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Delaware Supreme Court Sanctions Use of 4.99 Percent NOL Poison Pill Using 'Unocal' Analysis, as Modified by 'Unitrin'

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On Monday Oct. 4, 2010, the Delaware Supreme Court affirmed the Court of Chancery's decision to sanction the use of a poison pill with a 4.99 percent trigger to protect a company's net operating losses (''NOLs'').[2]

Respecting a familiar *Unocal* maxim, the court made clear: ''[Delaware] corporate law is not static [and] must grow and develop in response to, indeed in anticipation of, evolving concepts and needs.'' [3]

In analyzing the first poison pill triggered in modern memory,[4] the Court upheld the Selectica Board's (''Board'') decisions to adopt the 4.99 percent pill aimed at protecting $165 million in NOLs, to decline to exempt the triggering party from its effects, to utilize the exchange feature of the pill, and to adopt a reloaded pill to replace the triggered one.

The Parties

Prior to the litigation, Selectica and Trilogy had long been competitors and maintained a ''complicated'' and ''adversarial'' relationship in the corporate software industry. In 2004, Trilogy filed patent litigation against Selectica, resulting in a $7.5 million judgment.

In 2007, Trilogy made additional patent claims and secured a $17 million patent infringement settlement from Selectica. Further, in 2005, Trilogy made two acquisition offers that the Board declined.

The Supreme Court affirmed the Court of Chancery's analysis under 'Unocal'—as modified by 'Unitrin'—and applied the concomitant two-prong test.

Using the Pill to Protect NOLs

Since its IPO in March 2000, Selectica had consistently operated at a loss and accrued approximately $165 million in NOLs.

Federal tax law allows a corporation to use its NOLs to offset profits for up to 20 years. However, Section 382 of the Internal Revenue Code imposes significant limitations on the use of NOL carryforwards in the event of an ''ownership change.'' This provision was designed to prevent corporations from trading in NOLs. An ownership change occurs when shareholders, owning 5 percent or more of a corporation's stock, trade more than 50 percent of outstanding stock during any three-year period.

By mid-2008, approximately 40 percent of Selectica's Section 382 qualifying stock had already changed hands, leaving the company's $165 million NOL asset at great risk.

After once again seeking to buy Selectica, or its assets, Trilogy began purchasing Selectica shares on the open market and within just a few weeks, Trilogy had purchased 1.5 million shares and become a 6 percent shareholder.

Keenly aware that Trilogy's purchases had put its NOLs in jeopardy, the Selectica Board acted to protect its NOLs by amending its industry-standard 15 percent poison pill trigger to 4.99 percent in order to preempt a Section 382 change in ownership. The revised poison pill provided that preexisting 5 percent or greater shareholders—including Trilogy—would be grandfathered and permitted to purchase up to an additional 0.5 percent without triggering the pill (subject to a 15 percent cap).

Soon thereafter, Trilogy purposely triggered the amended poison pill by purchasing an additional 124,061 shares of Selectica, thereby becoming a 6.7 percent shareholder. Trilogy subsequently filed a Schedule 13D indicating that it intended to continue buying Selectica shares.

At roughly the same time, Trilogy's principals made new settlement demands on Selectica, allegedly pertaining to a breach of a prior agreement. When Trilogy's demands for millions from Selectica were rejected, it pressed forward in buying through the pill trigger. Trilogy officers testified that they triggered the pill to (1) ''bring some clarity and urgency'' to the parties' discussions, (2) ''bring accountability'' for Selectica's ''illegal behavior'' in adopting a low-threshold pill, and (3) ''accelerate discussions'' about Trilogy's proposed settlement.

The shareholder rights plan provided that the Board could exempt an entity that triggered the poison pill if the Board determined that the entity and its purchase would not endanger the NOLs. Selectica then attempted to convince Trilogy to agree to a standstill until it could secure a court ruling on its pill so as to exempt Trilogy under this provision. Trilogy turned down Selectica's offer on three separate occasions.

In light of Trilogy's Schedule 13D statement that it intended to continue to purchase shares and Trilogy's

(continued on page 311)

[1] Mr. Varallo was counsel for Selectica in the trial and appellate courts. The opinions expressed in this article are those of the authors and not necessarily those of Richards, Layton & Finger or its clients.

[2] *Selectica, Inc. v. Versata Enters., Inc.*, C.A. No. 193, 2010 (Del. Oct. 4, 2010), *aff'g*, C.A. 4241-VCN (Del. Ch. Feb. 26, 2010).

[3] *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985).

[4] Steven M. Davidoff, ''*The Uses and Abuses of Poison Pills*,'' N.Y. TIMES DEALBOOK (Feb. 3, 2010).

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(continued from back page)
repeated refusal to agree to a standstill, the Selectica Board was put to a decision to either allow the pill's "flip-in" to occur, or alternatively to exchange all rights under the pill for new shares of stock (effectively a discriminatory dividend). Because of, among other things, the uncertain effect of the flip-in on the Section 382 calculation, Selectica determined to use the exchange feature of the pill. Trilogy's holdings were diluted from roughly 6.7 percent to approximately 3.3 percent. Having exercised the rights (and thus being unprotected against further attacks on its assets), Selectica also adopted a new 4.99 percent rights plan.

[T]he primary issue was whether the rights plan—considered in conjunction with the staggered board provision—rendered the possibility of a successful proxy contest realistically unattainable.

The Court's Analysis

The Court began its analysis by clarifying that, while the Delaware courts had consistently sanctioned the use of the poison pill as an anti-takeover device, the emergence of the low-threshold NOL pill—adopted to preserve specific corporate assets—deserved careful consideration under *Unocal*, because by its nature the pill indirectly operated to forestall hostile takeovers. The Supreme Court affirmed the Court of Chancery's analysis under *Unocal*—as modified by *Unitrin*—and applied the concomitant two-prong test.[5]

Accordingly, the Court first considered whether the Board reasonably perceived a threat to corporate policy and effectiveness. The Court cited the numerous meetings between the Board and its tax advisors, independent committee, and investment banker. Referencing DGCL § 141(e), the Court found that the Board conducted a reasonable investigation and properly acted in good faith reliance on Delaware counsel and various expert advisors in determining that the "NOLs were an asset worth protecting and thus, that their preservation was an important corporate objective."

Notably, the trial court observed that the low 4.99 percent trigger for the NOL pill was "driven by our tax laws and regulations . . . [and] measured by reference to an external standard, one created neither by the Board nor by the Court," and this observation was affirmed on appeal.

As mandated by *Unocal*, the Court next considered whether the Board's response "was preclusive or coercive and, if neither, whether the response was 'reasonable in relation to the threat' identified."

In analyzing whether the Board's measures were preclusive, the Supreme Court clarified that the *Unitrin* standard of "mathematically impossible" was ipso facto subsumed within the "realistically unattainable" standard; thus, "there is, analytically speaking, only one test of preclusivity: 'realistically unattainable.' "

As a result, the primary issue was whether the rights plan—considered in conjunction with the staggered board provision—rendered the possibility of a successful proxy contest realistically unattainable.

Reiterating *Moran*, the Court found that while a shareholder rights plan may discourage the formation of a proxy contest, it did not materially alter the voting of individual shares, and that other effects on proxy contests were otherwise "highly conjectural."[6]

The Court gave particular weight to the fact that (1) recent takeover battles were won by proxy contests waged by shareholders wielding less than 10 percent of total shares; (2) more than 50 public companies had NOL poison pills set at a similar 5 percent threshold; (3) RiskMetrics—a prominent proxy vote advisory firm—supported NOL pills set with reasonable terms, trigger, and sunset provisions; (4) expert testimony showed that recent proxy contests waged at microcap companies by 5.5 percent or less shareholders yielded a 66 percent success rate (33 percent where a staggered board was also in place); and (5) the Selectica NOL poison pill was narrowly tailored to address Section 382.

In sum, the Court found that the low threshold pill did not preclude proxy contests: "[t]he key variable in a proxy contest [is] the merit of the bidder's proposal and not the magnitude of its stockholdings."

Trilogy's second argument—that coupling the staggered board provision with the 5 percent poison pill trigger collectively precluded proxy contests—was similarly unavailing. Citing *Carmody*, the Court reiterated that a three-year staggered board did not preclude a takeover, it only delayed it by requiring two successful proxy contests to gain control of the board.[7]

[W]hile 'Selectica' clearly establishes that the use of a 4.99 percent pill to protect NOL assets is not per se invalid, adoption and subsequent use of such pills remains subject to close scrutiny in court.

Finally, the court determined that the Board's reaction to the Trilogy threat was within the range of reasonableness standard articulated in *Unitrin*, particularly in light of the fact that Trilogy was (1) a competitor, (2) quickly accumulating stock, (3) endangering valuable corporate assets, and (4) seeking to coerce the Board by threat of asset impairment.

Notwithstanding its unequivocal affirmance of the trial court's carefully reasoned decision, however, the Supreme Court warned that "[t]he fact that the NOL Poison Pill was reasonable under the specific facts and circumstances of this case, should not be construed as generally approving the reasonableness of a 4.99% trigger . . . ."

Thus, while *Selectica* clearly establishes that the use of a 4.99 percent pill to protect NOL assets is not per se invalid, adoption and subsequent use of such pills remains subject to close scrutiny in court.

[5] *Unitrin, Inc. v. Am. Gen. Corp.*, 651 A.2d 1361 (Del. 1995).

[6] *Moran v. Household Int'l, Inc.*, 500 A.2d 1346 (Del. 1985).

[7] *Carmody v. Toll Bros., Inc.*, 723 A.2d 1180 (Del. Ch. 1998).