Delaware Court Upholds Poison Pill to Preserve NOLs

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This column provides an informal exchange of ideas, questions, and comments arising in everyday tax practice. Readers are invited to write to the editors: Sheldon I. Banoff, Suite 1900, 525 West Monroe Street, Chicago, Illinois 60661-3693, Sheldon.Banoff@kattenlaw.com, and Richard M. Lipton, 130 East Randolph Drive, Chicago, Illinois 60601, Richard.M.Lipton@BakerNet.com.

A recent decision of the Delaware Court of Chancery, *Selectica, Inc. v. Versata Enterprises, Inc.*, Civ.A. No. 4241-VCN, 2010 WL 703062 (2/26/10), has upheld a corporation's "poison pill" that was designed to protect the future availability of the corporation's NOLs. The court held that a board of directors can validly conclude that the triggering stockholders' acquisition of their company's stock posed a threat to the company's ability to use its NOLs under Section 382. Moreover, the court held that protecting a corporation's NOLs can be a valid corporate objective. The case is expected to be widely discussed in the corporate/securities law literature, but its relevance to tax advisors and their clients is the focus of this column.

Brooks Giles, a corporate and securities law attorney with Katten Muchin Rosenman LLP in Chicago, gives us the following insight on *Selectica*.

Shareholder rights plans, or "poison pills," were first implemented by public companies in 1982 and were originally intended to discourage hostile bidders and encourage negotiated transactions by making excess acquisitions of the target's stock prohibitively expensive. A rights plan accomplishes this by distributing purchase rights to all existing shareholders. Those rights are tied to a trigger event, typically the acquisition of 15% to 20% of the outstanding shares by a hostile investor.

Following a trigger event, shareholders (other than the hostile investor) will be entitled to acquire additional shares at a substantial discount to market. The result is substantial dilution (80% or more) to the hostile investor, in both economic and voting percentage terms. Rights plans often also carry an exchange feature, permitting the target company's board of directors to exchange rights for additional shares, which also has the effect of diluting the hostile investor, but by a lesser degree than the exercise of purchase rights would.

Poison pills thus force hostile acquirors either to undertake lengthy and costly proxy contests to unseat the board, or to negotiate for a "friendly" deal. Because of this, Delaware courts have stated that any decision to implement a rights plan, including a decision to permit exercise of the rights, would be subject to careful scrutiny to "ensure that a defensive measure to thwart or impede a takeover is indeed motivated by a good faith concern for the welfare of the corporation and its stockholders" and not a desire to entrench the board and management.

While a pill with a 15%-20% trigger may help prevent hostile investors from forcing changes in control, a 15%-20% trigger may not protect against impairment of NOLs from ownership changes because Section 382 takes into account 5%-or-greater holders for its ownership change analysis. Several corporations, including Citigroup and Pulte Homes, have implemented rights plans with 4.99% triggers to address this very issue, as did Selectica, Inc.

Selectica, a micro-cap company with no history of operating profits, had an estimated $160 million in NOLs, which vastly exceeded its market capitalization of $11.5 million. Selectica also had a share ownership profile that is concentrated in the hands of a few institutional investors. Trilogy, Inc. and its 83%-held subsidiary Versata Enterprises were competitors of Selectica. In November 2008, Trilogy disclosed that it had acquired beneficial ownership of Selectica in excess of 5%.

During the several years prior to Trilogy's disclosure, Selectica's board had examined the NOLs, including applicable ownership changes, and worked on a business plan for recognizing value from the NOLs. The board eventually determined to undertake a sale process and hired advisors to identify potential acquisition partners that could maximize the value of the NOLs.

Following Trilogy's disclosure, Selectica's board, after meeting with its advisors, determined that the cumulative acquisition of stock by shareholders over the prior three-year period totaled approximately 40%. The board then examined Selectica's rights plan, which at the time had a 15% trigger. After considering the value of the company's NOLs, and the threat that an ownership change would

have on that value, the board decided to amend the rights plan to lower the trigger to 4.99%, grandfathering-in existing shareholders (including Trilogy) at their then-existing holdings. Selectica announced the amendment on 11/17/08.

A month later, Trilogy acquired additional shares and triggered the pill. Over the next two weeks, Selectica's board met several times to consider the development and attempted to negotiate a resolution with Trilogy. Failing that, Selectica's board, on the advice of a special committee appointed to make a recommendation in the matter, decided to implement the exchange feature in its pill, diluting Trilogy down to approximately 3.3% and "reloading" the pill for future use. The board did not allow shareholders to exercise the actual purchase rights, due in part to the uncertainty of the impact that the more pronounced dilution under that feature might have on the ownership change analysis. Selectica then filed an action for a declaratory judgment that the board's actions were lawful.

In the subsequent Delaware Chancery litigation, Trilogy accused the board of breaching its fiduciary duties in adopting the pill, in amending the pill to lower the threshold from 15% to 4.99%, and in implementing the exchange to dilute Trilogy and reload the pill. After a lengthy bench trial, the court held for Selectica's board.

First, the court noted that "the legitimacy of the poison pill is settled law" and concluded that "the protection of company NOLs may be an appropriate corporate policy meriting a defensive response when threatened.... Indeed, the protection of corporate assets against an outside threat is arguably a more important concern of the Board than restricting who the owners of the Company might be...." (Footnotes omitted.)

Second, the court held that the board had satisfied the applicable legal standard for adopting a defensive measure by demonstrating that, in good faith and after reasonable investigation, it had reasonable grounds for believing that a danger to corporate policy and effectiveness existed, and that the defensive measure taken was reasonable (e.g., neither coercive nor preclusive) in relation to the threat posed. A large part of this holding rested on the extensive process undertaken by Selectica's board, including the appointment of a special committee and the retention of expert advisers to assist it in its analysis.

Finally, the court noted that a defensive measure will not be upheld if it operates to unreasonably preclude takeovers or effective stockholder action, and specifically, "where the measure 'makes a bidder's ability to wage a successful proxy contest and gain control either "mathematically impossible" or "realistically unattainable."'" Since with less than 5% ownership a successful proxy contest, though expensive, is still possible and realistically attainable, the court held the board's actions were not preclusive.

Selectica is noteworthy for its holdings, which serve to resolve several questions, the most important of which is whether an NOL pill is per se illegal. Nevertheless, it seems possible that the case, with different facts, could have gone the other way. Selectica has no real assets other than its NOLs, which are enormous relative to its market capitalization, and a concentrated shareholder base, which serves to put that singular asset at risk. These facts, taken together with the intensive process the board undertook with respect to the NOLs, made protection of NOLs a compelling goal for Selectica and its board.

The court itself noted that Delaware law requires "that the defensive response employed be a proportionate response, not the most narrowly or precisely tailored one." If a pill with an NOL threshold may not even be a proportionate response, whether due to the relative value of the NOLs sought to be protected or the relative likelihood of an ownership change, we may yet see more challenges to threshold levels of these pills or the timing of their adoption, if not the pills themselves.

For tax practitioners, what is the likely impact of *Selectica*? Given the emphasis the court placed on the Selectica board's process, one might anticipate that more NOL valuations and ownership change analyses will be ordered, and creative plans for realizing NOLs will be in greater demand, since they could be an integral part of establishing the reasonableness of a board's decision to implement a NOL-based poison pill.

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