

# Delaware Upholds a 4.99% Poison Pill

Selectica vs. Versata and its implications for boards.

By Matthew W. Abbott and Steven J. Williams

A recent decision by the Delaware Chancery Court upholding a 4.99 percent poison pill has highlighted both the latitude afforded to directors acting to protect against corporate threats and the importance of building a record that supports those actions.

In the recent *Selectica v. Versata* decision, the Court reiterated well established law upholding garden-variety poison pills and applied those concepts to a different type of pill that carries a low trigger threshold of 4.99 percent designed to protect a company's tax net operating loss carry-forwards (NOLs). Beyond upholding an increasingly popular adaptation of the traditional poison pill, the decision serves as a useful reminder of the issues that every director and advisor should consider in crafting corporate defenses.

In the current environment, anti-takeover protections have received renewed focus from all quarters, as target boards, concerned with depressed stock prices, confront opportunistic buyers, while, at the same time, shareholders and institutions increasingly emphasize good corporate governance and board accountability. One such anti-

takeover tool is the shareholder rights plan, or "poison pill", which has seen a resurgence of sorts, with new pill adoptions expanding in 2008 for the first time since 2004-2005, according to Shark Repellent.

Poison pills are typically structured as rights issues that, once triggered, allow all stockholders (other than the triggering stockholder) to purchase shares at a dramatic discount to market (this is often called the "flip-in" feature). The classic poison pill is designed to prevent a bidder from acquiring the corporation without the consent of the target board. Usually, the rights are triggered by an acquisition of between 15 and 20 percent of the company's outstanding stock, and, prior to that trigger point, the board retains substantial latitude to modify or eliminate the pill in the context of a friendly transaction. In a hostile acquisition, an acquirer may always pursue a proxy fight or other route to take control of the board, and, once in that position, remove the pill in order to permit an acquisition to go forward. When used appropriately, poison pills have generally been upheld by courts, including in Delaware.

As necessity is the mother of invention, some companies with significant tax net operating losses (NOLs) have turned to a pill with a low trigger threshold of 5 percent or less to protect those assets against any limitation on their use under Section 382 of the Internal Revenue Code. Limitations are generally imposed if there is a more than 50 percent increase in the ownership of a company's stock by 5 percent shareholders over a three-year period. While still a minority of overall pill adoptions, instances of these so-called "NOL" or "382 pills" have increased from a mere 5 percent of all pills adopted in 2007 to 30 percent of all pills adopted in 2009, according to Shark Repellent.

Selectica was a company with significant NOLs. While NOLs are an inherently contingent asset (because they have value only if the company has taxable income to offset), Selectica's board received expert advice that it had NOLs of over \$160 million. The board engaged experts on several occasions to analyze the NOLs' value and was acutely intent on avoiding impairment under Section 382.



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Trilogy was a competitor with a contentious relationship with Selectica, marked by patent conflicts and unsuccessful attempts to acquire Selectica, that had begun making open market purchases of Selectica's stock after its acquisition proposals were rejected. When Selectica realized that Trilogy had amassed 5 percent of its shares, the board again retained experts to analyze the likelihood of NOL impairment and was advised of a substantial risk. Accordingly, the board lowered the trigger threshold for its existing poison pill from 15 percent to 4.99 percent, grandfathering existing 5 percent shareholders. Further, the board took the additional step of creating an independent committee to review the pill periodically, including the trigger threshold, and determine whether it remained in shareholders' best interests.

Despite the 4.99 percent threshold, Trilogy continued buying Selectica stock and intentionally triggered the pill. After considering several options and consulting with its advisors, the Selectica board opted to employ a share exchange feature in the pill, rather than the more dilutive flip-in feature, and then "reloaded" the pill by issuing new rights. As a result, Trilogy's ownership was diluted from 6.7 percent to 3.3 percent; far less dilution than it might have suffered under the pill's flip-in. Selectica then filed a motion for declaratory

judgment that the NOL pill and share exchange were valid, which Trilogy contested.

In upholding Selectica's actions, the Court applied the analysis established by *Unocal v. Mesa Petroleum* and its progeny. Under *Unocal*, a board's defensive actions when facing a possible change in control are subject to enhanced scrutiny because of the "omnipresent specter" that the board may have acted in its own interests and not those of its shareholders. To have the protection of the business judgment rule, a board must establish that it had "reasonable grounds for believing that a danger to corporate policy and effectiveness existed", which necessarily include elements of good faith and reasonable investigation, and that its actions were reasonable in relation to the threat posed, and neither coercive nor preclusive.

While Selectica does not represent a significant departure from existing Delaware decisions, the Court, in its application of *Unocal*, provides at least two important reminders for boards of directors. First, reasonableness must underlie board action, and perfection is not required. Based upon extensive expert advice and analysis, the Court determined that the board reached a reasonable conclusion that Selectica's NOLs represented a valuable corporate asset that was worthy of protection. Having reached that conclusion, the

Court held that a board's response to a threat against those assets need only be proportionate, not the most narrowly or precisely tailored.

Second, key to establishing reasonableness is a record showing a considered and extensive process, strengthened by expert advice where appropriate. At each step in the process, the Selectica board built a record that established a basis for ascribing value to the NOLs as a corporate asset, weighed the risk to that asset and showed a measured response to the perceived risk. Among other things, the Court noted the board's attempt to find alternative solutions to Trilogy's triggering of its pill and its adoption of the more moderate share exchange rather than the flip-in.

Notwithstanding the foregoing, we do caution that the *Unocal* analysis is fact based. In addition to the facts surrounding the Selectica board's process and actions, the Court noted that the board was faced not with an amorphous threat of NOL impairment, but with the specific threat of a competitor who sought to use the shareholder franchise to impair corporate assets. The Court cautioned against companies using NOLs as a "pretext" and warned that NOL pills will continue to be carefully reviewed. Thus, whether the Court would invalidate an NOL pill or any pill for that matter under different circumstances remains an open question.