March 27, 2020

Using Rights Plans to Preserve Net Operating Losses

EXECUTIVE SUMMARY

- Companies with significant net operating losses (NOLs) may wish to take steps to protect these losses from limitation under Section 382 of the Internal Revenue Code (the Code), particularly in circumstances where equity valuations are depressed and interest rates are low.
- One of the most effective ways that companies can seek to protect NOLs is by adopting an NOL rights plan.
- Courts have endorsed the adoption of NOL rights plans as a mechanism to protect corporate assets and shareholder value.
- In the event additional protections for NOLs are required, a charter amendment prohibiting acquisition of shares equal to or greater than five percent may also be appropriate (although obtaining shareholder approval of such an amendment may not be practical in the short term).
- We expect a significant number of public companies to adopt NOL rights plans to protect NOLs from limitation under Section 382 of the Code, particularly in sectors most exposed to the economic repercussions of COVID-19.
- In seeking to adopt an NOL rights plan and/or charter amendment, companies should ensure that they follow appropriate processes and satisfy applicable legal and stock exchange requirements.

A. OVERVIEW OF NOL RIGHTS PLANS

In the midst of focusing on the unprecedented crisis affecting employees, customers and communities, boards of directors will also wish to ensure that they are taking appropriate steps to protect and preserve valuable corporate assets. In the context of the recent market moves and the potential for a prolonged period of economic uncertainty, businesses experiencing significant revenue drops as a result of COVID-19 may have, or will likely accumulate, significant net operating losses (NOLs) that can be used to offset corporate tax liabilities in future years. In addition, many companies may have accumulated significant NOLs in the past that they wish to protect for future use. However, due to the operation of Section 382 of the Internal Revenue Code (the Code), companies' ability to use NOLs may be limited in the event of certain acquisitions of a company's equity securities. One of the most effective means of protecting these valuable tax assets is by adopting an NOL shareholder rights plan (also known as an NOL poison pill), which protects NOLs from being limited by Section 382 of the Code.

B. RATIONALE FOR ADOPTING NOL RIGHTS PLANS

The limitation on a company's ability to carry forward its NOLs, capital losses and certain credits under Section 382 of the Code is typically caused by an "ownership change" of the company. An "ownership change" occurs if a shareholder or group of shareholders owning at least five percent of a company's common stock increases its ownership (individually or as a group) by 50 percent over their lowest ownership percentage within the prior three years.

If such an ownership change occurs, Section 382 imposes an annual limit on the amount of a company's NOLs that can be used to offset income taxes. This annual limit is equal to the product of the market value of the company's equity immediately prior to the ownership change and the federal long-term tax-exempt interest rate then in effect, subject to certain complex tax adjustments. As many companies have or will accumulate significant operating losses and write-downs arising from COVID-19, or have significant NOLs from previous years that they intend to use in the future, there may be material financial consequences if such NOLs were to expire in connection with the acquisition of the securities of the company, particularly in circumstances where interest rates are at record lows. This risk is particularly acute for companies experiencing a disconnect between their market capitalizations and the intrinsic value of their businesses, as these companies may be especially vulnerable to approaches by investors and strategic buyers opportunistically seeking to acquire equity securities at significantly depressed prices.

An NOL rights plan is intended to address this risk. Like the takeover defense rights plan, the NOL rights plan triggers an automatic and substantial dilution of the triggering shareholder's investment in the company in the event that the shareholder acquires more than a specified percentage of the outstanding shares of a company (4.99 percent in the case of NOL rights plans, and as much as 15 to 20 percent in the case of takeover defense rights plans) by permitting the company's other shareholders to acquire additional shares at a significant discount to market prices. However, unlike takeover defense rights plans, which serve as a general defense against hostile takeovers, NOL rights plans are specifically tailored to preserve accrued NOLs that might otherwise expire pursuant to Sections 382 and 383 of the Code upon acquisition by a shareholder of five percent or more of the common shares of a company. As such, NOL rights plans provide a mechanism to protect NOLs in certain circumstances so that they remain available to be used as an offset against current and future tax liabilities and as a corporate asset to be valued appropriately in any board-approved sale of the company.

Although no two crises are precisely analogous, the response of companies in the 2008 financial crisis may be an appropriate analog to current circumstances. After 2008, when many companies incurred significant

NOLs and precipitous declines in their market capitalization, companies took steps to preserve NOLs for future use. From 2007 to 2009, the number of NOL rights plans adopted per year increased significantly, from four in 2007 to 37 in 2009.

Since the beginning of March 2020 (when the economic effects of COVID-19 began to be felt most acutely by US companies) there has been a further significant increase in the rate of adoption of rights plans, with 13 companies adopting new rights plans (nine takeover defense rights plans; four NOL rights plans). We expect that this trend will continue and a significant number of public companies will adopt rights plans, particularly in those sectors that have been disproportionately affected by the COVID-19 pandemic.

C. IMPORTANT CONSIDERATIONS WHEN ADOPTING AN NOL RIGHTS PLAN

While NOL rights plans are similar in structure and effect to takeover defense rights plans, a board should take care to tailor any NOL rights plan to the particular situation faced by the company. To effect an NOL rights plan, the board generally declares a dividend of certain rights to all holders of common stock entitling each holder to purchase a corresponding share of preferred stock. If the NOL rights plan is triggered in the event of an ownership change, each holder of preferred stock is entitled to purchase common stock at a predetermined, below-market exercise price designed to maximize the dilutive effect of the NOL rights plan. While the mechanics will necessarily vary between companies, typical NOL rights plans generally include the following features:

- a definition of beneficial ownership that closely tracks Section 382 of the Code and any Treasury regulations promulgated thereunder (particularly in circumstances where a company has significant institutional investors);
- grandfathering of existing five percent or greater shareholders up to their current ownership percentage;
- a mechanism to track coordinated activity by otherwise unrelated parties and acquisitions by way of derivative instruments such as total return equity swaps or other similar arrangements;
- board discretion to waive the application of the rights plan in certain circumstances (e.g., when an acquisition of equity securities is not expected to jeopardize NOLs); and
- an expiration date tied to either a specific date (often three years) or the expected useful life or expiration of the NOLs.

When seeking to adopt any form of rights plan, including an NOL rights plan, it is critical that the company's board of directors clearly communicate to the company's shareholders and the securities markets the rationale for adopting the rights plan. While an NOL rights plan may incidentally provide significant takeover defense protection, its primary purpose is to protect the company's NOL carryforwards from being limited under Section 382 of the Code. By attempting to expand the scope of an NOL rights plan by bundling in additional anti-takeover protections, companies may ultimately jeopardize the plan by exposing it to claims from shareholders that might otherwise be avoided.

The timing for adoption of an NOL rights plan is also critical, and differs in material respects from the timing for takeover defense rights plans. Unlike traditional takeover defense rights plans, which may be kept "on the shelf" until they are needed in the context of a hostile takeover or activist approach, if a company decides that it needs to adopt an NOL rights plan in light of current circumstances, including the prevailing interest rate environment, it should do so promptly to ensure that its NOLs are protected from use limitations in the event of shareholder ownership changes.

Finally, companies should attempt to anticipate the reactions of institutional investors such as Vanguard and BlackRock and proxy advisory firms such as ISS and Glass Lewis to the adoption of an NOL rights plan. While institutional investors and proxy advisory firms have generally disapproved of takeover defense rights plans in recent years, NOL rights plans are usually viewed more favorably, provided that they are appropriately tailored. That said, proxy advisory firms generally recommend that shareholders vote case-by-case on management proposals for NOL rights plan ratification, taking into account a wide variety of factors beyond the terms of such a plan or amendment itself, including a company's existing governance structure, board independence, existing takeover defenses, track record of responsiveness to shareholders and any other problematic governance concerns. If a company can point to significant pre-tax NOLs and adopts an NOL rights plan of short (three-year or less) duration, and there is no apparent ulterior motive at play, there is a greater likelihood that proxy advisory firms and institutional investors will support the adoption of the rights plan.

D. CHARTER AMENDMENTS – AN ALTERNATIVE TO ADOPTING AN NOL RIGHTS PLAN IN CERTAIN CIRCUMSTANCES

When assessing the merits of whether to adopt an NOL rights plan, boards of directors should be aware that an NOL rights plan does not protect valuable NOLs in the event that a new or existing shareholder either inadvertently exceeds the five percent threshold or intentionally "buys through" the threshold. The risk of a shareholder inadvertently exceeding the five percent threshold is exacerbated by the fact that shareholders do not usually have visibility into the (often complicated) calculations used to determine whether an ownership change has occurred under Section 382. This risk is particularly acute for companies operating in a period of heightened volatility, when the value of companies' publicly held securities can change materially in short periods of time.

To address the risk of an inadvertent trigger or a shareholder "buying through" the threshold, many companies consider coupling an NOL rights plan with adoption of a charter amendment of limited duration that prohibits shareholders and groups of shareholders from acquiring five percent or greater positions in their stock and renders any acquisition of shares in excess of that threshold null and void. Unlike NOL rights plans, which only have a deterrent effect, the charter amendment more comprehensively addresses the risk of an ownership change ocurring under Section 382 as a result of an acquisition of shares by a shareholder (although a company will remain exposed to the risk that a large shareholder will sell some or all of its shares and create other five percent shareholders as a result). However, charter amendments are usually time consuming to adopt and therefore not practical in the short term when immediate protection for NOLs is needed; adopting a charter provision requires shareholder approval and places additional weight on obtaining a favorable recommendation from proxy advisory firms. Moreover, even if such a charter amendment is approved by shareholders, in some states the amendment may nevertheless not be enforceable against shareholders who did not vote their shares in favor of the amendment. If a board of directors decides to pursue a charter amendment (either alone or together with an NOL rights plan), the board will face a number of important tactical and practical decisions regarding the timing and manner of implementation, and should consult with experienced legal advisors and a proxy solicitor.

E. ADOPTING AN NOL RIGHTS PLAN

If a board of directors is considering adopting an NOL rights plan, the board should develop a process to ensure that the applicable requirements of state and federal law and the relevant stock exchanges are satisfied. In practice, this usually means:

- receiving presentations from outside counsel regarding directors' fiduciary duties, the potential reactions of major institutional investors and corporate governance watchdogs to the rights plan, considerations relating to the selection of a record date and payment date for the plan, and the other mechanics of the rights plan;
- receiving presentations from the chief financial officer or other member of management regarding the magnitude of and potential for using the company's NOLs;
- developing a robust communications plan to ensure the reasoning behind the board of directors' actions is well understood by shareholders and the market; and
- periodically reviewing the rights plan to ensure that the value of the company's NOLs warrant retaining such protections.

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