POISON PILL UPDATE: DELAWARE CHANCERY COURT UPHOLDS NOL RIGHTS PLAN WITH 4.99% TRIGGER

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To Our Clients and Friends:

In a case of first impression, decided on February 26, 2010, the Delaware Court of Chancery declared that a board's adoption of a 4.99% flip-in trigger in a shareholder rights plan was a valid exercise of the board's business judgment. The lower threshold, which was designed to protect the corporation's net operating loss carry-forwards for tax purposes ("NOLs"), was deemed to be a reasonable response to the specific threat posed by a "longtime competitor [who] sought to employ the shareholder franchise intentionally to impair corporate assets, or else to coerce the [corporation] into meeting certain business demands under the threat of such impairment." The Chancery Court's post-trial opinion in *Selectica, Inc. v. Versata, Inc.*, C.A. No. 4241-VCN (Feb. 26, 2010) is the latest in a long line of cases upholding the legitimacy of the poison pill, albeit in a context where protection of a specific corporate asset – and not gaining leverage in a contest for corporate control – was the board's primary objective.

BACKGROUND

Since becoming a public company in 2000 at an IPO price of $30 per share, Selectica had never posted an annual profit. By the time its competitor, Versata, filed a Schedule 13D in November 2008 indicating ownership of more than 5% of its common stock, Selectica had become a microcap company and had been exploring its strategic alternatives, including a sale or breakup of the company. One of Selectica's principal assets was an NOL of approximately $165 million, and, prior to the events at issue, the company had conducted a number of analyses to better understand the value of its NOL asset and any threats to it under applicable tax laws and regulations.

Section 382 of the Internal Revenue Code places substantial restrictions on the use of NOLs following an "ownership change." An "ownership change," though a highly complex, fact-specific determination, is generally deemed to have occurred when more than 50% of a company's stock ownership changes over a three-year period. Only shareholders who hold a 5% or greater stake in the company and have increased their ownership stake during the testing period are generally considered for Section 382 purposes. For this reason, among others, a number of companies with significant NOLs to protect have adopted so-called NOL pills with 5% triggers in recent years. Selectica's expert witness identified 50 such public companies, including some among the Fortune 1000. NOL pills otherwise work in much the same way as a traditional rights plan.

Faced with the news that its competitor, Versata, whose relationship with Selectica was "complicated and often adversarial," had acquired a little more than 5% of Selectica's common stock, Selectica's board met several times with its financial and legal advisors, as well as a Section 382 tax accounting expert, to consider the impact of Versata's actions on Selectica's NOLs. Selectica's experts advised that the cumulative ownership increase of 5% stockholders over the past three years stood at 40%, and, therefore, that additional acquisitions of roughly 10% of the float by new or existing 5% holders would permanently limit the company's ability to use its NOLs in the future. The board, on November 16, 2008, adopted an amendment to its rights plan (which had a 15% trigger) that reduced the trigger to 4.99%, with grandfathering and a 0.5% cushion for existing 5% or more holders.

Following an unsuccessful meeting with Selectica's management, Versata continued buying more shares, bringing its ownership stake to 6.7% and thereby becoming an "Acquiring Person" under Selectica's NOL pill. This started a 10 business-day clock during which Selectica's board could declare Versata an "Exempt Person" if it determined that Versata's ownership of more than 4.99% would not jeopardize the company's NOLs. Selectica offered Versata a standstill agreement, which Versata declined. Finding no basis to declare Versata exempt, the board decided to exchange the rights outstanding under the NOL pill (other than those held by Versata) for new common stock, thereby reducing Versata's ownership stake in the company from 6.7% to 3.3%. (Allowing the "flip-in" to occur could have reduced Versata's stake to 1%.) The board also adopted a new NOL rights plan on substantially the same terms.

THE COURT'S DECISION

Selectica sought a declaration that its directors' actions were proper exercises of their fiduciary duties under Delaware law and, specifically, under the enhanced scrutiny standard of *Unocal*. Versata countersued to have the NOL pill declared invalid and sought money damages for breach of fiduciary duty. Ruling in favor of the Selectica board, the Court found:

- Preservation of NOLs is a valid corporate objective, which merits a defensive response when threatened;
- The board properly relied on expert advice in concluding that the NOLs, whose value is inherently contingent and thus speculative, were a legitimate asset worth protecting;
- The 4.99% pill trigger was not preclusive as to an insurgent's ability to gain corporate control (the Court credited expert testimony regarding the success rates of less than 10% shareholders in proxy contests); and

- The board's response taken as a whole (adoption of NOL pill, effecting the exchange rather than a more dilutive flip-in and adopting a reloaded NOL pill subject to periodic independent committee review) was reasonable relative to the threat posed by Versata's actions.

Noting that prior Delaware decisions had "only considered the poison pill in the context of an anti-takeover device," the Court commented that "the protection of corporate assets against an outside threat is arguably a more important concern of the Board than restricting who the owners of the Company might be." It is worth noting that proxy advisor RiskMetrics' position on NOL pills is significantly more liberal than it is on the more customary poison pill. RiskMetrics is now generally supportive of NOL pills and will analyze them on a case-by-case basis provided they are adopted for the purpose of preserving the company's NOLs.

Please feel free to contact us with any questions.

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