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PROFESSIONAL CORPORATION

WSGR ALERT

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DELAWARE CHANCERY COURT UPHOLDS ADOPTION AND USE OF POISON PILL TRIGGERED BY COMPETITOR'S ACQUISITION OF STOCK

RE: *Selectica, Inc. v. Versata Enterprises, Inc.* (C.A. No. 4241-VCN)

Topical Relevance: Mergers & Acquisitions – Adoption and Use of Poison Pills

On February 26, 2010, the Delaware Court of Chancery issued a post-trial opinion upholding the adoption and use of a poison pill aimed at preserving net operating losses (NOLs)[1] of Selectica. This decision updates the guidance and analysis set forth in *Moran v. Household Int'l.*[2] and *Unocal Corp. v. Mesa Petroleum Co.*[3] concerning the adoption and use of defensive measures generally, and in particular the use of poison pills.

While the court stressed the fact-specific limits of its holding, the decision is important for a number of reasons, including that this is the first opinion issued by a Delaware court upholding a modern poison pill that was triggered by a potential acquirer/hostile bidder. The court's opinion includes a number of important points for companies, including the following:

- The *Unocal* test, which provides the standard by which a board's decision to adopt defensive measures is judged, "operates to exclude only the most egregious defensive responses." Thus, in order to be deemed preclusive or coercive under the second prong of the *Unocal* standard, "the measure must render a successful proxy contest a near impossibility or else utterly moot."
- In determining the reasonableness of the board's finding of a threat, the court carefully scrutinized the record created by the board in considering the issues, including the number of meetings held by the board and its extensive use of independent experts. This record led the court to conclude that even if the board's view of the value of a particular asset was questionable, the court "will not substitute its judgment for the reasonable conclusions of the Board."
- With respect to the second prong of the *Unocal* test, the court found that a response is reasonable and not coercive or preclusive of a change in control so long as the defensive measure at issue did not render such a change a "near impossibility or else utterly moot.
- Thus, the Delaware Court of Chancery remains deferential to a board's adoption and use of a poison pill, even one with the low "trigger" common in NOL pills, provided that the board can establish a strong record that it acted independently, on an informed basis, and in good faith.

Background

Selectica and Trilogy are competitors that provide enterprise software solutions for contract management and sales configuration. In both July and October 2008, Selectica rejected acquisition proposals by Trilogy. Selectica's value consisted primarily of its cash reserves, its intellectual property portfolio, and its NOLs, which an expert retained by Selectica estimated to be worth approximately $160 million. After Selectica rejected the October 2008 offer, Trilogy notified Selectica that it had purchased more than 5 percent of Selectica's outstanding stock and that it would be filing a Schedule 13D shortly, which it did on November 13, 2008. Within four days of its Schedule 13D filing, Trilogy acquired an additional 1 percent of Selectica.

The Selectica board of directors met on November 16 to discuss the impact of Trilogy's acquisition of Selectica's shares on its NOLs and to consider amending its

[1] NOLs are tax losses realized by a corporation that, if not carried back to prior profitable periods, can be used to shelter future income from taxation. Thus, NOL carry-forwards may operate to reduce the amount of future income tax owed. Under the Internal Revenue Code (IRC), an ownership change may, depending on the value of the loss at the time of the ownership change, result in a substantial diminution in the value of the NOLs to a corporation. The precise definition of an "ownership change" under the IRC is complex, but, at its most basic, an ownership change occurs when more than 50 percent of stock ownership changes over a rolling three-year period.

[2] 500 A.2d 1346 (Del. 1985).

[3] 493 A.2d 946 (Del. 1985).

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shareholder rights plan. At that meeting, the board received expert advice that, among other things, the NOLs were a significant asset and their value was at risk in the near term due to the potential of an "ownership change" under the Internal Revenue Code (IRC). The board then unanimously passed a resolution amending Selectica's shareholder rights plan, decreasing the beneficial ownership trigger from 15 percent to 4.99 percent while grandfathering in existing 5 percent shareholders and permitting them to acquire up to an additional 0.5 percent without triggering the pill (NOL pill). If the NOL pill was triggered, the amended rights plan allowed the board 10 days to decide to exchange rights (other than those held by the triggering entity) for shares of common stock, or to allow the rights to "flip-in" automatically.[4] On December 19, Trilogy intentionally triggered the pill by purchasing additional shares of Selectica, bringing its ownership share to 6.7 percent.

After numerous board meetings during the 10 days following Trilogy's disclosure of its triggering acquisition, on January 2, 2009, the board passed a resolution expressly confirming that the board's delegation of authority included the power to effect an exchange of the rights under the pill and to declare a new dividend of rights under an amended rights plan, and then passed resolutions that implemented these conclusions, thereby adopting a "reloaded NOL pill" and instituting the rights exchange. The exchange doubled the number of shares of Selectica common stock owned by each shareholder of record other than Trilogy and its affiliates, thereby reducing Trilogy's ownership share from 6.7 percent to 3.3 percent.

Selectica filed suit in the Delaware Court of Chancery seeking a declaratory judgment that the following were valid and proper actions: (i) adoption of the NOL pill on November 16; (ii) authorization of the exchange on January 2; and (iii) adoption of the reloaded NOL pill and issuance of a new rights dividend on January 2. Trilogy filed counterclaims seeking: (i) a declaratory judgment that both the NOL pill and the reloaded NOL pill were invalid and unenforceable; (ii) an order enjoining or rescinding the exchange and requiring Selectica to redeem the rights dividend; and (iii) monetary damages for breaches of fiduciary duty.

Court's Conclusions

The court found that Selectica's actions satisfied the standards set forth in *Unocal*. Under the *Unocal* test, which provides the standard by which a board's decision to adopt defensive measures is judged, directors have the initial burden of showing that "they had reasonable grounds for believing that a danger to corporate policy and effectiveness existed," and that the defensive measure was "reasonable in relation to the threat posed" as well as "not preclusive or coercive." Once the board satisfies this test, its decision is afforded the protection of the business judgment rule, and the burden is shifted to the party challenging the board's decision to show how that decision breached the board's duty of care and/or loyalty.

The court noted that the principal function of Selectica's pill was to prevent the forfeiture of potentially valuable assets, which is a departure from the originally intended use of poison pills and the situation that the *Unocal* test analyzes—namely, protection against hostile takeover attempts. The court found that the protection of NOLs may be an appropriate corporate policy meriting a defensive response when threatened, and stated that "the protection of corporate assets against an outside threat is arguably a more important concern of the Board than restricting who the owners of the Company might be." The court pointed out that "as NOL value is inherently unknowable ex ante, a board may properly conclude that the company's NOLs are worth protecting where it does so reasonably and in reliance upon expert advice." The court found that the record was replete with evidence, including the advice of experts, that the board had ample reason to conclude that the NOLs were an asset worth protecting and that Trilogy's stock acquisitions threatened the corporate objective of maintaining the value of the NOLs by subjecting Selectica to an "ownership change" under the IRC.

Having concluded that the board's determination that a threat existed to a corporate objective was reasonable, the court proceeded to analyze whether the board's response was reasonable in relation to the threat. While Trilogy's expert testimony suggested that a poison pill with a less than 5 percent trigger "has a substantial preclusive effect," the court could not make the requisite finding that the pill was preclusive and thereby draconian. Specifically, the court stated: "The requirement of either the mathematical impossibility or realistic unattainability of a proxy contest reinforces the exactness of the preclusiveness standard. It is not enough that a defensive measure would make proxy contests more difficult—even considerably more difficult." Rather, the court stated, "the measure must render a successful proxy contest a near impossibility or else utterly moot."

Finding that the pill was neither coercive nor preclusive, the *Unocal* test required that the court shift the focus of enhanced scrutiny to the range of reasonableness. Here, the court detailed that the board had discussed the impact of the pill on the shareholders and established a committee to monitor the likelihood of a near-term ownership change and to increase the pill threshold if the burden of the pill on shareholders outweighed the benefit of preserving the NOLs.

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[4] The resolution adopting the NOL pill also established the Independent Director Evaluation Committee to conduct periodic reviews to "determine whether the Rights Agreement continues to be in the best interest of the Corporation and its stockholders," as well as to review other developments that could impact use of the pill.

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The court also discussed that it had to consider the reasonableness of Selectica's response in relation to the specific threat posed by Trilogy and not the more general threat of impaired NOLs. Pointing out that a board's "timing in moving to protect NOLs through the adoption of a poison pill is certainly relevant to the question of whether the board reasonably perceived a legitimate threat to the corporation," the court concluded that "Trilogy failed to suggest any meaningfully different approach that the Board could have taken in November and December 2008 to avoid the seemingly imminent impairment of Selectica's NOLs by Trilogy." The court stated, "In this instance, Trilogy, a competitor with a contentious history, recognized that harm would befall its rival if it purchased sufficient shares of Selectica stock, and Trilogy proceeded to act accordingly. It was reasonable for the Board to respond, and the timing of Trilogy's campaign required the Board to act promptly."

The court's opinion suggests a number of important points for directors and officers. One of the most important points is the emphasis again by the court on a good process, including full board deliberation and the use of independent experts to develop a strong record. In this case, the board held a number of meetings to consider the issues surrounding the use of the NOLs, and received independent, expert advice on the potential value and use of the NOLs. The directors were able to make strong use of this record in the litigation, as the court found persuasive the board's conclusion that the NOLs had significant value that was worth protecting through the use of the pill.

The decision is also another strong opinion by the Delaware Court of Chancery deferring to the business judgment of an independent board. The fact that this pill had such a low trigger—4.99 percent because of the IRC ownership-change rules, rather than the more customary 15 percent in more common pills—makes its acceptance even more significant.[5] The court's language that this low threshold did not act as a bar on someone running a proxy contest, notwithstanding Selectica's classified board, is also significant, as the court held that a pill should not be found preclusive so long as it does not render a proxy contest a "near impossibility or else utterly moot." This language provides considerable discretion for boards acting in good faith and with due care to adopt appropriate defensive measures.

Finally, it is worth noting that a number of judges in Delaware and commentators have been discussing the standards of review appropriate to a board's decisions subsequent to the triggering of a pill. This is the first such decision on the issue, but it is likely that more will be written on this topic, and that the key issues will continue to be board process and the record created to support that process.

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[5] According to the *New York Times*, 41 companies, including such large companies as Citibank, have NOL pills with 5 percent triggers. See Steven Davidoff, "Delaware Broadens Standards for Poison Pills," at http://dealbook.blogs.nytimes.com/2010/03/02/delaware-broadens-standards-for-poison-pills/.

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