

The attached article, Corporate Governance Update: Delaware Ruling Reinforces
Validity of the Poison Pill, was published in the New York Law Journal
on March 25, 2010

March 25, 2010

Corporate Governance Update: Delaware Ruling Reinforces Validity of the Poison Pill

David A. Katz
and
Laura A. McIntosh*

A recent decision by the Delaware Court of Chancery strongly reinforces both the continued relevance of the shareholder rights plan and the primacy of boards' business judgment. *Selectica, Inc. v. Versata, Inc.*,¹ decided by Vice Chancellor Noble last month, concludes the saga of the first triggering of a modern poison pill—and represents the first judicial scrutiny of a pill designed to protect a company's net operating losses ("NOLs"). The opinion makes several important points: first, that a poison pill can be an appropriate mechanism for protecting a company's NOLs, despite the NOLs' uncertain value; second, that lowering a rights plan's triggering threshold to 4.99 percent in order to convert a traditional poison pill to a NOL pill in response to a competitor's accumulation of shares is permissible under *Unocal* and its progeny; third, that directors have broad latitude to draw reasonable conclusions about the value of a company's NOLs, the severity of the threat posed by a particular shareholder, and the appropriate defensive response under the circumstances; and finally, that even after a pill has been triggered and the acquirer diluted, a board is permitted to implement a new pill (*i.e.*, "reload") to deter further acquisitions that could jeopardize the company's NOLs. Recent takeover trends and the widely publicized Cadbury-Kraft deal highlight the importance of takeover defenses in the current environment.

The *Selectica* Decision

The events leading up to the *Selectica* decision, as well as the opinion itself, provide useful insights into the workings of the modern poison pill, in both the NOL context and the market for corporate control generally. A bit of background: Selectica had struggled since going public in 2000 and, by failing to achieve positive net income in any year, had generated \$165 million in NOLs for federal tax purposes by 2008.² Between 2005 and 2008, Selectica rejected several acquisition offers by its competitor Trilogy, Inc. (of which Versata is a subsidiary).³ At the end of 2008, Trilogy and Versata acquired more than 5 percent of Selectica's outstanding stock and continued to acquire shares.⁴ In response, the Selectica board reviewed the effect of

* David A. Katz is a partner at Wachtell, Lipton, Rosen & Katz. Laura A. McIntosh is a consulting attorney for the firm. The views expressed are the authors' and do not necessarily represent the views of the partners of Wachtell, Lipton, Rosen & Katz or the firm as a whole.

¹ C.A. No. 4241-VCN (Feb. 26, 2010).

² *Selectica* at 5-6, 9.

³ *Selectica* at 6, 14.

⁴ *Selectica* at 15.

Trilogy's acquisitions on Selectica's NOLs and, after thorough discussion and with the advice of outside experts, determined to amend Selectica's existing shareholder rights plan to reduce the threshold from a typical 15 percent trigger to the 4.99 percent necessary to protect the value of Selectica's NOLs.⁵ (Existing 5 percent shareholders were grandfathered in and permitted to acquire up to an additional 0.5 percent without triggering the distribution of rights.)⁶ The board also established a committee of independent directors to review the rights plan periodically to ensure that it continued to be in the best interests of shareholders and to review the trigger threshold to ensure that it remained appropriate. Shortly thereafter, Trilogy intentionally triggered Selectica's poison pill by increasing its stockholdings to 6.7 percent and refused repeated requests by Selectica to enter into a standstill agreement to give the board time to evaluate the situation. The Selectica board then determined to allow the exchange feature of the pill to trigger, which diluted Trilogy's holdings to 3.3 percent. The board also amended the rights plan to "reload" the poison pill.⁷

After reiterating the settled law in Delaware upholding the adoption of rights plans as "consistent with a board's fiduciary duties and business judgment,"⁸ Vice Chancellor Noble analyzed the Selectica board's actions under the line of cases beginning with *Unocal*.⁹ With respect to defensive actions taken by a board in the context of a possible change of control, Delaware requires that the board show good faith and reasonable investigation and demonstrate that its defensive response is reasonable in relation to the threat posed; a defensive measure is deemed unreasonable if it is either coercive or preclusive.¹⁰

The court noted that the case presented a unique application of the poison pill: Rather than protecting a company from a change of control, the Selectica pill was designed to protect a corporate asset. The court found that, though NOLs ultimately may be of no value to a company, the board may, reasonably and in reliance on expert advice, conclude that the company's NOLs were worth protecting.¹¹ This objective necessitated the low trigger threshold of 4.99 percent, determined by the directors with reference to tax laws and regulations.¹² The court observed that while a trigger under 5 percent may have a "substantial preclusive effect," nonetheless it did not constitute actual preclusion.¹³

In upholding the Selectica board's decisions as valid exercises of business judgment, the court made two key statements. First, the court stated that "It is not enough that a de-

⁵ *Selectica* at 15-16.

⁶ These shareholders remained subject as well to the original cap of 15 percent. *Selectica* at 19.

⁷ *Selectica* at 30. Once reloaded, the poison pill could be triggered again if a shareholder exceeded the specified percentage of shares.

⁸ *Selectica* at 32.

⁹ *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985).

¹⁰ *Selectica* at 33-34, citing *Unocal* and *Unitrin, Inc. v. Am. Gen. Corp.*, 651 A.2d 1361 (Del. 1995).

¹¹ *Selectica* at 41, 47, 52.

¹² *Selectica* at 69.

¹³ *Selectica* at 59.

fensive 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.”¹⁴ And moreover, 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.”¹⁵ The holding and language in *Selectica* indicate that poison pills, used reasonably by an informed board, remain powerful and legitimate tools for protecting corporate objectives—even outside the takeover context.

NOL Pills After *Selectica*

Selectica’s board did many things correctly. Consulting extensively with outside experts as to the potential value of the NOLs and thoroughly discussing the benefits and detriments of available options before making any decisions related to the rights plans appeared to be important steps. Establishing an independent board committee to review the pill, which probably was not legally required, was a good method to demonstrate that the pill was aimed not at board or management entrenchment but at protecting shareholder value in the NOLs. Attempting to negotiate a standstill with Trilogy before allowing the exchange feature to trigger showed reasonableness and the board’s desire to respond appropriately to the level of threat to shareholder value. Choosing the exchange feature of the plan (in which Selectica issued one additional share of common stock to each holder of a right, other than Trilogy, whose rights were voided) rather than the “flip-in” feature (in which rights would give each holder other than Trilogy the ability to purchase Selectica stock for cash at a substantial discount) was almost certainly the right choice, for though it had less dilutive effect on Trilogy, it offered greater certainty and a shorter time horizon for effecting the dilution.

There are also a few ways in which Selectica’s experience can be improved upon in future situations. Most obviously, the mechanics of implementing the exchange feature of the rights plan presented problems for the company and the stock exchanges; Selectica’s trading had to be halted for a month while the exchange process was formulated. With the benefit of Selectica’s experience and the mechanics it developed to effect the exchange feature, companies should be able to incorporate technical procedures into their poison pills in order to minimize disruption in a similar situation in the future.¹⁶

Selectica’s pill contained a “post-trigger safety valve,” or the ability of the board to redeem the pill after an acquirer has triggered it, if the board determines that the acquisition does not endanger the value of the NOLs. This feature requires careful consideration. Redeemability can put boards under a great deal of pressure and may potentially lessen the deterrent effect of a rights plan. How much it may lessen deterrence, if at all, likely depends on the

¹⁴ *Selectica* at 60.

¹⁵ *Selectica* at 66.

¹⁶ Selectica and its advisors developed mechanics to ensure that Trilogy and its affiliates did not receive shares in exchange for their rights. The details are available in Selectica Press Release, “Selectica Announces Process for Completing Transfer of Exchange Shares; Trading Expected To Resume Wednesday, February 4, 2009 (Jan. 27, 2009),” available at http://www.selectica.com/news/PDFS/Selectica_Press_Releases_105.pdf.

particular dynamics among the board, the shareholders (especially any large, influential ones) and the triggering party. Notwithstanding the post-trigger safety valve in the *Selectica* case, the Selectica board did allow the pill to trigger; there is no question that an acquirer is taking a large gamble if it crosses a pill threshold and then hopes to pressure the target board into redeeming the pill. Boards do, of course, have the right to waive an acquisition before the pill is triggered by amending the pill.

Takeover Trends Today

There is evidence that hostile deals are on the rise. One source estimates that, since 2007, unsolicited bids represent 11 percent of U.S. announced acquisitions, as compared to 6.8 percent over the past decade.¹⁷ At the same time, takeover defenses continue to decline. According to SharkRepellent.net, there were 346 poison pills in effect at S&P 1500 companies in 2009, representing a steady decline from a 10-year high of 924 in 2002.¹⁸ Similarly, classified boards at S&P 1500 companies have declined from a high of 935 in 2002 to 672 in 2009.¹⁹

The combination of these two factors can put companies in a precarious position. The pending takeover of Cadbury by Kraft is an example of what can happen when all defenses are removed. Under British law, Cadbury was essentially prohibited from taking any frustrating action in response to Kraft's advances: poison pills and staggered boards are not permitted in the U.K.; nor is changing the date of the shareholder vote. As one commentator put it, "England is as close as any country gets to a true shareholder democracy. Any bid gets put to a vote, and all the board can do is offer an opinion."²⁰ Without any real defenses, the Cadbury board was limited to chasing other offers to provide leverage to use in negotiations with Kraft on the price to be paid to shareholders; that the company ultimately would be sold did not appear to be in doubt.²¹

One problem with "shareholder democracy" in a takeover situation is that hedge funds and other short-term shareholders may have the power to determine the fate of the company. By the end of 2009, estimates of arbitrageurs' holdings in Cadbury ranged from 15 to over 30 percent.²² With their interest in a quick profit, such shareholders want to make a deal regardless of whether it will impair potential long-term value. Another related problem is that the board is the only potentially powerful player in negotiations who can represent stakeholders

¹⁷ See Jessica Silver-Greenberg, "M&A Goes Hostile," *BusinessWeek*, Mar. 9, 2010 (citing statistics from Dealogic).

¹⁸ SharkRepellent.net, "Poison Pills in Force Year Over Year (includes non-U.S.-incorporated companies)" (subscription required).

¹⁹ SharkRepellent.net, "S&P 1500 Classified Board Trend Analysis (includes non-U.S.-incorporated companies)" (subscription required).

²⁰ Andrew Ross Sorkin, "Do Stockholders Really Know What's Best?" *NYTimes.com*, Nov. 17, 2009.

²¹ The Cadbury board was rumored to have briefly considered the idea of merging with a smaller rival, in order to make itself less attractive to Kraft as the hostile bidder, but this unlikely defensive maneuver would not necessarily have been more advantageous to shareholders than a Kraft offer. See Alexander Smith, "Cadbury/Ferrero, A Sweet Dream," *Reuters Breakingviews*, Nov. 17, 2009.

²² See Sorkin, *supra*; Reuters, "Cadbury Frets Over Stakes Built up by Arbitrageurs," Dec. 20, 2009.

other than shareholders. The British, already upset by the foreign acquisition of a national icon, are now having to deal with the impact of the transaction on various non-shareholder constituencies.²³

Final Thoughts

As the Cadbury-Kraft deal shows, companies with no takeover defenses are very vulnerable. Indeed, the transaction has prompted the United Kingdom's Takeover Panel, an independent body in charge of enforcing the U.K. Takeover Code, to consider whether to make changes to the country's takeover laws.²⁴ In the United States, despite shareholder activist pressure, companies are still able to protect themselves from hostile acquirers and other corporate predators; companies that fail to do so proceed at their own risk. Moreover, decisions to dismantle takeover defenses should not be taken lightly.

The *Selectica* decision in Delaware confirms that the poison pill remains an important defense for a board to use in protecting the company's long-term strategic interests. The poison pill, which in most instances can be adopted by a board on very short notice, can be used to defend against takeover attempts as well as to protect NOLs and perhaps other potentially valuable corporate assets. A board of directors, acting on a reasonable and well-informed basis, can and should use the latitude of business judgment to adopt, amend and reload rights plans that they believe to be in the best interests of the company and its shareholders.

²³ See Cecile Rohwedder & Alistair MacDonald, "Kraft Faces Probe on Cadbury," Wall St. J., Mar. 8, 2010; see also AP, "Angry Britons Ask: Where's Kraft CEO?" Mar. 21, 2010.

²⁴ See Louise Armistead & Helia Ebrahimi, "Cadbury Takeover Row Prompts Rules Revamp," Telegraph.co.uk, Feb. 25, 2010.