Protecting NOLs in an Uncertain World

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Overview

- **Net operating losses (or "NOLs") can be used to offset income, generating valuable cash tax benefits[1]**

- **A company's annual use of its NOLs will be limited if it undergoes a 50% "ownership change"**
    - Measured on a rolling, cumulative basis over 3 years
    - Can result from aggregate acquisitions and sales by ≥5% shareholders and from equity issuances

- **Limitation is calculated based on applicable interest rates (published monthly by IRS) and the equity value of the company at the time of the ownership change**

- **In the current pandemic, interest rates are low and many companies have had steep declines in their stock price, so this limitation could be severe**
    - Lower trading values may also attract investors and make it easier for them to accumulate large stakes, increasing the likelihood of an ownership change

- **In this environment, a company with substantial NOLs should consider how to preserve their value**

- **An NOL pill—also known as a Section 382 Shareholder Rights Plan—or a charter restriction may be a suitable strategy**
    - Even if the company has accumulated NOLs in the past and decided not to implement these measures, it may be appropriate to reevaluate this position in light of the current environment
    - These measures will also be relevant to companies that historically have been profitable but are expecting to incur losses in light of the current environment

[1] This presentation addresses US tax law considerations around NOLs that are relevant for US corporations. Use of losses accrued in any foreign jurisdiction will depend on laws of that jurisdiction.

NOLs and Other Tax Assets

- **A taxpayer can generally deduct operating losses in one year against income in another year**
  - If expenses exceed income in a given tax year, an NOL is created
  - Length of time an NOL may be carried forward or carried back and percentage of income it may offset depend on when the NOL arose and when it is used[1]

Year NOL Arose	NOL Can Be Carried Back	NOL Can Be Carried Forward	NOL Can Offset
2017 or earlier	2 years	20 years	100% of taxable income
2018, 2019 or 2020	5 years	Indefinitely	100% of taxable income if carried to 2020 or earlier years 80% of taxable income if carried to 2021 or later years
2021 or later	0 years	Indefinitely	80% of taxable income

- **Value of NOLs will depend on future income and tax rate**
  - The sooner the NOLs are expected to be used, the more valuable they are
  - The higher the tax rate, the greater the tax savings
    - US Federal income tax rate is currently 21%, so every $100 of NOL can create a cash tax benefit of $21
    - Rate was 35% before 2018, so $100 of NOL can create a cash tax benefit of $35 when carried back to these earlier years. Any company that was profitable in those earlier years should consider carrying back NOLs to extent of earlier year income before carrying forward to offset future year income

- **Other tax assets, including R&D tax credit carryforwards and foreign tax credit carryforwards, can be used to offset future tax liabilities on a dollar-for-dollar basis**

[1] This chart reflects changes implemented by legislation enacted in March 2020 in response to the current pandemic (the "CARES" Act).

"Ownership Change"

- **A company is subject to additional limits on the use of its NOLs and other tax assets if it undergoes an "ownership change"**
  - Similar rules limit use of other tax attributes (like R&D credits and foreign tax credits) upon an ownership change
- **A company undergoes an ownership change when its ≥5% shareholders increase their ownership stake by more than 50 percentage points in the aggregate during a rolling 3-year period**
  - Each ≥5% shareholder's current ownership stake is compared to its lowest stake during the preceding 3 years
  - If the sum of the increases exceeds 50%, an ownership change has occurred (the decreases are ignored)
- **Special rules apply to determine a company's ≥5% shareholders**
  - Ownership is measured based on the value of the stock, without regard to voting power
  - Investors that share certain relationships or act in a coordinated manner are aggregated
  - A ≥5% shareholder may include a person who owns stock through an intermediate entity and an ownership change may occur upon a full or partial transfer of the equity in that intermediate entity
  - All shareholders that individually own <5% are generally aggregated and treated as a separate ≥5% shareholder (a so-called "public group")
- **Because public groups are aggregated and treated as separate ≥5% shareholders, certain transactions can cause an ownership change even if no particular investor acquires a ≥5% stake**
  - A stock issuance in connection with an M&A transaction or in a public offering
  - A stock buyback
  - A sale of stock by a ≥5% shareholder
- **As a result, if a company with NOLs is close to an ownership change, its flexibility to issue shares in an acquisition or public offering or to buy back stock without impairing the value of its NOLs may be limited**

Section 382 NOL Limitation

- **If a company undergoes an ownership change, future use of pre-change NOLs is limited**
  - Notably, Section 382 does *not* limit the company's ability to carry back NOLs to offset prior year income
- **The limitation consists of two components—an annual "base limitation" and the "BIG enhancement"**
- **Base limitation = market capitalization * specified interest rate (published monthly by IRS)**
  - Rate is 1.63% for April 2020 and will likely decrease in the near term
- **BIG enhancement: For the first 5 years, an amount determined by reference to the company's gross asset appreciation ("built-in gain" or "BIG")**
  - This will depend on specific facts, but for many companies will be substantial
  - BIG enhancement was established under a 2003 IRS Notice, but Treasury has said it plans to repeal the IRS Notice
    - Timing is uncertain, but any repeal would not apply retroactively to a company that has a prior ownership change (including any company whose ownership change was effected by an agreement signed or announced before repeal)
- **A significant drop in market capitalization can greatly reduce both components of the limitation, and thereby increase the negative impact of an ownership change, particularly when interest rates are low**
- **For example, if a company with a $500 million NOL, a market capitalization of $200 million and no built-in gain in its assets experiences an ownership change, it would only be permitted to carry forward $3.26 million of its NOL per year**

NOL Pills

- **Like traditional poison pills, NOL pills deter acquisitions of stock above a specified threshold by diluting the ownership of anyone who crosses that threshold**
  - Company issues dividend on its common stock consisting of a "right" to purchase preferred stock
  - Rights may be triggered by the company when a person (or group) acquires enough stock to beneficially own >4.99%
    - Rights become separately transferable and exercisable to purchase common stock or a common-stock-equivalent at a substantial discount
    - Alternatively, company can exchange each right for a share of common stock
    - All rights held by the person (or group) that crosses the triggering threshold are null and void, resulting in significant dilution to that person (or group)
  - Since tax rules require aggregation of all ≥5% acquisitions, the only practical way to provide NOL protection is to set the trigger threshold at 4.99% (which is lower than the typical 10-15% threshold for traditional poison pills)
- **Definition of "beneficial ownership" of stock is modified to take into account tax rules**
  - Tax rules generally capture those who enjoy the economic benefits and burdens of ownership; voting power is irrelevant
  - Tax rules aggregate investors that share certain relationships or that act in a coordinated manner
- **Shareholders that already own 4.99% or more at time of adoption of NOL pill are grandfathered, but still trigger NOL pill if they increase ownership**
- **NOL pills typically have a term of 1-3 years, often with a shareholder vote within 1 year**
  - Board reviews the NOL pill periodically to assess whether it is still warranted
  - Expires upon exhaustion or expiration of NOLs and other tax assets
- **Board retains discretion**
  - Can exempt persons, groups or transactions
  - Can amend the rights or redeem them at a nominal price at any time before they are triggered
  - Can decide not to trigger rights for inadvertent acquisitions above the threshold

Other Considerations

- **While NOL pills are specifically designed to protect tax assets by preventing ownership changes, they do so by discouraging investors from accumulating large stakes in the company**
  - As such, NOL pills are considered defensive measures under Delaware law

- **A company considering adopting an NOL pill should anticipate shareholder reaction, and take into account in particular the voting guidelines of proxy advisory firms (*e.g.,* ISS and Glass Lewis)**

- **ISS, *e.g.*, differentiates between NOL pills and traditional poison pills in its proxy voting guidelines**
  - ISS recommends that shareholders vote *against* adopting any NOL pill with a term that exceeds 3 years or, if shorter, the exhaustion of the NOLs
  - ISS takes a case-by-case approach on all other NOL pills, considering the following factors in particular:
    - The ownership threshold to transfer (recognizing that NOL pills generally set the threshold slightly below 5%)
    - The value of the NOLs
    - Shareholder protection mechanisms (*e.g.*, sunset provision, or commitment to cause expiration of the NOL pill upon exhaustion or expiration of NOLs)
    - The company's existing governance structure, including board independence, existing takeover defenses, track record of responsiveness to shareholders and any other problematic governance concerns

- **ISS recommends that shareholders vote *against*, or withhold votes from, all director nominees if the company has a poison pill that was not approved by shareholders, subject to two exceptions:**
  - New nominees are excepted from this recommendation and, instead, considered on a case-by-case basis
  - ISS considers nominees on a case-by-case if the board adopts an initial pill with a term of one year or less, depending on the disclosed rationale for the adoption, and other factors as relevant (such as a commitment to put any renewal to a shareholder vote)

- **For these reasons, NOL pills with 3 year terms are still frequently subject to shareholder approval within the first year**

Charter Restrictions

- **While an NOL pill is a powerful and important tool in preserving the value of NOLs, its protection against an ownership change is somewhat incomplete**
  - First, acquisitions by would-be ≥5% shareholders are not prohibited, they are simply deterred
    - If an investor does accumulate a large enough stake to trigger the NOL pill—either intentionally or inadvertently—the Company may invoke the NOL pill to dilute the investor, but any damage caused by the acquisition (*e.g.*, an "ownership change") cannot be undone
  - Second, the NOL pill does not deter sales by ≥5% shareholders, even though those sales can cause or contribute to an ownership change

- **A Company may achieve stronger protection by amending its charter to prohibit:**
  - Acquisitions that would cause an investor to become a ≥5% shareholder (or increase the stake of any existing ≥5% shareholder) and
  - Sales by existing ≥5% shareholders

- **A charter restriction typically requires shareholder approval and therefore takes time to implement**
  - Under Delaware law, the company must give notice and call a shareholder meeting (or obtain written consents if permitted) and obtain shareholder approval by a majority of shareholders entitled to vote

- **A company that adopts an NOL pill in the short-term may also consider adopting a charter restriction in due course**

Comparison of NOL Pill to Charter Restriction

	NOL Pill	Charter Restriction
Effect	*Deters* purchases of stock that would increase the ownership of existing ≥5% shareholders or create new ≥5% shareholders, but does not affect sales	*Prohibits* purchases and sales of stock by existing ≥5% shareholder or that would create new ≥5% shareholders
Mechanism	Causes significant dilution of acquirors who pass 4.99% ownership threshold	Voids prohibited transfers
Duration	Generally expires within 1 to 3 years	Can be unlimited in time
Ease of Implementation	Can be implemented quickly by the board without shareholder approval	Requires shareholder approval (in Delaware, by a majority of shareholders entitled to vote)

Appendix

Recent Precedents

- **The following 8 companies have adopted NOL Pills to-date in 2020**
  - AIkido Pharma Inc. (March 23, 2020)
  - Aviat Networks, Inc. (March 3, 2020)
  - Cohen & Co. Inc. (March 10, 2020)
  - Drive Shack Inc. (March 5, 2020)
  - Gannett Co., Inc. (April 6, 2020)
  - Unisys Corp. (February 5, 2020)
  - Warrior Met Coal, Inc. (February 13, 2020)
  - Whiting Petroleum Corp. (March 26, 2020)

- **The following 6 companies have implemented, extended or proposed extending NOL-related charter restrictions in 2019 and to-date in 2020**
  - Acacia Research Corp. (adopted 2019)
  - AIG, Inc. (adopted 2011; extended 2014 & 2017; extension proposed 2020)
  - Cloud Peak Energy (adopted 2019)
  - CNO Financial Group, Inc. (adopted 2016; extended 2019)
  - FalconStor Software (adopted 2019)
  - Warrior Met Coal Inc. (adopted 2016; extended 2019)

CRAVATH

Worldwide Plaza
825 Eighth Avenue
New York, NY 10019-7475
+1-212-474-1000 Phone
+1-212-474-3700 Fax

CityPoint
One Ropemaker Street
London EC2Y 9HR England
+44-20-7453-1000 Phone
+44-20-7860-1150 Fax