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NOL Poison Pill – A Timely Prescription

Recent market trends, which themselves often lead to increased turnover in a company's shareholder base, may increase the risk that companies with significant NOL assets could face a limitation on their use fixed at an inopportune moment as a result of the statutory formula.

With recent stock market volatility and sharp drops in stock market prices coupled with the continuing low interest rate environment, management and boards of directors of companies with significant net operating loss carryforwards (NOLs) may want to consider taking steps to preserve these valuable tax assets. Section 382 of the Internal Revenue Code applies formulaic limitations on the ability of a company to utilize its NOLs in future years if it undergoes an "ownership change" (i.e., an ownership increase of fifty percentage points or more by 5% shareholders of the company during a three-year testing period). In general, the applicable rules provide that any purchase or sale by a 5+% shareholder is relevant in determining whether an ownership change has occurred, but a purchase or sale by a less than 5% shareholder is ignored unless it causes the shareholder to then own 5% or more of the company's stock. If an ownership change has occurred, there will be a "Section 382 limitation" on use of the NOLs to shield taxable income in future years. This annual limitation will be based on the product of the company's equity value at the time of the ownership change and a specified adjustable IRS long-term tax-exempt interest rate (hence the concern with the confluence of depressed stock market prices and low interest rates).

While the Section 382 rules were intended, in part, to limit the use of target NOLs by acquirers, the ownership change test also can catch companies that simply experience turnover in their base of large stockholders. As a result, "loss corporations" often explore ways to prevent acquisitions of 5% or greater stakes in their stock in order to reduce the likelihood that an ownership change will occur. The most effective means to accomplish this is the enactment of a charter provision that prohibits acquisition of 5% or greater positions and includes forfeiture mechanisms if the threshold is exceeded. While effective, these restrictions, modeled on similar ownership caps in REIT or regulated industry charters, require shareholder approval which may not be forthcoming or obtainable in a timely fashion, if at all.

An alternative is the implementation by the board of directors of an NOL rights plan, or poison pill, which seeks to deter the accumulation of 5+% positions (and further acquisitions by existing 5% holders) by threatening significant dilution to the offending stockholder by giving all other stockholders the right to acquire additional shares at a significant discount. The structure, operation and steps for implementation of the NOL rights plan are substantially similar to those of a traditional anti-takeover poison pill (see our *M&A Update* on Poison Pill Plumbing), although certain provisions are adjusted to reflect the intended purpose of the NOL rights plan:

- The plan typically uses a triggering beneficial ownership threshold just below 5%, as compared to a 10-20% range in traditional plans
- The definition of "beneficial ownership" for purposes of determining whether the threshold has been breached usually references ownership as defined under either securities laws and/or Section 382
- The plan often includes significant exemptive discretion to the board of directors, including if it determines that a particular acquisition will not jeopardize the NOL assets
- In order to limit the instances in which exemptive permission is sought, the plan may include special built-in calculation provisions for the benefit of certain institutional shareholders (*e.g.*, a mutual fund complex) where the IRS determination of ownership differs from SEC beneficial ownership principles (*i.e.*, fund-by-fund vs. complex-wide)

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- Current 5+% shareholders are usually grandfathered, subject to a "headroom" provision that caps further acquisitions (typically at 1% or less)
- Most NOL plans will include a sunset provision tied to either a specific date (often three years) or the expected useful life of the NOLs being protected, with earlier expiration if the NOLs are fully utilized or the plan is deemed no longer to be necessary
- Unlike many anti-takeover plans, an NOL plan often excludes provisions that pick up ownership of derivatives and "wolfpack" activity in calculating the triggering of the beneficial ownership threshold

While the NOL rights plan can be enacted by a board of directors without shareholder approval, in practice about half of implementing companies have submitted the plan to shareholder ratification at their next annual meeting. Although governance constituencies may complain about the corollary anti-takeover impact of the NOL poison pill, shareholders have been largely supportive of these plans in resulting votes, with both ISS and Glass Lewis willing to recommend in favor of ratification if certain minimum criteria are met. A robust communications plan is advisable around the time of enactment and the shareholder ratification vote to ensure the reasoning behind the board's action is well understood. In addition, the validity of an NOL plan has been upheld by a Delaware court in 2011 (*Selectica*).

It is important to note that an NOL plan is not a guaranteed way to prevent a Section 382 ownership change. This inherent limitation stems from the plan acting as a deterrent to the existence of 5% shareholders, by threatening significant dilution, as opposed to serving as a prohibition on such an accumulation. In addition, the plan does not affect the ability of existing 5% shareholders to sell their holdings, transactions which frequently will count in determining whether there has been an ownership change.

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Recent market trends, which themselves often lead to increased turnover in a company's shareholder base, may increase the risk that companies with significant NOL assets could face a limitation on their use fixed at an inopportune moment as a result of the statutory formula. In recent years, dozens of companies have turned to an NOL rights plan as an effective and efficient means of temporarily preserving the value of the tax assets that could be severely impaired if there is significant acquisition or sale activity by large stockholders.

If you have any questions about the matters addressed in this *M&A Update*, please contact the following Kirkland authors or your regular Kirkland contact.

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