PRESERVATION OF NET OPERATING LOSSES OF BANK HOLDING COMPANIES

VIJAY SEKHON & RYAN HICKS*

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I. Introduction

In December 2015, the Board of Governors of the Federal Reserve System (the Federal Reserve) published guidance severely limiting the ability of bank holding companies to protect their net operating losses (a valuable tax asset) through "poison pills" or transfer restrictions in their charters or bylaws.[1] These limitations have had a significant adverse financial impact on bank holding companies

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* Vijay Sekhon is a Partner at Sidley Austin LLP and an Adjunct Professor at the University of California, Berkeley School of Law. Ryan Hicks is an Associate at Sidley Austin LLP. The views expressed herein are those of the authors and do not necessarily reflect the views of Sidley Austin LLP or the authors' colleagues at Sidley Austin LLP.

[1] BD. OF GOVERNORS OF THE FED. RESERVE SYS., DIV. OF BANKING SUPERVISION & REGULATION, SR 15-15, SUPERVISORY CONCERNS RELATED TO SHAREHOLDER PROTECTION ARRANGEMENTS (Dec. 3, 2015) ("If supervisory or applications staff determine that a particular shareholder protection arrangement impairs the ability of a holding company to raise or maintain capital . . . Federal Reserve staff should consult with appropriate Board supervisory staff to determine the appropriate action.").

and impeded their ability to raise capital.[2] This article argues that the Federal Reserve should permit bank holding companies to implement such "poison pills" and transfer restrictions to protect their net operating losses similar to companies in all other industries, which would improve the capital and financial position as well as increase shareholder value of bank holding companies.

II. Net Operating Losses

Companies in financial distress generally accumulate significant net operating losses (NOLs), which result when a company's allowable tax deductions (including expenses) exceed its gross income in a taxable year.[3] Under Section 172 of the Internal Revenue Code of 1986, as amended (the Code), NOLs can generally be carried back to the two taxable years immediately preceding—and carried forward for 20 taxable years following—the year in which the NOLs were incurred to offset net taxable income in such years for federal income tax purposes.[4] As a result, NOLs are a valuable asset for a company, sometimes the most valuable.[5]

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[2] *See* Douglas P. Faucette & Daniel P. Weitzel, *Federal Reserve Takes Aim at Shareholder Protections*, LAW360 (Apr. 19, 2016, 5:13 PM), https://www.law360.com/banking/articles/786435/federal-reserve-takes-aim-at-shareholder-protections ("Ironically, the board's position may actually foster short-termism, also known as quarterly capitalism, with respect to public holding companies and deter capital formation at private holding companies."); Robert Klingler, *Supervisory "Concerns" with Shareholder Protection Arrangements*, BANK BRYAN CAVE, (Feb. 9, 2016), http://bankbryancave.com/2016/02/supervisory-concerns-with-shareholder-protection-arrangements [https://perma.cc/5MBU-M4F8] ("It is true, of course, that these restrictions limit the secondary market . . . and the Federal Reserve's Change in Bank Control Act regulations each also limits the secondary market for holding company stock.").

[3] 26 U.S.C. § 172(c) (2012) (defining the term "net operating loss" and outlining the tax deductibility of these losses).

[4] *Id.* § 172(b). Since the passage of the original Revenue Act of 1913, taxpayers have been allowed to use losses to offset profits in the same taxable year (even if the losses were from a separate business venture), but originally, those losses could not be carried forward to future years. Congress acknowledged the inequities this created, and in 1921, following the expiration of a temporary one-year carryover allowance, Congress enacted a law permitting loss carryovers over a three-year period. *See infra* note 9. Loss carryovers were later eliminated entirely as part of the New Deal legislation of 1933, only to be restored in 1938. Since then, the carryforward (and

Congress has noted that this ability to carry back and carry forward NOLs provides "essential protections against excessive hardships inherent in a [federal income] tax based upon an arbitrary annual accounting."[6] For ease of administration and revenue raising purposes, the federal income tax system requires the apportionment of a company's lifetime into annual periods (i.e., taxable years), although profitability (and, therefore, the basis for determining a company's federal income tax burden) is more appropriately measured over the company's lifetime.[7] Companies that generate positive net taxable income during a taxable year are generally required to pay federal income tax to the federal government, whereas companies that incur losses during a taxable year do not receive a check from the federal government.[8] As a result, disparities arise with respect to the federal income tax treatment of companies that have a relatively constant net taxable income year over year versus companies that have wild fluctuations in net taxable income during that time period, even though the cumulative earnings of those companies may be identical.[9]

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carryback) periods have expanded through various revisions of the Code. Stephen Mihm, *The Tangled History of Business-Loss Tax Write-Offs*, BLOOMBERG VIEW (Oct. 6, 2016), https://www.bloomberg.com/view/articles/2016-10-06/the-tangled-history-of-business-loss-tax-write-offs ("Beginning in 1938 and then in subsequent revisions, individuals and businesses regained their ability to spread out losses over ever-greater lengths of time.").

[5] *See, e.g.*, Thomas W. Bottomlee, Jason S. Bazar & Arthur C. Walker, *Don't Ignore a Target's NOLs: The Price and Structure of Your Deal Can Depend on Them*, 9 M&A J. 1 (2009) ("[A] target corporation's NOL carryforwards that exist as of the closing date represent an economic asset . . . ."); Diane L. Dick, *Bankruptcy's Corporate Tax Loophole*, 82 FORDHAM L. REV. 2273, 2289 (2014) ("Tax attributes are often the most sizeable asset of a struggling company . . . .").

[6] S. REP. NO. 72-665, at 11 (1932).

[7] 26 U.S.C. § 441 (2012) ("Taxable income shall be computed on the basis of the taxpayer's taxable year."); John K. McNulty, *Flat Tax, Consumption Tax, Consumption-Type Income Tax Proposals in the United States: A Tax Policy Discussion of Fundamental Tax Reform*, 88 CALIF. L. REV. 2095, 2145–46 (2000) ("In this view, an income tax, in measuring 'changes in wealth' as well as consumption, comes closer to measuring lifetime wealth or capacity to consume and to pay tax.").

[8] 26 U.S.C. § 11 (2012) (providing the formula for taxing corporations).

[9] Assume a flat federal corporate income tax rate of 40% for the following simple example. Company X has net income of $100 in Year 1 and net income of $100 in Year 2. Therefore, Company X is required to pay a total of

Allowing the latter companies to carry back and carry forward NOLs provides for more equitable federal income tax treatment and alleviates a federal income tax burden that would otherwise be disproportionate to such companies' profitability over their lifetimes.[10]

As a simplified illustration of how NOLs work, assume NewCo begins conducting business in Year 1 and incurs a $100 net taxable loss in each of its first five years. Because NewCo has not had any profits during that period, it cannot use these losses to offset any profit for income tax purposes.[11] As a result, NewCo has $500 aggregate NOL carryforwards.[12] The $100 NOL generated in Year 1 could be carried forward to any of Years 2 through 21 to offset taxable income in those years, whereas the $100 NOL generated in Year 5 could be carried back to Years 3 and 4 or carried forward to Years 6 through 25.[13] Assuming NewCo has net taxable income of $200 in Year 6, NewCo would use its earliest-expiring NOLs (i.e., those from Years 1 and 2) to offset this income.[14] NewCo would therefore have no income tax liability at the end of Year 6 and would retain $300 in NOL

$80 in federal income taxes over the two-year period ($100 x 40% = $40 in Year 1 and $100 x 40% = $ 40 in Year 2). Now assume Company Y has a net loss of $400 in Year 1 and net income of $600 in Year 2. Without the ability to use NOLs to offset net income in Year 2, Company Y has no federal income tax obligation in Year 1, but has a $240 federal income tax liability in Year 2 ($600 x 40% = $240). Therefore, although both Company X and Company Y had aggregate net income of $200 over the two-year period, Company X has a $40 federal income tax liability (40% effective tax rate), while Company Y has a $240 federal income tax liability (an effective tax rate of over 100%). This example demonstrates the need for carrying back and carrying forward NOLs as an "averaging device." *See* J. Clifton Fleming Jr., *Reflections on Section 382: Searching for a Rationale*, 1979 BYU L. REV. 213, 214 (1979) (discussing corporate NOL carryover as an income averaging device).

[10] *See* 26 U.S.C. § 172(b) (discussing net operating losses, carrybacks, and carryovers).

[11] *See* 26 U.S.C. § 1211(a) (2012) ("In the case of a corporation, losses from sales or exchanges of capital assets shall be allowed only to the extent of gains from such sales or exchanges.").

[12] *See* § 172 (explaining the tax treatment of NOLs and carryforwards).

[13] *See* §172(b)(1)(a)(i) ("[N]et operating loss carryback to each of the 2 taxable years preceding the taxable year of such loss . . . ."); § 172(b)(1)(a)(ii) ("[N]et operating loss carryover to each of the 20 taxable years following . . . .").

[14] *See id.*

carryforwards for use against future net taxable income (with $100 expiring in each of Years 22, 23 and 24).[15]

III. Internal Revenue Code Section 382 Limitations

Unsurprisingly, as a result of the substantial federal income tax benefits, many companies previously acquired target companies in part to take advantage of the target companies' NOLs (*i.e.*, to use the target companies' NOLs to offset future federal net taxable income).[16] Recognizing that such use of NOLs undermines the rationale for their existence and after other laws failed to sufficiently curb such trafficking (*e.g.*, Section 269 of the Code)[17], Congress enacted Section 382 of the Code to prevent such "trafficking" of NOLs by limiting the ability of a "loss corporation" (*i.e.*, a corporation entitled to use a net operating loss carryover or having a net operating loss for the taxable year in which the ownership change occurs) to utilize NOLs of a target company that accumulated prior to the acquisition.[18] Section 382 is

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[15] *See id.*

[16] *See, e.g.*, Bottomlee, Bazar, & Walker, *supra* note 5, at 2 (explaining, with respect to the value of NOLs to an acquiring company, "if the buyer is a member of a profitable consolidated group of corporations, the target's NOLs may be of significant value to such buyer and its consolidated group even if the target's own income projects are not particularly strong"); Richard H. Nicholls, *Net Operating Loss Carryovers and Section 382*, 22 TAX NOTES, 609, 610 (1984) ("Forty years ago, apparently in response to frequently cited advertisements in the Wall Street Journal and The New York Times offering corporate shells with loss carryovers for sale, Congress enacted the forerunner of section 269 for the purpose of denying deductions or credits to taxpayers engaging in certain corporate transactions the principal purpose of which was to obtain tax benefits which could not otherwise be enjoyed."). For a discussion of the legislative history of Section 382, see Mark Hoenig, *Trafficking in Net Operating Losses: What's So Bad?*, 145 TAX NOTES 919, 923–29 (2014) ("And so, the legislative effort to address the problem of trafficking in tax losses persisted . . . . To address loss trafficking, Congress concurrently added section 382.").

[17] 26 U.S.C. § 269 (2012) (disallowing tax deductions for acquisitions "the principal purpose for which . . . is evasion or avoidance of Federal income tax by securing [a] benefit . . . which such person or corporation would not otherwise enjoy . . . .").

[18] 26 U.S.C. § 382 (2012) ("The amount of the taxable income of any new loss corporation for any post-change year which may be offset by pre-change losses shall not exceed the section 382 limitation for such year."); 26 C.F.R. § 1.382-2T(a)(1) (2017) ("A corporation is a new loss corporation and thus

generally triggered upon an "ownership change" of a company, which occurs if the percentage of the stock of the company owned by one or more of the company's five-percent shareholders increases by more than 50 percentage points over the lowest percentage owned by such shareholder(s) during the prior three years (starting in the taxable year in which the company first accrued NOLs that can be carried forward).[19] Following an ownership change, the use of pre-ownership change NOLs to offset net taxable income in any post-ownership change year is generally limited to an amount equal to the product of (i) the value of the company immediately prior to the ownership change, multiplied by (ii) the U.S. federal long-term tax-exempt bond rate.[20] However, if the company does not continue its business

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subject to limitation under section 382 only if an ownership change has occurred with respect to such corporation."). In addition to Section 382, Congress and the U.S. Department of the Treasury have enacted other rules, in part, to stop taxpayers from engaging in transactions simply to use or acquire NOLs or to limit the benefits of such NOLs. *See, e.g.*, 26 U.S.C. §§ 269, 384, 7701(o) (2012) ("If . . . the principal purpose for which such acquisition was made is evasion or avoidance of Federal income tax by securing the benefit of a deduction, credit, or other allowance which such person or corporation would not otherwise enjoy, then the Secretary may disallow such deduction, credit, or other allowance"; "If a corporation . . . such corporation has a net unrealized built-in gain, the income of such corporation for any recognized period taxable year (to the extent attributable to recognized built-in gains) shall not be offset by any preacquisition loss of any other member of such group."; "In the case of any transaction to which the economic substance doctrine is relevant, such transaction shall be treated as having economic substance only if the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position, and the taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into such transaction."; 26 C.F.R § 1502-21(c) (2017) (discussing net operating losses). A discussion of these other provisions is beyond the scope of this article.

[19] § 382(g), (i) ("There is an ownership change if immediately after any owner shift involving a 5-percent shareholder or any equity structure shift the percentage of the stock of the new loss corporation owned by 1 or more 5-percent shareholders has increased by more than 50 percentage points, over the lowest percentage of stock of the old loss corporation (or any predecessor corporation) owned by such shareholders at any time during the testing period.").

[20] *Id*. at § 382(b)(1) ("Except as otherwise provided in this section, the section 382 limitation for any post-change year is an amount equal to—(A) the value of the old loss corporation, multiplied by (B) the long-term tax-exempt rate.");

enterprise at all times during the two-year period beginning on the date of the ownership change, the company is generally prohibited from using any of its pre-ownership change NOLs to offset future net taxable income.[21]

IV. NOL "Poison Pills" and Transfer Restrictions

For a company with substantial NOLs, the limitations imposed by Section 382 results in a significant loss of the company's value following an ownership change. Moreover, Section 382 limitations can be triggered inadvertently, with no action by the company and/or without an acquiring shareholder's awareness of the consequences of such an acquisition.[22] To avoid this catastrophic result, companies with significant NOLs have adopted "poison pills" and/or transfer restrictions in their charters or bylaws to deter or prevent shareholders from engaging in transactions that would constitute an ownership

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26 C.F.R. § 1.382-5(a) (2017) ("Following an ownership change, the section 382 limitation for any post-change year is an amount equal to the value of the loss corporation multiplied by the long-term tax-exempt rate applies with respect to the ownership change, and adjusted as required by section 382 and the regulations thereunder."). The value of any capital infusions received during the two years prior to the ownership change is disregarded for purposes of determining the value of the company before an ownership change. § 382(l)(1) ("Any capital contribution received by an old loss corporation as part of a plan a principal purpose of which is to avoid or increase any limitation under this section shall not be taken into account for purposes of this section."). The long-term tax exempt bond rate is the highest of the U.S. federal long-term bond rates for any month during the month of the ownership change and the two months prior to the ownership change, determined in accordance with 26 U.S.C. § 1274(d) (2012). § 382(f)(1) ("The long-term tax-exempt rate shall be the highest of the adjusted Federal long-term rates in effect for any moth in the 3-calendar-month period ending with the calendar month in which the change date occurs.").

[21] § 382(c) ("[I]f the new loss corporation does not continue the business enterprise of the old loss corporation at all times during the 2-year period beginning on the change date, the section 382 limitation for any post-change year shall be zero.").

[22] *The Sometimes Hidden Implications of Section 382*, GARDNER CARTON & DOUGLAS TAX UPDATE (Gardner Carton & Douglas, Washington, D.C.), Feb. 2004, at 1–3 (explaining how Section 382 has become a source of confusion for many corporations).

change for the purposes of Section 382.[23] These NOL "poison pills" are typically effected through shareholder rights plans, which typically deter the acquisition of five percent or more of a company's stock (and additional acquisitions by existing five-percent shareholders) by granting all other shareholders the right to acquire additional shares at a significant discount following any such acquisition without the company's prior approval, thus diluting the triggering shareholder.[24] NOL transfer restrictions in charters and/or bylaws typically prevent any acquisition of five percent or more of a company's stock (and additional acquisitions by existing five-percent shareholders) without the company's prior approval.[25] Accordingly, NOL poison pills and transfer restrictions have served as an effective means of preserving the ability of companies to utilize NOLs (and therefore preserving the value of such tax assets) that could otherwise be severely impaired.[26]

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[23] *See, e.g.*, Sarah Webber & Kate Davis-Nozemack, *NOL Poison Pills: Using Corporate Law for Tax Purposes*, 117 J. TAXATION 312, 312 (2012) ("To maintain NOL control, corporate tax planning may utilize defensive tactics found in corporate law, including an NOL poison pill plan."); Daniel E. Wolf, *The Net Operating Loss Poison Pill—A Timely Prescription,* LAW360 (Oct. 30, 2015, 10:21 AM), https://www.law360.com/articles/720765/the-net-operating-loss-poison-pill-a-timely-prescription (discussing the implementation by a board of directors of "an NOL rights plan, or poison pill").

[24] Webber & Davis-Nozemack, *supra* note 23, at 314 ("These pill plans are often adopted simultaneously to work together to deter potential acquirers.").

[25] *Id*. at 315 ("For an NOL poison pill that seeks to avoid § 382 NOL limitations, the ownership threshold trigger is set below 5%, usually at 4.9%.").

[26] Perhaps the most well-known example of an NOL being triggered involved a stockholder rights plan implemented by Selectica, Inc. (Selectica). In November 2008, Versata Enterprises, Inc. and its affiliates (Versata) acquired 5.1% of Selectica, who at the time had a rights plan with an ownership threshold of 15%. Selectica's board of directors, who had previously declined multiple takeover proposals by Versata, ordered a Section 382 analysis that suggested that acquisitions of roughly 10% of the company's stock by 5% stockholders would result in limitations on the company's ability to use its NOLs. The board then resolved to reduce the threshold in the rights plan to 4.99%. Shortly thereafter, Versata knowingly triggered the poison pill by acquiring additional shares, bringing its total holdings of Selectica to 6.7%. After considering its options, the Selectica board of directors then declared that under the rights plan all Selectica stockholders (other than Versata) would receive one share of common stock for each existing stockholder right. This effectively diluted Versata's ownership from 6.7% to 3.4%. Versata sued, but the Delaware Supreme Court upheld the Selectica board's use of the pill.

V. Federal Reserve SR 15-15

In December 2015, the Federal Reserve severely limited the ability of bank holding companies to implement NOL poison pills and transfer restrictions when it issued *SR 15-15: Supervisory Concerns Related to Shareholder Protection Arrangements* (SR 15-15).[27] The stated purpose of SR 15-15 was to "explain supervisory concerns related to arrangements structured by bank and savings and loan holding companies (collectively 'bank holding companies') to protect the financial investments made by shareholders (collectively 'shareholder protection arrangements')."[28] In particular, the Federal Reserve's concern was that these shareholder protection arrangements "could have negative implications on a holding company's capital or financial position, or limit the holding company's ability to raise capital in the future."[29]

Among various other arrangements, the shareholder protection arrangements described in SR 15-15 include provisions in which "[e]xisting shareholders of the holding company are able to acquire additional shares at significant discounts to market value in a new offering if any shareholder crosses a specific ownership threshold."[30] In a footnote, the Federal Reserve noted that this referred to "'poison pills' . . . designed to preserve net operating losses within the requirements of Section 382 of the Internal Revenue Code."[31] The Federal Reserve explained:

> Arrangements of these types (in whatever form) have the potential to impose additional financial obligations on a holding company or restrict in some way the primary or secondary market for the holding company's shares. Often, these arrangements serve to

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Versata Enters., Inc. v. Selectica, Inc., 5 A.3d 586, 598–99 (Del. 2010) (discussing Versata's use of a poison pill to dilute Selectica's ownership share).

[27] BD. OF GOVERNORS OF THE FED. RESERVE SYS., DIV. OF BANKING SUPERVISION AND REGULATION, *supra* note 1 (objecting to certain shareholder protection arrangements that shield existing shareholder investments at the expense of the company's overall health).

[28] *Id*.

[29] *Id*.

[30] *Id.*

[31] *Id*. n.4 ("Provisions of this type are often referred to as 'poison pills' and were originally developed as defenses against contested acquisitions.").

> protect the value of the initial investment made by a particular subset of shareholders rather than the viability of the issuing holding company, or, in other ways, provide current shareholders with an advantage over future, similarly situated, investors.[32]

Accordingly, the Federal Reserve announced it would review such arrangements and consider appropriate action, and ultimately, that the Federal Reserve "may direct a holding company's board of directors to modify or remove a shareholder protection arrangement that gives rise to safety-and-soundness concerns."[33] In practice, the Federal Reserve has prevented bank holding companies from adopting NOL "poison pills" or transfer restrictions in their charters or bylaws.[34] While the Federal Reserve's concerns regarding shareholder protection arrangements are justifiable as a general matter, as further explained below, these concerns are misguided with respect to NOL "poison pills" and transfer restrictions, which function to benefit the company rather than particular shareholders.

VI. NOL Protection Devices Are Beneficial to Bank Holding Companies with Substantial NOLs

"Poison pills" and other takeover defenses have been generally accepted as legitimate under Delaware and other states' corporate laws to the extent they are a proportionate response to a legally cognizable threat.[35] Unless a takeover defense is preclusive or

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[32] *Id.*

[33] *Id.*

[34] *See, e.g.*, Faucette & Weitzel, *supra* note 2 (describing a Federal Reserve Letter that mentions the use of poison pills as part of a "non-comprehensive list of arrangements which have raised supervisory concerns"); Klinger, *supra* note 2 (arguing the Federal Reserve's Supervisory Letter indicates the Federal Reserve is interested in preventing arrangements which benefit a specific subset of shareholders of a bank holding company). Although discussions with the Federal Reserve are confidential and details cannot be disclosed, we are aware of several instances in which the Federal Reserve has prohibited our clients from adopting NOL poison pills and other transfer restrictions.

[35] In *Unocal Corp. v. Mesa Petroleum Co.*, the Delaware Supreme Court held that takeover defenses are valid if the board of directors can show that it had reasonable grounds for believing that a danger to corporate policy or effectiveness existed, and that the defense was reasonable in relationship to the threat posed. Assuming the directors satisfy that burden, the business

coercive, the defense is valid as long as it is within a "range of reasonableness."[36] More importantly, the Delaware Supreme Court has expressly upheld the validity of NOL poison pills, holding that the potential loss of a company's NOLs is a cognizable threat to a corporation and that an NOL "poison pill" is a proportionate response to that threat.[37]

Furthermore, NOL "poison pills" and transfer restrictions are not adopted to entrench management, but rather to protect valuable tax assets of a company. Proposals to implement NOL "poison pills" and/or transfer restrictions are often submitted to shareholders for ratification, and proxy advisory firms ISS and Glass Lewis have generally been supportive of such proposals.[38] In many cases, the effectiveness of NOL "poison pills" and transfer restrictions is limited to a specific time period or the expected useful life of the company's

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judgment rule applies, which, practically speaking, will result in the takeover defense being upheld. Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 955 (Del. 1985) (finding defensive mechanisms can be used provided they are reasonable in relation to the threat). For an in-depth discussion of *Unocal* and its progeny, see STEPHEN M. BAINBRIDGE, MERGERS AND ACQUISITIONS (Foundation Press 3d ed. 2012).

[36] Unitrin, Inc. v. Am. Gen. Corp., 651 A.2d 1361, 1387–88 (Del. 1995) ("If a defensive measure is not draconian, however, because it is not either coercive or preclusive, the *Unocal* proportionality test requires the focus of enhanced judicial scrutiny to shift to 'the range of reasonableness.'"); *see also* Moran v. Household Int'l, 500 A.2d 1346 (Del. 1985) (upholding the validity of a "poison pill" as a reasonable response to a general threat of coercive takeover tactics by hostile bidders).

[37] Versata Enters., Inc. v. Selectica, Inc., 5 A.3d 586 (Del. 2010) (finding use of a poison pill to protect NOLs was reasonable); *see also* SIMON M. LORNE & JOY MARLENE BRYAN, 11A ACQUISITIONS & MERGERS: NEGOTIATED AND CONTESTED TRANSACTIONS § 5:68.50 (2017) ("Since the Delaware Chancery's decision in February 2010 that upheld the validity of the NOL poison pill in *Selectica*, 21 corporations have either adopted shareholder rights plans that provide for an NOL pill or amended their previously existing shareholder rights plans to provide for such a pill. Eight of those corporations implemented their NOL pill after the Delaware Supreme Court upheld the Chancery Court's decision.").

[38] Wolf, *supra* note 22 ("While the [NOL] can be enacted . . . without shareholder approval . . . about half of implementing companies have submitted the plan to shareholder ratification . . . . [S]hareholders have been largely supportive of these plans in resulting votes, with both ISS and Glass Lewis willing to recommend in favor of ratification if certain minimum criteria are met.").

NOLs.[39] NOL "poison pills" and transfer restrictions also generally give the company's board of directors discretion to exempt particular transactions that will not jeopardize the NOLs or will otherwise maximize shareholder value.[40]

Given that companies, courts, and shareholders generally support NOL "poison pills" and transfer restrictions, the sole question is whether the Federal Reserve's supervisory concerns merit differential treatment for bank holding companies as compared to companies in all other industries.[41] As explained below, restricting the use of NOL "poison pills" and transfer restrictions by bank holding companies does not further the regulatory objectives declared by the Federal Reserve, and in fact is counterproductive to those objectives and decreases the capital and financial position, as well as, shareholder value of bank holding companies.[42]

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[39] *Id*. ("Most NOL plans will include a sunset provision tied to either a specific date (often three years) or the expected useful life of the NOLs being protected . . . .").

[40] *Id*. ("The plan often includes significant exemptive discretion to the board of directors, including if it determines that a particular acquisition will not jeopardize the NOL assets . . . ."); *see also* First Sec. Grp., Inc., Stock Purchase Agreement (Form 8-K, Exhibit 10.2) (Feb. 25, 2013) (explaining First Security Group, Inc.'s private placement is exempt from the Company's "NOL Rights Plan," while also representing that each investor will be issued preferred stock purchase rights pursuant to the NOL Rights Plan); Old Second Bancorp, Inc., Current Report (Form 8-K) (Apr. 8, 2014) (reporting that issuer's Tax Benefits Preservation Plan was amended to exempt two investors in a public offering).

[41] Anthony Garcia, *Poison Pills and Net Operating Loss Assets: Protecting the Balance Sheet or the Board of Directors?* FACTSET INSIGHT (Jan. 16, 2015), https://insight.factset.com/poison-pills-and-net-operating-loss-assets-protecting-the-balance-sheet-or-the-board-of-directors [https://perma.cc/97ML-7CQN] ("Since 2009, 141 companies have included NOL-specific provisions as part of a poison pill and 89 total NOL poison pills are presently in-force.").

[42] *See* Klinger, *supra* note 2 ("Supervisory Letter SR 15-15 indicates that the Federal Reserve's objection is that these provisions restrict 'in some way' the primary or secondary market for the holding company's shares, and serve 'to protect the value of the initial investment made by a particular subset of shareholders rather than the viability of the issuing holding company.'").

A. NOL Protection Devices Do Not Limit a Bank Holding Company's Ability to Raise Capital

First, NOL poison pills and transfer restrictions do not present "negative implications on a holding company's capital or financial position, [or] limit [the] holding company's financial flexibility and capital-raising capacity."[43] The issuance of additional shares to non-triggering shareholders pursuant to an NOL "poison pill" and the limitations on transfers imposed by NOL transfer restrictions are not financial burdens to bank holding companies, but rather devices designed to preserve valuable tax assets.[44] Furthermore, NOL "poison pills" and transfer restrictions do not limit the bank holding companies' ability to raise capital, but rather increase the attractiveness of such companies to investors because of the protection of such companies' valuable tax assets.[45] As we have personally observed in our practice, investors in bank holding companies are reluctant to ascribe value to NOLs of bank holding companies that are not protected by NOL "poison pills" or transfer restrictions, making it more difficult or impossible for such companies (especially distressed bank holding companies with large NOLs) to raise capital. Prior to the

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[43] *Id.* ("SR 15-15 cites a wide array of potentially objectionable shareholder protection arrangements, but then indicates that supervisory staff has 'in some instances' found that these arrangements would 'have negative implications on a holding company's capital or financial position, limit a holding company's financial flexibility and capital-raising capacity, or otherwise impair a holding company's ability to raise additional capital.").

[44] *Id.* ("[T]he examples also extend significantly further to potentially capture a wide array of shareholder agreements, including those frequently used to preserve Subchapter S eligibility, and certain arrangements commonly entered into to protect deferred tax assets from undergoing an 'ownership change' under Section 382 of the Internal Revenue Code.").

[45] *See id.* (challenging the view that implementing mechanisms to preserve NOLs is a limitation on a bank holding company's ability to raise capital and reasoning that "[r]ather, preserving the deferred tax asset is absolutely critical to the institution's ability to raise capital; sometimes representing significantly more value than the institution has on a stand alone basis"). The preservation of a company's NOLs has also been an important consideration in the context of mergers between two bank holding companies prior to the Federal Reserve's adoption of SR15-15. *See, e.g.*, PacWest Bancorp, Agreement and Plan of Merger (Form 8-K, Exhibit 2.1) (July 22, 2013) (including a covenant in Section 5.23 that "PacWest shall adopt a section 382 shareholder rights plan designed to preserve the net operating losses and certain other tax assets of the Surviving Corporation").

Federal Reserve's adoption of SR 15-15, prospective investors often required, as a condition to making an investment, that a bank holding company implement NOL "poison pills"[46] or transfer restrictions[47] to preserve its tax assets, and we are aware of at least one example in which a bank failed after its holding company experienced difficulties attracting capital, primarily as a result of the restrictions imposed by SR 15-15.

In addition, by not permitting NOL protection mechanisms, the potential impairment of NOLs resulting from a Section 382 ownership change itself would be catastrophic to bank holding companies' capital and financial position, as such companies would lose a valuable tax asset and therefore incur substantial income tax liabilities that would not match their cumulative financial performance over a multi-year time period.[48] Also, prohibiting bank holding companies' preservation of NOLs through the use of NOL "poison pills" and transfer restrictions decreases the value of bank holding companies relative to companies in other industries and results in a disproportionate tax burden for bank holding companies without any

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[46] *See, e.g.*, Cent. Pac. Fin. Corp., Investment Agreement (Form 8-K, Exhibit 10.1) (Nov. 4, 2010) (requiring, in Section 3.18 of the "Covenants" section to the investment agreement, that Central Pacific Financial Corp. "take all action necessary to implement a Section 382 shareholder rights plan"); FNB United Corp., Investment Agreement (Form 8-K, Exhibit 10.2) (Apr. 26, 2011) (requiring in Section 3.19 that FNB United Corp. implement the Tax Benefits Preservation Plan within 30 days); W. Coast Bancorp, Form of Investment Agreement (Form 8-K, Exhibit 10.1) (Oct. 23, 2009); Articles of Amendment to the Articles of Incorporation of Southcrest Fin. Grp., Inc. (Sept. 20, 2013) (filed with the Secretary of State of the State of Georgia on September 26, 2013).

[47] *See, e.g.*, Sterling Fin. Corp., Amended and Restated Investment Agreement (Form 8-K, Exhibit 10.1) (May 5, 2010) (attaching, as Exhibit A, form Articles of Amendment to the Restated Articles of Incorporation of Sterling Financial Corporation, which designate the terms of a series of preferred stock to be issued to the investor and set forth transfer restrictions "for the purpose of permitting the utilization" of NOLs).

[48] *See* Fleming, *supra* note 9 and accompanying text ("The section 172 NOL mechanism is commonly considered an averaging device for mitigating discrimination between taxpayers with both positive and negative income years in a given time period and taxpayers who have the same net income as the former group over the same time period but who receive it in level amounts without loss years.").

legitimate justification.[49] As a result, investors are more likely to invest their capital in companies other than bank holding companies, which is inapposite to the Federal Reserve's mission to preserve the capital and financial position of bank holding companies.[50] Therefore, the Federal Reserve's enforcement initiative under SR 15-15 with respect to NOL "poison pills" and transfer restrictions is not only misguided, but exacerbates the problems it seeks to prevent.[51]

B. NOL Protection Devices Preserve Economic Value for the Entire Company, Rather than Protecting a Particular Shareholder's Investment

Second, contrary to the Federal Reserve's assertion, NOL "poison pills" and transfer restrictions are not designed to protect "a particular subset of shareholders,"[52] but instead to protect tax assets that, in many instances, have substantial value to the company and *all* of its shareholders and other stakeholders.[53] The only disadvantaged

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[49] *See* Wolf, *supra* note 22 ("In recent years, dozens of companies have turned to an NOL rights plan [poison pill] as an effective and efficient means of temporarily preserving the value of the tax assets that could be severely impaired if there is significant acquisition or sale activity by large stockholders.").

[50] *Compare* BD. OF GOVERNORS OF THE FED. RESERVE SYS., DIV. OF BANKING SUPERVISION AND REGULATION, *supra* note 1, at 72–74, ("The Federal Reserve promotes the safety and soundness of [large, complex financial institutions] through robust supervision and regulation programs . . . ."), *with* Faucette & Weitzel, *supra* note 2 ("Absent some of these protective provisions, initial capital formation may be impeded and further consolidation of the industry is likely. The result will be a smaller number of larger institutions.").

[51] Faucette & Weitzel, *supra* note 2 ("Ironically, the Board's position may actually foster short-termism, also known as quarterly capitalism, with respect to public holding companies and deter capital formation at private holding companies.").

[52] BD. OF GOVERNORS OF THE FED. RESERVE SYS., DIV. OF BANKING SUPERVISION AND REGULATION, THE FEDERAL RESERVE SYSTEM PURPOSES & FUNCTIONS (10TH ED.): (PART 5) SUPERVISING AND REGULATING FINANCIAL INSTITUTIONS AND ACTIVITIES (2016), at 72–74 ("Often, these arrangements serve to protect the value of the initial investment made by a particular subset of shareholders rather than the viability of the issuing holding company . . . .").

[53] Wolf, *supra* note 22 ("While the NOL rights plan can be enacted by a board of directors without shareholder approval, in practice about half of

persons with respect to NOL "poison pills" and transfer restrictions are potential acquirers that would trigger the Section 382 limitations *without providing any additional capital to the bank holding company*.[54] Thus, the Federal Reserve's concern that NOL "poison pills" and transfer restrictions are designed to protect certain shareholders at the expense of others are without merit.

Prior to the Federal Reserve's restrictions on NOL "poison pills" and transfer restrictions in SR 15-15, bank holding companies frequently implemented these devices in order to protect their valuable NOLs.[55] Following SR 15-15, instead of simply accepting the detrimental financial consequences of forfeiting valuable NOLs following a Section 382 ownership change, bank holding companies have begun pursuing inefficient and imperfect solutions to reduce this risk. The most common example of this is a prior notice letter, pursuant to which a new investor agrees to consult with the company and notify the purchaser of the potential consequences of triggering a Section 382 ownership change prior to engaging in a purchase or sale of such investor's shares.[56] Imperfect solutions such as these should be

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implementing companies have submitted the plan to shareholder ratification . . . .").

[54] *See* Webber & Davis-Nozemack, *supra* note 23, at 313 ("[P]oison pill plans often serve as a stall tactic to afford the target corporation additional time to secure capital . . . .").

[55] *See, e.g.*, Hometrust Bancshares, Inc., Tax Benefits Preservation Plan (Form 8-K, Exhibit 4.1) (Sept. 25, 2012); *see also* PacWest Bancorp, *supra* note 44, at 1 ("WHEREAS, for United States federal income tax purposes . . . Parties intend that the Merger will qualify as a reorganization . . . .").

[56] *See, e.g.*, HCSB Fin. Corp., Form of Prior Notice Letter (Form 8-K/A, Exhibit 10.1) (Mar. 2, 2016) ("The Company and the Purchasers acknowledge that the Company has valuable [NOL] carry-forwards, the use of which would be limited if the Company were to experience an 'ownership change' under Section 382 of the Code as a result of the transfer of the Securities issuable hereunder . . . ."). In this Prior Notice Letter, the purchaser acknowledges that the company has valuable NOLs that would be limited in connection with an "ownership change" under Section 382. Accordingly, the purchaser agrees to consult with the company at least ten days prior to any proposed purchase or sale of its shares regarding the potential adverse tax implications the transaction could have on the NOLs (and if requested by the company, to disclose the potential tax implications to the other party to the transaction). The purchaser also acknowledges that a legend reflecting this notice requirement will be placed on the purchaser's stock certificates. We have observed similar agreements in connection with other private bank holding companies.

unnecessary given the benefits of NOL "poison pills" and transfer restrictions that are supported by companies, courts, and shareholders in all industries other than bank holding companies following the Federal Reserve's adoption of SR 15-15.

VII. Conclusion

In summary, because the preservation of NOLs benefits companies with significant NOLs and their shareholders, permitting bank holding companies to implement NOL "poison pills" and transfer restrictions does not (contrary to the assertions in SR 15-15) benefit certain shareholders at the expense of others. Furthermore, because companies in other industries are able to use NOL "poison pills" and transfer restrictions to protect these valuable tax assets, permitting bank holding companies to take the same reasonable measures would make it easier for bank holding companies to attract capital (especially distressed bank holding companies that need the most capital). Therefore, the Federal Reserve should exempt NOL "poison pills" and transfer restrictions from the restrictions set forth in SR 15-15 as soon as possible to minimize further financial harm to bank holding companies.