833.

stock deduction with respect to its Subsidiary stock. This would have permitted an immediate deduction to Parent of $39 million. But it also would have completely wiped out Subsidiary's share of the net operating loss.[82] Could Parent claim the deduction?

The answer was "no." Because the net operating loss carryforward was property of Subsidiary's estate, Parent was enjoined from claiming the worthless stock deduction and thereby destroying such property.[83] The case produced three opinions, one each at the bankruptcy court, district court and Second Circuit.[84] Although slightly different, the rationale of all three opinions is similar. For convenience, this section addresses all three together.

The main argument relies on *Segal* and Congress's explicit approval of *Segal* for the proposition that net operating loss carrybacks are property of the estate.[85] The opinions recognize that the Court had not ruled on carryforwards. However, the *Prudential Lines* opinions found no reason why the rationale in *Segal* should not also apply to carryforwards. In particular, the opinions indicated that the twin concerns the Court expressed about carryforwards, such as interference with a "fresh start" as well as the possibility of leaving the estate open for an extended period of time, do not apply to corporate debtors in bankruptcy.[86] The upshot is that if net operating loss carry*backs* were property, so too should be net operating loss carry*forwards*, at least for corporations.

The opinions all observe that the result furthers the purpose of the Bankruptcy Code to bring anything of value into the estate and facilitates a reorganization of the company.[87] Finally, although apparently not critical to their

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[82] *Id.* The technical reasons for this are discussed *infra* at note 106. The bankruptcy plan apparently indicated Subsidiary intended to use these net operating losses to reduce its cash tax liabilities on future operations, thereby freeing up additional resources for payments to creditors. *Id.* at 834.

[83] *Id.* at 842 (citing to § 362(a) of the Bankruptcy Code (automatic stay)). The Second Circuit also referenced the bankruptcy court's general equitable power under § 105(a) of the Bankruptcy Code. *In re Prudential Lines, Inc.*, 928 F.2d at 574. The district court opinion suggests the purpose of the reference to § 105(a) was to overcome creditor's arguments that the injunction extended beyond the completion of the plan. *In re Prudential Lines, Inc.*, 119 B.R. at 432.

[84] Off. Comm. of Unsecured Creditors v. PSS S.S. Co. (*In re* Prudential Lines, Inc.), 107 B.R. 832, 833 (Bankr. S.D.N.Y. 1989), *aff'd*, 119 B.R. 430 (S.D.N.Y. 1990), *aff'd*, 928 F.2d 565 (2d Cir. 1991).

[85] *In re Prudential Lines, Inc.*, 928 F.2d at 571 ("The [*Segal*] Court held that a NOL carryback was property of an individual debtor's estate."); *In re Prudential Lines, Inc.*, 107 B.R. at 837 ("[*Segal*] involved the closely analogous issue of whether a NOL carryback is property of a bankruptcy estate."). For discussion of the legislative history related to *Segal*, see *supra* notes 75-78 and accompanying text.

[86] *In re Prudential Lines, Inc.*, 928 F.2d at 573 ("Thus, the concern that the *Segal* Court expressed does not apply to a situation involving a corporate debtor. When the fresh start policy is not implicated, the argument for including NOL carryforwards as property of the bankruptcy estate is strengthened."); *In re Prudential Lines, Inc.*, 107 B.R. at 838 ("The conceptual and the practical distinctions noted by the [*Segal*] Court simply disappear in the case of a reorganized company.").

[87] *In re Prudential Lines, Inc.*, 928 F.2d at 573 ("Including NOL carryforwards as property of a corporate debtor's estate is consistent with Congress' intention to 'bring anything of value that the debtors have into the estate.'" (quoting H.R. REP. No. 95-595, at 176 (1977))); *In re Prudential Lines, Inc.*, 119 B.R. at

holdings, two opinions favorably cited the *Bob Richards* decision to the effect that equitable considerations can override the mechanical rules of the I.R.C. and regulations.[88]

Prudential Lines was about a parent corporation attempting to effectively take a wholly owned subsidiary's net operating loss for itself. It did not address the issue of dispersed shareholders whose disposition of the stock might also destroy the value of a debtor corporation's net operating loss. As discussed above, the application of I.R.C. § 382 tests relatively small shareholders—five-percent holders—and does not require coordinated action for destruction to occur. Should transactions involving these shareholders also be enjoined if they could impair a debtor's net operating losses?

The bankruptcy court in *In re Phar-Mor*, decided shortly after *Prudential Lines*, answered yes.[89] There, the debtor corporation had already undergone significant changes in its ownership but falling short of the 50% threshold in I.R.C. § 382.[90] The court enjoined two large shareholders from disposing of shares because they owned a sufficient amount such that their disposal would trigger an ownership change. The court relied on *Prudential Lines* for the position that the net operating loss carryforward was property of the estate and therefore an asset "entitled to protection while Debtors move forward toward reorganization."[91] The court concluded that the shareholders could still sell their shares with bankruptcy court approval, which would require "a balancing of the interests of all creditors and equity security holders in preserving the NOL against the interest of the individual applicant in realizing a significant benefit from the sale or transfer."[92]

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432 ("The right to use a NOL carryover to obtain favorable tax treatment is of value to an ongoing business and is certainly something of value to the debtor as part of a reorganization plan. When creditors go unpaid due to the very losses giving rise to the NOL, they ought to be able to realize the value of a NOL carryover as property of the bankruptcy estate upon reorganization."); *In re Prudential Lines, Inc.*, 107 B.R. at 838 ("Strong policy reasons, moreover, support the conclusion that debtor's potential ability to utilize NOLs is property of an estate.").

[88]*In re Prudential Lines, Inc.*, 928 F.2d at 571 (favorably citing to *Bob Richards* twice in arguing "[t]he fact that a subsidiary's NOL ultimately may be used to offset another corporation's income does not mean that the subsidiary loses any interest in its NOL"); *In re Prudential Lines, Inc.*, 107 B.R. at 839-40 (analogizing to the *Bob Richards* rule in arguing "[i]t is hardly contrary to bankruptcy purposes to avoid transactions so motivated or to require a solvent affiliate having positive income to return to an insolvent debtor its share of tax savings achieved through the filing of a consolidated return utilizing losses generated by the debtor during the one year pre-bankruptcy period permitted by § 548 of the [Bankruptcy] Code if the debtor failed to receive reasonably equivalent value.").

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

[90]*Id.* at 925.

[91]*Id.* at 927.

[92]*Id.* The author is not aware of a court order approving a sale of stock that would impose a limitation. A more likely occurrence is that the first day order would be revoked once it was determined that the NOL was not expected to be valuable to the corporation as a result of the expected results of the plan. Although outside the scope of this Article, many debt restructurings occurring pursuant to bankruptcy plans result in substantial cancellation of indebtedness of income that is excluded from gross income under

The opinion was quite brief. Although recognizing the issue was "somewhat more ethereal than in *Prudential Lines*,"[93] the opinion does not bother to evaluate the significance of any differences from *Prudential Lines*. For example, the shareholder in *Prudential Lines* was a former controlling shareholder who was actively seeking to effectively extract the net operating loss from the debtor, while in *Phar-Mor* the shareholders appeared to be non-controlling shareholders who did not have a present interest in selling. In effect, to preserve the debtor's net operating loss, the bankruptcy court pre-emptively determined shareholders could only sell shares with the bankruptcy court's permission.

The result of this line of cases is that orders restricting equity trading to preserve net operating losses have become virtually routine.[94] The author is not aware of any further published opinions with any significant discussion of the legal merits of these orders nor any successful attempt to categorically challenge them.[95] Perhaps that is because it is rather unlikely that a large shareholder of a corporation in bankruptcy could expect to have both an equity interest retaining any significant value and a counterparty interested in acquiring such equity interests, or, alternatively, because shareholders in most corporate bankruptcies are wiped out anyway and creditors have no interest in challenging orders that only affect shareholders.

III. AFTER *RODRIGUEZ*

Rodriguez makes clear this line of cases must be re-evaluated.[96] *Prudential Lines* appears to establish that the tax attribute of net operating losses is a property right under the federal bankruptcy laws. It does so with no reference to applicable state law or care for the elaborate statutory scheme surrounding I.R.C. § 382.[97]

I.R.C. § 108. However, the cost to this exclusion is that the NOLs must be reduced by the amount of the excluded income. Where the amount of debt canceled exceeds the amount of the NOLs, the plan itself will eliminate the NOLs entirely and accordingly there is no further reason to attempt to avoid a limitation (or destruction) on their use as a result of I.R.C. § 382.

[93]*Id.*

[94]For additional discussion and examples, see GORDON D. HENDERSON & STUART J. GOLDRING, TAX PLANNING FOR TROUBLED CORPORATIONS § 1002.4.1.1.

[95]There is *dicta* in a Seventh Circuit opinion suggesting *Prudential Lines* dealt with a distinct problem and should not be read as a universal prescription. *In re* UAL Corp., 412 F.3d 775, 778-79 (7th Cir. 2005) ("Although a sale of stock could affect United's interest in its loss carry-forwards, this would not occur because of anything the ESOP possessed or controlled. *Prudential Lines*, the principal authority invoked in support of the bankruptcy court's decision, dealt with a distinct problem . . . . *Prudential Lines* holds that taking the deduction would have exercised control over the debtor's operating losses; there is no equivalent example of control (or consumption) of a loss carry-forward in an investor's simple sale of stock.").

[96]To the author's knowledge, no court has published an opinion re-examining net operating loss orders following *Rodriguez*.

[97]Other commentators have questioned *Prudential Lines* also. The decision was criticized shortly after

Indeed, *Prudential Lines* (and *Segal* too) suffer from a number of the same deficiencies *Rodriguez* identifies in *Bob Richards* and its progeny. For example, the *Rodriguez* decision specifically observes that the "Internal Revenue Code . . . creates no property rights" and that "Congress has generally left the determination of property rights . . . to state law."[98] But that is precisely what *Prudential Lines* did. It found a property right under the I.R.C. *Prudential Lines* makes no analysis whatsoever of applicable state law, whether corporate or in equity, in setting forth its analysis.

No doubt this is because *Prudential Lines* viewed *Segal* as a precedent and considered only whether carryforwards ought to be subject to a different rule. However, it was probably incorrect in any case for *Prudential Lines* to begin its analysis with *Segal*. Neither *Segal* nor Congress's approval of it is about net operating loss carrybacks per se. Rather, it is about refunds relating to pre-closing periods that happened to arise because of a carryback. Presumably the same issue would present itself if the taxpayer had overpaid estimated taxes but could not claim a refund until filing its tax return post-petition. Indeed, the *Segal* court repeatedly characterizes the issue as a "loss-carryback refund claim," and the legislative history cited refers only to a "right to a refund" and does not mention net operating loss carrybacks at all.[99]

At the time of *Prudential Lines*, there was a serious question about whether *Segal* had effectively been overruled by the Court's subsequent cases.[100] In any event, whether or not *Segal* was good law then, it is clear after *Rodriguez* that the *Prudential Lines/Segal* analytical method is flawed. A proper analysis must begin with state corporate and property law, as well as related equitable doctrines under state law.

Similarly, although *Prudential Lines* appears to be interpreting the statu-

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its publication. *See, e.g.*, Joni Larson, *The Bankruptcy Court Overlooks Tax Law in* In Re Prudential Lines, Inc.: *An NOL Should Not Be Property of a Bankruptcy Estate*, 29 WILLAMETTE L. REV. 23 (Winter 1993); NAT'L BANKR. CONF., REFORMING THE BANKRUPTCY CODE: THE NATIONAL BANKRUPTCY CONFERENCE'S CODE REVIEW PROJECT, FINAL REPORT C.1 (1994) (arguing that the result of *Prudential Lines* under § 362 of the Bankruptcy Code "stretches the meaning of those words beyond any contemplation that Congress could have had for them"). The decision continues to attract criticism. *See* Vadim Mahmoudov, *Intragroup Wars: Abusive Parents, Rebellious Subsidiaries*, 150 TAX NOTES 1555, 1560 (2016) ("Stepping back, it is far from clear that the *Prudential Lines* result is right. Why should a court be able to turn off a tax deduction that is allowed to parent by the tax code?"); 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 Carryforward: Examining the Emerging Trend*, 77 AM. BANKR. L.J. 285 (2003) (criticizing *Prudential Lines*, particularly in the context of injunctions on trading in public corporation securities).

[98]Rodriguez v. FDIC, 140 S. Ct. 713, 718 (2020) (internal citations and quotations omitted).

[99]*See supra* note 75 and accompanying text.

[100]For example, both *Butner* (holding state law determined property rights) and *National Bank of Commerce* (holding the Internal Revenue Code generally creates no property rights) had been decided after *Segal* but before *Prudential Lines*.

tory definition of property, as a practical matter it is really a federal common law decision about the scope of bankruptcy protection. The *Rodriguez* court cautions that such federal common law making is only appropriate where the federal government has a "unique interest" in the issue.[101] Not only does the federal government have no unique interest in this issue, from a strict revenue perspective the federal government may actually *prefer* Parent claim the worthless deduction, since it would wipe out a $74 million net operating loss at a cost of a $39 million immediate deduction.[102] Similarly, in the case of traditional net operating loss first day orders, an I.R.C. § 382 limit of zero as a result of equity trading would also benefit the federal government since the net operating loss would be effectively eliminated. In any event, it is unclear why there is any federal government interest in preserving a debtor's net operating loss.[103]

Prudential Lines also appears to conflict with another case similar to the theme in *Rodriguez*—the *Noland* case discussed above.[104] In particular, *Noland* disallowed categorical rewriting of carefully set statutory priority for equitable reasons. The *Prudential Lines* case effectively establishes a priority for Subsidiary's net operating loss over Parent's worthless stock deduction, even though the relevant I.R.C. provisions do not provide for any such priority and could be interpreted to provide the opposite.[105]

There is simply no basis for this result in the I.R.C. The relevant I.R.C. provision in *Prudential Lines* was I.R.C. § 382(g)(4)(D), which effectively provides that if Parent takes a worthless stock deduction on Subsidiary's stock, Subsidiary will no longer be able to use net operating losses to offset future income.[106] The purpose of this section is to prevent two deductions for the same loss, as losses of Subsidiary would likely be reflected in a loss on Subsidiary stock as well.[107]

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[101]*Rodriguez*, 140 S. Ct. at 717.

[102]This assumes Subsidiary would have been able to promptly use the $74 million NOL.

[103]There is an interesting statutory conflict underlying all of this. As acts of Congress, the Bankruptcy Code and the Internal Revenue Code are co-equal. However, from a taxing perspective, it would be superior for the NOLs to be destroyed, since that would increase future tax collections. In contrast, from a bankruptcy perspective, the trustee must attempt to preserve as much as it can for the benefit of creditors of the bankrupt.

[104]*See supra* note 51 and accompanying text.

[105]Where Subsidiary could not use its net operating loss, however, Parent was permitted to claim a worthless stock deduction. *See* Nisselson v. Drew Indus., Inc. (*In re* White Metal Rolling & Stamping Corp.), 222 B.R. 417, 426-27 (Bankr. S.D.N.Y. 1998).

[106]Technically, I.R.C. § 382(g)(4)(D) provides that Parent is treated as reacquiring stock at the end of the taxable year and having never owned it in the preceding three years. The effect of this is to create an ownership change for Subsidiary. The zero limitation follows since Subsidiary's equity value must be zero for Parent to be able to claim worthlessness in the first place.

[107]*See* H.R. REP. No. 100-391, at 1096 (1987) ("Present law may allow the same economic loss to be deducted twice, since the net operating loss carryforwards of a corporation are also reflected in the loss

There is nothing in I.R.C. § 165 or 382 indicating in any way that the deduction should not be available if a subsidiary is in bankruptcy. This silence is particularly noteworthy because I.R.C. § 382—an unusually complex and technical section even for the I.R.C.—*already* contains specific relief provisions addressing corporations in bankruptcy.[108] Moreover, worthlessness implies deep distress, and it is hard to imagine the drafters of these rules would be unaware that such a transaction might occur where a subsidiary was in bankruptcy.[109] None of these cases even discuss why Congress's carefully crafted scheme should not be followed.[110] Indeed, as an act of Congress, I.R.C. § 382 arguably sets forth the federal government's precise interest in the issue.

Returning again to *Segal*, there was no question as to which taxpayer could claim the loss—the only question was whether the fact that the filing and subsequent receipt of a tax refund after filing for bankruptcy relief prevented the refund from entering the bankruptcy estate. This was wholly a matter of bankruptcy law. In contrast, the issue in *Prudential Lines* is much more fundamental to the tax law. In particular, the effect of the worthless stock deduction is to permit Parent to effectively vacuum the loss out of Subsidiary. Undoubtedly, under such a scenario, Subsidiary loses and Parent wins. But only one of the two entities can claim the deduction. Which of the two gets it is a tax policy choice appropriate for Congress to decide, without arbitrary disturbance by bankruptcy courts.[111]

The same point applies to trading restrictions under a traditional first day order governing net operating losses of the debtor. The result intended to be avoided is merely a consequence of Congress's carefully crafted statutory scheme, which already explicitly provides limited relief for corporations in bankruptcy. It is not clear why bankruptcy courts should construct additional relief not offered by the I.R.C.

To be clear, the objection here is merely that the courts have based this relief on finding a property right for bankruptcy purposes under the I.R.C. As *Rodriguez* and the Court's other precedents instruct, the proper analysis

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inherent in the stock. The committee believes that a shareholder should not be allowed to claim that a corporation is worthless and later (directly or indirectly) enjoy the use [of] the corporation's losses.").

[108] *See* I.R.C. § 382(l)(5)-(6).

[109] I.R.C. § 382(g)(4)(D) was added in the Revenue Act of 1987, Pub. L. No. 100-203, § 10225, 101 Stat. 1330-413, only one year after the enactment of the modern version of I.R.C. § 382.

[110] The opinions do suggest the courts were reacting to bad behavior on the part of Parent and certain important shareholder-managers. The Second Circuit opinion lays out a timeline demonstrating that Parent did not even mention the possibility of claiming a worthless stock deduction until three years after Subsidiary filed for chapter 11 protection and over one year after an initial plan of reorganization was prepared. *In re* Prudential Lines, Inc., 928 F.2d 565, 567 (2nd. Cir. 1991).

[111] Note that the precise problem in *Prudential Lines* would also now be subject to consolidated return regulations intended to prevent loss duplication. *See* Treas. Reg. § 1.1502-36.

for whether such a property right exists is based upon state law. On this line of analysis, appropriate protection could certainly be available. For example, it is common for corporations emerging from bankruptcy or that otherwise have substantial NOLs to include charter restrictions intended to prevent a change of control from occurring.[112] To the extent these are enforceable under state law and in place at the time of a bankruptcy filing, a bankruptcy trustee would presumably be able to enforce them. It is also conceivable that even in the absence of a specific contractual provision, state law equitable doctrines could permit the bankruptcy court to fashion similar protection.

The author recognizes the approach in *Prudential Lines* and *In Re Phar-Mor* is intuitively appealing to avoid unfairly penalizing companies in bankruptcy. But the reasoning appears to be exactly what the Supreme Court has admonished lower courts not to do, in part to prevent bankruptcy courts from making decisions unmoored from the authority given to them.[113]

IV. THE RELATED PROBLEM OF THE "TAX STATUS" OF THE DEBTOR

The lack of a strong theoretical basis for this line of cases is even more apparent when they are applied to the closely analogous issue of preserving the taxpayer's tax status. Many entities are "flow-through" entities for tax purposes. Flow-through entities generally do not pay income taxes on their

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[112]One reason for this is that if the bankrupt corporation relied on I.R.C. § 382(l)(5) to avoid an I.R.C. § 382 limitation in connection with its restructuring plan, a subsequent ownership change occurring within two years would result in a limitation of zero regardless of the corporation's equity value. I.R.C. § 382(l)(5)(D).

[113]As a further example, bankruptcy courts have, relying on the *Prudential Lines* line of cases, issued orders extending to claims trading by *creditors* of the debtor corporation. As discussed above, I.R.C. § 382 does not cause a limitation to apply as a result of trading by debtholders. Instead, the purpose of this is to preserve the eligibility of the debtor corporation to equitize its creditors without limiting its net operating losses by taking advantage of special relief available under the I.R.C. and Regulations. I.R.C. § 382(l)(5) permits a debtor corporation to disregard the effect on its ownership of equitization of its debt occurring pursuant to a bankruptcy plan provided that the creditors receiving equity meet certain requirements. Treas. Reg. § 1.382-9(d) effectively provides that creditors not becoming five-percent shareholders as a result of the equitization generally are deemed to meet these requirements. As a consequence, claims trading orders generally limit trading in creditor claims that could be equitized into substantial equity of the debtor corporation. Thus, these orders preserve the ability of the debtor corporation to engage in a plan involving substantial equitization of its debt without resulting in an I.R.C. § 382 limitation.

The author is aware of no extended opinion considering whether this type of action is permitted under the Bankruptcy Code. It is possible there is limited interest in challenging these orders because, as a practical matter, it is to the benefit of the creditors (as future owners of the business) to preserve eligibility for this exception, or alternatively, that the creditors generally do not own or acquire claims that would cause them to become five-percent shareholders as a result of the consummation of the plan. Regardless, these orders face the same issue, and perhaps even more so, than those related to first day trading orders in stock.

activities.[114] Instead, tax items "flow-through" to their owners who take those items into account and pay corresponding taxes.[115] "S corporations" are a type of flow-through entity and the most common type of corporation in the United States. Other flow-through entities include partnerships, disregarded entities (such as most limited liability companies), qualified Subchapter S subsidiaries and qualified real estate investment trust ("REIT") subsidiaries.

Flow-through status depends on the type of entity and various provisions of the I.R.C. Virtually every flow-through entity can elect to be treated as "opaque"—i.e., a taxpayer—and, in some cases, this election may be made by its shareholders rather than the entity itself. In addition, in some cases, unilateral actions by owners of the entity may cause the flow-through entity to become opaque. Is its status as a flow-through entity "property" of an entity's bankruptcy estate subject to preservation by the bankruptcy court?

A. S Corporations and the "Tax Status" of the Debtor

The main authorities in this area focus on preserving a corporation's S corporation status. This is because S corporation status is only available if every shareholder meets very strict requirements, including that the shareholders generally be U.S. individuals.[116] Accordingly, a shareholder's transfer to an ineligible shareholder, such as a partnership or corporation, automatically revokes a corporation's "S" status (even if the transferee is wholly under control of the transferor). Additionally, an S corporation can simply elect to revoke its S corporation status, although it must obtain its shareholders' consent to do so (S corporations are only permitted to have at most 100 shareholders, however, so this is typically manageable).[117] Thus, S corporation status can be easily terminated by nearly trivial actions by shareholders.

In the bankruptcy context, there may be a substantial benefit to shareholders from doing so. By revoking the S corporation election, the corporation itself becomes a taxpayer and the tax consequences of the bankruptcy are due and payable by the now non-S corporation, rather than the shareholders. One particularly beneficial circumstance to attempt this strategy is where the bankrupt corporation intends to sell assets. If the corporation is an S corporation, the asset sale will produce taxable income that the shareholders will have to pay on a flow-through basis.[118] By contrast, if the S election were

[114]Flow-through entities, however, may be liable for other types of taxes, such as payroll taxes and sales taxes.

[115]Flow-through entities may also be owned by other flow-through entities, in which case tax items continue to be allocated through these tiers of flow-through entities until they reach an opaque taxpayer, such as an individual or corporation.

[116]I.R.C. § 1361(b)(1).

[117]I.R.C. §§ 1362(d)(1), 1361(b)(1)(A) (100 shareholder limitation).

[118]If the asset sale and the consummation of the bankruptcy plan occur in the same year, it is possible

revoked, so that the corporation is a C corporation, the corporation would pay its own tax on the sale.

These were the facts of the leading case in this area: *Trans-Lines West*.[119] There, an S corporation, with the consent of its sole shareholder, revoked its S election one month before filing for bankruptcy.[120] The IRS argued on summary judgment that the revocation could *not* as a matter of law constitute a fraudulent conveyance. In other words, the IRS was suing to *respect* the revocation of the S corporation election. This was because if the corporation were the taxpayer, the IRS would have priority claims over unsecured creditors in the bankruptcy case.[121] But if the shareholders were the taxpayers, the IRS would be unable to leverage the bankruptcy court proceedings since the shareholders themselves were not debtors. The trustee opposed the IRS motion and argued that the revocation could be avoided.

The court determined it had to rule on two points: (1) whether the S corporation status was property; and (2) whether the revocation of S corporation status was a transfer of that property.[122] As to the first point, the court found that the I.R.C. created a property interest in S corporation status because it provided an S corporation a guaranteed, indefinite right to use that status until revocation or termination.[123] The court then turned to whether the revocation amounted to a transfer under § 548(a) of the Bankruptcy Code.[124] The court relied primarily on *In re Russell*, which held that a debtor's pre- and post-petition elections to carry forward net operating losses that had the effect of denying substantial tax refunds to the estate were transfers the trustee could avoid.[125] The revocation of the S corporation

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the shareholders will have offsetting capital losses, assuming their S corporation shares become worthless. I.R.C. § 165. However, if the asset sale occurs prior to the consummation of the plan, any worthlessness loss will arise in a year after the sale, and cannot be carried back to the year of sale. I.R.C. § 1212(b).

[119]Guinn v. Lines (*In re* Trans-Lines W., Inc.), 203 B.R. 653 (Bankr. E.D. Tenn. 1996).

[120]The case also involved an action by the trustee to declare the revocation invalid due to various technical defects in the revocation form. The court, however, found that the trustee did not have standing to press the claim because a successful revocation required shareholder consent and IRS acceptance of the applicable forms and these were the two proper parties to pursue any claims that the revocation was technically deficient. *Id.* at 660.

[121]*See* 11 U.S.C. §§ 503, 507.

[122]*In re Trans-Lines* W., 203 B.R. at 661.

[123]*Id.* at 661-62 (citing I.R.C. § 1362(c)).

[124]The Bankruptcy Code defines "transfer" extremely broadly. *See* 11 U.S.C. § 101(54) ("The term 'transfer' means—(A) the creation of a lien; (B) the retention of title as a security interest; (C) the foreclosure of a debtor's equity of redemption; or (D) each mode, direct or indirect, absolute or conditional, voluntary or involuntary, of disposing of or parting with—(i) property; or (ii) an interest in property.").

[125]Gibson v. United States (*In re* Russell), 927 F.2d 413 (8th Cir. 1991). Electing to carry forward the net operating losses meant they were not carried *back* to prior periods in which the bankrupt earned income. The carryback of these losses would have resulted in a refund. Under current law, net operating losses generally cannot be carried back, although this rule was modified slightly as a result of legislative responses to the COVID crisis. *See* I.R.C. § 172(b)(1)(D), as amended by the Coronavirus Aid, Relief, and Economic Security (CARES) Act, Pub. L. No. 116-136 (2020). However, at the time, net operating

election was analogous, since the effect was identical—an increase in the debtor's tax liability.[126] Accordingly, the court found the revocation was a transfer and therefore could amount to a fraudulent transfer upon further factual development at trial.[127]

Trans-Lines West involved a formal revocation of S corporation status by the corporation itself. A revocation generally will not occur once the corporation files for bankruptcy because it is rarely in the interest of the trustee or the creditors to cause the corporation to become a taxpayer and to introduce a new creditor (the IRS) with higher priority. However, S corporation status could still be terminated by a transfer by a shareholder to an ineligible shareholder because S corporation status automatically terminates if an ineligible shareholder holds S corporation shares.[128] In this regard, several courts followed *Trans-Lines West* and prohibited such transfers on the same theory courts followed *Prudential Lines* to prohibit transfers that would destroy NOLs.[129]

B. Majestic Star

The Third Circuit upended this practice in the 2013 *Majestic Star*

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losses were by default carried *back* and a special election was necessary to carry them *forward*. The election also prevented any carrybacks at all (in other words, it was not possible to partially carry back and partially carry forward a net operating loss). *See* I.R.C. § 172, as in effect prior to amendment by the Tax Cuts and Jobs Act, Pub. L. No. 115-97 (2017).

[126] *In re Trans-Lines W.*, 203 B.R. at 663.

[127] The IRS's motion also extended to Tennessee's fraudulent conveyance law, but the court found the statute was sufficiently similar to the Bankruptcy Code on the matter that the same outcome obtained. *Id.* at 664-65.

[128] I.R.C. § 1362(d)(2).

[129] *See* Halverson v. Funaro (*In re* Funaro, Inc.), 263 B.R. 892, 898 (B.A.P. 8th Cir. 2001) ("[A] corporation's right to use, benefit from, or revoke its Subchapter S status falls within the broad definition of property [under the I.R.C.]."); Parker v. Saunders (*In re* Bakersfield Westar, Inc.), 226 B.R. 227, 234 (B.A.P. 9th Cir. 1998) (concluding that the holding in *Trans-Lines West* "is consistent with the Ninth Circuit's definition of 'property'"); Walterman Implement v. Walterman (*In re* Walterman Implement Inc.), Bankr. No. 05-07284, 06-9067, 2006 Bankr. LEXIS 921, at *12, 2006 WL 1562401, at *4 (Bankr. N.D. Iowa May 22, 2006) ("[T]he right to revoke [a] Subchapter S election is property . . . as defined in § 541[ ] . . . [and] the revocation of Debtor's subchapter S status is also voidable under § 549 as a postpetition transfer.").

In theory, these transfer restrictions are significantly more burdensome than in the typical NOL trading order. A typical NOL trading order prohibits a shareholder from becoming a five-percent shareholder without court authorization, but it does not generally interfere with the ability of a current less-than-five-percent shareholder to dispose of its shares into the market. In contrast, a transfer restriction to preserve S corporation status effectively renders the shares untransferable because such a limited category of persons are eligible shareholders, and moreover, any transferee would also be subject to the same restrictions on its own future transfer. However, as a practical matter, these same transfer restrictions apply outside of bankruptcy also, because shareholders would not be willing to accept a loss of valuable S corporation status as a result of another shareholder's transfer. Indeed, most S corporations include limitations in their charter or through shareholders' agreements limiting the ability of shareholders to transfer to ineligible shareholders.

case.[130] There, the debtor was a "qualified subchapter S subsidiary" or "Q-Sub" of a parent S corporation.[131] A Q-Sub is also a flow-through entity where all items of income flow up to the shareholders of the S corporation.[132] However, a Q-Sub may only keep this status so long as it is a subsidiary of an S corporation.[133] In the *Majestic Star* case, the parent S corporation was not in bankruptcy, and its sole shareholder wanted to intentionally revoke Parent's S corporation election. If the revocation was allowed, the Q-Sub would lose its status as such (since it would no longer be the subsidiary of an S corporation) and would no longer be a flow-through entity.

Ending Q-Sub status was a deliberate plan. Had the debtor remained a Q-Sub, the sole shareholder of the S corporation would have owed any restructuring taxes, such as cancellation of indebtedness income or gains on any asset sales.[134] As a C corporation, however, the bankrupt entity itself would be liable for those taxes. As a practical matter, this shifted the tax liabilities to the creditors who were in effective control of the debtor. Moreover, because the IRS would have priority for its taxes in bankruptcy over unsecured creditors, the revocation would have immediately reduced the funds of the estate available to those creditors. The trustee sued to avoid the revocation of S corporation status and the corresponding loss of Q-Sub status.

Although the status in question was Q-Sub status, the *Majestic Star* court focused on the question of whether S Corporation status was "property" of its bankruptcy estate because Q-Sub status follows from S corporation status.[135] The court agreed with the *Trans-Lines West* court that the I.R.C., rather than state law, controlled whether the debtor had a property interest in its S Corporation status.[136] However, the court expressly declined to follow *Trans-Lines West* and instead concluded that the I.R.C. did not create a property interest in a corporation's Q-Sub status.[137] In the first place, the court found any analogy to net operating losses unpersuasive because net operating losses were more clearly valued and could not generally be terminated by shareholder actions over which the corporation had no control.[138] Moreover, because of the limitations on S corporation qualification, it

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[130]Majestic Star Casino, LLC v. Barden Dev., Inc. (*In re* Majestic Star Casino, LLC), 716 F.3d 736 (3d Cir. 2013).

[131]*Id.* at 741.

[132]I.R.C. § 1361(b)(3).

[133]*Id.*

[134]Note that because the S corporation itself was not in bankruptcy, and perhaps was not insolvent, the exclusions for cancellation of indebtedness income under I.R.C. § 108 would generally not be available.

[135]The case was nominally about standing, but it was necessary to resolve the substantive issue as the trustee's standing to seek relief depended on whether the debtor's Q-Sub status was property of the estate. *Majestic Star*, 716 F.3d at 749.

[136]*Id.* at 752.

[137]*Id.* at 758.

[138]*Id.* at 757.

would be nearly impossible for a corporation to convey the benefit of its S corporation status to a buyer.[139] Finally, the result would be inequitable because the S corporation shareholders would bear taxes on activities for which all the proceeds would flow to creditors.[140] It followed that because S corporation status was not property, Q-Sub status could also not be property.[141]

Several courts have followed *Majestic Star* and held that S corporation status is not property of the bankruptcy estate.[142] The author is not aware of any subsequent cases considering *Majestic Star* and rejecting it in favor of *Trans-Lines West*. Thus, it appears the current view is that S corporation status, and by analogy Q-Sub or other flow-through status, is *not* property of the bankruptcy estate. Nevertheless, *Majestic Star* is the only opinion issued by a circuit court of appeals and there remains potential for a split.

C. After Rodriguez

Majestic Star and *Trans-Lines West* are inconsistent with *Rodriguez* for many of the same reasons as *Prudential Lines* and its progeny. As discussed, *Majestic Star* and *Trans-Lines West* in fact agreed the proper legal standard was whether the I.R.C. created a property interest in S corporation status. *Trans-Lines West* included virtually no discussion on this point, skipping straight to an analysis of federal law.[143] This itself is a fatal error under *Rodriguez*, which chastised *Bob Richards* for bypassing the question of what federal interest there could be in the allocation of a refund.

Majestic Star included a more complete discussion of the point. First, *Majestic Star* cited three Supreme Court cases—*Butner*, *Bess* and *National Bank of Commerce*—in setting forth the legal standard that absent a contrary federal interest, state law controls the determination of property rights.[144]

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[139]*Id.*

[140]*Id.*

[141]*Id.* at 758. None of these distinctions are necessarily convincing on their own terms. As an initial matter, *Prudential Lines* was precisely about the circumstance where a shareholder eliminated a net operating loss of a corporation by taking an action over which the subsidiary had no control—claiming a worthless stock deduction. Second, the entire point of I.R.C. § 382 is to limit the ability of a corporation to "transfer" the value of its net operating losses to a subsequent buyer. Moreover, valuation of net operating loss carryforwards is notoriously difficult, since their value depends on the corporation's ability to earn net income and the tax rate in effect at the time. Finally, as discussed further below, the court misunderstands the equities because it fails to appreciate how debt-financed activities are taxed.

[142]*See* Harker v. Cummings (*In re* GYPC, Inc.), No. 17-31030, 2020 Bankr. LEXIS 2384 (Bankr. S.D. Ohio, Aug. 4, 2020); Arrowsmith v. United States (*In re* Health Diagnostic Lab'y, Inc.), 578 B.R. 552 (Bankr. E.D. Va. 2017).

[143]Guinn v. Lines (*In re* Trans-Lines W., Inc.), 203 B.R. 653, 661 (Bankr. E.D. Tenn. 1996).

[144]*Majestic Star*, 716 F.3d at 751 (citing United States v. Nat'l Bank of Com., 472 U.S. 713, 722 (1985); Butner v. United States, 440 U.S. 48, 54 (1979); United States v. Bess, 357 U.S. 51, 55 (1958)). Although *Trans-Lines West* did not cite these same cases, it cited *Barnhill v. Johnson*, 503 U.S. 393 (1992), which itself cites *Butner*. *In re Trans-Lines W., Inc.*, 203 B.R. at 661.

However, *Majestic Star* went on to cite to *Bess* and *Drye*, both tax lien cases, for the proposition that: "once it has been determined that state law creates sufficient interests in the [taxpayer] to satisfy the requirements of [the federal revenue statute], state law is inoperative, and the tax consequences thenceforth are dictated by federal law."[145] *Majestic Star* also observed that § 346 of the Bankruptcy Code refers to the I.R.C. to determine whether a separate taxpayer is created by filing of bankruptcy and what attributes that separate taxpayer may have.[146]

This discussion, however, is unlikely to be satisfactory under the *Rodriguez* standard. First, the *Rodriguez* opinion cites *Butner*, *Bess* and *National Bank of Commerce* as setting forth a largely blanket standard that state law governs property rights in bankruptcy and that the I.R.C. does not create property rights.[147] The basic point of *Rodriguez* is clear: the exception for controlling federal interests appearing from time to time in the cases is a very narrow one.

The citations to *Bess* and *Drye* are insufficient under this standard. Both of these cases were about whether a federal tax lien could attach to property in contravention of other state law.[148] However, in each case it was absolutely clear that property interests in the relevant property existed under state law. The question instead was whether unrelated state law—an inheritance disclaimer in the case of *Drye* and law regarding creditor's liens in the case of *Bess*—could defeat a federal tax lien on those interests. Thus, it is not entirely clear that *Bess* and *Drye* are about the existence of state law property interests. However, to the extent they are, clearly there is an overriding federal interest in ensuring the collection of federal taxes that cannot be made subject to the vagaries of state law.[149]

There is no such unique federal interest in the qualification of a corporation as an S corporation or a Q-Sub. Undoubtedly such status affects who pays taxes, and when such taxes are paid, but the provisions of the I.R.C. clearly permit taxpayers to plan into and out of these structures—a point the

[145]*Majestic Star*, 716 F.3d at 751 (quoting *Bess*, 357 U.S. at 56-57) (alterations reflect those included in the *Majestic Star* opinion, which itself reiterated *National Bank of Commerce*'s citation of *Bess*).

[146]As discussed, only bankruptcy filings by individuals result in the creation of a separate taxpayer. I.R.C. § 1398 governs which attributes of an individual transfer to the separate taxpayer created by bankruptcy and appear intended to avoid disruption.

[147]*See supra* note 98 and accompanying text.

[148]Drye v. United States, 528 U.S. 49 (1999) (heir retroactively disclaimed property to avoid having it seized pursuant to a tax lien). *Bess* concerned whether a federal tax lien could attach to the cash surrender value of an insurance policy notwithstanding state law providing that no creditor's liens could be attached to such cash surrender values. *Bess*, 357 U.S. at 51.

[149]Indeed, the *Drye* Court observed "federal tax law 'is not struck blind by a disclaimer.'" *Drye*, 528 U.S. at 59 (quoting United States v. Irvine, 511 U.S. 224, 240, (1994)). The *Bess* case was about much the same thing—a federal tax lien could attach notwithstanding state law provisions on the ownership of life insurance proceeds. *Bess*, 357 U.S. at 56-57.

IRS itself made in the *Trans-Lines West* case.[150] Although this issue was not raised in *Majestic Star*, it could be argued that the fact that the IRS obtains administrative priority for post-petition taxes in the event the bankrupt corporation becomes (or remains) a C corporation is somewhat similar to *Drye* and *Bess* in that it facilitates tax collection. However, it is hard to make this case convincingly since the I.R.C. clearly permits S corporations to retain their status as such in bankruptcy, and, in addition, the IRS has numerous tools to collect taxes from non-bankrupt taxpayers even if doing so may be somewhat more inconvenient. For the same reason, the citations to the Bankruptcy Code's cross references to the I.R.C. simply have nothing to do with property rights.

The upshot is that *Majestic Star* and *Trans-Lines West* are almost certainly unreliable. After *Rodriguez* it is clear they do not analyze the correct question, and bankruptcy courts should face anew the question of whether S corporation status and other flow-through status is a property right by applying relevant state law.

D. Equities and the Tax Treatment of Debt-Financed Proceeds

Although not the focus of this Article, it is inevitable in analyzing state law interests that courts will consider equitable matters in evaluating a corporation's tax status. This is likely because, just as it is with net operating losses, state law is unlikely to directly address these issues. Indeed, it is possible to read *Majestic Star* as the court's reaction to a perceived inequity—namely that S corporation shareholders would have to pay tax on proceeds that ultimately benefited the creditors.[151]

However, the inequity *Majestic Star* seems to be concerned with is not necessarily an inequity at all, but rather a necessary consequence of the manner in which the federal tax law treats debt-financed proceeds. In particular, the incurrence of debt does not result in income to the borrower, on the theory that the receipt of proceeds is offset by an obligation to repay the

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[150]*See* Guinn v. Lines (*In re* Trans-Lines W., Inc.), 203 B.R. 661, 663 (Bankr. E.D. Tenn. 1996) ("In support of this argument, the IRS claims that 'an individual has the right to structure his financial affairs in his own best interest.' According to the IRS, this right includes the right to engage in pre-bankruptcy planning.").

[151]Majestic Star Casino, LLC v. Barden Dev., Inc. (*In re* Majestic Star Casino, LLC), 716 F.3d 736, 757 (3d Cir. 2013) ("Finally, aside from their flawed reasoning, *Trans-Lines West* and its progeny (and the Bankruptcy Court's decision in this case) also produce substantial inequities. Taxes are typically borne and paid by those who derive some benefit from the income . . . . If a bankruptcy trustee is permitted to avoid the termination of a debtor's S-corp or Q-Sub status, then any income generated during or as part of the reorganization process (such as from the sale of assets) is likely to remain in the corporation, and ultimately in the hands of creditors, but the resulting tax liability must be borne by the S-corp shareholders.").

advanced funds.[152] Nonetheless, if the borrower uses those funds to purchase an asset, the borrower obtains basis in the asset in the same manner as if the borrower had used its own funds.[153] Further, if the asset produces deductible depreciation or amortization, the borrower is entitled to compute its tax deductions taking into account basis attributable to the borrowed proceeds.[154]

In the ordinary course, all of this amounts to a substantial timing benefit. While the debt is outstanding, the taxpayer is entitled to the benefit of deductions attributable to asset basis funded by the debt. However, the borrower must eventually earn enough income to repay the debt at its maturity, and this income will presumably be taxable.[155] Similarly, upon a sale or other disposition of the property, the full proceeds are includible in income, even if the full amount of the proceeds must be used to repay the debt incurred to purchase the property, and if the buyer takes the property subject to the liability, that assumption by the buyer is treated as additional consideration.[156]

Critically for bankrupt debtors, a borrower must also recognize income when debt is canceled. This follows from the fact that following the cancellation, the offsetting obligation is no longer present.[157] Indeed, the Supreme Court has ruled that the cancellation of indebtedness constitutes taxable income to the borrower.[158] Practically, the income inclusion merely unwinds the prior tax benefits. There is nothing at all inequitable about this.[159]

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[152]Comm'r v. Tufts, 461 U.S. 300, 307 (1983) ("When a taxpayer receives a loan, he incurs an obligation to repay that loan at some future date. Because of this obligation, the loan proceeds do not qualify as income to the taxpayer. When he fulfills the obligation, the repayment of the loan likewise has no effect on his tax liability.").

[153]Crane v. Comm'r, 331 U.S. 1, 11 (1947).

[154]This result is not specifically provided for under the I.R.C. Rather it is the product of the manner in which Treasury chose to address the issue from the very first revenue act, which Congress assented to through apparent silence and which was finally confirmed by the Supreme Court. *See Crane*, 331 U.S. at 10-11 ("It may be added that the Treasury has never furnished a guide through the maze of problems that arise in connection with depreciating an equity basis [*i.e.*, excluding value attributable to debt], but, on the contrary, has consistently permitted the amount of depreciation allowances to be computed on the full value of the property, and subtracted from it as a basis. Surely, Congress' long-continued acceptance of this situation gives it full legislative endorsement.").

[155]For a simple example, assume the borrower invested $100 of proceeds borrowed on a 10-year note in an asset that depreciates on a straight-line basis over 10 years (thereby producing $10 of depreciation deductions per year). Assume the asset retains its value notwithstanding the deductible tax depreciation, and the borrower has no other income or deductions. At the end of 10 years, the borrower would sell the property for $100 and repay the note. At the time of the sale, the property's basis would be zero, thereby giving rise to $100 of income that precisely offsets the prior 10 years of $10 annual deductions.

[156]*Tufts*, 461 U.S. at 317.

[157]*Id.*

[158]United States v. Kirby Lumber Co., 284 U.S. 1 (1931). The principle was subsequently codified under I.R.C. § 61(a)(11).

[159]*Tufts*, 461 U.S. at 312-13 ("Moreover, this approach avoids the absurdity the Court recognized in

The results do not change a great deal if the debt is incurred by a flow-through entity. As discussed above, the very essence of a flow-through entity is that, for tax purposes, its owners pay taxes on the operations of the entity. A flow-through entity can incur debt, and if it does so, its owners can benefit from the favorable timing benefits for debt-financed proceeds described above.[160] By the same token, if the flow-through entity engages in a transaction that unwinds those benefits—whether a sale of assets or a cancellation of debt—the tax consequences should flow to the very same owners who previously benefitted.[161]

The *Majestic Star* court simply did not acknowledge this point. For example, suppose the relevant assets had been sold for nothing more than the amount of the liabilities and with no change to the flow-through status of the entities. In this case, the shareholders would have paid tax on this sale to the extent the amount of liabilities exceeded the basis of the assets, even though the shareholders would have received no proceeds after repayment of the liability. But this is the precise result that should obtain under the I.R.C. The current tax offsets prior tax benefits claimed by the very same shareholder. The contrary result in *Majestic Star* actually shifts tax liabilities properly payable by shareholders to the company's creditors.[162]

Crane. Because of the remedy accompanying the mortgage in the nonrecourse situation, the depreciation in the fair market value of the property is relevant economically only to the mortgagee, who by lending on a nonrecourse basis remains at risk. To permit the taxpayer to limit his realization to the fair market value of the property would be to recognize a tax loss for which he has suffered no corresponding economic loss.").

[160]Admittedly, the precise type of flow-through entity may affect the manner in which debt-financed proceeds benefit owners. For example, in the case of a disregarded entity, the owner of the entity is treated as incurring the debt itself and undertaking the transactions of the entity itself. In contrast, in the case of a partnership, a complex set of rules allocates liabilities and economic activity of the partnership to the partners. *See* I.R.C. §§ 704, 752.

[161]Note that avoiding cancellation of indebtedness income is not generally a reason to revoke the S election but may be a reason to cause a partnership to be treated as a corporation. This is because the exclusions from cancellation of indebtedness income are determined at the S corporation level for S corporation shareholders but at the partner level for holders of interests in partnerships. I.R.C. § 108(d)(6)-(7). Thus, although shareholders of the S corporation would ordinarily pay tax on cancellation of indebtedness income of the S corporation, they are permitted to exclude such tax from income if the S corporation is insolvent or in bankruptcy, even if the shareholders themselves are not. This same benefit does not apply to partners of a partnership.

[162]The *Majestic Star* court also improperly focused on Q-Sub status as a special tax benefit rather than as a type of flow-through entity. *See* Majestic Star Casino, LLC v. Barden Dev., Inc. (*In re* Majestic Star Casino, LLC), 716 F.3d 736, 758 (3d Cir. 2013), As discussed, Q-Sub status is a peculiar provision available to corporate subsidiaries of S corporations that treats them as disregarded entities for federal tax purposes. However, Q-Sub status is simply a type of disregarded entity, and there is no requirement that a subsidiary of an S corporation be a Q-Sub to be a disregarded entity. Indeed, the Q-Sub in the *Majestic Star* case could have converted to a limited liability company and retained its status as a disregarded entity for tax purposes, even if the parent corporation ceased to be an S corporation. In this case, the bankrupt's liabilities would still have flowed to its shareholder just as it had when it was a Q-Sub. The *Majestic Star*

V. CONCLUSION-STATE LAW SOLUTIONS

Ultimately, the awkward analysis of *Majestic Star* is not surprising because it illustrates the precise issue the Supreme Court took up *Rodriguez* to emphasize. The federal common law is limited, and federal courts are not equipped to independently work out complex tax issues with nary more than their own sense of equity. Admittedly, this is a little bleak—the underpinnings of critical bankruptcy tax issues such as first day trading orders and entity tax status are likely unfounded and inconsistent with Supreme Court precedent.

However, the *Rodriguez* case also creates substantial opportunity. *Rodriguez* admonishes bankruptcy courts to look to state law to resolve these issues. And state law is replete—to use *Rodriguez*'s own term—with potential solutions. For example, most legal entities are creatures of state law, and state law sets forth provisions regarding their existence and their ownership. It would be entirely possible for state corporate law to provide that, as a matter of law, trading in shares of a bankrupt corporation would not be permitted to the extent it resulted in an I.R.C. § 382 ownership change.

While this could require legislative action, parties can also engage in self-help. For example, as mentioned above, companies with substantial net operating losses sometimes include provisions in their charter that invalidate transfers that could give rise to an I.R.C. § 382 ownership change. In theory, these provisions could be included in advance and made self-executing upon the filing of a bankruptcy action. Similarly, almost all S corporation charters include stringent transfer restrictions to preserve the S corporation status of the entity. Potential creditors could demand these provisions and also prohibit shareholders from consenting to a revocation of that status without the creditor's consent. So too for partnerships and disregarded entities, which are almost always corporate law limited liability companies. The limited liability company is typically governed by an operating agreement, and this agreement could include a provision that conversion of the entity into a C corporation would be prohibited absent creditor consent, perhaps to apply only upon a bankruptcy filing or other indication of distress.

Thus, although federal courts may provide less relief on their own, in fact the net result of *Rodriguez* ought to be to cause parties to consider more carefully the specific results they want in bankruptcy and how they want to achieve them.

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court appears to acknowledge this possibility but only in a footnote and does not expand on the reason for its unavailability.