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Selectica, Inc. v. Versata Enterprises, Inc: A Case Study on the Use (and Usefulness) of Experts in Delaware Corporate Litigation

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Selectica, Inc. v. Versata Enterprises, Inc.: A Case Study on the Use (and Usefulness) of Experts in Delaware Corporate Litigation

By Jonathan S. Kitchen, Gregory V. Varallo and Margot F. Alicks[*]

The Delaware Court of Chancery's decision in *Selectica, Inc. v. Versata Enterprises, Inc*[1] has garnered a great deal of attention for its analysis and treatment of the low threshold poison pill used by Selectica, Inc. ("Selectica") to protect its net operating loss carry-forwards ("NOLs"),[2] and the fact that it was the first time a poison pill has ever been triggered in modern memory.[3] However, the Selectica Court's interesting analysis of the statutory protections afforded to directors by General Corporation Law Section 141(e) ("Section 141(e)") highlights the great depth of protection available to directors who take counsel from qualified experts in the course of their deliberations.

At the same time that it issued its Memorandum Opinion after trial, the Selectica Court also issued a lesser-known second opinion which resolved the parties' dispute over the admissibility of the opinion testimony of certain of Selectica's experts at trial (the "Experts Opinion"). In the Experts Opinion, the Court explained the various reasons why an expert

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[1] 2010 WL 703062 (Del. Ch. Feb. 26, 2010). The memorandum opinion is currently on appeal to the Delaware Supreme Court, No. 193, 1010 (Del. Apr. 7, 2010), while an appeal of the letter opinion, C.A. No. 4241-VCN, letter op. (Del. Ch. Feb. 26, 2010), has not been pressed.

[2] This is a tax concept described in detail, *infra*.

[3] Steven M. Davidoff, *The Uses and Abuses of Poison Pills*, N.Y. TIMES DEALBOOK, February 3, 2010, *available at* http://dealbook.blogs.nytimes.com/2010/02/03/on-the-uses-and-misuses-of-poison-pills (noting that *Selectica* involved the first intentional triggering of a poison pill in modern memory).

testifying on the basis of personal, boots-on-the-ground experience can be as (if not more) helpful to the Court than one testifying purely from an academic perspective.

These twin opinions thus provide an interesting case study on the importance and usefulness of qualified experts, both in the board and court rooms.

Background of *Selectica*

Selectica arose from a corporate board's adoption of a 4.99% flip-in poison pill (the "NOL Pill") designed to protect the company's NOLs, or net operating loss carry-forwards, a valuable tax asset.[4] One of Selectica's competitors, Trilogy, Inc. ("Trilogy" and, together with its subsidiary Versata Enterprises, Inc., "Versata"), had a long and involved history with Selectica. For reasons beyond the scope of this article, Versata determined to "chew" through or trigger Selectica's NOL Pill.[5] Selectica, operating in unchartered territory, proceeded only upon careful consideration of the issues it faced and in reliance on a number of outsider advisors, including a tax expert familiar with Internal Revenue Code Section 382.

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[4] Net operating loss carry-forwards are:

> tax losses realized and accumulated by a corporation that can be used to shelter future (or immediate past) income from taxation. If taxable profit [is] realized, the NOLs operate to provide a refund of prior taxes paid or to reduce the amount of future income tax owed. Thus, NOLs can be a valuable asset, as a means of lowering tax payments and producing positive cash flow.

Selectica, 2010 WL 703062, at *1. In order to prevent taxpaying entities seeking to benefit from the NOLs generated by other corporations through mergers or acquisitions, Internal Revenue Code Section 382 ("Section 382") compromises the value of NOLs when there is an "ownership change," *i.e.*, when 50% of the company's stock changes hands during a specified period of time. *Id.* In determining whether such a change in ownership has occurred, Section 382 looks at changes in the ownership of any holder of 5% or more of the corporation's outstanding shares. *Id.* This calculation is extraordinarily difficult and requires making factual assumptions, subject to varied interpretations of Section 382, upon which, the Court found, reasonable experts may disagree. *Id.*

[5] Beginning in mid-July 2008, Versata made several overtures, seeking to structure a transaction whereby it could acquire Selectica's NOLs without triggering Section 382. *Id.* at *5.

In order to confirm the validity of its actions in adopting the NOL Pill, allowing the pill to deploy,[6] and adopting a second NOL Pill (the "Reloaded NOL Pill") in an effort to continue to protect the value of its NOLs, Selectica filed a declaratory judgment action in the Court of Chancery. Versata, in turn, counterclaimed.[7] After a full bench trial on the merits, the Court issued a Memorandum Opinion upholding the Board's use of the NOL Pill to protect its valuable corporate assets,[8] along with the Experts Opinion confirming the admissibility of the testimony of one of Selectica's key experts.[9]

The Pill Opinion applied the familiar two-pronged *Unocal*[10] standard in determining that the NOL Pill was a reasonable response to the threat posed by Versata. As articulated by the Court, the *Unocal* standard provides that

> in order to be afforded the protection of the business judgment rule with respect to the adoption of a defensive measure [such as a poison pill], the directors must show that they had reasonable grounds for believing that a danger to corporate policy and effectiveness existed. . . . [T]hey satisfy that burden by showing good faith and reasonable investigation . . . [and by] demonstrate[ing] that its defensive response was reasonable in relation to the threat posed.[11]

The Court confirmed that there is no *per se* rule prohibiting rights plans with triggers below a specified level under this fact-specific standard.[12] The Court noted that although poison pills

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[6] The exchange under the NOL Pill doubled the common stock holdings of all shareholders of record, other than Versata, thereby diluting Versata's holdings of Selectica stock from 6.7% to 3.3%. *Id.* at *11.

[7] *Id.* at *11.

[8] *Id.* at *24.

[9] C.A. No. 4241-VCN, letter op. (Del. Ch. Feb. 26, 2010).

[10] *See Moran*, 500 A.2d at 1356; *Hollinger*, 844 A.2d at 1084 ("The traditional test for examining whether a Rights Plan was permissibly adopted is that set forth in *Unocal*.").

[11] *Selectica*, 2010 WL 703062, at *12 (internal citations and quotations omitted).

[12] The Delaware Court of Chancery has never invalidated a rights plan based solely on the percentage of ownership triggering the pill. Much like the Court's jurisprudence concerning the validity of arguably "defensive" provisions in merger agreements, the analysis is decidedly contextual. Despite much discussion among practitioners and academics concerning the

were initially developed in response to hostile takeover activity in the 1980s,[13] they may be used for other purposes.[14] Indeed, in approving the 4.99% NOL Pill, the Court relied heavily on the expert testimony offered, some of which also had been presented to the Selectica Board as it made its decisions.

The Court recognized that the Board's reliance on a well qualified tax expert, John Brogan, a lawyer and partner in the accounting firm Burr, Pilger & Mayer, LLP, and on a seasoned investment banker, Jim Reilly of Needham & Co., provided it with in-depth advice relating to the status of the tax law calculation concerning the NOLs and their importance to the sale process the Company was then undertaking. Together with the detailed legal advice received by the Board from its regular outside counsel, litigation counsel and special Delaware counsel, the Board was well armed to meet a challenge in Court.

When that challenge came, Selectica also presented evidence to the Court from Peter Harkins, CEO of D.F. King and a highly experienced proxy solicitor, Patricia Pellervo of PwC,

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maximum permissible size of a termination fee, the Delaware Court of Chancery has steadfastly refused to adopt any bright-line rule approving or disapproving termination fees above or below a certain size or proportion of deal value. *See, e.g.*, *Paramount Commc'ns Inc. v. QVC Network Inc.*, 637 A.2d 34, 49 (Del. 1994); *La. Mun. Police Employees' Ret. Sys. v. Crawford*, 918 A.2d 1172, 1191 n.10 (Del. Ch. 2007) (emphasizing that the inquiry into the validity of termination fees is "by its very nature fact intensive, [and] cannot be reduced to a mathematical equation"); *In re IXC Commc'ns, Inc. v. Cincinnati Bell, Inc.*, 1999 WL 1009174, at *10 (Del. Ch. Oct. 27, 1999) ("It is very difficult to say that any termination fee is so excessive *on its face* that it is unenforceable.") (emphasis in original); *In re Toys R Us, Inc. S'holder Litig.*, 877 A.2d 975, 1016 (Del. Ch. 2005) ("Th[e] reasonableness inquiry does not presume that all business circumstances are identical or that there is any naturally occurring rate of deal protection, the deficit or excess of which will be less than economically optimal.").

[13] 1 R. Franklin Balotti & Jesse A. Finkelstein, *The Delaware Law of Corporations and Business Organizations* § 6.47, at 6-88 (3d ed. 1998) ("One of the most significant developments in takeover defense in the 1980s was the proliferation of mechanisms that grant stockholders of the target corporation special rights to purchase or sell securities under favorable or preferential conditions in the midst or as the result of a hostile takeover. These rights plans sometimes have been referred to as 'poison pills.'").

[14] *Selectica*, 2010 WL 703062, at *15.

and Professor Merle Erickson from the University of Chicago, experts on NOLs and NOL studies, as well as Professor John Coates of Harvard Law School, who was called to testify with respect to the prevalence of NOL Pills.

Implications of *Selectica* on the Usefulness of Experts in Delaware

In the Memorandum Opinion, the Court analyzed the protections available to the Board in selecting and relying upon expert assistance in difficult decision making. Finding that the record established that the Board placed "considerable reliance on the advice of outside experts" in taking the challenged actions,[15] the Court discussed the protections available to the Board through Section 141(e). Citing the statute explicitly, the Court stated:

> Under [GCL] § 141(e), where a board has relied on an expert's advice in making a decision, a due care claim challenging that decision must establish such facts as would make reliance on the expert opinion unreasonable.[16]

In particular, the Court found that a party attacking the Board's reliance on experts would

> need to show either that: (a) the Board did not in fact rely on the experts; (b) such reliance was not in good faith; (c) the Board did not reasonably believe that the relevant expert's advice was within that expert's professional competence; (d) the experts were not

[15] Versata attacked the qualifications of the company's outside advisors, arguing that the Board was not justified in relying upon the advice of its investment banker, Jim Reilly of Needham & Company, in valuing the NOLs because he was not specifically an expert on NOLs or Section 382. With respect to Selectica's Section 382 expert, John Brogan of Burr Pilger & Mayer, LLP, Versata argued that he could not be relied upon because he limited his opinion to the amount of available NOLs and the level of ownership changes, and not on how the NOLs could be used to generate value. The Court rejected both of these arguments, finding the Board's reliance on these experts to be reasonable in light of the low standard involved: "In order to reasonably rely on [an expert], the Board needed only find that [he] was an expert in the matters to which he was providing advice and that he had been selected with due care." *Id.* at *18.

[16] *Id.* at *17; 8 *Del. C.* § 141(e) ("A member of the board of directors, or a member of any committee . . . shall, in the performance of such member's duties, be fully protected in relying in good faith . . . upon such information, opinions, reports or statements presented to the corporation . . . by any other person as to matters the member reasonably believes are within such other person's professional or expert competence and who has been selected with reasonable care by or on behalf of the corporation.").

> selected with reasonable care, and the faulty selection was attributable to the directors; (e) the omitted information that the Board allegedly should have considered was so obvious and reasonably available that it was gross negligence by the Board to fail to consider it, regardless of expert advice or lack thereof; or (f) the decision of the Board was so unconscionable as to constitute waste or fraud.[17]

The Court provided an interesting judicial gloss on the language of the statute itself, which provides that directors who rely "in good faith" upon opinions of experts "selected with reasonable care" and which opinions the director "reasonably believes" are within the expert's "professional or expert competence" are "fully protected."[18] Points (a) through (d) of the Court's analysis, excerpted above, are taken almost directly from the statute. However, also interesting is the Court's choice to add two additional points, (e) and (f) cited above, which are not found on the face of the statute but are sound in light of established law pertaining to fiduciaries.

First, the Court noted that a board could not avail itself of the benefits of Section 141(e) if there was "obvious and reasonably available information" that the board should have considered but did not, measured against the "gross negligence" standard utilized in due care cases.[19] The Court cited to *Brehm v. Eisner*, in which the Delaware Supreme Court noted that "[p]laintiffs must rebut the presumption that the directors properly exercised their business judgment, including their good faith reliance on [an expert]."[20] The *Selectica* Court's addition to the language of Section 141(e), in this instance, appears to be a reasonable rejection of the "see no evil, hear no evil" approach as a proper exercise of business judgment.

Second, the Court created an equitable catch-all allowing a party challenging a transaction to strip a board of the benefits of Section 141(e) if the board's decision,

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[17] *Id.* at *17-19.
[18] 8 *Del. C.* § 141(e).
[19] *Id.* at *17.
[20] 746 A.2d 244, 261 (Del. 2000).

notwithstanding its reliance on experts, was "so unconscionable as to constitute waste or fraud."[21] In other words, fraudsters cannot hide behind the statutory protection available when they bring in experts to assist them in their misdeeds. In creating such a catch-all, the Court's interpretation of Section 141(e) appears exceedingly sensible. Indeed, if even the time honored attorney-client privilege is subject to a crime-fraud exception,[22] why should reliance on other experts be exempt?

There are two other issues on which the Court ruled which have implications for the use of outside advisors. First, the Court rejected arguments going to the sufficiency of the advice the Board received. It did this in two areas. Versata presented evidence at trial, in the form of the expert opinion of Elliot Freier, a former partner at Irell & Manella, that a more thorough Section 382 study would have shown that the company had already undergone an ownership change, or at least would have given the Board a more granular sense of the threat it was facing. Leaving aside that that study was only done for the litigation and was therefore not available to the Board at the time, and that his opinion was contradicted by the opinion of Patricia Pellervo, a partner at PwC, the Court ruled that the absence of a more thorough study did not render the advice given at the time unreliable, particularly given "the context of the rushed timeline."[23]

Likewise the Court rejected the argument that a precise valuation of the NOLs was necessary, or that the company should have modeled the likelihood of the NOL's being monetized under various scenarios. All the Board had to do, the Court ruled, was to "reasonably conclude that the NOLs were a legitimate asset worth protecting," noting that "the absence of a

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[21] *Id.* at *17.

[22] *See* D.R.E. 502(d) ("[I]f the services of the lawyer were sought or obtained to enable or aid anyone to commit or plan to commit what the client knew or reasonably should have known to be a crime or fraud."); *see also* Del. Lawyers' R. Prof'l Conduct 1.6(b)(2).

[23] *Selectica*, 2010 WL 703062, at *18.

formal study did not mean that the directors were unreasonable in concluding that a sufficiently material probability existed to merit the asset's preservation, or that such a determination was not implicit in their calculations."[24]

With the two minor extra-statutory caveats, likely designed to give the Court a role in cases where experts are used inappropriately, the Court thus reaffirmed that, by itself, the use of experts has great significance to the outcome of a challenge to corporate decision making. Indeed, the Court's finding the Selectica Board's determination that the NOLs were valuable and deserving of protection, was in large part due to the Board's use and reliance on the expertise of outside advisors.

Implications of *Selectica* on the Use of Experts in Delaware Corporate Cases

Another key issue in *Selectica*—whether the NOL Pill, the exchange of rights diluting Versata's holdings, and the adoption of the Reloaded NOL Pill were reasonable actions under *Unocal*—also turned on a battle of the experts.[25] This battle, appearing only briefly in the Court's Memorandum Opinion,[26] spurred a tangential clash in motion practice that led the Court contemporaneously to issue the less widely known Experts Opinion. That decision gave guidance on the admissibility of expert testimony, and the Court's reasoning suggests that corporate litigators would be wise to consider seeking out and presenting experts with real-world experience rather than only academics.

Specifically, in the overarching dispute, the parties' experts battled over the likelihood that a takeover bid would be rendered "mathematically impossible" or "realistically

[24] *Id.* at *19.
[25] *Selectica*, 2010 WL 703062, at *20-21.
[26] *Id.*

unattainable" by the low threshold NOL Pill.[27] Versata's expert, Professor Allen Ferrell of Harvard Law School, was a traditional academic and relied on academic studies for his conclusions. By contrast, two of Selectica's experts, Professor John Coates and Peter Harkins, relied on more practical approaches. Coates had been a partner at Wachtell, Lipton, Rosen & Katz, the law firm that invented the poison pill in the early 1980s, and drew on that experience to testify to their widespread use. But it was Harkin's testimony that drew the Court's ruling in the Experts Opinion. Harkins did not rely on academic literature in forming his opinions and instead based his expert testimony on his twenty-eight years of hand-on experience in the proxy solicitation field, including service as CEO at a proxy solicitation firm with sixty-plus years of experience in the industry. By focusing on a practical analysis of the fifteen proxy contests occurring in the three-year period ending in December 2008 in micro-cap companies like Selectica, Harkins was able to show that even where the challenger controlled less than 5.49% of the outstanding shares, that challenger had successfully obtained board seats in ten contests, including in five contests involving companies with classified boards.[28] Harkins likewise placed emphasis in his work on the shareholder profile of Selectica itself, the ownership of which is highly concentrated in a very small number of significant shareholders. Through this practical approach, which relied on real world data and practical experience, Mr. Harkins was able to convince the Court that there was no truly preclusive effect in companies similar to Selectica from the use of an NOL pill.

In pretrial motion practice, Versata had advocated for the exclusion of Mr. Harkins on the grounds that

[27] *Id.* at *20.
[28] *Id.*

> his analysis is not supported by sound reasoning and methodology . . . [because] he relies on no academic or empirical studies to support his conclusions and bases his opinions solely on general experience in proxy solicitations without any explanation of how his experience leads to the conclusions reached, why his experience provides a sufficient basis for his opinions, or how his experience is reliable applied to the facts of this case.[29]

The Court rejected Versata's argument,[30] which closely resembled a request that the Court impose a blanket requirement that experts rely solely upon academic studies, finding "that practical experience can often provide as helpful assistance as can the fruits of academic analysis."[31] The Court noted that, while "Harkins did not rely on any academic evidence in providing his opinion, he may properly rely on his own experience from the hundreds of proxy solicitations and contests he has worked on during his twenty-eight years in the proxy solicitation business."[32] The Court determined that it had found Mr. Harkins' testimony helpful[33] in its

[29] C.A. No. 4241-VCN, letter op., at 2 (internal quotations and citations omitted).

[30] Although Versata's motion *in limine* addressed three of Selectica's four experts, in the Experts Opinion the Court noted that, because it had "only relied in [the Pill Opinion] on those portions of expert testimony that were not subject to a *Daubert* challenge, . . . the Court need not determine fully the extent to which much of the contested testimony should have been admitted." *Id.* at 1. In fact, the only Selectica expert to whom the *Daubert* analysis did apply was a nonacademic expert, Mr. Harkins. *Id.* at 2.

[31] *Id.*

[32] *Id.* at 2-3.

[33] Rule 702 of the Delaware Rules of Evidence ("Rule 702") is substantially similar to its federal counterpart. Indeed, the Delaware Supreme Court has explicitly adopted federal precedent governing the admissibility of expert evidence. *Bowen v. E.I. DuPont de Nemours & Co.*, 906 A.2d 787, 794 (Del. 2006) (adopting *Daubert v. Merrell Dow Pharm., Inc.*, 509 U.S. 579 (1993), and *Kumho Tire Co., Ltd. v. Carmichael*, 526 U.S. 137 (1999)). Whether that testimony is helpful to the court is at the core of the court's determination of admissibility. In *Selectica*, the Court followed this approach, admitting nonacademic testimony it found to be helpful in its determination of the *Unocal* analysis. *Holbrook v. Lykes Bros. Steamship Co.*, 80 F.3d 777, 789 (3d Cir. 1996) (Rule 702 embodies a "strong and undeniable preference for admitting any evidence having some potential for assisting the trier of fact.") (quotation omitted); *Daubert*, 509 U.S. at 591 (explaining that Rule 702 requires that the expert's testimony assist the trier of fact to understand the evidence).

refusal to "conclude that the NOL Pill, Exchange, and Reloaded NOL Pill were preclusive, and thereby draconian."[34]

Conclusion

Selectica, aside from its historical implications for the law of rights plans, offers practical guidance to both corporate transactional and litigation practitioners. The Court's analysis of Section 141(e) provides an intuitive gloss on the statutory language, highlighting the benefits of using expert advisors properly where a board is faced with new and challenging decisions in the boardroom. The *Selectica* Court also offers guidance concerning the helpfulness of practical experts to assist in the determination of whether a board's decision passes muster in the courtroom. As this case study has sought to show, the Court's holdings regarding the use of experts—while typically overshadowed by the theoretical importance of *Selectica* as poison pill precedent—are also of value to corporate counsel in many other contexts.

[34] *Selectica*, 2010 WL 703062, at *21.