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Recent Developments

Protecting Corporations' Tax Assets Through Shareholder Rights Plans

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Stock price declines, which may present attractive buying opportunities to opportunistic investors, pose special risks to corporations with net operating losses ("NOLs"), "built-in" losses and other valuable tax assets. Accumulations of significant positions in such a corporation's stock could result in an inadvertent "ownership change" (generally, a greater than 50 percentage point increase in ownership by five-percent shareholders in any three-year period) under Section 382 of the Internal Revenue Code. If a company experiences an ownership change, Section 382 will substantially limit the extent to which pre-change NOLs and other "built-in" losses stemming from pre-change declines in value can be used to offset future income. As with operating assets, boards of directors should evaluate the potential risks to these valuable tax assets and consider possible actions to protect them.

One potential mechanism that may be implemented in a relatively short time is the adoption of a shareholder rights plan designed to prevent a Section 382 ownership change (a "382 Rights Plan"). Indeed, in recent months, a growing number of corporations with significant tax assets have adopted 382 Rights Plans—USG Corporation, Reinsurance Group of America, Incorporated, and Hovnanian Enterprises, Inc. are a few examples. These 382 Rights Plans generally incorporate a 4.9% threshold, deterring new shareholders from accumulating a stake of five percent or more, as well as deterring existing five-percent shareholders from increasing their stake in a way that would cause a Section 382 ownership change.

With proper advice and planning, 382 Rights Plans can be designed to comply with the governance and anti-takeover guidelines advocated by proxy advisory firms and potentially avoid withhold vote recommendations and other consequences. For example, RiskMetrics Group recently announced that it recognizes the unique features of 382 Rights Plans and stated that it would consider, on a case-by-case basis (despite the low threshold of such plans), management proposals to adopt them based on certain factors—including, among others, the threshold trigger, the value of the tax assets, the term of the plan and shareholder protection mechanisms. In accordance with this position, RiskMetrics recommended a vote "For" Hovnanian's 382 Rights Plan.

Boards of directors of corporations with significant tax assets should periodically evaluate whether such tax assets are at risk and instruct management to closely monitor any changes to the corporations' ownership structure that could contribute to or result in a Section 382 ownership change. As part of this effort, it may be advisable for these corporations either to consider adopting a 382 Rights Plan or to make all necessary preparations in advance so that a 382 Rights Plan can be adopted quickly in the event that a threat to this valuable corporate asset materializes.

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