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# USING APPRAISAL TO PROTECT NET OPERATING LOSS CARRYFORWARDS

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**ABSTRACT**—The Internal Revenue Service's net operating loss rules enable corporations to use one year's losses to offset their tax liability in future years. However, a corporation's ability to do so depends on its maintaining the same ownership: if enough of a corporation's stock changes hands, it loses the ability to take advantage of all of its prior losses. In response to the threat of ownership changes, corporations have enacted particularly strict "poison pills," which are designed to prevent stock from changing hands. However, a side effect of these poison pills is that they ameliorate the threat of hostile takeovers, thereby reducing managers' incentives to maximize corporate welfare. In this Comment, I suggest using the appraisal mechanism to alleviate the need for poison pills and ownership-change restrictions by enabling corporations to pursue damages against shareholders who trigger the devaluing of their net operating losses. The proposed appraisal regime properly balances the interests of tax law and corporate law by ensuring that net operating losses will not be freely transferred but will also not serve as an excuse for allowing managerial incentives to deviate from the proper goal of shareholder wealth maximization.

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## INTRODUCTION

The separation of ownership and control, which requires that control over corporate assets rests in the hands of managers rather than shareholders, is perhaps the most fundamental tenet of the law of corporations.[1] It reflects the principle that corporations are democratic bodies[2] and ensures that corporate policies reflect the interests of parties with substantial financial stakes.[3] In spite of this, § 382 of the Internal Revenue Code (IRC) flouts that principle by enabling minority shareholders to substantially decrease a corporation's value by impairing its net operating losses (NOLs).[4]

NOLs are tax assets that a corporation earns when its operating losses exceed its income over the course of a taxable year.[5] They can be "carried back" to offset past income, thereby reducing tax burdens from prior years, or "carried forward" and used to offset future taxable income.[6] Their use,

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1 STEPHEN M. BAINBRIDGE, THE NEW CORPORATE GOVERNANCE: IN THEORY AND PRACTICE 4 (2008) (arguing that "[c]orporation law virtually carves the separation of ownership and control into stone," and that "[s]hareholders have essentially no power to initiate corporate action"); *see also* DEL. CODE ANN. tit. 8, § 141(a) (2001); FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 1 (1st Harvard Univ. Press paperback ed. 1996) ("In most substantial corporations . . . each investor has a small stake compared with the size of the venture. The investor is therefore 'powerless.'").

2 Grant M. Hayden & Matthew T. Bodie, *One Share, One Vote and the False Promise of Shareholder Homogeneity*, 30 CARDOZO L. REV. 445, 446 (2008); Barry M. Wertheimer, *The Shareholders' Appraisal Remedy and How Courts Determine Fair Value*, 47 DUKE L.J. 613, 613 (1998).

3 EASTERBROOK & FISCHEL, *supra* note 1, at 72–73; Bernard Black & Reinier Kraakman, *A Self-Enforcing Model of Corporate Law*, 109 HARV. L. REV. 1911, 1945–46 (1996) ("The case for the one share, one vote rule [for electing corporate managers] turns primarily on its ability to match economic incentives with voting power and to preserve the market for corporate control as a check on bad management.").

4 *See* I.R.C. § 382 (2006); Versata Enters., Inc. v. Selectica, Inc., 5 A.3d 586, 602 (Del. 2010) (quoting an expert's testimony that NOLs are "ownership controlled" assets (internal quotation marks omitted)).

5 § 172.

6 *Id.*

however, is subject to substantial limitations. One such limitation prevents a corporation from taking advantage of the full value of its NOLs if it undergoes a change in ownership.[7] Because the IRC permits an owner of a mere 5% of a corporation's shares to bring about an "ownership change" by engaging in a small trade, the NOL is subject to limitation—and consequent devaluing—based on the unilateral acts of minority shareholders.[8] The situation is troublesome: minority shareholders are less likely than are managers to take into account the interests of the corporate entity as a whole,[9] and therefore, allowing for minority control over substantial assets places corporate interests in peril.

Corporations have attempted to restore managerial primacy by adopting shareholder rights plans ("poison pills") that effectively preclude shareholder engagement in the sorts of trades that result in NOL impairment by limiting shareholders' ability to amass stock beyond a certain threshold.[10] Although NOL pills are ostensibly adopted for the laudable purpose of restoring managerial primacy, they come with harmful collateral effects and can work to the detriment of shareholders. By substantially reducing the likelihood that a corporation's management will turn over, the presence of an NOL pill reduces managers' incentives to increase the corporation's profitability.[11] Thus, loss corporations with NOL poison pills

[7] The rules regarding NOL impairment are extraordinarily complex, but only their most basic aspects are vital to the analysis of defensive tactics. *See Selectica*, 5 A.3d at 589 ("The precise definition of an 'ownership change' under Section 382 is rather complex. At its most basic, an ownership change occurs when more than 50% of a firm's stock ownership changes over a three-year period. Specific provisions in Section 382 define the precise manner by which this determination is made. Most importantly for purposes of [analyzing defensive tactics relating to NOLs], the only shareholders considered when calculating an ownership change under Section 382 are those who hold, or have obtained during the testing period, a 5% or greater block of the corporation's shares outstanding."); Robert S. Bernstein, *Using Poison Pills to Protect Tax Attributes*, CORP. TAX'N, Nov.–Dec. 2009, at 32, 32 ("NOL rights plan[s] differ from poison pills historically used to protect against takeovers by setting their trigger levels at much lower thresholds. In the corporate takeover context, poison pills have historically had trigger levels between 10–20% of outstanding shares."); Paul H. Edelman & Randall S. Thomas, *Resetting the Trigger on the Poison Pill:* Selectica*'s Unanticipated Consequences* 18 & n.58 (Vanderbilt Law Sch., Law & Econ. Working Paper No. 10-16, 2010), *available at* http://ssrn.com/abstract_id=1631941.

[8] *See Selectica*, 5 A.3d at 589.

[9] *See* Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 954 (Del. 1985) ("[T]he board's power to act derives from its fundamental duty and obligation to protect the corporate enterprise, which includes stockholders, from harm reasonably perceived, irrespective of its source.").

[10] Merle Erickson & Shane Heitzman, *NOL Poison Pills:* Selectica v. Versata, 127 TAX NOTES 1369, 1369 (2010).

[11] *See* Edelman & Thomas, *supra* note 7, at 5 ("First, a lower poison pill trigger level will decrease the amount of stock that a potential strategic acquirer can accumulate making it more difficult for it to prevail in a proxy contest for corporate control since the acquirer will have control over fewer votes."); *see also* Frank H. Easterbrook & Daniel R. Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161, 1169 (1981) ("The most probable explanation for unfriendly takeovers emphasizes their role in monitoring the performance of corporate managers.").

might suffer further losses simply because of their newfound inability to replace their managers. Despite these concerns, the Delaware Supreme Court validated an NOL poison pill in the 2010 case *Versata Enterprises, Inc. v. Selectica, Inc.*,[12] and it appears that the pill's importance will only increase.[13]

When used to justify a stringent poison pill, the NOL begets a vicious cycle. Logic would suggest that underperforming managers—the sorts of executives who oversee firms that take substantial losses—should be susceptible to replacement. But the NOL pill encourages the opposite result in two ways. First, it entrenches such managers by making hostile takeovers unlikely.[14] Relatedly, it decreases the market's ability to perform its oversight function.[15] To the extent that the market for corporate control[16] encourages efficient management by aligning the interests of managers with those of shareholders,[17] the pill's interference with that market increases the likelihood of future losses. Instead of encouraging loss corporations to right the ship, the NOL pill locks in underperforming managers and untethers them from the constraints that the market for corporate control would ordinarily impose.

In addition, NOL pills undermine the policy underlying the IRC's "change in ownership" provision. While that provision is designed to minimize the effect of NOLs on the acquisition market,[18] the existence of the NOL poison pill magnifies the effect of the carryforward by permitting it to justify an incredibly effective takeover defense. The NOL pill thus uses the tax rules as a justification for altering the acquisition landscape, which is precisely what the rules were intended *not* to do.

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12 5 A.3d at 586.

13 *See, e.g.*, John Laide, *Companies Taking Steps to Preserve Net Operating Loss Carryforwards (NOLs): 382 Poison Pills and Charter Ownership Limits*, SHARKREPELLENT.NET (Nov. 3, 2009), https://www.sharkrepellent.net/request?an=dt.getPage&st=1&pg=/pub/rs_20091103.html&Companies_Taking_Steps_to_Preserve_Net_Operating_Loss_Carryforwards&rnd=78448.

14 *See Selectica*, 5 A.3d at 601; Edelman & Thomas, *supra* note 7, at 5.

15 *See, e.g.*, Easterbrook & Fischel, *supra* note 11, at 1196.

16 For a detailed explanation of the market for corporate control, see *infra* Part II.A.2.

17 *Cf.* Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833, 850 (2005) ("In publicly traded companies with dispersed ownership, the interests of management do not fully overlap with those of shareholders, and management thus cannot be automatically counted on to take actions that would serve shareholder interests. As a result, agency costs that reduce shareholder value might arise. Without adequate constraints and incentives, management might divert resources through excessive pay, self-dealing, or other means; reject beneficial acquisition offers to maintain its independence and private benefits of control; over-invest and engage in empire-building; and so forth. Adequate governance arrangements, however, can provide constraints and incentives that reduce deviations from shareholder-value maximization.").

18 *See* 4 BORIS I. BITTKER & LAWRENCE LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS ¶ 95.5.1, at 95–68 (3d ed. 2003) ("Congress sought [in § 382] a limitation that would make NOL carryovers a relatively neutral factor in acquisitions.").

There appear to be two options: invalidating NOL pills and leaving loss corporations' tax assets subject to the whim of minority shareholders, or permitting the adoption of NOL pills. Both options liberate corporate managers from the constraints of the market for corporate control and undermine a primary purpose of the federal tax rules regarding NOLs. This Comment suggests a third option: extending and modifying the appraisal remedy, which has traditionally served to protect the interests of minority shareholders against freeze-out mergers,[19] in order to require shareholders who trigger NOL-impairing "ownership changes" to internalize the lost value and bear the costs of the lost NOLs.

By requiring such "triggering shareholders" to pay for the entire lost value of the NOL, courts would force them to internalize the damage that their transactions caused the corporation. As a result, the shareholders would be disinclined to undergo NOL-impairing trades without first determining that the benefits of their transactions were likely to exceed the costs to the corporation. The transactions would be worthwhile only if the triggering event could be expected to create a tangible benefit not only for the impairing shareholder, but also for the corporation as a whole.

Permitting shareholders of loss corporations to sue triggering shareholders would effectively protect NOLs while still encouraging changes in corporate control. Although appraisal would not be as effective as are poison pills at eviscerating the threat of NOL impairment, my proposal is superior to the poison pill regime precisely because the appraisal regime would permit shareholders to impair NOLs if they thought it efficient. Still, appraisal would adequately protect nonimpairing shareholders: under an appraisal regime, impairment would be limited to situations in which some corresponding benefit, such as a change in corporate control, could outweigh the loss of the NOL. If a 5% shareholder determined that bolstering his ownership share would increase his likelihood of voting in new corporate management, in turn improving the efficiency of corporate operations, the availability of appraisal would not bar him from doing so. But by still ensuring that nonimpairing shareholders were protected, NOL appraisal could effectively establish a "reservation price" that ensured all shareholders that their investments in NOL-carrying corporations would be fortified against arbitrary, unconsidered, or downright subversive NOL impairment.[20]

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[19] For a straightforward description of the appraisal remedy as it is traditionally applied to mergers, see Bayless Manning, *The Shareholder's Appraisal Remedy: An Essay for Frank Coker*, 72 YALE L.J. 223, 231 (1962) ("If the shareholder objects to a merger between corporations A and B, and his stock in corporation A plummets as a result of the announcement of the merger, he is entitled to a valuation that disregards the sudden drop.").

[20] *See, e.g.*, EASTERBROOK & FISCHEL, *supra* note 1, at 145–61 (arguing that the purpose of the appraisal remedy is to establish a "reservation price" that ensures payment for a good that would otherwise be subject to uncompensated, involuntary transfer).

In addition to both freeing the market for corporate control and adequately protecting investors, appraisal would likely do a better job than does the NOL pill of comporting with § 382's goals. Section 382 determines the value of an NOL after an ownership change, and its terms are expressly designed to "make NOL carryovers a relatively neutral factor in acquisitions."[21] Poison pills in general, and NOL pills in particular, dramatically alter the landscape of the law of mergers and acquisitions,[22] and the very fact that an NOL can be used to justify a takeover defense turns § 382's hope for neutrality on its head. By eliminating the need for a poison pill to protect the NOL, the appraisal remedy would encourage free transfers of equity interests and make acquisitions of NOL-carrying corporations look, quite simply, much more traditional.

In Part I, I endorse the argument that a regime that fails to protect the value of NOLs would be an undesirable one. However, in Part II, I demonstrate that the NOL pill is a harmful safeguard of value because it thwarts the aims of the NOL rules and undermines managerial efficiency. In Part III, I propose extending the appraisal remedy to the context of NOL-impairing transactions, discuss the advantages of that proposal, and address a number of counterarguments.

## I. DANGERS OF INSUFFICIENTLY PROTECTIVE AND OVERPROTECTIVE REGIMES

Before considering how to shield NOLs from ownership changes, policymakers should reflect on why protecting the NOL is an appropriate corporate objective in the first place. In the only case to test the validity of the NOL pill, *Versata Enterprises, Inc. v. Selectica, Inc.*, the Delaware Supreme Court simply assumed that a corporate board of directors could permissibly determine that the NOL asset was worth protecting.[23] Noting the fairly obvious legitimacy of the board's desire to protect the value of the NOL, though, gives rise to an interesting question: what, exactly, is the threat? The conclusion that NOLs are worth protecting is an incomplete one; the conclusion that they are worth shielding from the unilateral actions of small shareholders is more useful. That conception of the problem demonstrates that the challenge is not to determine how to prevent NOLs from being impaired, but rather whom to trust with the decision regarding whether a given transaction is worth the lost value of NOLs.

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[21] *See* BITTKER & LOKKEN, *supra* note 18, ¶ 95.5.1, at 95–67.

[22] *See, e.g.*, Edelman & Thomas, *supra* note 7, at 5; Martin Lipton, *Pills, Polls, and Professors Redux*, 69 U. CHI. L. REV. 1037, 1037, 1043–50 (2002) (recounting the immediate and substantial impact of the poison pill following its invention in 1982).

[23] 5 A.3d 586, 600 (Del. 2010) (inquiring into the reasonableness of a board of directors' inquiry into the value of NOLs, rather than into the permissibility of the board's conclusion that NOLs were worth protecting).

By permitting relatively small shareholders to dramatically affect the value of a corporation's NOLs, § 382 creates the possibility of a negative externality.[24] A 5% shareholder who causes an ownership change suffers the effects of that change on a pro rata basis and is not forced to internalize the entire cost of the lost NOL. The remainder of that cost, of course, falls pro rata on other shareholders. There is thus reason to be suspicious of transactions that lead to ownership changes: the actors who engage in them have no reason to consider the welfare of the corporation as a whole.[25]

Much of corporate law is designed to reduce the agency costs that inhere when ownership is separated from control and managers are not forced to internalize the costs of their decisions. There has, however, been no discussion of ways in which corporate law should adapt to force 5% shareholders—those who, under § 382, can wield great power without facing the consequences of its exercise—to internalize costs. Rather, courts and analysts have avoided the externality problem by placing decision making in the hands of managers who have the option of adopting poison pills that effectively preclude NOL impairment.[26]

That decision would be unimpeachable if NOL impairment were always undesirable, or if corporate managers could unfailingly be trusted to accurately value NOLs. But neither condition is an eternal truth. Some transactions might impair NOLs but nonetheless maximize corporate welfare because the increased ownership of the triggering shareholders can lead to the election of new management or to synergies.[27] The question that advocates of the NOL poison pill must confront, then, is which parties—minority shareholders, directors, or the courts—are best situated to value the NOL.

[24] Externalities have been defined as existing

> whenever some person, say *X*, makes a decision about how to use resources without taking full account of the effects of the decision. *X* ignores some of the effects—some of the costs or benefits that would result from a particular activity, for example—because they fall on others. They are 'external' to *X*, hence the label *externalities*. As a consequence of externalities, resources tend to be misused or 'misallocated,' which is to say used in one way when another would make society as a whole better off.

JESSE DUKEMINIER ET AL., PROPERTY 46 (7th ed. 2010).

[25] In *Selectica, Inc. v. Versata Enterprises, Inc.*, for example, the court noted that two firms competing for the same business might have reason to trigger ownership changes in order to harm one another's NOLs. C.A. No. 4241-VCN, 2010 WL 703062, at *24 (Del. Ch. Feb. 26, 2010) ("Trilogy, a competitor with a contentious history, recognized that harm would befall its rival if it purchased sufficient shares of Selectica stock, and Trilogy proceeded to act accordingly."), *aff'd sub nom. Selectica*, 5 A.3d 586.

[26] *See infra* Part II.

[27] *See, e.g.*, EASTERBROOK & FISCHEL, *supra* note 1, at 162 ("[B]idders won't make [tender] offers unless they believe they can use the target's assets well enough to make the premium payment profitable, which implies increased productivity.").

## II. DEFICIENCIES OF THE NOL POISON PILL

Although it is clear that unchecked ownership control over NOLs leads to the possibility of undesirable externalities, it is not at all apparent that allowing boards of directors to adopt poison pills and serve as gatekeepers is a desirable alternative. Despite its failsafe effectiveness as a protector of NOL value, the NOL pill comes with the side effect of undermining managers' incentives to act in the best interest of shareholders.[28] That collateral effect prevents the NOL pill from being an optimal response to the externality problem.

Putting aside managerial incentives, there are strong reasons to think that the NOL pill is in tension with the purpose of the NOL rules. The rules, which are designed largely to *avoid* making NOLs a relevant factor in the acquisition market, are significantly undermined when they are used to justify the existence of poison pills that block acquisitions.[29] An approach that would mitigate the effect of NOLs on takeovers would likely better comport with the policy underlying § 382.

The first portion of this Part discusses the ways in which the NOL pill interferes with managers' incentives and "locks in" underperforming managers. The second portion analyzes the disparity between the aims of the NOL pill and the principles that § 382 espouses.

### *A. Managerial Discretion, Efficiency, and the Market for Corporate Control*

The great strength of the NOL pill—that it transfers the power to value NOLs from minority shareholders to directors—is also a great weakness. Corporate managers are, for a number of reasons, likely to be fairly ineffective at administering NOL pills to the benefit of shareholders.[30] Although managers are generally more inclined to take corporate welfare into account than are minority shareholders, managers are not perfect agents of corporate interests.[31] The market for corporate control, which creates a feedback loop linking managers' interests to corporate welfare, suffers great harm at the hands of the NOL pill, thus reducing managers' incentive to protect corporate interests.

Even apart from the agency problems that the NOL pill creates, the pill's collateral function of making directors' jobs safer is bad for shareholders. Often, though not always, the managers whose jobs the NOL

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[28] *See infra* Part II.A.1–2.

[29] *See* BITTKER & LOKKEN, *supra* note 18.

[30] *See generally* Panter v. Marshall Field & Co., 646 F.2d 271, 300 (7th Cir. 1981) (Cudahy, J., concurring in part and dissenting in part) (arguing that managerial discretion is inappropriate in cases involving takeover defenses).

[31] *See generally* Bebchuk, *supra* note 17 (arguing for an increase in shareholder power over managers as a means of improving corporate governance).

pill protects will be the same ones who oversaw the corporation as it took the losses that the pill protects. While annual corporate profits are undoubtedly not a perfect indicator of managerial efficiency, a system that allows corporate managers to use the losses that they oversee to increase their own job security creates a perverse incentive and likely keeps bad managers in their jobs.

This section explains why the NOL pill is properly conceptualized not as the only possibility for protecting the value of NOLs, but rather as one option of many, and as the option that places discretion not in the hands of the court or of shareholders, but in those of directors. Next, I argue that, just like shareholders, directors are in a suboptimal position to determine the value of NOLs. Finally, I argue that the biases of directors are particularly harmful as they relate to NOL pills as opposed to other takeover defenses.

*1. The NOL Pill and Managerial Discretion.—Selectica* analyzed the NOL pill as if it was the only means by which NOL value could be protected,[32] which it was in Delaware at the time. Nevertheless, the adoption of a scheme that permits the NOL pill reflects a policy choice in favor of permitting corporate managers, rather than other constituencies, to determine the value of the NOL.

The NOL poison pill protects the value of NOLs by preventing shareholders from buying enough stock to trigger impairment.[33] Although the adoption and exercise of the poison pill to block an acquisition are subject to judicial review,[34] scrutiny of poison pills in Delaware and elsewhere has traditionally been quite permissive: courts tend to defer to the judgment of directors as long as their actions are "reasonable."[35] Within the range of reasonableness and good faith, then, boards of directors are permitted to place whatever value they choose on the NOL.[36] Because NOLs are extremely difficult to value,[37] though, the reasonableness

[32] *See* Versata Enters., Inc. v. Selectica, Inc., 5 A.3d 586, 599–601 (Del. 2010).

[33] *See* Edelman & Thomas, *supra* note 7.

[34] *See Selectica*, 5 A.3d at 586.

[35] *See* Lipton, *supra* note 22, at 1046 ("Delaware chose a middle ground: Takeover defenses were permitted, but they were to be judged, in common law fashion, under a fact-intensive, case-by-case analysis in which the directors would effectively bear the burden of showing not only their good faith, but also the 'reasonableness' of their chosen response.").

[36] *See, e.g.*, *Selectica*, 5 A.3d at 586, 600–01.

[37] For a discussion of the difficulties inherent in valuing NOLs before they are used, see Erickson & Heitzman, *supra* note 10, at 1371–72 ("The NOL can be thought of as an out-of-the-money option (or rather, a portfolio of options) that will be exercised before expiration when taxable income is positive. There is often substantial uncertainty about the timing and magnitude of future period taxable income, hence knowing exactly when a given NOL will be exercised is impossible. Valuation becomes even more complex because operating and financing decisions that drive taxable income realizations are themselves influenced by the existence of the NOL. Moreover, the tax rate at the time the NOL is *used* (not created) determines its future value, but forecasting future period federal and state tax rates is

limitation is hardly a limitation at all. And while managers who confront a possible buyer of a 5% share can always determine not to use a rights plan if the benefits of the transactions might outweigh the costs of the lost NOL, the next two subsections demonstrate both that managers are institutionally likely to overestimate the value of NOLs and that their overestimation has tangible consequences for shareholder welfare.

Having demonstrated that permitting shareholders to value NOLs without any second-guessing would be a dangerous policy choice,[38] and having suggested that the NOL pill places some degree of discretion over NOL valuation into the hands of managers, we move to the problems with trusting corporate management to value NOLs.

*2. Director Incentives and the Market for Corporate Control.*—The argument in favor of a robust market for corporate control is relatively simple, but undergirds an enormous body of scholarship that is wary of limiting the free transferability of stock.[39] Relying on that scholarship, one can conclude that there is a serious risk of detriment to corporate interests if the NOL poison pill is an option for a corporation looking to protect the value of its NOLs.

The typical argument against the poison pill grows out of the premise that shareholders, who are interested in seeing the maximum possible return on their investments, have different incentives from managers, whose interests are not inherently tied up in corporate profitability.[40] The market for corporate control aligns these incentives by creating an intuitive feedback loop.[41] If a corporation is poorly governed, the argument goes, investors will be inclined to exit by selling their shares. The resulting increase in the supply of shares for sale will cause the market price of each share to decrease. As the price of shares decreases, potential acquirers will notice that the corporation's assets, if managed more efficiently, would lead to a return greater than the one reflected in the current price of shares, which is deflated only as a result of poor management.

Those potential acquirers, attracted to the bargain price at which they can gain control of the corporation, will offer stockholders the opportunity to tender their shares at a given price, usually above market value, in the hopes that they will be able to secure enough of an ownership stake—and the voting power that accompanies that stake—to replace the existing

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difficult, particularly for longer horizons. Finally, the discount rate is an important determinant of the present value of the NOLs." (footnotes omitted)).

38 *See supra* Part I.

39 *See* Air Prods. & Chems., Inc. v. Airgas, Inc., 16 A.3d 48, 126–28, 126 n.505 (Del. Ch. 2011) (providing a thorough analysis of the scholarship on poison pills and, in particular, of the scholarship arguing that takeover defenses hinder maximization of corporate welfare).

40 *See* Bebchuk, *supra* note 17.

41 *See* Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110, 112 (1965).

managers with more effective ones. To the extent that the new owners are able to manage the corporation more efficiently, they will see the firm's value increase, and will profit on a pro rata basis.[42]

Thus, if managers perform poorly, they lose their jobs. If they perform well, share prices approach their potential, potential bidders have no reason to think they could do better than the incumbents, and the current managers keep their jobs.[43]

The argument against restricting stock transferability is that it breaks the chain reaction.[44] When incumbent managers can undercut an attempted acquisition, they are no longer subject to the constraints that tie their well-being to that of shareholders. When the people making the decisions have no reason to manage efficiently, share prices will go down and nobody but the directors will benefit.

*3. The NOL Pill and Proxy Contests.*—The traditional arguments against the "feedback loop" are twofold. First, commentators including Martin Lipton, the inventor of the poison pill,[45] have stressed that even if the feedback loop argument is mostly true, it relies on the premise that share prices move in perfect lockstep with managerial efficiency.[46] If markets are not perfectly efficient, Lipton and others argue, managers will eschew productive long-term corporate planning for short-term profit maximization in order to protect their jobs.[47] The permanent "for sale" sign hanging in the window would undermine, rather than encourage, directors' attempts to maximize welfare.[48] While the argument is perfectly appealing, it's not particularly relevant to the NOL pill debate: even if the traditional poison pills that block shareholders from buying up to 20% are enough to take down the "for sale" sign, the argument has nothing to say about the implications of pills that are even more restrictive.

The second argument, that proxy battles—elections for directorial positions—sufficiently protect shareholders' interests in maintaining

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[42] *See id.* at 113.

[43] *See* Frank H. Easterbrook, *The Race for the Bottom in Corporate Governance*, 95 VA. L. REV. 685, 695 (2009) ("[O]utsiders are free to gather up stock and displace the incumbents, making a profit if (and only to the extent that) the firm is more valuable after the transformation than it was before. The takeover mechanism judges governance by *results* rather than process. . . . A meta-analysis of empirical work by Lucian Bebchuk and others shows that what *really* helps investors are changes that promote the market for corporate control: rescinding poison pills helps; removing staggered boards helps because outsiders can take control more quickly; removing supermajority requirements for mergers helps investors." (footnote omitted)).

[44] *Id.*

[45] *Cf.* Moran v. Household Int'l, Inc., 490 A.2d 1059, 1063–68 (Del. Ch. 1985) (chronicling the invention), *aff'd* 500 A.2d 1346 (Del. 1985), *abrogated on other grounds by* Tooley v. Donaldson, Lufkin, & Jenrette, Inc., 845 A.2d 1031, 1035–40 (Del. 2004).

[46] *See* Lipton, *supra* note 22, at 1041 & nn.13–14.

[47] *Id.*

[48] *Id.*

managerial efficiency, is more relevant.[49] That argument proceeds from the premise that "[t]he pill does not prevent a proxy fight to remove and replace a board of directors that refuses to redeem the pill."[50] Even if the NOL pill precludes an activist shareholder from buying up shares in order to oust management on the strength of his own votes, the argument presumes, he can convince other shareholders to rise up and elect a board that is more capable of, or at least more interested in, maximizing shareholder wealth.[51]

The point as it relates to NOL pills has been contentiously debated[52] but it should probably be dismissed. There are two theoretical counterarguments, both of which were advanced in *Selectica*. The first one relies on the premise that shareholders rely on certain signals from proxy solicitors in order to determine those solicitors' credibility and decide how to vote.[53] Because a 5% cap on share ownership might "prevent[] a potential dissident from signaling its financial commitment to the company so as to establish such credibility,"[54] the NOL pill substantially handicaps dissident shareholders, makes them unable to replace even tremendously inefficient directors, and therefore entrenches bad management.[55]

The second counterargument focuses on the incentives of dissident shareholders rather than on those of the voters they seek to convince.[56] It notes that anyone owning less than a 100% interest in a corporation faces a free-rider problem when deciding whether to conduct a proxy contest to change management.[57] While the dissident shareholder lays out the entire cost of the proxy contest, he will reap only a pro rata portion of the benefits that accrue from improved management. The more limited the dissident's ownership share, the more daunting the free-rider problem is. At a point, it is simply not worth the trouble to change management. As Professor Ferrell argued in *Selectica*, "along with the reduced likelihood of success at a 5% position, the capped position would mean that the challenger would be unable to internalize more of the benefits by increasing her share ownership."[58] Together, the two arguments demonstrate that whether or not the NOL pill "makes a bidder's ability to wage a successful proxy contest and gain control either 'mathematically impossible' or 'realistically

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49 In fact, the argument played a very prominent role in Delaware's decision to validate the poison pill. *See infra* notes 52–60 and accompanying text.

50 Lipton, *supra* note 22, at 1037.

51 *Id.*

52 *See* Versata Enters. v. Selectica, Inc., 5 A.3d 586, 601–04 (Del. 2010).

53 *Id.* at 601.

54 *Id.*

55 *Id.* at 601–02.

56 *Id.*

57 *Id.*

58 *Id.* at 602 n.24.

unattainable,'"[59] the pill sure makes the proxy contest a heavy lift.[60] Given the plausibility of the arguments against allowing directors themselves to interfere with the market for corporate control,[61] permitting directors' valuations of the NOL to interfere with the possibility of successful proxy contests is troublesome.

*4. Protecting and Relying on Ineffective Directors.*—The arguments against allowing directors to limit ownership shares to 5% are quite strong even as they relate to the average corporate manager. When we talk about the NOL pill, though, it is worth noting we are often *not* talking about the average manager. Instead, the directors who will often be responsible for valuing NOLs will be the very directors who oversaw their corporations' losses. Permitting those directors to use the losses that they have overseen in order to protect their own jobs presents clear moral hazard. The market for corporate control protects good managers; the NOL pill protects bad ones.

And why trust loss directors to properly value their NOLs? Directors, like all other sentient beings, tend to overestimate their own abilities.[62] The *Selectica* court appeared to take note of the problem, remarking that "since it became a public company in March 2000, [Selectica] has lost a substantial amount of money and failed to turn an annual profit, despite

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[59] *Id.* at 601 (quoting Carmody v. Toll Bros., Inc., 723 A.2d 1180, 1195 (Del. Ch. 1998)) (internal quotation marks omitted).

[60] In response to Professor Ferrell's expert testimony, Professor John C. Coates presented an empirical expert report that demonstrated, to the satisfaction of both the Delaware Chancery Court and the Delaware Supreme Court, that pills restricting ownership to below 5% did not render successful proxy battles impossible. *Id.* at 602; *see also* Selectica, Inc. v. Versata Enters., Inc., C.A. No. 4241-VCN, 2010 WL 703062, at *21 (Del. Ch. Feb. 26, 2010) (summarizing testimony regarding the difficulty of waging a proxy battle from a 5% foothold), *aff'd sub nom. Selectica*, 5 A.3d 586. Nevertheless, as a fairly obvious theoretical matter, a dissident shareholder who controls a large percentage of the shares of a given corporation has a better chance than a dissident who controls a smaller percentage.

[61] A further problem with the incentives that the NOL pill creates reveals itself when one questions whether any *individual* corporation's decision not to adopt a poison pill has an effect on that corporation's value. Because of the ability to adopt "morning-after" pills—poison pills adopted after a potential acquirer announces its intention to increase its ownership stake—some commentators have argued that the acquisition-chilling effect of a pill is accomplished by *all* corporations in jurisdictions in which the pill is legal. *See, e.g.*, John C. Coates IV, *Takeover Defenses in the Shadow of the Pill: A Critique of the Scientific Evidence*, 79 TEX. L. Rev. 271, 287–88 (2000). This argument has not been made with regard to NOL pills, but there is reason to believe that a court's clear ratification of the legality of the NOL pill is tantamount to the adoption of a "shadow pill" by each corporation in the jurisdiction.

[62] EASTERBROOK & FISCHEL, *supra* note 1, at 183 ("Managers commonly believe that *their* firms are undervalued because they have rosy estimates of future profits; investors who are more skeptical will think the stock worth less than the managers do without a tinge of myopia. Managers most likely to grumble about 'undervalued' stock would be those least astute at understanding the firm's future in their hands . . . .").

routinely projecting near-term profitability."[63] Because the value of an NOL is in large part a function of the future profitability of the corporation to which it belongs,[64] even unconflicted directors are probably not good at determining what their NOLs are worth. Add in the systemic incentive to overestimate the NOLs' value and retain the poison pill, and the directors' job looks even harder. And because the 5% cap on ownership imposes such a substantial limitation on the market's policing ability, no one is there to check the directors' work. The NOL pill does not fare well in its bid to properly align corporate directors' incentives, but as we will see, it is just as abysmal at furthering the purposes of tax law.

### *B. Section 382 and the NOL Pill*

The NOL pill undermines the purposes of § 382 by making loss corporations more difficult to acquire than other corporations. The NOL impairment rules represent the IRC's attempt to prevent carryforwards from "imped[ing] sales of inefficiently operated businesses to new owners who could manage them better."[65] It does this through an elaborate series of rules designed to make NOL carryovers "a relatively neutral factor in acquisitions."[66] However, the use of § 382 to justify a particularly restrictive poison pill, perhaps the most effective single defense against acquisitions,[67] turns § 382 upside down.

My discussion of § 382 proceeds with a brief explanation of the great lengths to which § 382 goes to make carryforwards acquisition-neutral.[68] Following that explanation, I outline the ways in which the NOL pill gets § 382 severely wrong.

*1. Section 382: Making NOLs a Neutral Factor*.—Under § 172 of the IRC, a corporation may deduct against a given year's income the amount of its operating losses from previous years.[69] Should a corporation become profitable during the time in which it carries its NOLs forward, those NOLs

[63] *Selectica*, 2010 WL 703062, at *2.

[64] *See supra* note 37.

[65] BITTKER & LOKKEN, *supra* note 18.

[66] *Id.*

[67] *See* Lipton, *supra* note 22, at 1037 ("The pill prevents a hostile tender offer from being consummated unless and until the board of directors of the target redeems the pill. The pill does not prevent a proxy fight to remove and replace a board of directors that refuses to redeem the pill. It was and is a fundamental aspect of the pill that a proxy fight is the only way in which a raider can override a well-founded decision of the board to reject and block a takeover bid.").

[68] For a complete discussion of § 382's operation, see BITTKER & LOKKEN, *supra* note 18, ¶ 95.5.

[69] I.R.C. § 172(a) (2006) ("There shall be allowed as a deduction for the taxable year an amount equal to the aggregate of (1) the net operating loss carryovers to such year, plus (2) the net operating loss carrybacks to such year.").

serve to shield the corporation from tax liability.[70] NOLs can therefore be an extremely valuable asset in the hands of businesses that expect to realize gains within the carryforward period.[71]

The carryover provisions in § 172 "perform a needed averaging function by reducing the distortions caused by the annual accounting system,"[72] ensuring that a firm that invests, say, $5 in year one and does not experience a return on that investment until the next taxable year is not penalized by the IRC for failing to realize an immediate return. The policy thus encourages development of, and investment in, business practices that will be beneficial in the long term even if they are costly in the short term.

Free transferability of NOL carryforwards, however, would undermine the policies that § 172 seeks to advance. Those policies are furthered only if carryforwards are not transferable in a way that permits a loss to offset unrelated income.[73] In a regime that permitted free transferability, losses would rarely offset related income: firms that are uncertain of whether they will turn a profit in the near term necessarily value their NOLs less highly than firms that are more confident of their own near-term profitability. There would nearly always be a firm that valued a given NOL more than did the loss corporation, and that firm would be willing to purchase the NOLs in order to offset its own income. Thus, "the NOL deduction would often provide an inducement to transfers of businesses from more to less efficient managers."[74] Put another way, if firms were able to traffic freely in NOLs by buying "shell" companies for the value of their tax assets, profitable corporations would be enabled to, at the federal government's expense, deduct losses that they themselves had not actually sustained. Congress, reluctant to permit that result,[75] passed § 382 of the IRC.[76]

But § 382 does not provide for the complete destruction of the NOL asset upon an ownership change.[77] Rather, it allows NOLs to "survive an acquisition intact" but seeks a middle ground by permitting acquirers to

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70 For a discussion of the difficulties inherent in valuing NOLs before they are used, see *supra* note 37.

71 *See, e.g.*, Erickson & Heitzman, *supra* note 10, at 1370 ("NOLs used . . . to offset past or future taxable income[] provide a basis for a refund of prior taxes paid or reduce the amount of future income tax that must be paid. In either case, NOLs can generate cash flows for [a] firm, although the cash flows are uncertain in terms of timing and amount."); Randall Smith & Sharon Terlep, *GM to Get Tax Break Worth Billions*, WALL ST. J., Nov. 3, 2010, at B1 ("Investors typically view tax-loss carry-forwards losses as important assets in bolstering a company's balance sheet.").

72 STAFF OF JOINT COMM. ON TAX'N, 100TH CONG., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, at 294 (Comm. Print 1987).

73 *Id.*

74 BITTKER & LOKKEN, *supra* note 18.

75 *See* STAFF OF JOINT COMM. ON TAX'N, *supra* note 72.

76 *See* I.R.C. § 382 (2006).

77 *Id.*; *see also* BITTKER & LOKKEN, *supra* note 18 ("Congress sought [in § 382] a limitation that would make NOL carryovers a relatively neutral factor in acquisitions.").

take dramatically reduced annual deductions.[78] The reduced deduction is intended to match the expected amount that the loss corporation would have been able to deduct if it had liquidated its assets and invested them.[79] The reasoning behind this policy is that if NOLs simply evaporated upon changes of ownership, the corporations that had suffered losses would always value their NOLs *more* highly than any potential acquirer would. Loss firms would have a reason to value themselves more highly than would potential acquirers, and otherwise synergistic acquisitions would be deterred. The complexities of § 382 are meant to make acquirers and loss corporations place the same value on carryforwards. The Section was intended to prevent NOLs from playing a role in acquisitions. But the result that § 382 was designed to avoid is precisely the one that the NOL poison pill brings about.

*2. How Director Discretion Foils § 382.*—By placing the responsibility for valuing NOLs in the hands of the very people who have the strongest systemic incentive to overvalue them,[80] the NOL pill renders § 382 nearly useless. Although the pill furthers one aim of corporate law by preventing small shareholders from exercising disproportionate control over important corporate assets, it makes NOLs a star player in acquisitions. By limiting the ownership share and attendant voting power that a potential acquirer can obtain before challenging an incumbent board, the NOL pill seriously threatens the interests of activist shareholders.[81] To the extent that an active market for corporate control benefits all shareholders,[82] the restrictions that the NOL pill places on acquisitions acts as a serious impediment to shareholder wealth maximization. And directors are not likely to give way to a dissident's good ideas and determine that losing the NOL (and retracting the pill) is a good idea, even when it is.[83] The pill, quite simply, makes acquisitions far less likely than they would be in the pill's absence.

Recognizing that sound policy demands that shareholders be protected from a tyrannical minority is different from concluding that the NOL pill is an ideal mechanism. The fact that small minority shareholders cannot properly value NOLs does not mean that the privilege to do so should default to conflicted directors. There are other options. As I argue in the next Part, providing an appraisal right for non-impairing shareholders is an attractive one.

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78 BITTKER & LOKKEN, *supra* note 18.

79 *Id.*

80 *See supra* Part II.A.

81 *See supra* Part II.A.3.

82 For an assertion that an active market for corporate control increases overall shareholder wealth, see, for example, Easterbrook & Fischel, *supra* note 11.

83 As Judge Posner put it, "[n]o one likes to be fired." Dynamics Corp. of Am. v. CTS Corp., 794 F.2d 250, 256 (7th Cir. 1986), *rev'd on other grounds*, 481 U.S. 69 (1987).

## III. BUILDING AN APPRAISAL REMEDY FOR NOLS

The challenge, it seems, is to find a party that is capable of fairly valuing the NOL while still discouraging small minority shareholders from imposing externalities. Having noted that neither shareholders nor directors are well suited for this task, I argue in this Part that courts can provide an adequate last resort. In addition, they can impose constraints that would encourage corporate directors and would-be NOL impairers to come to fair and efficient agreements regarding NOL value. In this Part, I begin by constructing and explaining the benefits of a regime that would use the appraisal remedy to protect NOLs. I then address some flaws with the regime.

### *A. The NOL Appraisal Remedy*

It is intuitively obvious that judges have no special insight into the value of NOLs.[84] It may, in fact, be the case that they are less skilled at valuing NOLs than are shareholders or directors. Nevertheless, because shareholders have no reason to take externalities into account and directors face systemic biases, the appraisal remedy is worth exploring as a reasonable alternative. In this section, I explore the built-in advantages of an appraisal rule by outlining the contours of my proposed appraisal regime and demonstrating why the presence of an appraisal regime as a background rule would likely contribute to efficient private ordering.

*1. Appraisal as a Liability Rule.*—Although the appraisal remedy varies greatly by jurisdiction,[85] the fundamental idea of appraisal is to create a backstop liability rule for shareholders. When a firm undergoes an extremely significant transaction, objecting shareholders are permitted to use the judicial system to ensure that they have been fairly compensated for their shares.[86] Usually, appraisal creates an action against the party that benefits from the transaction: for example, in a freeze-out merger in which minority shareholders are purged, dissenting shareholders often have an opportunity to seek a judicial valuation of their shares in order to ensure that they have received a fair price.[87]

Appraisal, in other words, creates a liability rule. In situations in which appraisal is available, parties can seek "an external, objective standard of

[84] *See* Dodge v. Ford Motor Co., 170 N.W. 668, 684 (Mich. 1919) ("The judges are not business experts.").

[85] *See generally* Robert B. Thompson, *Exit, Liquidity, and Majority Rule: Appraisal's Role in Corporate Law*, 84 GEO. L.J. 1 (1995).

[86] *See* Paul G. Mahoney & Mark Weinstein, *The Appraisal Remedy and Merger Premiums*, 1 AM. L. & ECON. REV. 239, 239 (1999).

[87] *See* George S. Geis, *An Appraisal Puzzle*, 105 NW. U. L. REV. 1635, 1641–44 (2011).

value [that] is used to facilitate the transfer" of shares.[88] Where negotiation between the holder of a good and a potential buyer is costly or extremely difficult, liability rules permit easy transfers and reduce bargaining costs.[89]

As we have seen, the NOL creates just such a situation: the incentive structures of minority shareholders and of incumbent directors make both parties unable to determine the fair value of NOLs. If minority shareholders are not forced to compensate the corporation at all, they will undervalue NOLs because they do not have to pay the entire cost of impairment. Directors might be even worse: when a corporation benefits from a change in ownership, it is likely a result of the directors losing their jobs. Directors cannot, therefore, be expected to give up NOLs willingly. The third option, which would force minority shareholders who trigger NOL impairment to compensate shareholders for their lost value as determined by the courts, solves the problem.

*2. Designing an Appropriate Appraisal Remedy*.—So how would it work? First, potential insurgent shareholders would have to predict that by impairing the NOL they would see some financial return. If they knew that impairing the NOL was tantamount to buying it for an as-yet-unknown price, they would want to be confident in a return on their investment. The most likely form of that return would be increased managerial efficiency. Therefore, the most probable event in which NOL impairment would occur would be as part of a takeover attempt.[90] Aspiring NOL-impairers would note that their chances at a successful takeover would be improved by an increased ownership share, and would consider buying a large block of shares regardless of its impact on the NOL.

If the investor triggered impairment of the target corporation's NOLs, other shareholders could sue for the NOLs' value.[91] This is where the

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88 *See* Guido Calabresi & A. Douglas Melamed, *Property Rules, Liability Rules, and Inalienability: One View of the Cathedral*, 85 HARV. L. REV. 1089, 1106 (1972) ("In terms of economic efficiency the reason [for liability rules] is easy enough to see. Often the cost of establishing the value of an initial entitlement by negotiation is so great that even though a transfer of the entitlement would benefit all concerned, such a transfer will not occur. If a collective determination of the value were available instead, the beneficial transfer would quickly come about.").

89 *Id.* at 1106–07.

90 The reason for this is important enough to warrant an analogy, and tender offers provide one that is almost perfect. In that arena, we assume that "bidders won't make [offers above market price] unless they believe they can use the target's assets well enough to make the premium payment profitable, which implies increased productivity." EASTERBROOK & FISCHEL, *supra* note 1, at 162. An NOL-impairing stock purchase is tantamount to a purchase above market value: the investor suffers a loss in the amount of whatever portion of the company's total value represents the NOL. But who would buy up shares just to make himself pay? Nobody. An investor would make the purchase only if he expected to realize a return on investment in the form of increased productivity.

91 Although judges have constructed an astounding number of procedural hurdles to prevent the use of appraisal in merger situations, *see* Geis, *supra* note 87, at 1645–48, none apply cleanly or are necessary to the NOL appraisal scheme proposed here.

liability rule would kick in. Courts would take evidence on the value and likelihood of the future profitability of the loss firm, review the other factors that are relevant to NOL valuation, and award the lost value of the NOL to the target corporation.[92] The remaining shareholders would enjoy the regained value of the NOL on a pro rata basis. The activist shareholder would have "bought" the right to impair the NOL from the corporation at a price that the court, as the only readily available and unbiased party, determined was a fair value.[93] Appraisal would create a relatively streamlined process that prevented both the externality explained in Part I and the biased valuations of Part II.

*3. Bargaining in the Shadow of NOL Appraisal.*—Adding to the benefits of appraisal is the plausible intuition that liability rules encourage private ordering. As it stands today in Delaware, for example, conflicted directors are unlikely to calculate "fair" NOL valuations: they are incented to arrive at high valuations in order to prevent share purchases that would lead to takeovers, and the courts' permissive and procedural review does not serve as much of a check.[94]

With a liability rule in the background, that could change.[95] To see how, add to the proposed appraisal regime an option for the loss corporation to bargain away shareholders' right to sue for the value of NOLs. Now, when activist shareholders consider triggering NOL impairment, they have two options. First, as before, they can simply buy through the NOLs and rely on the court's later estimate of their value.

As an alternative, the shareholders can approach the directors and attempt to negotiate a settlement: by paying an agreed-upon price ex ante, the activist shareholders can impair the NOLs and avoid litigation afterwards. Unlike in an NOL pill regime, the directors here are constrained: they do not stand to increase their job security by refusing to negotiate because the activists can simply go over their heads and purchase shares directly from shareholders. The only thing stopping the activists from doing so is their estimate of the court's later judgment; the directors' monopoly on the right to impair the NOLs has vanished, and with it has gone their upper hand. It is in just this manner that liability rules have been

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92 *See supra* note 37.

93 It is important to note that the difficulties in valuing NOLs do not prevent corporations and the market from routinely attempting to approximate their value. *See, e.g.*, Mary Margaret Frank & Jonathan Right, *The Value of Net Operating Losses* (Univ. of Va. Darden Sch. Found. Working Paper No. UVA-C-2256, 2007), *available at* http://ssrn.com/abstract=1276995. Any merger or acquisition involving a firm that carries NOLs necessarily involves a NOL valuation; the question in this Comment is simply who should be responsible for taking their best shot at a valuation.

94 *See supra* Part I.

95 *See, e.g.*, T. Nicolaus Tideman & Gordon Tullock, *A New and Superior Process for Making Social Choices*, 84 J. POL. ECON. 1145, 1148 (1976) (arguing that the presence of background valuation rules encourages honesty in parties' initial valuations of goods).

used in a number of areas of the law to encourage private ordering, and they have been extremely effective.[96]

### *B. Arguments Against Appraisal*

Although the appraisal remedy puts the responsibility for valuing NOLs in the hands of the only unbiased party, there are a number of possible arguments against its efficacy. The first, that judges are in a poor position to value the NOLs as compared to directors—who are experts—flounders upon consideration of directors' biases. The second, that appraisal would *over*protect NOLs as compared to the regime proposed in Part I and, therefore, would undermine the market for corporate control in the same ways that the NOL pill does, falters as a result of the hazards that accompany the Part I approach.[97]

*1. Judges Are Not Business Experts.*—An argument that can be made against the NOL appraisal regime proposed here is that it takes NOL valuation out of the hands of experts and instead entrusts it to judges who are unlikely to perform the task competently. This argument is well reasoned, and it has been leveled at a number of regimes that place complex corporate decisions in the hands of judges.[98]

With regard to NOL appraisal, however, the criticism misses the mark. First, directors' expertise is of questionable value when stacked against their conflicts of interest. If directors have a professional incentive to overestimate value, is it at all relevant that they would otherwise be capable of getting it right?[99] If well-intentioned directors are incapable of accurately

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[96] *See* Daniel A. Crane, *Bargaining in the Shadow of Rate-Setting Courts*, 76 ANTITRUST L.J. 307, 308 (2009) (discussing judges' ability to act as rate regulators in antitrust cases, and noting that "judges' lack of expertise to set rates should not be thought a major detraction from this sort of remedy. Courts rarely exercise their rate-setting powers even when they retain them. The interesting question is not whether courts are any good at setting rates—they are not, but that may not matter—but what happens to the bargain of the licensor and the licensee when the shadow of a rate-setting court lies upon them."); Thomas J. Miceli & Kathleen Segerson, *A Bargaining Model of Holdouts and Takings*, 9 AM. L. & ECON. REV. 160, 160 (2007) ("[I]n the absence of eminent domain, holdouts are a significant threat, resulting in costly delay. However, if the developer has the power to use eminent domain to acquire the land from holdouts, all sellers will bargain, thus avoiding delay."). *But cf.* Lipton, *supra* note 22, at 1064 ("[T]o be an effective negotiator . . . the board needs the fundamental power of any successful negotiator: the ability to 'just say no' and walk away. The poison pill provides that power, which is why the pill is legal and why it enables directors to do their job effectively.").

[97] See *supra* Part I (arguing that if minority shareholders can impair NOLs without reimbursing the corporation, they will dramatically undervalue NOLs and impose externalities on other shareholders).

[98] *See, e.g.*, Lipton, *supra* note 22 (arguing for director primacy in the face of takeover attempts); Joel Seligman, *Reappraising the Appraisal Remedy*, 52 GEO. WASH. L. REV. 829, 830 (1985) (arguing that in the merger context, appraisal is rarely used in part because of "unpredictable standards for valuation").

[99] Panter v. Marshall Field & Co., 646 F.2d 271, 300 (7th Cir. 1981) (Cudahy, J., dissenting) ("The theoretical justification for the 'hands off' precept of the business judgment rule is that courts should be reluctant to review the acts of directors in situations where the expertise of the directors is likely to be

evaluating their own professional performance, of what use is their general understanding of business?[100]

In any event, judges regularly obtain their own unbiased experts.[101] Disinterested expertise is more valuable than interested expertise, of course, and the availability of appraisals, masters, and other neutral experts should assuage any concern about the relative expertise of judges and conflicted directors.

Finally, in the absence of any reason to suspect that judges would systemically overvalue or undervalue NOLs, one can be fairly confident that most parties would not litigate at all. While appraisal sets up a backstop to ensure that activist shareholders get a fair shake, it does not mandate that the parties go to court. In fact, it encourages parties not to litigate by increasing the likelihood that they will arrive at a fair deal by negotiating.[102] Appraisal takes the conflict out of the experts, but it does not take the experts out of the conflict.

*2. Too Strong a Deterrent Against Acquisitions?*—Another argument is that NOL appraisal would not adequately avoid the pitfalls of the pill. The logic is fairly simple: if an activist investor wants to buy up shares, triggering NOL impairment in the process, it is likely because he sees a potential gain from increased productivity in the future. That gain will benefit activist and passive shareholders alike, and the activist *already* faces a free-rider problem.[103] Why should appraisal exacerbate it by transferring additional wealth from the activist to the others? Shouldn't the activists lose only their pro rata share of the NOL, rather than having to compensate the passive shareholders who stand to gain from the takeover?

There is no satisfying answer. Just as the regime described in Part I would underdeter harmful NOL impairment, the appraisal rule overdeters beneficial transfers of wealth. A perfect rule would sort out those acquisitions that were designed earnestly to result in changes of corporate control and would take a Part I (pro rata) approach to the NOL loss in those

greater than that of the courts. But, where the directors are afflicted with a conflict of interest, relative expertise is no longer crucial.").

[100] *See* EASTERBROOK & FISCHEL, *supra* note 1, at 162 ("Deficient managers are no less likely to *believe* that they are doing the best for the firm than are superior managers; inability to tell what is best for the firm may be what makes a managerial team deficient. And craven managers, like the rest of us, reduce cognitive dissonance by believing that what's best for them is also best for their firms."); *see also supra* Part II.A.4.

[101] *See* FED. R. CIV. P. 53 (outlining a judge's authority to appoint masters); Seligman, *supra* note 98, at 830 ("[I]n many jurisdictions the initial appraisal valuation is made by an appraiser, not a judge . . . .").

[102] Seligman, *supra* note 98, at 830 ("[A]ppraisal statutes emphasize negotiations before an appraisal valuation proceeding may begin.").

[103] Recall Professor Ferrell's observation that even a successful takeover artist who improves corporate efficiency cannot reap 100% of the benefit unless he owns 100% of the shares. *See supra* notes 52–58 and accompanying text.

cases. It would differentiate takeover attempts, on the one hand, from harmful transfers designed only to damage the NOL on the other, and eliminate the incentive to engage in the latter by forcing appraisal and full reimbursement.[104] But in the absence of an adequate mechanism for sorting out the two types of acquisitions, a prophylactic rule favoring appraisal and overdeterrence is preferable simply because it encourages negotiation and places discretion in the courts, who might use that discretion to reach toward the "perfect" rule proposed above. Further, because the appraisal proceeding would take place *after* an attempted takeover, it might be clear to all parties whether an acquisition was a good-faith takeover attempt or a bad-faith destruction of assets. Although appraisal may provide too strong a deterrent to some well-intentioned acquisitions, it is the best of the three available approaches.

## CONCLUSION

Although the NOL pill provides valuable protection for shareholders of loss corporations, it comes at a high cost both to shareholders and to the realization of § 382's policy aims. The pill perverts the NOL impairment provisions in § 382, rendering hostile acquisitions of loss corporations more difficult despite the fact that § 382 embodies a congressional effort to make the NOL a neutral factor in acquisitions.

Despite these shortcomings, the NOL pill accomplishes an important objective by increasing the ability of corporations to defend their assets against corporate raiders. A corporate law landscape that disallowed the NOL pill and did not offer a sufficient replacement would leave loss corporations at the mercy of competitors or other raiders, who would be able to buy enough shares to devalue their carryforwards while internalizing only a portion of the harm.

By taking a lead role in valuing NOLs, courts could avoid the harmful results of granting broad deference to conflicted corporate managers. Under an appraisal regime, NOLs would be protected not by a broad grant of discretion to directors, but by a requirement that insurgents compensate corporations whose NOLs they impaired. Appraisal would lead to two distinct positive results, both of which would further the policies of § 382 and the efficiency of the market for corporate control. First, appraisal would eradicate the NOL pill and return the mergers and acquisitions market to the status quo that prevailed before the NOL pill gained prominence.

Second, the liability rule would facilitate private ordering by providing a background rule that would not favor either insurgents or directors. Directors who know that their valuations will be given "business judgment"

[104] Note that this rule is the only one that honors § 382's admonition to maintain NOLs' neutrality in acquisitions. *See supra* Part II.B. Unfortunately, the difficulties in sorting good-faith acquisitions from bad faith ones simply make this rule too difficult to administer.

deference, limited only by the broad scope of "reasonableness," will tend to overvalue NOLs. Directors negotiating in the shadow of meaningful judicial intervention, however, will be constrained to arrive at lower and more accurate valuations. This, again, would enable insurgent shareholders aiming to maximize corporate wealth to undergo cost–benefit analyses regarding the value of increased ownership as it relates to their likelihood of undergoing successful proxy contests. By removing the power to value NOLs from conflicted directors, the appraisal remedy would further the policy goals that the IRC seeks to advance and benefit the interests of all relevant parties.