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Delaware Chancery Upholds 4.99% Poison Pill

In the recent *Selectica v. Versata* decision, the Delaware Chancery 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% designed to protect a company's tax net operating loss carryforwards (NOLs). In validating the adoption of an NOL pill by the Selectica board and its actions in response to the intentional trigger of the pill by a competitor, Vice Chancellor Noble reminds us of the substantial latitude afforded boards of directors in responding to perceived threats to a company and its assets.

Selectica is a micro-cap company that had never been profitable and had thus built up a significant store of NOLs. While the value of NOLs is inherently contingent (*i.e.*, because NOLs have value only to the extent that a company entitled to their use has taxable income to offset), Selectica's board received expert advice that it had NOLs of more than \$160 million and was acutely focused on avoiding any limitation on their potential use pursuant to Section 382 of the U.S. Internal Revenue Code. Such a limitation is imposed, in general, if there is a more than 50% increase in the ownership of the stock of a company by 5% shareholders over a three-year period.

Trilogy is a competitor with a contentious relationship with Selectica marked by several lawsuits against Selectica for patent infringement and several unsuccessful attempts to acquire Selectica. Following a 2008 announcement by Selectica of an intent to evaluate strategic alternatives, Trilogy again contacted Selectica about a possible acquisition and subsequently made two offers, each of which was rejected by the Selectica board. Trilogy was asked to join the general auction process that Selectica was conducting, but Trilogy refused and began making open market purchases of Selectica stock.

When Selectica realized that Trilogy had amassed 5% or more of its stock, the board again retained experts to analyze the likelihood of NOL impairment and was advised that there was a substantial risk. As a result, the board lowered the trigger ownership threshold for its existing poison pill from 15% to 4.99%. The pill grandfathered existing 5% shareholders. Concurrently with the amendment of the pill, the board created an independent board committee to review the

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pill periodically, including the trigger threshold, based on corporate and shareholder developments and whether it remains in the best interests of its shareholders.

Despite the new 4.99% threshold, Trilogy continued to purchase Selectica stock and intentionally triggered the NOL pill, eventually acquiring 6.7% of the shares. After considering several options and consulting with its advisors, the Selectica board ultimately opted to pursue the share exchange feature of the pill and then to “reload” its NOL pill by issuing new rights. Trilogy’s ownership was thus diluted from 6.7% to 3.3%, far less dilution than it might have suffered had a “flip-in” occurred under the pill. The board made this decision in part because it had been advised that the flip-in itself might have impaired the NOLs. In addition, it should be noted generally that the flip-in is only potentially more dilutive as it requires all shareholders to exercise their rights and pay cash to acquire the shares at a discount for the full dilutive effect. Selectica then filed a motion for declaratory judgment that its adoption of the two NOL pills and authorization of the 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*, defensive actions taken by a board in the context of a possible change in control are subject to enhanced scrutiny because of the “omnipresent specter” that a board may have acted in its own interests to the detriment of the corporation and its shareholders. Thus, in order to have the protection of the business judgment rule, a board must establish that (i) 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 (ii) its actions were reasonable in relation to the threat posed, and neither coercive nor preclusive. In addition to the opinion’s helpful discussion of *Unocal* standards, we note the following key points:

- *The use of a poison pill to protect a distinct group of corporate assets is permitted under the right circumstances.* The Court extended the *Unocal* analysis to an NOL pill despite its differences from the traditional poison pill (*i.e.*, the former protects corporate assets, while the latter protects against hostile acquisitions). While the Court upheld the NOL pill, it did caution against companies using accumulated NOLs as a “pretext for perpetuating a board-preferred shareholder structure” and warned that, for this reason, NOL pills will continue to be subject to careful review.
- *Process and reliance on outside experts remain critically important.* Although the Court accepted that NOLs have an uncertain and contingent value, it found that the Selectica board had conducted numerous studies of the company’s NOLs and reasonably determined that such assets were valuable and worth protecting. In so holding, the Court cited Section 141(e) of the DGCL and repeatedly emphasized the board process and role of experts in advising the Selectica board.
- *A board’s response need only be proportionate, not the most narrowly or precisely tailored one.* The Court found that the Selectica board’s adoption of the NOL pill and implementation of the share exchange were reasonable in relation to the perceived threat and not preclusive. Although the NOL pill had a low trigger threshold of 4.99%, that threshold was deemed not to preclude effective shareholder action, including via a proxy contest. The Court stated that the defensive measure must render a proxy contest a “near impossibility or else utterly moot,” and that only the most “egregious defensive responses would be considered preclusive.” The fact that Selectica had a staggered board did not affect the Court’s analysis.

Upon finding that the board's actions were not preclusive, the Court then determined that such actions were reasonable in response to the specific threat posed, noting in particular the board's attempts to find alternative solutions, its extensive process and its adoption of the exchange remedy under the pill rather than the flip-in provision. According to the Court, and important to the Court's analysis, the board was faced not with an inadvertent change in ownership that might result in NOL impairment, but rather with a competitor who sought to use the shareholder franchise to impair corporate assets. Thus, while the Court upheld an NOL pill on these particular facts, the *Unocal* analysis as applied to poison pills is a fact-specific undertaking and it remains an open question as to whether the Court would reach a different conclusion about NOL pills, or indeed traditional pills, on a different set of facts.

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This memorandum is not intended to provide legal advice with respect to any particular situation and no legal or business decision should be based solely on its content. If you have questions regarding the foregoing, please contact Matthew W. Abbott (212-373-3402), Robert B. Schumer (212-373-3097), Steven J. Williams (212-373-3257) or Frances F. Mi (212-373-3185).