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Delaware Supreme Court Affirms NOL Poison Pill Under Unocal

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On October 4, 2010, the Delaware Supreme Court affirmed the Delaware Court of Chancery's decision in *Selectica Inc. v. Versata Enterprises, Inc. and Trilogy, Inc.*,¹ which upheld the use of a shareholder rights plan with a 4.99% ownership trigger designed to protect the corporation's ability to utilize its net operating losses (NOLs) in response to an "ownership change" under Section 382 of the Internal Revenue Code.² This case is important in that the Delaware courts address for the first time the actual use of an NOL rights plan.

Applying the standard under *Unocal Corp. v. Mesa Petroleum Co.*,³ the Supreme Court affirmed the Chancery Court's conclusion that the "protection of company NOLs may be an appropriate corporate policy meriting a defensive response when threatened."⁴ The Supreme Court noted that while Selectica's NOL rights plan was reasonable under the particular facts and circumstances, the decision was not an affirmation that a 4.99% ownership trigger was, in and of itself, reasonable and that a particular response to a takeover bid would be judged by the actions of the board at that time.

Background

Selectica is a microcap enterprise software company that had accumulated approximately \$160 million in NOLs by the end of December 2008. In 2006, Selectica retained outside tax advisors and accountants to evaluate its NOLs and determine whether they were subject to any limitations under Section 382. Selectica's accountant, who specialized in NOL calculations, conducted an analysis of Selectica's NOLs, including the then-current valuation of the NOLs and an examination of whether Selectica had undergone a Section 382 ownership change since 1999. The accountant provided the board with his written report, which was periodically updated in the following years.

Selectica and Trilogy, a private company and long-time competitor of Selectica's, had a contentious relationship going back to April 2004. Trilogy had sued Selectica twice for patent infringement, questioned Selectica about its option backdating practices and had made two offers to acquire some or all of Selectica's business, both of which were rejected. Upon rejection of the second offer to buy Selectica in October 2008, Trilogy began acquiring shares of Selectica and, in November 2008, notified Selectica that it had acquired more than 5% of Selectica's outstanding shares.

In light of the notice it received from Trilogy, Selectica's board met to determine the impact of Trilogy's ownership interest on Selectica's ability to utilize its NOLs. Present at the meeting were Selectica's legal counsel, tax advisors, bankers and the accountant responsible for evaluating and

reporting on the NOLs. An updated analysis of the NOLs indicated that over the past three years, 5%-and-greater shareholders had accumulated approximately 40% of Selectica's outstanding shares, putting the company at significant risk of an ownership change which would impair its ability to utilize its NOLs. The board considered various alternatives, including an amendment to Selectica's existing shareholder rights plan and possible strategic transactions, and decided to amend Selectica's shareholder rights plan to reduce the triggering threshold from 15% to 4.99% (NOL Pill), while grandfathering in existing 5%-and-greater shareholders and permitting them to acquire up to an additional 0.5% without triggering the pill. The board also appointed an independent committee to periodically review the NOL Pill, the appropriate trigger percentage, and whether such plan continued to be in the best interests of the corporation and its stockholders.

In mid-December 2008, Trilogy intentionally bought additional shares of Selectica, thereby knowingly triggering the NOL Pill and became an "acquiring person" under the rights plan. Selectica then brought an action in the Court of Chancery seeking declaratory judgment to confirm the validity of its NOL Pill.

Under the terms of the NOL Pill, the Selectica board could exempt Trilogy from the effects of the NOL Pill if it determined that Trilogy would not jeopardize or endanger the availability to Selectica of the NOLs. If the board did not exempt Trilogy, the NOL Pill would, under its terms, automatically "flip-in," unless the board took affirmative action to implement the dilutive exchange provision of the NOL Pill.

In January 2009, the independent committee of the board, after discussions with financial and legal advisors and three failed attempts to enter into a standstill agreement with Trilogy, determined that Trilogy would not be exempted from application of the NOL Pill and that an exchange of rights for common stock should occur. In addition, because the rights, once exchanged, would no longer protect Selectica or its NOLs, the independent committee also declared a new dividend of rights to all stockholders on terms similar to the then-existing NOL Pill (Reload Pill). Upon implementation of the share exchange, Trilogy's ownership dropped from 6.7% to 3.3%. Selectica thereafter amended its complaint to seek declaratory relief as to the validity of the share exchange and the Reload Pill. Trilogy counterclaimed, seeking invalidation of those actions on legal and equitable grounds, including on the grounds that a 4.99% trigger was *per se* invalid.

The Chancery Court's Evaluation of the Selectica Board's Actions Under *Unocal*

The Chancery Court evaluated the board's actions under the two-part test set forth in *Unocal*, which requires that a board adopting defensive measures show that (i) it had reasonable grounds for concluding that a threat to a corporate objective existed, satisfied by a showing of good faith and reasonable investigation, and (ii) its response was reasonable in relation to the threat posed, reasonableness being measured by whether the defensive measure was coercive or preclusive.

Existence of a Threat

In applying *Unocal*, the court first considered whether the preservation of NOLs was a valid corporate objective. Trilogy argued that NOLs could not be viewed as assets worthy of protection absent a reasonable expectation of their probable future use. The Chancery Court noted that sanctioning low-threshold shareholder rights plans, or poison pills, could have the effect of guaranteeing 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."⁵ However, based on expert testimony, the Chancery Court also noted that, although the value of NOLs is "inherently

unknowable ex ante, a board may properly conclude that the company's NOLs are worth protecting where it does so reasonably and in reliance upon expert advice."⁶ In light of the fact that the board had received advice from advisors with substantial experience in valuing NOLs, the Chancery Court concluded that the protection of NOLs may be an appropriate corporate objective warranting a defensive response when threatened and was satisfied that the directors had acted reasonably in determining that the NOLs were worth preserving and that Trilogy's actions were a serious threat to Selectica's ability to utilize its NOLs.

Reasonable Response

Under the second prong of *Unocal*, the Chancery Court considered whether the actions of the Selectica board were reasonable in relation to the threat posed. Under *Unitrin, Inc. v. Am. Gen. Corp.*,⁷ a defensive measure is unreasonable if it is either coercive or preclusive. Trilogy argued that the NOL Pill was preclusive because the low trigger threshold made the possibility of an effective proxy contest realistically unattainable by preventing it from accumulating enough shares to establish credibility, especially when coupled with a classified board. Relying in part on a proxy solicitor's testimony that several shareholders had successfully obtained board seats in proxy contests where such shareholders held 5.5% or less of the subject company's outstanding shares, and where the subject company had a classified board, the Chancery Court found that the low trigger threshold of the NOL Pill and the Reload Pill were not preclusive because they did not "render a successful proxy contest a near impossibility or else utterly moot."⁸

Upon determining that the NOL Pill and the Reload Pill were not preclusive, the Chancery Court then considered whether the board's actions fell within a range of reasonableness as related to the specific threat of NOL impairment. The Chancery Court reviewed the board's decision-making processes as a whole, including the board's internal debates regarding responsive actions, consideration of the impact on shareholders, establishment of an independent committee, and ultimately its decision to adopt the NOL Pill, implement the less dilutive share exchange instead of the "flip-in" feature of the pill, and adopt the Reload Pill. In balancing the board's actions against the backdrop of the parties' contentious relationship, Trilogy's intentional attempt to impair the NOLs or coerce the company into meeting its demands and Trilogy's refusal to enter into a standstill agreement, the Chancery Court found that the combination of the NOL Pill, the share exchange and the Reload Pill was a proportionate response to the threatened impairment of Selectica's NOLs. Trilogy appealed.

Summary of the Supreme Court's Holding

The Supreme Court, in *Versata Enterprises, Inc. and Trilogy, Inc. v. Selectica, Inc.*, affirmed the Chancery Court's finding that protection of NOLs may be an appropriate corporate policy worthy of defensive action when threatened and held that Selectica's board had shown it had reasonable grounds to believe Selectica's NOLs were in danger of impairment as a result of Trilogy's stock ownership.

With respect to the issue of preclusiveness, and in response to Trilogy's argument that the NOL Pill coupled with a classified board is preclusive, the Supreme Court noted that simply because a combination of defensive measures makes it more difficult for an acquiror to gain control of a corporation, such measures are not automatically preclusive and held that the combination of the NOL Pill with a classified board did not constitute a preclusive defense. The description of the preclusive standard used by both the Chancery Court and the Supreme Court in this matter sets a particularly high standard for invoking the preclusive prong of *Unocal*.

On the final issue of reasonableness, the Supreme Court held that the adoption of the NOL Pill, implementation of the share exchange and adoption of the Reload Pill was a proportionate response to the threat to Selectica's NOLs. The Supreme Court noted that (i) adoption of the NOL Pill was reasonable in light of the three failed attempts to negotiate with Trilogy, (ii) the share exchange was a more proportionate response because it resulted in less dilution than the "flip-in" mechanism of the NOL Pill, and (iii) the Reload Pill was a necessary measure because even though the NOL Pill and share exchange had hampered the immediate threat to Selectica's NOLs, it did not eliminate the general threat of an ownership change under Section 382 because a 40% ownership change still existed and without the Reload Pill there was nothing to discourage additional acquisitions by 5%-and-greater shareholders.

The Supreme Court cautioned that this case "should not be construed as generally approving the reasonableness of a 4.99% trigger in the rights plans of a corporation with or without NOLs"⁹ and that any decision by Selectica's board to continue to use the Reload Pill would be held to the "same fiduciary standards any other board of directors would be held to in deciding to adopt a defensive mechanism."¹⁰

The Future of NOL Rights Plans

Whether NOL rights plans will become commonplace remains to be seen, but the *Selectica* decision opens the door for more companies to use these plans to protect specific threats to their NOLs. As of October 7, 2010, approximately 45 companies had implemented NOL rights plans¹¹ (more recently referred to as Tax Benefit Preservation Plans), including Autobytel Inc., Citigroup, Inc., Deerfield Capital Corp., Hovnanian Enterprises Inc., Leap Wireless, Kana Software, Inc., and KB Home. Of these 45 plans, eight were adopted following the initial *Selectica* decision in February 2010.

Additionally, RiskMetrics Group has indicated that it will consider NOL rights plans on a case-by-case basis, considering the threshold trigger, value of the tax assets, existing corporate governance structure, term of the plan and shareholder protection mechanisms.¹²

Advice for Corporations Considering NOL Rights Plans

Corporations considering NOL rights plans should consider the following:

- *The Evaluation Process.* In *Selectica*, it was of significant importance that the board had been proactive in its review and analyses of its NOLs, had established an independent committee to periodically review its rights plan to determine whether it continued to be in the best interests of the corporation and its shareholders, and had relied on the counsel of outside advisors, expert in their field, when considering the value of its NOLs. Outside advisors should be providing boards with complete and thorough written analyses or reports and not high-level summaries or cursory reviews. The use of outside independent directors can materially enhance the showing of the board's good faith and reasonable investigation, and when coupled with reliance on the advice of outside advisors constitutes a "prima facie showing of good faith and reasonable investigation."¹³
- *Evaluate the Potential Threat and Reasonableness of Response.* Boards considering NOL poison pills must evaluate their current risk of an ownership change under Section 382, the likelihood that such change may occur, and the impact such change would have on the corporation's ability to use its NOLs. In the face of a threat, consider other options, such as

standstill agreements or share exchanges. Selectica's attempts to secure standstill agreements from Trilogy and Trilogy's continued refusal to enter into such agreements weighed in Selectica's favor. Additionally, both the Chancery Court and Supreme Court looked favorably upon Selectica's decision to utilize the less dilutive share exchange. An exchange feature has advantages over the "flip-in" feature because it causes less dilution, the extent of the dilution is certain and automatic, and the exchange feature has a cashless exercise. The dilutive certainty of the exchange feature allows companies to more easily determine ownership percentage changes and the potential impact on the NOL assets, whereas with a flip-in not all stockholders may exercise their rights, resulting in an inadvertent increase in the ownership percentages of those shareholders who do exercise their rights.

- *Implement a pre-approval process and eliminate post-trigger waivers.* Often NOL poison pills allow the board, under certain circumstances, to waive the trigger threshold after it has been exceeded. These post-trigger waivers may make a board more susceptible to pressure from the acquiror, result in litigation, and once the threshold is crossed the NOL asset is damaged. By eliminating post-trigger waivers, potential acquirors may be more incentivized to seek a waiver from the board in advance of any triggering acquisition, which also allows the board to consider the request for such waiver without undue pressure.
- *Limited Deterrent Effect.* Lower trigger thresholds and depressed stock prices may not have the deterrent effect of traditional poison pills. Because the trigger threshold is low, acquirors may be more willing to trip an NOL poison pill because the potential dilution is not as great, especially in situations where the target company's stock price is very low (as was the case in *Selectica* at \$1.00 per share). Additionally, the costs to the company of a poison pill trigger could exceed the costs to the acquiror. If an acquiror decides to trigger a poison pill, the company's board should be prepared to adopt a new poison pill immediately to maintain the protection sought to be obtained by triggered poison pill.

Conclusion

Selectica is another reminder for boards to lay their groundwork. The *Selectica* board met often and established a record attributing value to the NOLs and that it was responding to what it perceived to be a legitimate threat to corporate policy and effectiveness after taking advice from experts. The opinion underlines the importance of using expert advisers where a board considers adopting or amending any defensive measures.

The case also demonstrates the willingness of the Delaware courts to consider and validate new parameters for defensive tactics in response to unique corporate threats. *Selectica* may open the door for companies to test other forms of shareholder rights plans, including those that capture derivatives or synthetic long positions, which have not yet been tested in the Delaware courts.

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¹ C.A. No. 4241-VCN, 2010 WL 703062 (Del.Ch. Feb. 26, 2010).

² Section 382 of the Internal Revenue Code (Section 382), generally limits a corporation's ability to utilize its NOLs against future or immediate past taxable income when the corporation undergoes an ownership change. An ownership change occurs when there is a greater than 50% increase in ownership of the corporation by 5%-and-greater shareholders in any three year period. NOLs can have substantial value if a corporation becomes profitable or merges with a profitable corporation. However, they can become markedly less valuable upon an ownership change and therefore companies use NOL rights plans to protect their NOL carry-forwards against the threat that changes in ownership could inadvertently limit the company's ability to use the NOLs to reduce future income taxes.

³ 493 A.2d 946 (Del. 1985).

⁴ *Versata Enterprises, Inc. and Trilogy, Inc. v. Selectica, Inc.*, 2010 WL 3839786 at *12 (Del. October 4, 2010).

⁵ *Selectica*, 2010 WL 703062 at *15.

⁶ *Id.*

⁷ 651 A.2d 1361 (Del. 1995).

⁸ *Selectica*, 2010 WL 703062 at *21.

⁹ *Versata*, 2010 WL 3839786 at *18.

¹⁰ *Id.*

¹¹ www.sharkrepellent.net

¹² 2010 US Sustainability Proxy Voting Guidelines,
http://www.riskmetrics.com/sites/default/files/2010_RMG_Sustainability_Policy.pdf

¹³ *Selectica*, at *12.