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DELAWARE UPHOLDS STOCKHOLDER RIGHTS PLAN TO PROTECT TAX BENEFITS (NOLS)

The economic crisis in the United States has, in part, contributed to more companies taking actions to protect an ever growing asset – namely, net operating loss carryforwards or NOLs. Because certain ownership changes in a company involving 5% stockholders could substantially limit or delay the ability of a company to use its NOLs to offset future income, some companies have resorted to adopting stockholder rights plans, or NOL poison pills, to discourage an investor from triggering the ownership change set out in Internal Revenue Code Section 382¹. With a typical threshold of 4.99%, NOL poison pills have been adopted by more than 35 U.S. public companies since January 2009.

Traditional poison pills (whose ownership trigger thresholds typically range between 10%-20%) that are adopted to deter unwanted takeovers have on multiple occasions found legitimacy under Delaware law, and the dilutive effect of such poison pills has historically been a sufficient deterrent to share accumulation in excess of the applicable poison pill threshold. However, in December 2008, Trilogy, Inc., through its subsidiary Versata Enterprises, Inc., intentionally increased its shareholdings in Selectica, Inc. thereby triggering Selectica's NOL poison pill.

Delaware Chancery Court Ruling

- Extends *Unocal* analysis to poison pills in the context of protecting a corporate asset
- In relying on expert advice, Boards may properly conclude that protecting a company's NOLs merit a defensive response when threatened
- That the ability to use NOLs is contingent on there being future income to offset is not a bar to finding that such NOLs are worth preserving
- A poison pill with a 4.99% threshold is not per se preclusive or coercive and may be a reasonable response in relation to an identified threat

BACKGROUND

Selectica is a micro-cap Delaware company that provides enterprise software solutions for complex contract management and sales configuration processes. Over the past several years, Selectica has accumulated an estimated \$160 million in NOLs for federal income tax purposes. In November 2008, Trilogy, a primary competitor of Selectica, together with Versata, indicated that it had acquired a 5.1% ownership stake in Selectica and intended to purchase additional shares.

In an effort to protect its NOLs, the Selectica Board approved an amendment to the company's existing poison pill to reduce the pill's threshold trigger from 15% to 4.99% (while also grandfathering in existing 5% stockholders, including Versata, and permitting Versata to acquire an additional 0.5% without triggering Selectica's poison pill). In the face of the Board's action, Versata bought through the pill's newly-reduced trigger. Following failed attempts at negotiating a standstill agreement with Versata, the Selectica Board opted to exercise the NOL pill's exchange feature thereby doubling the number of shares of Selectica stock owned by each stockholder of record,

other than Versata, and diluting Versata's ownership interest in Selectica from 6.7% to approximately 3.3%. The Selectica Board also approved a new NOL poison pill with a 4.99% threshold.

Selectica sought a declaratory judgment from the Delaware court validating the Board's actions in reducing the pill threshold to 4.99%, authorizing the rights exchange and adopting the new NOL poison pill, and Versata counterclaimed challenging the validity of the such actions and arguing that the Selectica Board breached its fiduciary duties in taking such actions.

At issue in *Selectica v. Versata* was the appropriate standard under Delaware law with which to assess the reasonableness of the NOL poison pill as a defensive mechanism. Traditionally, in order to determine whether a board's adoption of a poison pill should be accorded the benefit of the deferential business judgment rule standard of review, Delaware courts initially review the board's action under the principles first articulated in the 1985 decision of *Unocal Corp. v. Mesa Petroleum Corp.* As applied to the adoption of a traditional poison pill, *Unocal* requires a board to first demonstrate that (i) after a reasonable investigation, it is determined in good faith that a threat to the company's policy and effectiveness exists and (ii) that the poison pill is a proportional response to the specific perceived threat. At the outset of *Selectica*, it was unclear whether the Chancery Court would employ a standard *Unocal* analysis in determining whether the Board's actions in the context of an NOL poison pill should be afforded the business judgment rule standard of review. In concluding that the *Unocal* analysis applied, the Court noted that the "protection of corporate assets against an outside threat is arguably a more important concern to the Board than restricting who the owners of the Company might be."

Good Faith and Reasonable Investigation. Due in part to the apparent independence of the Selectica Board members empowered with decision-making authority with respect to the NOL poison pill activities and the lack of any evidence that the Board members' actions stemmed from a desire for entrenchment, the Chancery Court determined that there was sufficient evidence that the Selectica Board acted in good faith and conducted a reasonable investigation.

Existence of a Threat. Given that the primary purpose of an NOL poison pill is to protect a valuable corporate asset, as opposed to guard against a hostile takeover, the case presented a novel scenario for assessing the first prong of *Unocal*. Notwithstanding Versata's arguments to the contrary, the Chancery Court concluded that the "protection of company NOLs may be an appropriate corporate policy meriting a defensive response when threatened." The Court highlighted the Selectica Board's deliberative process in assessing the nature of the threat posed by Versata. In particular, the Court determined that the Board's conclusions were supported by ample advice of experts with respect to the value of Selectica's NOLs, including Section 382 analyses that were continually updated by Selectica's accountants.

Proportionality and Reasonableness of Response. In addressing the second prong of *Unocal*, the Chancery Court considered whether the Board's defensive actions constituted a proportional and reasonable response to Selectica's identified threat. In evaluating proportionality, Delaware courts focus on whether the poison pill is "preclusive or coercive."² The Delaware courts further analyze whether the company's response was reasonable in relation to the threat identified. Versata argued that the NOL poison pill was a preclusive measure – both on its face and in conjunction with Selectica's other defensive measures (e.g., its staggered Board). The Chancery Court conceded that NOL poison pills with lower than 5% triggers, in general, may have substantial preclusive effects. However, the Court explained that a preclusive measure is one that would "render a successful proxy contest a near impossibility or else utterly moot." In the Court's opinion, neither the NOL poison pill nor amended NOL poison pill met this formidable standard.

The Chancery Court also determined that the Selectica Board met its obligation to evaluate the reasonableness of its defensive actions. In assessing reasonableness, the Court afforded the Selectica Board's actions a significant degree of deference. Among other things, the Chancery Court considered that the Board (i) engaged in significant internal debate regarding the range of potential responses and (ii) established a committee to monitor the continued usefulness of an amended NOL poison pill. In addition, Versata failed to articulate a meaningfully superior (and plausible) alternate solution³. Moreover, the Board utilized the NOL poison pill's

exchange feature, rather than simply allowing a “flip-in” to occur. Consequently, Versata “experienced less dilution in its position than a poison pill is traditionally designed to achieve.”

IMPLICATIONS

While the decision in *Selectica* extended the boundaries of Delaware’s jurisprudence regarding defensive measures, it would be hasty to conclude that Delaware courts will universally rubber stamp all NOL poison pills post-*Selectica*. The Chancery Court noted that NOL poison pills, like the one adopted by *Selectica*, “must be subject to careful review.” Especially given the potential anti-takeover effects incident to NOL poison pills, it appears the Chancery Court was mindful to limit its holding to the particular facts before it. That said, the *Selectica* decision should give boards of directors greater comfort that Delaware courts recognize the protection of NOLs as a legitimate corporate objective and the careful and reasoned adoption of NOL poison pills as an appropriate measure in support of that objective.

The *Selectica* decision is perhaps most useful in providing a road map for board action related to the protection of NOLs. The Chancery Court stressed the importance of the Board’s deliberative process in evaluating the threat to the company’s NOLs. Companies would be well served to engage competent tax and accounting advisors to conduct a detailed Section 382 analysis, including assessing the potential harm to the company if its NOLs were to lose some or all of their usefulness. The process is further enhanced with the regular participation of companies’ legal and financial advisors in the board decision-making processes. Among other things, such advisors should counsel boards regarding the Delaware law implications of adopting a NOL poison pill, investor relations issues related to such an adoption, ramifications of adopting or triggering the NOL poison pill, and alternate mechanisms to address the threat to the companies’ NOLs. The *Selectica* decision serves as a reminder that Delaware courts will be less inclined to second-guess board actions where such actions are taken in good faith, properly informed and supported by a company’s expert advisors.

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¹ Generally, an ownership change under Section 382 occurs when the percentage of stock held by one or more stockholders owning at least 5% of the company’s stock has increased by more than 50 percentage points over the lowest percentage of the company’s stock held by such stockholders during a three-year period.

² In general, a defensive measure is preclusive when its operation absolutely precludes an acquisition of the company. A defensive measure is coercive when it operates to force management’s preferred alternative upon the company’s stockholders.

³ The Chancery Court notes that an amendment to *Selectica*’s certificate of incorporation adding limitations on the transferability of stock would have required stockholder approval and would not have precluded Versata from acquiring additional shares in the interim.