

Delaware Court Upholds Use of 4.99% Poison Pill to Protect NOLs

The Delaware Chancery Court issued an important decision last week in *Selectica, Inc. v. Versata Enterprises, Inc.*, upholding Selectica's adoption and deployment of a rights plan with a 4.99% trigger designed to protect the company's net operating loss carryforwards. The *Selectica* decision was the first to examine a poison pill after being triggered, and the first to analyze its use in the context of protecting corporate assets as opposed to preventing hostile takeover attempts. Applying a straightforward analysis under *Unocal*, Vice Chancellor Noble found that: (i) the Selectica board of directors was reasonable in concluding that Selectica's NOLs were valuable corporate assets, (ii) the 4.99% trigger of the NOL rights plan was not per se preclusive, and (iii) the board's actions in adopting the NOL rights plan and subsequently implementing its share exchange feature were reasonable in relation to the perceived threat to the value of the NOLs.

Selectica's NOL Pill

In recent years, a number of companies with significant net operating loss carryforwards have adopted so-called "NOL Pills" to deter acquisitions that would contribute to an "ownership change" under Section 382 of the Internal Revenue Code, which would limit the amount of future taxable income that can be offset by NOLs. Because "ownership change" is defined generally for this purpose as a greater than 50% increase in ownership by "5% shareholders" in any three year period, NOL Pills generally incorporate a 4.99% threshold trigger—far lower than the traditional 15% flip-in trigger.

In November 2008, the Selectica board voted to amend its existing rights plan to reduce the threshold trigger from 15% to 4.99% after learning that the cumulative increase in ownership by "5% shareholders" over the preceding three year period approached 40%, potentially endangering its accumulated NOLs. The board's NOL analysis was prompted by the discovery that Trilogy, a long-time competitor and would-be acquiror, had accumulated a 5% stake in Selectica. Selectica's amended rights plan grandfathered existing 5% holders and permitted them to purchase up to an additional 0.5% without triggering its NOL Pill.

Shortly after Selectica amended its rights plan, Trilogy intentionally bought through the NOL Pill's threshold. Under the rights plan, this triggered the start of the ten-day period after which the rights would automatically "flip in," becoming exercisable for \$36 worth of newly-issued common stock at a price of \$18 per right. Throughout this ten day period, the board repeatedly offered to "exempt" Trilogy's purchases under the pill in exchange for Trilogy's execution of a standstill agreement. Trilogy rejected the standstill and made clear that relief from the NOL Pill was not its goal, but rather that it sought to coerce the Company into meeting various business demands by Trilogy under the threat of impairment to Selectica's NOLs.

Unocal Analysis

After noting that the adoption of poison pills has been repeatedly upheld by the Delaware courts such that "the legitimacy of the poison pill is settled law," Vice Chancellor Noble outlined the *Unocal* analysis, under which Selectica must show that it had reasonable grounds for concluding that a threat to a corporate policy and effectiveness existed and that its response was neither preclusive nor coercive and was reasonable in relation to the threat posed.

Despite characterizing the NOLs as “assets of speculative and questionable value [with respect to which the board lacked] an explicit plan for how such value might be realized,” Vice Chancellor Noble concluded that the Selectica board “needed only reasonably [to] conclude that the NOLs were material relative to the then-market value of the Company, and that the NOLs, if preserved, had a long window during which they would be available for use.” Placing great weight on the board’s reliance on expert advice that the NOLs were an asset worth protecting, the court concluded that the Board acted reasonably, and the court did not explore further whether the board had considered the probability of the NOLs’ value being realized.

The court went on to examine whether a poison pill with a less than 5% trigger is preclusive under *Moran v. Household*, which held that a 20% pill is not per se preclusive because it does not “strip shareholder of their rights to receive tender offers” or “fundamentally restrict proxy contests.” Here again, although Vice Chancellor Noble found that a 4.99% trigger has a “substantial preclusive effect,” he held that in order to be preclusive, a defensive measure must render a successful proxy contest a “near impossibility or else utterly moot, given the specific facts at hand,” and that the NOL Pill (and the replacement, “reloaded” pill which Selectica adopted after the NOL Pill had been triggered) did not meet this standard. The court’s repeated use of the words “mathematical impossibility” or “near impossibility” can be seen to render the traditional preclusiveness test virtually meaningless and, therefore, may not be strictly applied in other future contexts.

The court then addressed the reasonableness of Selectica’s response to the perceived threat to the value of its NOLs. Noting the board’s decision to implement an exchange of new shares for the NOL poison pill rights, rather than utilize the default flip-in mechanism, Vice Chancellor Noble emphasized that Trilogy consequently experienced less dilution in its position than a poison pill is traditionally designed to impose. While acknowledging that the board did not specifically consider alternative or less severe methods of protecting the NOLs, the court held that “Unocal and its progeny require that the defensive response employed be a proportionate response, not the most narrowly or precisely tailored one.” Similarly, Vice Chancellor Noble noted that the 4.99% threshold was linked to an external standard established by the tax laws and regulations, and not an arbitrary level selected by the company.

Significant Practical Implications

Importance of process and procedure. Although the court’s analysis appears to have been influenced by its negative perception of the aggressive strategy pursued by Trilogy in “employing the shareholder franchise intentionally to impair corporate assets, or else to coerce the Company into meeting certain business demands under the threat of such impairment,” Vice Chancellor Noble pointedly placed very significant weight on the careful process followed by Selectica directors:

- beginning two years prior to adopting the NOL Pill, the Selectica board established a record of analyzing the value of the NOLs, based on the advice of tax, accounting and investment banking experts
- the board met frequently as events unfolded, together with its expert advisers
- the board was quick to retain Delaware counsel, was briefed on its duties under Delaware law and assessed the reasonableness of its actions under the appropriate standard
- the board delegated final decision-making authority over the adoption of the NOL Pill and the implementation of the exchange to an Independent Director Evaluation Committee, which was further charged with periodic review of the NOL plan and its trigger level

Share Exchange Mechanics. The court does not explore in detail the mechanics of the poison pill, but the case serves to highlight the advantages of the exchange feature over the traditional flip-in feature, particularly in the NOL context:

- certain and automatic dilution

- no cash outlay by stockholders
- may be perceived as a more restrained board response

Conclusion

In recent years, over 50 companies have adopted NOL Pills, and RiskMetrics now supports NOL rights plans on a case-by-case basis, as Vice Chancellor Noble notes in his opinion. The *Selectica* decision confers timely validation of this mechanism and will doubtlessly encourage further developments in this arena.

While the court itself acknowledges the possibility that “granting judicial sanction to low-threshold poison pills for the purpose of protecting NOLs guarantees the somewhat unpalatable outcome of acquiescing to the expansion of the universe of reasonable takeover defenses in order to protect assets of questionable, even dubious, value,” it remains to be seen whether other companies, or indeed future courts, will use employ the logic of this decision to justify further expansion of takeover defenses.

Ironically, given *Selectica*’s low trading price and the NOL Pill’s low threshold trigger, Trilogy probably did not suffer major financial losses from the NOL Pill’s dilution of Trilogy’s ownership position. *Selectica*, by contrast, suffered an extended suspension of trading in its stock, experienced a 50% decline in its stock price and put the company at risk of being delisted for failing to meet NASDAQ minimum trading price criteria.

- ▶ See *Selectica, Inc. v. Versata Enterprises, Inc.*, C.A. No. 4241-VCN (Del. Ch. Feb. 26, 2010)

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