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Selectica v. Versata: Delaware Chancery Court Upholds "Poison Pill" Shareholder Rights Plan with 4.99% Triggering Threshold Designed to Protect NOLs

COURT ACKNOWLEDGES RISK OF LOSING COMPANY'S NOLS IS A LEGALLY COGNIZABLE THREAT UNDER *UNOCAL*

On February 26, 2010, the Delaware Court of Chancery, in a case of first impression, dismissed a challenge to Selectica, Inc.'s shareholder rights plan, which contained a 4.99% "flip-in" triggering threshold.

The vast majority of Delaware corporations with shareholder rights plans (often referred to as "poison pills") utilize a 15% triggering threshold, the same threshold of ownership as the Delaware legislature recognized as a legitimate threat to corporate independence in adopting the Delaware state takeover statute (Delaware General Corporation Law Section 203), which itself utilizes a 15% triggering threshold. These rights plans are intended to give the company leverage to defend against a coercive and/or inadequate hostile takeover offer. Recently, however, a number of companies, including Selectica, have adopted so-called "NOL pills," intended not to protect the company from an unsolicited takeover or change of control, but rather to protect a valuable corporate asset – its net operating loss (NOL) carryforwards – which could be jeopardized if there is an ownership change under Section 382 of the Internal Revenue Code. For this purpose, an ownership change is generally defined as a change in ownership of more than 50% of the company's shares, counting only shareholders holding 5% or greater positions. As a result, poison pills adopted for this purpose typically have triggering thresholds of just under 5%.[1]

Key lessons from the case, explained in greater detail below, include:

- Potential loss of NOLs is a legally cognizable threat under *Unocal Corp. v. Mesa Petroleum Co.*
- A pill with a trigger below 15% is not *per se* invalid under Delaware law.
- A decision to lower the trigger in the face of a legally cognizable threat is not *per se* invalid under Delaware law.
- Despite the continual attack on rights plans, they remain valuable tools to protect shareholder value.

FACTUAL BACKGROUND

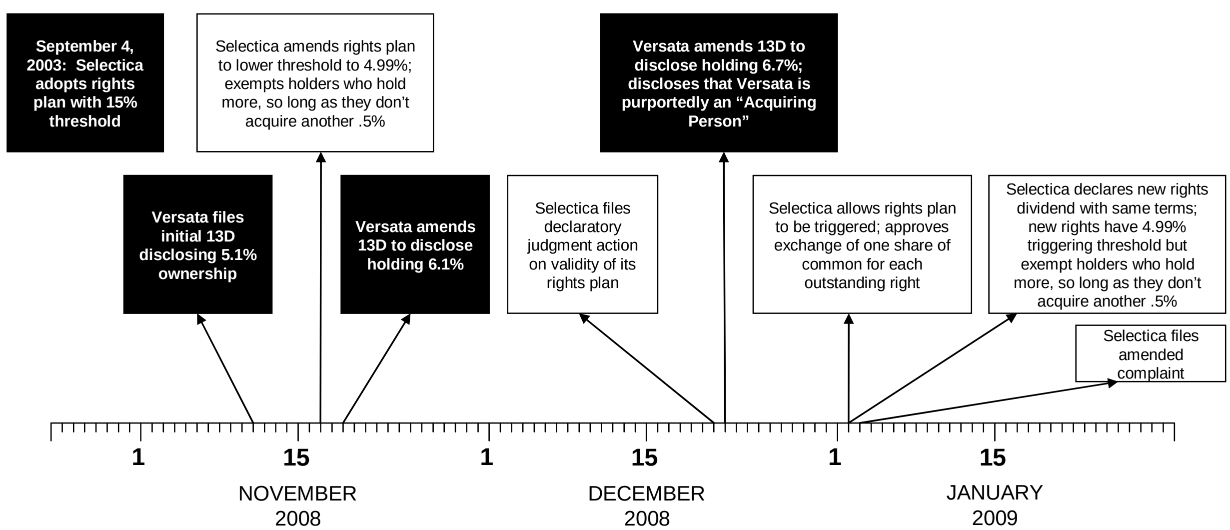
On November 11, 2008, at a time when Selectica's poison pill had a standard 15% triggering threshold, Versata Enterprises, Inc. and certain related parties filed a Schedule 13D disclosing a 5.1% ownership position in Selectica

[1] Companies seeking to protect NOLs may want to consider other mechanisms in addition to or in lieu of an NOL pill, such as amendments to their charters imposing restrictions on transfer. These mechanisms are beyond the scope of this update, but we are happy to discuss them with you**.**

common stock. Six days later, after reviewing the potential impact of further share accumulations on its NOLs, Selectica's board amended the pill to reduce the triggering threshold to 4.99%; holders who (like Versata) already held more than 4.99% were exempted, so long as they didn't thereafter acquire an additional .5%.

Two days after the amendment of Selectica's pill, on November 19, Versata updated its 13D filing to disclose a 6.1% ownership interest. It is unclear whether Versata was aware of the reduction in the triggering threshold two days earlier. However, there is no question Versata was aware of the reduction as it continued to buy Selectica shares, disclosing an updated ownership position of 6.7% on an amended 13D on December 22. In that amendment, Versata acknowledged that it was purportedly an "acquiring person" under Selectica's amended poison pill.

Like most standard rights plans, the Selectica plan provided that the rights would be triggered 10 days following a person announcing that it had crossed the triggering threshold. The Selectica plan also provided that the board could exempt an acquiring person from the rights plan during that same 10-day period. Conventional wisdom (and no doubt Versata's gambit) would have had the Selectica board exempt Versata so long as no additional shares were purchased, in order to afford an opportunity to negotiate a peaceful resolution. However, after Versata rebuffed Selectica's approaches, Selectica's board chose to deliver a firm punch to the nose instead, electing to exercise the pill's "exchange" feature, in which each outstanding right (other than rights held by Versata) would not become exercisable by the holder, but would instead be exchanged for one new share of Selectica common stock. This exchange resulted in the issuance of shares to all holders other than Versata, and thereby caused Versata's ownership percentage to be diluted from 6.7% to 3.3%. At the same time, Selectica declared a new rights dividend (with the same 4.99% threshold, exempting holders with a greater ownership position so long as they don't acquire an additional .5%), essentially "reloading" the original rights plan.



THE COURT'S DECISION

Because the Selectica board's decisions to lower the flip-in threshold to 4.99%, trigger the exchange feature of the rights plan in response to Versata's stock accumulation and reload the rights plan following the exchange all have potential antitakeover effects, the Court analyzed the board's actions under the two-pronged test established in 1985 in *Unocal*

Corp. v. Mesa Petroleum Co. Under *Unocal*, in order for the board to be afforded the protections of the business judgment rule with respect to its adoption of a defensive measure, the directors must show both that:

- they had reasonable grounds to believe a threat to corporate policy and effectiveness existed *and*
- the defensive action taken was reasonable in relation to that threat.

In order to be reasonable, a defensive action cannot be either coercive or preclusive, as the Delaware Supreme Court explained in 1995 in *Unitrin, Inc. v. American General Corp*. Moreover, the *Unitrin* Court required that where defensive actions are inextricably linked (like the lowering of the pill threshold, the triggering of the exchange and the reloading of the rights plan), the actions must be scrutinized in the aggregate as a unitary response to the perceived threat.

The Perceived Threat. The Court first addressed whether the preservation of Selectica's NOLs was a valid corporate objective, such that the potential loss of NOLs could be deemed a threat cognizable under *Unocal*. In determining that protection of a corporate asset such as an NOL is a valid corporate objective, the Court concluded that even though the value of NOLs is inherently incapable of being determined, and might ultimately be zero if a company fails to realize future profits, the board may nevertheless determine they are worth protecting where it does so reasonably and in reliance on expert advice. Indeed, the Court notes that "the protection of corporate assets . . . is arguably a more important concern of the Board than restricting who the owners of the Company might be."

The Defensive Response. The Court then moved to the second prong of the *Unocal* test, whether the Selectica board's actions were a reasonable response to the threat of impairing the company's NOLs. Citing *Unitrin*, the Court stated that a defensive measure is disproportionate and therefore unreasonable if it is draconian, being either coercive or preclusive. A defensive measure is coercive if it is aimed at cramming down on the shareholders a management-sponsored alternative and preclusive if it unreasonably precludes a takeover or effective stockholder action.

The Delaware courts long ago in *Moran v. Household International* determined that a poison pill with a 20% trigger was not *per se* preclusive because it did not strip stockholders of the right to receive tenders, provide an impenetrable barrier to control acquisitions or restrict proxy contests. Selectica argued, and the Court agreed, that the lower triggering threshold is not sufficiently different to reach a different result. The Court found no evidence that an insurgent starting below 5% could not realistically hope to prevail in a proxy contest at Selectica. It is not enough, the Court stated, that a defensive measure would make a proxy contest more difficult, even considerably more difficult – preclusiveness requires "mathematical impossibility or realistic unattainability."

Once the Court determined that the Selectica board's actions were neither coercive nor preclusive, *Unocal* required it to determine whether the defensive actions were in the "range of reasonableness." In light of the gravity of the threat to Selectica reasonably perceived by the board, the Court had little difficulty in finding the 4.99% threshold in the original rights plan and the reloaded rights plan both well-tailored to confronting the threat. The Court also noted that the 4.99% trigger was a response to the 5% standard imposed by the Internal Revenue Code, and not arbitrarily chosen by Selectica. The use of the exchange feature was, in fact, less onerous on Versata than the dilution that would have occurred under the rights plan's flip-in mechanism, so the Court also found that action to be reasonable. In this regard, the Court noted that Versata repeatedly refused to entered into a standstill in exchange for an "Exempt Person" determination by Selectica's board, which would have avoided the pill being triggered, and publicly suggested that it might purchase additional shares despite the known threat to Selectica's NOLs. Ultimately, the Court said, *Unocal* requires "that the defensive response employed be a proportionate response, not the most narrowly or precisely tailored one." Further, the Court found that the board conducted its decision-making process in good faith and with reasonable investigation (having met seven times between December 20, 2008 and January 12, 2009 to discuss the appropriate defensive response), and that it discharged its fiduciary duty of due care, in part by relying reasonably on expert opinions in analyzing the potential value of its NOLs.

CONSEQUENCES OF THE DECISION

With the Court declining to invalidate Selectica's rights plan, the action by Selectica's board to exercise the exchange feature proves a successful deterrent to further aggressive action by Versata (and perhaps other potential hostile parties) – Selectica made clear it would not tolerate aggressive action and would zealously defend the corporate bastion, Versata suffered significant dilution from 6.7% to 3.3% and, since the exercise of the exchange feature, Versata has not bought significant (if any) additional shares. Moreover, there is no expense or dilution to Selectica's shareholders; unlike an actual exercise of rights by shareholders, the exchange does not require shareholders to pay the exercise price of the rights in order to obtain the additional shares. And the reloaded rights plan remains in place to deter any further purchases.

More generally, we can glean several lessons from this decision:

- Because the primary purpose of the pill remains defensive, i.e. to preclude the acquisition of a large block of the company's stock without board consent, the *Unocal* standard rather than the straightforward business judgment rule applies.

- A pill with a trigger below the 15% level used in Delaware's state takeover statute is not *per se* invalid and will be upheld if it is a reasonable response to a legally cognizable threat under *Unocal* (here, the potential loss of the company's NOLs, which were a valuable asset despite their inherent inability to be currently quantified).

- The board's action to lower the trigger threshold in the face of a known potential hostile bidder (rather than as a pre-planned measure) may provide evidence that the board's intentions were not simply to protect the company's NOLs, but is not *per se* invalid.

- Because of the potential for abuse, poison pills remain subject to careful review, and courts will look carefully at the facts and circumstances surrounding their use in any particular challenge.

- NOL pills typically grant greater discretion to the company's board than more traditional pills aimed at changes of control.

- Despite the continual attack from academics, proxy advisors and some institutional investors, the *Selectica* decision is a reaffirmation by the Delaware Chancery Court that shareholder rights plans remain a valuable tool for corporate boards to protect shareholder value. *Issuers that have not implemented rights plans may want to reconsider that decision in light of their own unique circumstances. Issuers that have rights plans in place may want to consider whether to reevaluate their current terms.*

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