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Delaware Upholds 4.99% Rights Plan to Protect NOLs

Friday's decision by the Delaware Court of Chancery in the *Selectica* case upheld the use of a rights plan with a 4.99% trigger designed to protect the company's net operating loss carryforwards (NOLs), even when the challenger had busted through the threshold and suffered the pill's dilutive effect. *Selectica, Inc.* v. *Versata Enters., Inc.*, C.A. No. 4241-VCN (Del. Ch. Feb. 26, 2010). Vice Chancellor Noble's post-trial decision carefully considered the particular circumstances inherent in using a pill to protect NOLs, but it also contains much of importance to Delaware takeover doctrine generally. The decision confirms that rights plans remain an important bulwark, notwithstanding continued attacks from academic and other quarters.

Although Selectica never achieved an operating profit, it had generated NOLs of approximately $160 million. These NOLs could have substantial value in the event the company becomes profitable or merges with a profitable company, but under IRC § 382 they can be adversely affected if the company experiences an "ownership change" of over 50% during a three-year period (measured by reference to holders of 5% or larger blocks).

During 2008, the Selectica board considered and rejected several asset purchase and takeover proposals from Trilogy, a long-time corporate rival. After Trilogy then purchased some 6% of Selectica's shares, Selectica reviewed its NOL status and learned that additional acquisitions of roughly 10% of the float by new and existing 5% holders would significantly impair the NOLs. The Selectica board responded by amending the company's rights plan to lower the trigger from 15% to 4.99% (with a grandfather clause allowing preexisting 5% holders to purchase another 0.5%). The board also created an "Independent Director Evaluation Committee" to periodically review the new NOL plan and its trigger level. Shortly thereafter, Trilogy purposely bought through the NOL pill's limit, with the stated rationale of bringing "accountability" to the Selectica board and "expos[ing]" its "illegal behavior" in adopting the low-trigger NOL plan. After Trilogy repeatedly refused to enter into a standstill agreement to allow the board more time to review the matter, the Selectica board determined to allow the pill's exchange feature to trigger, doubling the number of outstanding shares held by holders other than Trilogy and diluting Trilogy from 6.7% to 3.3%.

Rejecting Trilogy's attack on the adoption and use of the NOL pill, Vice Chancellor Noble canvassed the acceptance of rights plans over the past 25 years. The Vice Chancellor noted that pills "remain a common feature of the corporate landscape;" that their adoption has been repeatedly upheld by Delaware courts "as consistent with a board's fiduciary duties and business judgment;" and that, as reaffirmed by the Delaware Supreme Court as a matter of *stare decisis*, "the legitimacy of the poison pill is settled law."

Turning to the merits of the challenge under *Unocal*, Vice Chancellor Noble noted that Selectica implemented the pill here to protect NOLs rather than for the customary purpose of deterring hostile takeovers. Given that "unique objective," the Court observed that "a pill designed to protect NOLs necessitates precluding a lesser accumulation of shares than might be appropriate for a pill designed to prevent a hostile acquirer from establishing a control position." The Court recognized that NOLs inherently "have the potential of ultimately providing zero value to the company" and that permitting the deployment of pills in the NOL context "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." The Court nonetheless ruled that directors may properly conclude that NOLs are worth protecting where they do so reasonably and in reliance on expert advice.

Vice Chancellor Noble further found that the pill's dilutive effect is not impermissibly "preclusive" under *Unocal*, and that even a combination of defenses that makes control acquisitions more difficult passes muster provided the defensive measures are not "insurmountable." Harking back to *Moran* v. *Household,* the Court noted that a rights plan may permissibly discourage proxy fights so long as it does not limit the voting power of individual shares or preclude successful proxy contests altogether. On this point, Trilogy had asserted that a 4.99% ownership limit coupled with Selectica's staggered board rendered a change in board control unrealistic. The Court found that while a trigger under 5% may suggest a "substantial preclusive effect" it does not establish actual preclusion, holding that the "high standard" required to invalidate a defensive measure excludes only "the most egregious defensive responses"—and that the "requirement of either the mathematical impossibility or realistic unattainability of a proxy contest reinforces the exactness of the preclusiveness standard." In terms likely to inform takeover debates in a variety of contexts, the Court stated:

> It is not enough that a defensive measure would make proxy contests more difficult—even considerably more difficult. To find a measure preclusive (and avoid the reasonableness inquiry altogether), the measure must render a successful proxy contest a near impossibility or else utterly moot, given the specific facts at hand.

The Vice Chancellor then found that the Selectica board had properly evaluated the reasonableness of its response in light of the danger the company faced, rejecting Trilogy's argument that the company should have adopted less powerful defensive measures. Importantly, the Court noted that "*Unocal* and its progeny require that the defensive response employed be a proportionate response, not the most narrowly or precisely tailored one." The Court concluded that "it is not for the Court to second-guess the Board's efforts to protect Selectica's NOLs."

The *Selectica* decision is an important statement of Delaware takeover law. While rooted in the special circumstances necessary for the protection of NOLs, Vice Chancellor Noble's opinion represents a timely meditation on the poison pill and its place in Delaware fiduciary duty doctrine. The decision constitutes a powerful rejoinder to those who have claimed that the pill has been weakened in recent years by newly emerging fiduciary constraints, or that bidders could simply trigger pills intentionally and then count on the courts to bail them out. Vice Chancellor Noble's decision demonstrates the continued vibrancy of the pill—25 years after *Household*—to defend a well-advised company against threats to corporate policy and effectiveness.

Theodore N. Mirvis
Eric S. Robinson
William Savitt
Ryan A. McLeod