Client Alert.

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Delaware Supreme Court Upholds NOL Poison Pill

Addresses Adoption, Triggering, and "Reloading" in Face of Threat to NOLs

On October 4, 2010, the Delaware Supreme Court affirmed the Selectica board's use of a "poison pill" shareholder rights plan to protect the tax benefits of Selectica's net operating losses ("NOLs").[1] The Court's opinion in *Selectica v. Versata* supports the board's decisions to implement and to actually trigger the pill, as well as to subsequently "reload" the pill, after the board found that a shareholder (Versata) intended to acquire enough shares to jeopardize the NOLs.

Key points affirmed by the Court include:

- Protection of NOLs may be a valid corporate policy, even if the value of the NOLs is uncertain in light of the difficulty in predicting a company's future profitability.
- A rights plan with a trigger below 15% is not necessarily invalid.
- Triggering an exchange of shares for rights and issuing shares to shareholders other than an acquiring person may be a reasonable response to a threat to NOLs.
- Reloading a pill, like adopting a new one, may be an appropriate response to a perceived threat.

However, the Court also emphasized that its opinion is context-specific, and that a board's actions must be reviewed in relation to the specific threat. The Court also reiterated that future use of the pill, including any decision not to redeem the pill, would be subject to review based on the circumstances prevailing at that time.

BACKGROUND

Selectica had a large amount of NOLs, and had retained accounting and financial advisors to advise it on the value of those NOLs. Selectica adopted its rights plan with a 15% triggering threshold but lowered the threshold to 4.99% after Versata, a competitor and creditor of Selectica, acquired more than 5% of Selectica's shares. The amended plan exempted Versata as an existing stockholder, so long as it did not acquire more than an additional 0.5% of Selectica's shares. However, Versata, with knowledge of its status under the plan, acquired additional shares in excess of that amount to bring it to an ownership position of 6.7%.

Selectica's plan provided a 10-day grace period after a party crossed the triggering threshold, during which the board could exempt the acquiring person from triggering the pill. During this period, Selectica's board met several times and discussed with its outside financial and accounting experts the potential impact of Versata's actions on Selectica's NOLs. Selectica also repeatedly asked Versata to enter into a standstill agreement, which Versata declined.

Selectica's board ultimately chose not to exempt Versata and proceeded to trigger the plan. Selectica elected to exercise the plan's "exchange" feature, in which each right (other than rights held by Versata) was exchanged for one new

[1] A more detailed summary of the background to the dispute and the lower court opinion is included in our March, 2010 update, http://www.mofo.com//files//Uploads/Images/100303Selectica.pdf

Selectica share, rather than the more dilutive "flip-in" mechanism that would have given all other shareholders the right to purchase multiple shares of Selectica stock at half the market price. At the same time, Selectica declared a new rights dividend under the plan, essentially "reloading" the plan.

THE SUPREME COURT AFFIRMATION

The Court affirmed the Chancery Court's earlier determination that the Selectica board's actions met the test established in *Unocal Corp. v. Mesa Petroleum Co*. Under this standard, in analyzing defensive measures, directors are afforded the protections of the business judgment rule if they demonstrate that (1) they had reasonable grounds to believe a threat to corporate policy and effectiveness existed, *and* (2) the defensive action taken was reasonable, and not preclusive or coercive, in relation to that threat.

The Perceived Threat. On appeal, Versata argued that Selectica's board had failed to properly investigate the threat to the NOLs, as Selectica had never been profitable and was therefore unlikely to use its NOLs. The Court held that the board took adequate steps to evaluate the NOLs and the threat to the NOLs posed by Versata, noting the board's good faith reliance on the advice of an outside tax advisor who specialized in NOLs and a financial advisor.

The Defensive Response. Versata argued that Selectica's plan and actions were not reasonable in response to the threat to the NOLs, and that a pill with a low trigger would be preclusive of an effective proxy contest. Noting that Delaware courts had already generally upheld plans with a 20% trigger, the Court affirmed that the Selectica plan's 5% trigger was not, by itself, enough to render the plan preclusive or coercive, principally on the basis that an insurgent operating under that constraint would still have a realistic chance to win a proxy contest.

The Range of Reasonableness. The Court also upheld the Chancery Court's finding that Selectica's actions were within the "range of reasonableness" required by *Unocal*. Citing the fact that Selectica had repeatedly approached Versata to propose a standstill agreement, and that Versata had intentionally triggered the rights plan in an apparent attempt to impair the NOLs (as well as trying to force a settlement to a separate patent dispute between the parties), the Court found no clear error in the Chancery Court's finding that the implementation and "reloading" of Selectica's plan was reasonable under the circumstances.

CONCLUSION

The Court emphasized that its decision was based on the specific context of the case, and "should not be construed as generally supporting the reasonableness of a 4.99% trigger in [pills of companies] with or without NOLs." The Court also emphasized that its decision does not allow the Selectica board to rest on its prior analyses with respect to the pill, and that the Selectica board would need to act with respect to the pill within its fiduciary duties in the context of other threats, including, for example any request to redeem the pill in connection with any tender offer. Nonetheless, boards should take comfort from the Court's affirmation of their ability to take reasonable steps to protect assets of their companies, even when the value of those assets may be subject to some uncertainty, provided the boards have undertaken a reasonable investigation of their situation and their proposed actions.

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Contact:

Michael O'Bryan
(415) 268-6352
mobryan@mofo.com

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