

12-2012

NOL Poison Pills: Using Corporate Law for Tax Purposes


Sarah J. Webber

University of Dayton, swebber1@udayton.edu

Karie Davis-Nozemack

Georgia Institute of Technology

Follow this and additional works at: https://ecommons.udayton.edu/acc_fac_pub

 Part of the [Accounting Commons](#), [Business Administration, Management, and Operations Commons](#), [Business Law, Public Responsibility, and Ethics Commons](#), [Corporate Finance Commons](#), and the [Nonprofit Administration and Management Commons](#)

eCommons Citation

Webber, Sarah J. and Davis-Nozemack, Karie, "NOL Poison Pills: Using Corporate Law for Tax Purposes" (2012). *Accounting Faculty Publications*. 57.

https://ecommons.udayton.edu/acc_fac_pub/57

This Article is brought to you for free and open access by the Department of Accounting at eCommons. It has been accepted for inclusion in Accounting Faculty Publications by an authorized administrator of eCommons. For more information, please contact frice1@udayton.edu, mschlangen1@udayton.edu.

NOL POISON PILLS: USING CORPORATE LAW FOR TAX PURPOSES

BY SARAH WEBBER & KARIE DAVIS-NOZEMACK

Summary

Hundreds of thousands of corporations report net operating loss (NOL) carryovers every year.¹ Corporations, with the benefit of NOL rules, may turn disappointing losses into favorable tax results. During economic recovery, corporations are in better position to fully utilize the benefits of NOLs generated in prior years. NOL usage is not without peril, however. Corporations should carefully monitor corporate ownership changes to ensure that NOLs are not lost to the NOL trafficking rules. Under the NOL trafficking rules, excessive shareholder turnover triggers substantial NOL limitations. Unfortunately, corporations are not in control of their shareholder turnover, and therefore not in complete control of their NOLs. To maintain NOL control, corporate tax planning may utilize defensive tactics found in corporate law, including an NOL poison pill plan. This article discusses the motivations, benefits and consequences of NOL poison pill plans.

Introduction

Net operating loss (NOL) poison pill plans have their roots in § 172 and § 382. While § 172 permits corporations to use NOLs to offset income, § 382 limits a corporation's NOLs if excessive corporate ownership change occurs. Section 382 is notoriously complex but a general understanding of this code section is necessary to explain the motivation for using NOL poison pill plans.

The NOL poison pill plan is a variation of traditional poison pill plans. During the 1980s, one strategy corporations employed to prevent hostile takeover attempts was the adoption of shareholder rights agreements, often referred to as poison pill plans. The traditional poison pill plan's goal was protection of the shareholder control premium.² In other words, poison pill plans were conceived to ensure that buyers paid shareholders adequately for gaining control of the corporation.

A poison pill plan is aptly named because it acts to poison the existing shares of stock to make the target corporation appear more difficult to acquire and therefore less attractive to the potential acquirer. In practice, poison pill plans often serve as a stall tactic to afford the target corporation additional time to secure capital, to identify a more preferable buyer, or to negotiate a higher price with the buyer.³

¹ IRS, 2009 Estimated Data Line Counts Corporation Tax Returns, available at <http://www.irs.gov/pub/irs-soi/09colinecount.pdf>, Form 1120, Line 29.

² Edward F. Greene, Regulatory and Legislative Responses to Takeover Activity in the 1980s: The United States and Europe, 69 TEX. L. REV. 1539, 1565 (1991).

³ Charles M. Yablon. "Symposium; Fundamental Corporate Changes: Causes, Effects, and Legal Responses: Poison Pills and Litigation Uncertainty," 1989 Duke L. J. 54, 56 (1989).

In the last decade, poison pill plan usage has dramatically decreased.⁴ The disfavor of poison pills is likely due to increased shareholder activism,⁵ as well as criticism that poison pills entrench management and are ultimately not in shareholder interest. Many years of research failed to prove the widely held view that poison pill plan usage is detrimental to shareholder interest; however, more recent research may finally show otherwise.⁶

NOL protection presents an alternative use for poison pills. Instead of the traditional poison pill's purpose of takeover defense, an NOL poison pill's primary purpose is to protect a tax asset. An NOL poison pill plan is very similar to a traditional poison pill plan. It has one crucial structural difference, however. An NOL poison pill plan is triggered at substantially lower shareholder ownership levels. While traditional poison pill plans have long been held permissible, until *Selectica* no court had determined whether an NOL poison pill plan's low trigger and purpose were permissible. In 2010, the *Selectica* case, discussed below, validated the use of NOL poison pill plans.

NOLs Generally

While a corporation's board and shareholders are usually unhappy with losses, § 172 can provide some comfort. Section 172 affords corporations a form of income averaging by allowing a corporation to offset past or future income with NOLs. Using an NOL carryback allows for the creation of tax refunds for previous tax years by offsetting prior year income with current NOLs. An NOL can generally be carried back for two years and carried forward for twenty years.⁷ Rather than use a carryback, a corporation may elect to use an irrevocable (on an annual basis) carryforward.⁸ A corporate NOL is calculated as gross income less deductions but includes an unlimited dividends received deduction and excludes prior NOLs as well as any domestic production deduction.⁹

While a corporation may use NOLs to offset income and possibly generate tax refunds, NOL usage relies on a corporation's ability to generate income or otherwise utilize

⁴ Karen Kroll, "Shareholder Activists Gaining Ground," www.complianceweek.com, August 2011 (citing Governance Metrics International) (stating that "In 2002, more than half of companies had 'poison pills' to thwart potential takeovers, compared with just 16% today."). See also Matteo Tonello, "Poison Pills in 2011," The Harvard Law School Forum on Corporate Governance and Financial Regulation (April 2011) (concluding "over the past decade, fewer and fewer public companies have maintained traditionally structured poison pills. In 2001, more than 2,200 corporations had poison pills in effect; a January 4, 2011 search through Capital IQ found that fewer than 900 corporations had poison pills in effect.").

⁵ *Id.*

⁶ John C. Coates IV, "The Contestability of Corporate Control: A Critique of the Scientific Evidence of Takeover Defenses," 79 Texas Law Rev. 271 (2000); Lucian Bebchuk, "An Antidote for the Corporate Poison Pill," *Op-ed* Wall Street Journal, Feb. 24, 2011 (citing Bebchuk's research with John Coates and Guhan Subramanian that "boards that defeated premium offers failed on average, even in the long run, to produce returns for their shareholders that made remaining independent worthwhile.").

⁷ § 172 (b)(1)(A).

⁸ § 172(b)(3).

⁹ § 172(d); Treas. Reg. 1.172-2(a). An NOL deduction can arise for individuals and trusts and estates as well as corporations; however, this article focuses on the corporate use of NOLs in the context of poison pill plans.

an NOL. For an NOL carryforward, an NOL's value and utility is contingent upon future circumstances. The perceived value of an NOL as an asset is demonstrated in financial reporting. The financial accounting rules permit an NOL to be recorded on a corporation's balance sheet as a deferred tax asset under FASB ASC 740 because of its anticipated future tax savings.¹⁰ An NOL deferred tax asset is valued as the gross NOL amount multiplied by the effective tax rate, unless prior negative evidence or concerns for future realization exist.¹¹ A long track record of losses or very large losses could be evidence of impaired usage. Consequently, corporations may carry NOLs at greatly reduced or nominal values. Although NOL usage lacks certainty, corporate boards are incentivized by an NOL's potential value to preserve it for possible future use.

§ 382 Limits and Shareholder Triggers

Congress intended § 382 to restrict NOLs after an acquisition.¹² This section attempts to limit the use of an NOL to the income that the target would have earned had no acquisition taken place. The rate of return on the target's value is used to calculate the amount of the limitation.¹³

To dissuade potential trafficking in NOLs, corporations with substantial shareholder ownership changes incur an NOL limitation under § 382.¹⁴ Specifically, if one or more of the shareholders who own at least 5% of the corporation's stock increase their ownership by more than 50% during a three-year testing period, then NOLs are limited.¹⁵

The ownership test is fairly complex, and its consequences may result from a single shareholder purchase or multiple shareholder transactions occurring over time. Calculating ownership requires use of segregation and aggregation rules, including the constructive ownership rules in § 318.¹⁶ Even shareholders who do not own 5% may be aggregated into direct or indirect public groups, which may be treated as 5% shareholders.¹⁷ Ownership changes may include shareholders who are 5% shareholders at any point during the testing period.¹⁸

Changes in ownership are measured by comparing a 5% shareholder's ownership on the testing date with that shareholder's lowest ownership percentage during the testing

¹⁰ Anthony Catanach and Shelley Wells-Catanach, "Net Operating Losses: How Much Are These "Assets" Really Worth?," 21 Commercial Lending Rev. 4 (July 2006).

¹¹ FASB ASC 740 ("A valuation allowance is recognized if, based on the weight of available evidence, it is more likely than not that some portion or all of the deferred tax asset will not be realized.").

¹² Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1985, at 295.

¹³ Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1985, at 296.

¹⁴ §382 applies limitations to Net Operating Losses as well as unrealized built in losses, but the discussion of §382 is limited to its application in the NOL setting.

¹⁵ Stock includes all stock except preferred stock that is not entitled to vote and several other restrictions. I.R.C. §§ 382(k)(6)(A) and 1504(a)(4); Treas. Reg. § 1.382-2(a)(3).

¹⁶ Treas Reg. 1.382-2T(h).

¹⁷ Treas Reg. 1.382-2T(j).

¹⁸ Treas. Reg. 1.382-2T(g).

period.¹⁹ Testing occurs on the date a shareholder either became a 5% shareholder with additional shares purchased or an already existing 5% shareholder acquired additional shares.²⁰ Stock options may be included under the option attribution rule that treats options as if they were exercised.²¹ The option attribution rule may extend to any contingent purchase, warrant, convertible debt, put, stock subject to risk of forfeiture, contract to acquire stock, or similar interests.²²

Even the disposition of stock can trigger § 382 application. Section 382 requires the disposition of any 5% or more shareholders' stock to be treated as if a new 5% shareholder is created, even if the total disposition is less than 5%.²³ Stock repurchases may also trigger a § 382 ownership change, as may tax-deferred reorganizations.²⁴ Special rules apply to stock offerings solely for cash or a small issuance.²⁵ Furthermore, the three-year testing period has an unusually broad interpretation;²⁶ however, the testing period may be less than the full three years if NOLs have not existed during the entire period.²⁷

If the NOL limitation is triggered by the ownership rules, the limitation can be quite significant. NOLs are limited to the value of the corporation multiplied by the long-term tax-exempt rate.²⁸ The rate was 3.5% for January 2012.²⁹ The value of a corporation is the fair market value of its outstanding stock³⁰ or market capitalization.³¹ In addition, a corporation may lose NOL usage entirely if the corporation fails to show it is operating as the same business enterprise following the ownership change. This continuity test requires either the corporation to continue the historical business operations pre-ownership change or use a significant portion of the corporation's assets in a new business following the ownership change.³²

As a result of the complex ownership rules, recordkeeping can become extremely burdensome. Yet, it is a critical necessity for corporations carrying NOLs. While corporations report ownership changes in a statement attached to the corporate tax return, it has been suggested that, in practice, some corporations may not undertake precise reporting while they are loss corporations.³³ Failing to undertake due diligence with

¹⁹ § 382(g).

²⁰ Treas. Reg. § 1.382-2T(e)(1).

²¹ § 382(l)(3)(A)(iv). Options are deemed exercised under the ownership, control and income tests in Prop. Treas. Reg. § 1.382-4(d).

²² § 382(l)(3)(A).

²³ Treas. Reg. § 1.382-2T(e)(1).

²⁴ Treas. Reg. 1.382-2T(j).

²⁵ See Treas. Reg. 1.382-3(j)(2) and (3). See also Prop. Treas. Reg. 1.382-3(j)(13), (14), (15).

²⁶ § 382(i).

²⁷ Treas. Reg. 1.382-2T(d).

²⁸ § 382(b).

²⁹ Rev. Rul. 2012-2.

³⁰ § 382(e).

³¹ TAM 9332004.

³² Treas. Reg. § 1.368-1(d)(1).

³³ Robert Rizzi, "New Respect for Trafficking in Losses: NOL Protections Take Hold," 37.3 Corporate Taxation at 30-34 (May/June 2010).

respect to the reporting requirement can create a situation where a corporate board may learn too late that the corporation's NOLs have been limited. This concern and lack of corporation control over NOLs is precisely what is driving the use of NOL poison pills.

Corporate Use of Poison Pill Plans

When poison pill plans were first promoted as a means to protect corporations against takeover attempts, there were two main types of plans: a "flip in" plan and a "flip over" plan. These pill plans are often adopted simultaneously to work together to deter potential acquirers.³⁴ The flip in plan is generally triggered with a purchase of 10% to 20% of the corporation's stock.³⁵ The ownership threshold is set at 10-20% because this is the range that generally creates a legitimate threat of takeover.

The flip in plan permits shareholders, excluding the potential buyer, the ability to buy additional discounted shares.³⁶ This dilutes the potential buyer's ownership percentage. If a potential acquirer triggers a poison pill plan, the acquirer is faced with two options: sell current stock holdings in the target corporation or continue to suffer losses as the stock becomes increasingly diluted by subsequent poison pill plans.³⁷

A flip over plan is the most common poison pill plan and often follows a flip in plan. A flip over plan occurs only if a buyer successfully merges the target corporation into itself or an affiliated company.³⁸ A flip over plan usually requires the successor corporation ("buyer") to offer the target corporation's shareholders the opportunity to buy the successor corporation's shares at a discounted price. The additional issued shares dilute the buyer's existing shareholders.

Several variations of poison pill plans have also developed but the ultimate goal of the poison pill plans has generally been to serve as an economic deterrent by making the acquisition of a corporation prohibitively costly to a potential buyer.³⁹ This ability to deter potential buyers is highly dependent upon the target corporation's access to capital and perceived economic conditions for the corporation. A corporation that adopts a poison pill plan while it has low market capitalization or suffers financial distress is less likely to benefit from the deterrent effect of a poison pill plan.⁴⁰

The NOL Poison Pill Plan- A Variation in Purpose and Trigger

³⁴ Stephen M. Bainbridge, *Corporation Law and Economics* 26-27 (2002).

³⁵ *Id.*

³⁶ Randall S. Thomas, *Judicial Review of Defensive Tactics in Proxy Contests: When Is Using a Rights Plan Right?*, 46 VAND. LAW. REV. 503 (1993).

³⁷ *Id.*

³⁸ *Id.*

³⁹ Matteo Tonello, "Poison Pills in 2011," *The Harvard Law School Forum on Corporate Governance and Financial Regulation* (April 2011).

⁴⁰ *Id.*

An NOL poison pill, like a traditional poison pill, is a collection of defensive maneuvers.⁴¹ Both are designed to poison shares to dissuade undesirable buyers. The impetuous for NOL poison pill usage and the level of ownership at which the plan is triggered are the only material differences between an NOL poison pill plan and a traditional poison pill plan.

The motivation for an NOL poison pill plan is different from that of a traditional poison pill plan. Instead of hostile takeover prevention, the primary objective of an NOL poison pill is to protect an asset: the future use of NOLs. Indeed, when a board adopts an NOL poison plan, it is typical for the board to disclose that its motivations are to protect these NOL tax assets.⁴² While the motivation for an NOL poison pill plan is NOL protection, this motivation does not limit the takeover defense value of an NOL poison pill plan. The ancillary takeover defense effect may be attractive to a board. Some commentators argue that an NOL poison pill plan's low ownership threshold affords it even more defensive value than traditional poison pill plans;⁴³ however, the discussion of the *Selectica* case below demonstrates this may not necessarily be true.

The key structural difference between an NOL poison pill plan and a traditional poison pill plan is the ownership threshold trigger. In a traditional poison pill plan, the pill is triggered when 10-20% ownership is reached. For an NOL poison pill that seeks to avoid § 382 NOL limitations, the ownership threshold trigger is set below 5%, usually at 4.9%.⁴⁴ Like a traditional poison pill plan, a board of directors may adopt an NOL poison pill plan without a shareholder vote.⁴⁵ A board retains further control by requiring an affirmative board of director vote that determines a triggering event has occurred.⁴⁶ Another similarity to the traditional position pill plans is inclusion of the ability of a board to waive a pill's provisions for specific owners or buyers. This allows a board the leverage to negotiate a better price with an interested buyer. Without such provisions, a poison pill's deterrent effect would be too great.

While most merger and acquisition deals factor the presence of an NOL into a corporation's price, a buyer will often downplay the value of the NOL as worth mere

⁴¹ Charles M. Yablon, Causes, Effects, and Legal Responses: Poison Pills and Litigation Uncertainty, 1989 Emory Law Journal 54, 58 (1989) (characterizing a poison pill as a collective of defensive techniques).

⁴² The authors reviewed the SEC filings of 38 corporations that adopted NOL poison pill plans. Of these 38 corporations, 37 corporations expressly stated that their motivation for adoption was protection of NOLs.

⁴³ Robert T. Miller, "NOL Pill Reloaded: *Selectica, Inc. v. Versata, Inc.*," Engage, Vol. 11, Issue 2, Sept. 2010 at p 15.

⁴⁴ Mark C. Van Deusen, "A Primer on Protecting Tax Losses from a Section 382 Ownership Change" (2010). *William & Mary Annual Tax Conference*. Paper 20 at 18. Available at:

<http://scholarship.law.wm.edu/cgi/viewcontent.cgi?article=1005&context=tax>

⁴⁵ Poison pill plans issue rights, which are options to purchase shares, and the issuance of rights does not require shareholder approval. Accordingly, a board may adopt a poison pill plan without shareholder approval. *See also Air Prods. & Chems., Inc. v. Airgas, Inc.*, 16 A.3d 48 (Del. Ch. 2011).

⁴⁶ Mark C. Van Deusen, "A Primer on Protecting Tax Losses from a Section 382 Ownership Change" (2010). *William & Mary Annual Tax Conference*. Paper 20 at 18. Available at:

<http://scholarship.law.wm.edu/cgi/viewcontent.cgi?article=1005&context=tax>

“pennies on the dollar” due to uncertainty over the NOL’s future use.⁴⁷ Some buyers, given their limited ability to utilize NOLs because of the ownership rules, may attempt to avoid compensating shareholders for NOLs altogether. In this circumstance, a buyer is incentivized to trigger the § 382 limitations.⁴⁸ This was certainly the case in *Selectica, Inc. vs. Versata Enterprises, Inc.* discussed below.

The NOL Poison Pill Tested in Court

Prior to 2010, it was unclear whether NOL poison pills would be held valid if tested in court. The court in *Selectica, Inc. vs. Versata Enterprises, Inc.* concluded that NOL poison pill (with an ownership change trigger of 4.99%) was permissible.⁴⁹

Selectica, Inc., a software company, had never made a profit. The corporation had \$167 million in NOLs but only \$33 million of nontax assets.⁵⁰ One of Selectica’s competitor’s, Trilogy, Inc.,⁵¹ made repeated unsuccessful attempts to obtain Selectica.⁵² Trilogy had also sued Selectica twice for patent infringement, and because of these lawsuits, Trilogy was one of Selectica’s creditors.⁵³ In 2008, Selectica received several unsolicited acquisition offers, including offers from Trilogy. Trilogy’s offers undervalued Selectica’s NOLs.⁵⁴ After Selectica’s board rejected Trilogy’s offers but unbeknownst to Selectica’s board, Trilogy began acquiring Selectica stock on the open market.⁵⁵

A few months later, Selectica’s board learned that Trilogy’s recent share acquisitions in addition to other shareholders’ prior acquisitions caused a 40% ownership change for § 382 purposes.⁵⁶ This revelation meant that, if Trilogy (or another 5% shareholder) acquired only 10% more, then § 382 could significantly limit Selectica’s ability to use its \$167 million in NOLs. To prevent this, the board amended its existing poison pill by reducing the ownership trigger from the traditional 15% level to 4.99%.⁵⁷ Trilogy allegedly threatened to trigger the poison pill and continued buying more shares.⁵⁸ Trilogy ultimately bought through the pill’s threshold.⁵⁹ Trilogy offered to sell back to Selectica the

⁴⁷ Thomas W. Bottomlee, Jason S. Bazar and Arthur C. Walker, “Don’t Ignore a Target’s NOLs: The Price and Structure of Your Deal Can Depend on Them,” 9 *The M&A Journal* 7, available at <http://www.mayerbrown.com/publications/Dont-Ignore-a-Targets-NOLs-The-price-and-structure-of-your-deal-can-depend-on-them-10-01-2009/>.

⁴⁸ See *Versata Enterprises Inc. v. Selectica, Inc.*, A.3d 586, 601 (Del. 2010) as an example of Trilogy’s incentive to trigger Selectica’s NOL poison pill.

⁴⁹ *Versata Enterprises Inc. v. Selectica, Inc.*, A.3d 586, 601 (Del. 2010).

⁵⁰ Merle Erickson and Shane Heitzman, “NOL Poison Pills: *Selectica vs. Versata*,” *Tax Notes* Jun. 21, 2010.

⁵¹ Trilogy’s subsidiary, Versata, Inc., was the entity subject to Selectica’s lawsuit.

⁵² Robert T. Miller, “NOL Pill Reloaded: *Selectica, Inc. v. Versata, Inc.*,” *Engage*, Vol. 11, Issue 2, Sept. 2010 at p 16.

⁵³ *Id.*

⁵⁴ *Versata Enterprises Inc. v. Selectica, Inc.*, A.3d 586, 601 (Del. 2010),

⁵⁵ *Id.*

⁵⁶ *Id.*

⁵⁷ *Id.*

⁵⁸ *Id.*

⁵⁹ *Id.*

shares it purchased in exchange for immediate repayment of Selectica's debt to Trilogy and \$5 million.⁶⁰

In corporate law, Trilogy's tactic would be considered greenmail. Greenmail is buying a target corporation's stock to threaten a takeover but instead selling it back to the target at a profit.⁶¹ Greenmail is legally permissible. Greenmail often results in the target corporation repurchasing the shares from the potential buyer at a premium in order to prevent a takeover.⁶² In response to Trilogy's greenmail attempt, Selectica's board had three choices. First, the board could allow its NOL poison pill plan to automatically flip in rights to the other shareholders such that the rights could be exercised for deeply discounted shares. This scenario had the potential of triggering the § 382 limitations on its own. Second, the board could declare Trilogy exempt from the NOL poison pill plan and effectively deactivate the plan for this situation. Or, third, the board could utilize another provision of the pill to exchange the shareholders' rights under the pill for shares.

The board triggered the poison pill under the third option and diluted Trilogy's ownership by half. Selectica preemptively filed a declaratory action against Trilogy because it wanted the court to declare the board's adoption, implementation and potential reuse of its NOL poison pill to be valid exercises of corporate power. The Delaware Supreme Court agreed that Selectica's NOL poison pill and its use were appropriate defensive measures given Trilogy's threat to Selectica's NOLs and Trilogy's greenmail attempts.

In upholding Selectica's NOL poison pill, the Court permitted an extremely low poison pill threshold of 4.99%. A threshold this low had not been previously validated. Furthermore, the case's outcome indicates the validity of poison pills for NOL asset protection purposes. While the litigated result was a favorable one for Selectica, the corporation suffered many economic costs in protecting its NOLs, including administrative and legal costs as well as disruption to its operations and management. Selectica also suspended trading of its common stock for approximately one month as the details of its NOL poison pill plan were implemented. While these costs were in many ways unique to Selectica, the risk of incurring administrative or legal costs is an important factor a corporation should weigh when considering adoption of an NOL poison pill plan.

Consequences of NOL Poison Pills & Considerations in Adoption

The use of NOL poison pills is not uncommon. Corporations such as Citigroup, Inc., Ford Motor Co., Hancock Fabrics, Inc., KB Home, Mirant Corp., and countless other

⁶⁰ *Id.*

⁶¹ Stephen M. Bainbridge, "Unocal at 20: Director Primacy in Corporate Takeovers," 31 Del. J. Corp. L. 769 (2006) at note 98.

⁶² *Id.*

corporations adopted NOL poison pills in 2009.⁶³ One of Selectica's experts found corporate usage as early as 1998.⁶⁴

To weigh the propriety of NOL poison pill usage, it is helpful to examine both the motivations for usage as well as the consequences. The motivation for NOL poison pill plans lies in the structure of the § 382 limitation. Typically, corporations can exercise tax planning to bring about tax consequences. For NOL limitations, it is the actions of the shareholders, not the corporation, its board, or management, which can trigger the NOL limitations. Corporate boards can find themselves desperate to preserve NOLs for possible future use. It is this desperation that has driven boards to attempt to gain tax-planning control through the use of NOL poison pill plans.

The consequences of adopting an NOL poison pill can be significant. First, an NOL poison pill has the effects of traditional poison pills in that it serves as a takeover defense mechanism.⁶⁵ Given the extremely low ownership trigger in an NOL poison pill plan (>5%), some argue that an NOL poison pill may be a significantly stronger takeover defense than a traditional poison pill plan.⁶⁶ A board should note that an NOL poison pill plan may drive away more potential buyers than is desired. Of course, just like a traditional poison pill plan, the existence of an NOL poison pill plan does not guarantee takeover defense. As previously stated, the *Selectica* case does not support the theory of an NOL poison pill as strong takeover deterrent. In *Selectica*, Trilogy was not deterred and bought through the pill. Trilogy, however, was a particularly aggressive and determined buyer/competitor. In other cases, undesirable buyers may not be as aggressive. Nonetheless, the NOL limitation rules incentivize a buyer to impair a target's NOLs.

The power of a poison pill plan has been historically understood to be in its deterrent effect. The perceived deterrent effect had been so great that Selectica's NOL poison pill plan appears to be one of the first poison pill plans to be triggered.⁶⁷ Even with its very low threshold, Selectica's poison pill plan was not sufficient to deter Trilogy's aggression. It is important to note that a poison pill plan serves as a deterrent to ownership changes, but to be a comprehensive deterrent the board needs the ability to reload the poison pill plan. A buyer who triggers a poison pill plan may only have ownership dilution one time if the board does not adopt the plan again.

Similar to a traditional poison pill plan, the NOL poison pill can be surmounted by patient and wealthy buyers. Most likely, an NOL poison pill plan will allow a board time to negotiate with a potential buyer, acquire more capital or find a preferred white knight buyer. Once a board has successfully negotiated with the buyer or a white knight, a board

⁶³ Merle Erickson and Shane Heitzman, "NOL Poison Pills: *Selectica v. Versata*," Tax Notes, Jun. 21, 2010 (table 3).

⁶⁴ *Id.*

⁶⁵ Robert T. Miller, "NOL Pill Reloaded: *Selectica, Inc. v. Versata, Inc.*," Engage, Vol. 11, Issue 2, Sept. 2010 at p 15.

⁶⁶ *Id.*

⁶⁷ Latham and Watkins, "Lessons from the First Triggering of a Modern Poison Pill: *Selectica, Inc. v. Versata Enterprises, Inc.*," March 2009.

will remove the poison pill plan or deem a buyer exempt from the poison pill plan. Selectica's board offered to deem Trilogy exempt if Trilogy would agree to cease buying additional shares.

A poison pill may be made even more potent by the use of classified boards. A classified board is a board in which the terms of the directors are staggered. For example, in a typical classified board, only one third of the directors are elected in any annual meeting. A classified board compounds the effect of a poison pill by forcing a buyer willing to trigger a pill to wait through two director election cycles to gain a majority of the board seats, which are needed to effectuate a sale in the absence of a tender offer. Shareholder rights groups have fought classified boards with some success.⁶⁸ From 2000 to 2009, nearly half of the S&P500 classified boards were declassified.⁶⁹ Research shows that classified boards may be associated with lower business valuation.⁷⁰ On the other hand, others dispute the causation and suggest that classified boards are an invaluable tool for resisting opportunistic takeovers.⁷¹

Another consideration for corporations may be the current disfavor of poison pill plans. Shareholder rights groups and proxy advisory companies have publicized their skepticism of poison pill plans.⁷² One proxy advisory company recommends that shareholders only support NOL poison pills that are in effect for three years (or less) and do not extend beyond the expiration of NOLs.⁷³ Shareholder rights groups are concerned that a poison pill plan can potentially dissuade buyers when a takeover or acquisition may maximize shareholder wealth. Previously, it was thought that boards should have exclusive authority to implement poison pill plans because shareholders lacked the sufficient information and the ability to properly analyze poison pill plans.⁷⁴ Over time, conventional wisdom has credited shareholders as sufficiently knowledgeable of corporation transactions and performance. Adding to the increased financial IQ of shareholders is the increased access to information, which furthers the argument that

⁶⁸ See Harvard Shareholder Rights Project Press Release, March 12, 2012, available at <http://srp.law.harvard.edu/releases/Press-release-NCF-SRP.pdf>.

⁶⁹ Lucian Bebchuk, "An Antidote for the Corporate Poison Pill," Op-ed Wall Street Journal, Feb. 24, 2011.

⁷⁰ Lucian Bebchuk, Alma Cohen, and Charles Wang, "Staggered Boards and the Wealth of Shareholders: Evidence from Two Natural Experiments," available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1706806.

⁷¹ Martin Lipton and Theodore Mervis, "Harvard's Shareholder Rights Project is Wrong," The Harvard Law School Forum on Corporate Governance and Financial Regulation, available at <http://blogs.law.harvard.edu/corpgov/2012/03/23/harvards-shareholder-rights-project-is-wrong/> ("There is no persuasive evidence that declassifying boards enhance stockholder value over the long-term, and it is our experience that the absence of a staggered board makes it significantly harder for a public company to fend off an inadequate, opportunistic takeover bid, and is harmful to companies that focus on long-term value creation.").

⁷² Institutional Shareholder Service's 2012 US Proxy Voting Summary Guidelines (suggesting shareholders vote against NOL poison pills if the term of the pill would exceed the shorter of three years and the exhaustion of the NOL and weigh on a case-by-case basis other management proposals to ratify a pill to preserve NOLs).

⁷³ *Id.*

⁷⁴ Lucian Bebchuk, "The Case Against Board Veto in Corporate Takeovers," 69 Univ. of Chicago Law Rev. 973 (2002).

shareholders should partake in the decision whether to implement a poison pill plan. While commentators have called for shareholder voting on poison pill plans, Delaware law currently gives the authority for poison pill adoption to boards.⁷⁵ It is possible that shareholder validation of a poison pill plan could improve the market reaction to a corporation implementing such a plan.

A criticism of poison pill plans, and a likely contributor to their disfavor, is the argument that poison pills entrench management. Management entrenchment can misalign management's interests and shareholders' interests by creating an incentive for management to invest in assets or policies that would overvalue management and help secure management's future employment.⁷⁶ Shareholder activists argue that management entrenchment may result in delayed investment returns and may deprive shareholders of maximum investment return.⁷⁷ While this criticism does not affect the legality of poison pill usage, the entrenchment criticism is likely to surface during poison pill usage.⁷⁸

Conclusion

Shareholder turnover can endanger NOL usage, and unfortunately shareholder turnover is largely outside the corporation's control. One of the few protective tools for maintaining control of NOL usage is an NOL poison pill plan. While permissible under Delaware law, an NOL poison pill plan can have a strong anti-takeover effect. This effect may be more than is desirable, particularly when used in conjunction with a classified board. The anti-takeover effect, however, may not dissuade aggressive buyers or buyers incentivized to trigger NOL limitations, as evidenced in the *Selectica* case. Furthermore, shareholder rights groups disfavor poison pills and advise shareholders to be skeptical of their usage. Poison pill plans have also been criticized for entrenching management. While NOL poison pill plans can function as protective tax planning, their usage carries significant baggage. Given these concerns, it would be wise to weigh their usage for NOL protection carefully.

A corporation is not solely limited to NOL poison pills to protect NOLs from § 382 limitation. Other options are available. For example, a corporation may include ownership change limitations within its articles of incorporation. Accordingly to one law firm, this practice has become a "standard protection" for corporations with significant NOLs.⁷⁹ This practice, however, is most common when a corporation emerges from bankruptcy.⁸⁰ Outside the bankruptcy context, it is required in some states, and advisable in others, to

⁷⁵ *Id.* See also *Air Prods. & Chems., Inc. v. Airgas, Inc.*, 16 A.3d 48 (Del. Ch. 2011) (addressing whether a board could maintain a poison pill when an all-cash tender offer had been offered to fully informed shareholders).

⁷⁶ Andrei Shleifer and Robert W. Vishny, "Management Entrenchment: The Case of Manager-Specific Investments", *Journal of Financial Economics* 25 (1989) 123-139.

⁷⁷ Matteo Tonello, "Poison Pills in 2011," *The Harvard Law School Forum on Corporate Governance and Financial Regulation* (April 2011).

⁷⁸ *Moran v. Household International, Inc.*, 500 A.2d 1346 (Del.1985).

⁷⁹ Latham and Watkins, "Lessons from the First Triggering of a Modern Poison Pill: *Selectica, Inc. v. Versata Enterprises, Inc.*," March 2009.

⁸⁰ *Id.*

obtain shareholder approval for such corporate charter limitations.⁸¹ Regardless of the choice of NOL protection, shareholder ownership changes should be monitored to ensure future NOL usage.

⁸¹ Mark C. Van Deusen, "A Primer on Protecting Tax Losses from a Section 382 Ownership Change" (2010). *William & Mary Annual Tax Conference*. Paper 20 at 20. Available at: <http://scholarship.law.wm.edu/cgi/viewcontent.cgi?article=1005&context=tax>