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Deposed CEOs at the Gate: Poison Pills and Tax

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More than 30 years ago, shareholder rights plans—known to friends and foes alike as "poison pills"—transformed public-company M&A. Martin Lipton, the Dr. Salk who vaccinated corporate America against hostile tender offers, got the idea for the shareholder rights plan in 1982, a few years into the takeover boom. As soon as the Delaware Supreme Court endorsed the pill as a legitimate exercise of business judgment [*see Moran v. Household Int'l, Inc.*, 500 A.2d 1346 (Del. 1985)], hundreds of public companies beat a path to Messrs. Wachtell, Lipton, Rosen & Katz's golden door.

The shareholder rights plan has been a fantastically effective piece of legal technology. In addition to buying a targeted company time to consider alternatives, a poison pill greatly strengthens incumbent management's bargaining position *vis-a-vis* an unwelcome suitor. In 2002, fully 60 percent of the S&P 500 had rights plans in force.

Then things shifted a bit. Shareholder proposals to dismantle existing rights plans became more common, and they were frequently successful. Proxy advisory firms, to which institutional investors were increasingly "outsourcing" their voting decisions, started to recommend voting *against* the directors of any company that adopted or renewed a poison pill without committing to put the matter to a shareholder vote within 12 months. Corporate America got the memo.

By the end of 2008, only 22 percent of the S&P 500 had a rights plan in force—almost a two-thirds decline in just six years. But that doesn't mean the pill was going the way of the dinosaurs. Incumbent managers generally concluded that they could avoid a lot of flak, yet remain securely ensconced, by keeping a rights plan "on the shelf." If an insurgent started pounding on the door to the C-suite, the pre-vetted plan could be up and running in less than 24 hours.

ALSO IN THIS ISSUE

The poison pill got a P.R. boost during the Great Recession. Citigroup and other corporations with Brobdingnagian losses started to adopt low-trigger plans to avert "ownership changes" described in Code Sec. 382(g). The goal was to protect their massive NOLs from Code Sec. 382(a), which severely limits the utilization of "pre-change losses." Proxy advisory firms recognized that something more than management entrenchment was at stake, so they went along with these "NOL rights plans."

Nevertheless, the number of plans *in force* has continued to fall. At the end of 2015, only 19 companies in the S&P 500—less than four percent—had a poison pill in place. But there were many hundreds of rights plans sitting on the shelf, ready for deployment if their corporate sponsors should find themselves "in play."

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This Time It's Personal

The *in terrorem* effect of the shareholder rights plan is undiminished. Rational economic actors understand that launching a hostile takeover will do them about as much good as banging their heads against a wall. For better or worse, we are still living in Mr. Lipton's world.

This is not to say that poison pills have disappeared from the news. But the focus seems to have shifted from the coolly calculating raiders of yesteryear to a rather different threat: deposed founder-CEOs. Let's look at two recent episodes involving charismatic CEOs whose controversial behavior got them kicked out of their own companies.

In the initial glare of publicity, the CEOs quietly turned over the keys. But it was not long before they were looking to regain control. As founders, they already owned lots of stock, so their former companies quickly adopted rights plans.

American Apparel

Dov Charney founded American Apparel in his college dorm room in the late 1980s. The company's daring advertisements—which sometimes included Mr. Charney himself—and idealistic labor practices made it a cultural icon. The mercurial founder-CEO owned 43 percent of American Apparel's stock.

Notwithstanding explosive growth, American Apparel always had trouble turning a profit. In March 2014, following a severe financial squeeze, Mr. Charney's ownership was reduced to 27 percent. In June, the board of directors suspended (and later terminated) Mr. Charney as CEO. The board cited, among other issues, allegations that Mr. Charney had sexually harassed numerous employees.

Once he had left the building, Mr. Charney started buying up American Apparel shares at a rapid clip. With his 43-percent stake restored, he called for a special meeting of shareholders. Mr. Charney demanded that the board be expanded and stocked with his supporters. He also threatened legal action if he was not restored as CEO.

American Apparel adopted a pill right after Mr. Charney filed his Schedule 13D. The purpose of the pill was to "limit the ability of any person or group, including Dov Charney, to seize control of the company without appropriately compensating all American Apparel stockholders." Although the rights plan can't take all the credit, Mr. Charney's bid collapsed.

Papa John's

In 1984, John Schnatter sold his 1971 Camaro Z28 and purchased $1,600 worth of used pizza equipment. He then started selling pies out of converted broom closet in the back of his father's bar. His company—now Papa John's International, Inc.—went public in 1993, and currently has more than 5,000 outlets around the world.

Mr. Schnatter, the eponymous "Papa John," figured prominently in the company's ad campaigns. In October 2017, he attracted unwelcome publicity when he became embroiled in the controversy surrounding NFL players' "take-a-knee" protests. Shortly after the NFL canceled its marketing agreement with Papa John's, Mr. Schnatter announced that he was stepping down as CEO.

On July 11, 2018, it was reported that Mr. Schnatter had made racially charged statements on a call with the marketing agency that had been hired to help him avoid further controversy. A few hours later, the ex-CEO resigned as chairman of the board of directors. The company terminated the agreement that had established Mr. Schnatter as the public face of Papa John's—the first step toward removing his smiling visage from the pizza box.

It was only a week until Mr. Schnatter revealed that his resignation had been a "mistake." His lawyer announced that the original Papa John was "not going to go quietly in the night." On July 26, the deposed CEO sued for access to the company's books and records, speculating that the directors had participated in a "coup."

The company had seen this coming. Three days *before*, it had adopted a limited-duration poison pill with a 15-percent ownership threshold. Mr. Schnatter is grandfathered in as the holder of 30.3 percent of the company's common shares, but the pill will be triggered if his ownership increases beyond 31 percent.

While Mr. Schnatter has been testifying about the coup in the Delaware Court of Chancery, hedge funds and other adventurous investors have been acquiring positions in the company. How it will all turn out is anybody's guess. But, unless Mr. Schnatter can get the pill removed, the dispute will *not* be decided by a race to acquire a majority of the company's stock.

Flipping Off Corporate Raiders: Tax Analysis

Shareholder rights plans have become a fact of corporate life. It is testimony to their effectiveness that they have generated next to nothing by way of tax litigation or IRS guidance. The only authority on point is Rev. Rul. 90-11 [1990-1 CB 10], which held that the *adoption* of a poison pill—a dividend under state corporate law—did not result in the realization of gross income by the target company's shareholders.

Rev. Rul. 90-11 assumed that, when the plan was adopted, the likelihood that it would be triggered was "both remote and speculative." What does this imply for a plan adopted in response to a specific threat, *e.g.*, rumblings from an angry ex-CEO? And even if adoption is not a taxable event, what are the tax consequences if a poison pill is actually triggered?

Pill Mechanisms

The first shareholder rights plans were developed in a hurry, in response to pending emergencies. Over the decades, they have evolved primarily by the accretion of more and more bells and whistles. Today's plans get the job done, but Mr. Lipton's signature innovation is now a bit of a Rube Goldberg machine.

Fortunately, we can limit ourselves to reviewing the operation of just two basic pill mechanisms. They work by threatening the would-be acquirer (Insurgent) or Insurgent's shareholders with dilution if the target company (Target) does not take timely steps to turn off the pill after it has been triggered. This is supposed to force Insurgent to negotiate an acquisition with Target's incumbent management—or else undertake a difficult and expensive proxy fight.

A "flip-in" plan gives Target's shareholders (except for Insurgent) the right to purchase additional shares at a large discount if Insurgent's ownership percentage crosses some threshold, *e.g.*, 20 percent. When shareholders (or their transferees) exercise these discount purchasing rights, they will dilute both the value of Insurgent's stake and the percentage it represents in the battle for control.

The original shareholder rights plans relied on a different mechanism. Under a "flip-over" plan, Insurgent can acquire shares of Target to its heart's content and never suffer dilution. But, if Insurgent gains control and tries to squeeze out Target's remaining shareholders, the flip-over plan turns the tables.

The plan lets Target's historic shareholders purchase shares of *Insurgent* at a 50-percent discount. Insurgent does not suffer dilution, but its *shareholders* certainly do. This is unlikely to go over well with the folks who elect Insurgent's board of directors.

Flip-over pills were initially portrayed as a device to compensate Target's shareholders for the loss of the higher price they would presumably have received in a negotiated acquisition. But the dilution they would inflict was enough to deter most takeover bids. However, flip-over plans proved useless against insurgents who were willing to live with minority shareholders after obtaining control. This was famously demonstrated in 1985, when Sir James Goldsmith seized control of Crown Zellerbach without triggering his prey's flip-over plan.

Thanks to inertia and word processing, flip-over provisions remain common in poison pills even today. Because of their weakness as an anti-takeover device, they are invariably accompanied by a flip-in feature, which does all the heavy lifting. Flip-over provisions persist, but they have become largely vestigial, like the human appendix.

Tax Consequences of Adoption

For corporate-law purposes, Target's adoption of a shareholder rights plan is a dividend of one "Right" on each of its common shares. Prior to a triggering event, the exercise price of a Right is set wildly out of the money. In addition, the Rights are not represented by separate certificates, and they cannot be transferred independently of the related common shares.

Things get interesting once a triggering event occurs. First, any Rights attached to *Insurgent's* shares become void. Second, Target's other shareholders become free to exercise their Rights and purchase additional shares of Target (let's focus on flip-in plans) worth *twice* what they are required to pay for them. The Rights also become transferable, so shareholders who do not feel like fronting any cash can sell their Rights to somebody who does.

In the old days, poison pills were adopted as a matter of good corporate hygiene. That's how 60 percent of the S&P 500 came to have one in force by the early 2000s. There was no reason for Target to wait for Insurgent to show up before taking action. Consequently, the vast majority of rights plans were adopted when there wasn't a cloud in the sky.

The right to buy Target stock at half price is theoretically valuable, even if it does not confer any benefit prior to a triggering event. Under Code Sec. 305(d), rights to acquire stock are considered "stock," so could *adoption* of a rights plan subject Target's shareholders to current tax under Code Sec. 305(b)(2)? After all, the essence of a flip-in plan is that it increases the proportionate interest of *some* of Target's shareholders at the expense of another (*viz.*, Insurgent).

But if a plan is adopted when there is no threat on the horizon, *which* shareholders should be taxed as having received a disproportionate distribution? *All* of them? In that case, where is the disproportion? If Insurgent isn't even in the picture, the *pro rata* distribution of Rights doesn't seem any worse than a *pro rata* distribution of common stock.

Even if we get past this objection, where is the companion distribution of *property* to the "other" shareholders that is required by Code Sec. 305(b)(2)(A)? Under Reg. §1.305-3(b)(4), payments of dividends or even interest to the "other" shareholders can fill the gap. But that doesn't help unless we assume that our merely hypothetical Insurgent already owns Target shares or debt when the pill is adopted.

The IRS started to engage with these issues in the late 1980s. America's biggest corporations were falling over themselves to adopt shareholder rights plans, and the IRS was under pressure to let them do so without tax complications. As an IRS official acknowledged at a conference in 1988, "One way or another, we are going to permit the tax-free creation of poison pill rights." [*See* Lee A. Sheppard, *IRS Will Allow Tax-Free Creation of Poison Pills*, 41 TAX NOTES 258 (1988) (quoting James Dahlberg, Branch Chief of the Corporation Tax Division).]

The result was Rev. Rul. 90-11, *supra*, which resolved the tax issue without bothering about technicalities. The IRS posited a case in which a corporation adopted a plan at a time when the likelihood that the Rights would ever be exercised was "both remote and speculative." At a minimum, that meant plans adopted *before* an insurgent even appeared on the scene.

Rev. Rul. 90-11 conceptualizes a poison pill as simply:

> a mechanism by which the corporation could, *in the future*, provide shareholders with rights to purchase stock at substantially less than fair market value as a means of responding to unsolicited offers to acquire [the corporation]. [Emphasis supplied.]

This formulation shifts the focus from the creation of the Rights on paper to the *activation* of those Rights following a triggering event. The "real" tax event is activation. That is when the Rights become exercisable in an economically meaningful way, as well as transferable like most other forms of property.

On this view, adopting a rights plan merely sets the stage for a *future* transaction. So, the IRS decided to wipe the slate clean. Rev. Rul. 90-11 declares that installation of a poison pill is a complete non-event:

> The adoption of Plan by [the corporation's] board of directors does not constitute the distribution of stock or property by [the corporation] to its shareholders, an exchange of property or stock (either taxable or nontaxable), or any other event giving rise to the realization of gross income by any taxpayer.

Although the IRS acted by administrative *fiat*, its conclusion makes sense. The value of the Rights created when a company adopts a plan depends on somebody triggering the plan. If the pill is doing its job, that will never happen.

Still, the Rights have *some* theoretical value as options, no matter how contingent the triggering event. But the IRS's decision to go with a "wait-and-see" approach is not hard to defend from an administrative perspective. The IRS may have painted with a broad brush, but any damage to the fisc has been immaterial.

Could the IRS have gone even further? These days, Target is unlikely to adopt a poison pill except in response to a specific takeover threat. Does Rev. Rul. 90-11 apply even if Insurgent is staring Target in the face?

There is a reasonable argument that it does. Rev. Rul. 90-11 did not assume that the poison pill was adopted when the *threat of a hostile takeover bid* was remote and speculative. What it said was that the board of directors adopted the plan at a time when the likelihood that the Rights *would ever be exercised* was remote and speculative.

Based on their track record, flip-in rights plans are almost 100-percent effective in deterring would-be acquirers from taking action that would constitute a triggering event. Even if Target waits till the last minute, adopting a plan will almost certainly prevent Insurgent from taking steps that would result in the dilution of its interest. Hence, the likelihood that Rights will be *exercised* will be "both remote and speculative" even if Target adopts the plan in response to a specific threat.

Well, maybe not always. Suppose that a deposed founder-CEO credibly announces that he is going to damn the torpedoes and proceed full steam ahead to regain control of "his" company. Even if Target knows that the deposed CEO will not be deterred by dilution, it will probably still adopt a pill for the benefit of its more tractable shareholders, including incumbent management.

Under this scenario, the likelihood of the Rights being exercised would *not* be remote and speculative at the time of adoption. By its terms, Rev. Rul. 90-11 would not apply. In theory, the IRS would have to decide whether adoption of the plan in response to the ex-CEO's bid was a taxable event to Target's shareholders.

If such a case were to arise, the tax stakes might not be great. If the deposed CEO charges ahead, the Rights *will* be exercised in the near future. So, it's fairly likely that adoption and exercise will occur in the same tax year.

What if the plan is adopted in December 2018, but the headstrong CEO does not get around to triggering it until January 2019? That would give shareholders and the IRS a *timing* issue to fight about. The question would be whether Target's shareholders are actually taxable when their Rights are activated.

Tax Consequences of Triggering Rights

Suppose that Insurgent triggers the pill, the Rights are activated, and Target's shareholders exercise or sell their Rights. Rev. Rul. 90-11 does not say how the shareholders are taxed when this "remote and speculative" contingency comes to pass. The IRS has left the question open for the last 28 years.

The lack of guidance is understandable. In all that time, there has been only *one* instance of Rights actually coming into force under a flip-in rights plan. In December 2008, Versata Enterprises, Inc., triggered the flip-in pill recently adopted by Selectica, Inc. Selectica's plan had a 4.99-percent threshold, which was intended to protect its NOL from Code Sec. 382.

Versata's existing stake exceeded five percent, but it was grandfathered in. Versata was still barred from increasing its interest by more than half a percentage point. Versata went on buying shares, triggered the pill, and got diluted from 6.7 percent down to 3.3 percent. The matter ended up before the Delaware Supreme Court, which upheld Versata's dilution under the low-trigger plan. [*See Versata Enterprises, Inc. v. Selectica, Inc.*, 5 A.3d 586 (Del. 2010).]

It is hard to know, even after 20 minutes of poking around on EDGAR, what (if anything) Selectica told its shareholders about the tax consequences of these events. Maybe not a lot. Diluting Versata increased the interest of Selectica's historic shareholders by a measly 3.2 percent. Selectica's principal asset was its NOL, so it probably wasn't brimming with E&P in any event.

The shareholders did not exercise their Rights for cash. Selectica exchanged the Rights directly for common stock, as it was permitted to do under the plan. This adjustment to Selectica's capital structure looks like a recapitalization under Code Sec. 368(a)(1)(E).

Recapitalizations are normally tax-free, but the fact that this one produced the same effect as a non-*pro-rata* stock dividend might give us pause. If Selectica managed to pay Versata some dividends or interest before the pill was triggered, could the transaction be treated as a series of distributions described in Code Sec. 305(b)(2)? After all, some shareholders increased their proportionate interests in Selectica, while others (Versata) got property.

Code Sec. 305(c) provides that certain transactions—including recapitalizations—can be treated as distributions under Code Secs. 301 and 305(b). However, Code Sec. 305(c) generally does not apply to a recap unless it is part of a *plan* to "periodically" increase a shareholder's proportionate interest in the corporation. [*See* Reg. §1.305-7(c)(i); Proposed Reg. §1.305-7(d)(i).]

Once triggered, a flip-in plan will increase the "old" shareholders' interest in the sponsoring corporation unless the board of directors turns it off. If the board keeps reloading the plan, it can even increase the shareholders' interest "periodically." But corporations obviously do not adopt poison pills *in order to* increase anybody's proportionate interest, so Code Sec. 305(c) should not apply.

Conclusion

Someday, perhaps, the IRS will venture out beyond the confines Rev. Rul. 90-11. But it is unlikely to do so until somebody triggers a poison pill maintained by a corporation with a large shareholder basis. It's going to take a very rich, very determined, and *very* ticked-off ex-CEO to cross that bridge.

If there are big changes at Tesla, it just might happen.