IS THE “TAX POISON PILL” THE LAST STAND FOR PROTECTING NOLS AFTER HEALTH CARE REFORM?

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The Delaware Court of Chancery’s recent Selectica opinion garnished substantial attention, but the court’s decision upholding the tax poison pill may be of even greater importance with the passage of the Health Care and Education Reconciliation Act of 2010 (H.R. 4872)—less than a month after Vice-Chancellor Noble issued his opinion. During the global economic recession, many companies accrued substantial tax losses that can be carried forward for up to twenty years and used to offset future income for federal tax purposes, called net operating loss carryforwards (“NOLs”). These valuable tax assets will provide substantial financial benefits for companies down the road but are vulnerable to spoilage from significant changes in company ownership. The passage of H.R. 4872 and Vice-Chancellor Noble’s ruling in Selectica are both newsworthy events, but upon further scrutiny they collectively present an important question: How can companies protect their deferred tax assets, namely NOLs?

H.R. 4872, specifically Section 1409, codifies the economic substance doctrine for federal taxation purposes and introduces a strict test for what qualifies as “economic substance” in a transaction. Essentially, the economic substance doctrine requires that a transaction have some legitimate business purpose other than favorable tax benefits in order to obtain preferential tax treatment. The economic substance doctrine has existed in common law since the Supreme Court’s Gregory v. Helvering decision in 1935, but courts applied the doctrine as a

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3 Id.

standard rather than a rule. Additionally, prior to H.R. 4872 courts had flexibility to find a business purpose in a transaction, and at least one professor jokes that tax lawyers “had drawers full of them.” Under H.R. 4872, the economic substance doctrine becomes codified in the Internal Revenue Code (“Code”) and the Code will now include a rigid two-part, rule-based test for applying the economic substance doctrine to a transaction. The first part of the test requires a meaningful change in economic position and the second part requires a substantial purpose for entering into the transaction. Both parts of the test, however, explicitly list “apart from Federal income tax effects” in the newly-amended Code. Because the provision is codified in statute, litigants cannot appeal to courts for exceptions in special tax-related circumstances. To raise the ante, if the transaction fails either element of the economic substance test, the Act prescribes substantial penalties (either 20% or 40%) even if the transaction meets all other requirements of a particular Code provision.

Under Selectica and the Code’s new two-part economic substance test, NOL shareholder rights plans (“tax poison pills”) may be the only effective, tax-free way for companies to protect their valuable tax assets. As illustrated by Selectica, the Code contains an unforgiving 5% “change of ownership” trigger that limits, and impairs, NOLs. Presumably, this provision exists to prevent profitable companies from acquiring and exploiting these tax assets through acquisitions. In Selectica, management sought to protect its NOLs from a statutory change of ownership by adopting a tax poison pill. The pill operated much like a traditional flip-in poison pill, except that it triggered at 4.99% ownership rather than the usual 15%. (A flip-in poison pill, triggered when a shareholder accumulates more than a defined threshold of a company’s stock, allows all other shareholders to purchase the company’s shares at a greatly-discounted price—severely diluting the triggering shareholder’s ownership interest.) Soon after, Trilogy, a competitor, intentionally triggered Selectica’s pill and litigation ensued. Under Delaware law, corporate defensive tactics are subject to the Unocal enhanced scrutiny analysis, under which management’s action must be in response to a legitimate threat to the company, not preclusive or coercive, and “reasonable in relation to the threat . . . posed.”

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5 H.R. No. 4872 § 1409(a) (codified at 26 U.S.C. § 7701(o)(1) (2010)).
6 Id.
7 § 1409(b)(2) (codified at 26 U.S.C.A. § 6662(i)(1) (2010)).
9 Id.
10 Id. at *8.
Chancellor Noble, applying this framework, upheld Selectica’s tax poison pill as reasonable in relation to the threat of Trilogy’s continued stock purchase invalidating Selectica’s NOLs.\textsuperscript{13} Vice-Chancellor Noble emphasized the heavy restriction a 4.99%-trigger poison pill places on shareholders, but proclaimed that Selectica’s fragile $160 million NOLs outweighed the burden.\textsuperscript{14} It is worth noting that Vice-Chancellor Noble was less concerned about the “omnipresent specter” of management acting in self-interest because Selectica was already in play and actively seeking a buyer for the company, which may explain his rather deferential scrutiny under the \textit{Unocal} doctrine.\textsuperscript{15} It is possible that Trilogy, an interested buyer, wanted to wipe out Selectica’s NOLs so that it could pay a lower price for Selectica, rather than compensate Selectica’s shareholders for deferred tax assets that the Code precluded Trilogy from using.

If H.R. 4872’s new two-part economic substance test applied to tax poison pills, they would fail. However, poison pills have a unique saving grace because they only trigger a stock transaction between a company and its shareholders. Thus, a company need not satisfy the economic substance doctrine when implementing a tax poison pill because certain Code provisions, immune to the economic substance doctrine under longstanding judicial precedent, clearly mandate that company distributions of its own shares to shareholders are nontaxable events. H.R. 4872 explicitly states that it does not disturb the determination of “whether the economic substance doctrine is relevant to a transaction,” so it is highly unlikely that this established rule will change.\textsuperscript{16} Conversely, if a company were to explore tax-free reorganizations or other transactions to protect its NOLs, it would need an additional substantial business purpose to satisfy the new two-part economic substance test. Except for dealing in its own stock, most company transactions are taxable unless a specific exception in the Code applies and the economic substance doctrine is satisfied. Consequently, but for Vice-Chancellor Noble’s opinion upholding the tax poison pill in \textit{Selectica} four weeks prior to H.R. 4872’s passage, companies might not have nontaxable means of protecting their NOLs.

Although there has been a steep decline in the number of companies with active poison pills, H.R. 4872’s passage should compel companies to evaluate their NOLs and determine whether a tax poison pill is an appropriate protective mechanism for these valuable tax assets. Further, because the SEC’s beneficial ownership and reporting threshold is 5%, companies that do not take proactive measures may not learn that their NOLs are in jeopardy until it is too late.

\textsuperscript{13} \textit{Selectica}, 2010 WL 703062 at *19.
\textsuperscript{14} \textit{Id.} at *15, *24.
\textsuperscript{15} \textit{Id.} at *12.
\textsuperscript{16} H.R. No. 4872 § 1409(a) (codified at 26 U.S.C. § 7701(o)(5)(c) (2010)).
Traditionally, activist shareholders and corporate insiders have clashed over the poison pill in scholarship, shareholder proposals, and the courts. In light of the Delaware Court of Chancery’s Selectica decision and Congress’ passage of H.R. 4872, however, companies and investors may discover a newfound need for this modern version of the established takeover defense. And considering the value and delicacy of NOLs, perhaps shareholder activists and management will find occasion to unite behind this twenty-first century takeover defense to preserve that which, once lost, is gone forever.