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# Delaware Court Upholds Triggering of Rights Plan

On February 26, 2010, the Delaware Court of Chancery issued a significant decision in *Selectica, Inc. v. Versata Enterprises, Inc.* addressing the use of stockholder rights plans, or "poison pills." The decision is ground-breaking in that it provides the first judicial review of rights plans used to protect net operating losses ("NOLs") and the only modern-day triggering of a rights plan. The court upheld the board's decisions to adopt a rights plan and then refuse to redeem the rights upon a deliberate triggering by a stockholder, thus diluting that stockholder's holdings from 6.1 percent to 3.3 percent of the company's shares. The court made clear that "as NOL value 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."

**Background**

Selectica, Inc., is a micro-cap company listed on the NASDAQ Global Market with a then-market capitalization of approximately $23 million. Over the years, it had accrued an estimated $160 million in NOLs that could be used to offset future taxable income. The company and certain large investors were exploring various ways that the company could utilize the NOLs. Due to prior changes in the company's stockholder base, however, the NOLs were at risk of being severely limited. Specifically, Section 382 of the Internal Revenue Code limits a corporation's ability to use NOLs following an "ownership change." In very general terms, an "ownership change" occurs if the percentage of stock owned by one or more "5-percent shareholders" has increased by more than 50 percentage points over the lowest percentage of stock owned by such shareholders at any time during the relevant testing period (generally three years). To avoid a Section 382 "ownership change," many companies in recent years have adopted shareholder rights plans commonly referred to as "NOL pills," which discourage any stockholder from accumulating approximately 5 percent or more of the company's shares and discourage any existing "5-percent shareholders" from acquiring additional shares. Companies have justified these plans as protecting a valuable corporate asset — the NOLs — from significant changes in their stockholder base.

Trilogy, Inc., is a privately-held company that competed with Selectica. It was also a creditor of Selectica as a result of successful patent infringement claims and had proposed unsuccessfully to acquire Selectica several times over a five-year period. During July 2008, it again approached Selectica about a possible acquisition but was rebuffed. As a result, it began accumulating Selectica shares and eventually became a 6.1 percent owner of Selectica. Selectica alleged that Trilogy's actual motive was to "extract money" from the company.

In response to Trilogy's stock purchases, the Selectica board met with its financial and legal advisors to amend its traditional rights plan to protect the NOLs. The amendments, which were approved by a special committee of two outside directors, lowered the plan's trigger from 15 percent to 4.99 percent, except for existing stockholders like Trilogy, which were prohibited from accumulating more than an additional 0.5 percent. Although Trilogy initially stopped buying shares, it later resumed its acquisitions and in December 2008 intentionally triggered the rights plan.

The rights plan provided the Selectica board with a 10-day period in which it could redeem the rights. During that time, Selectica tried to persuade Trilogy on three occasions to enter into a standstill agreement while the parties negotiated. Trilogy refused, indicating that the triggering was intended to pressure Selectica to negotiate over a host of issues, including the repurchase of Trilogy's shares in Selectica and renegotiating the terms of its debt from the patent litigation. The Selectica special committee obtained reconfirmed assurances from its financial and legal advisors that the NOLs were a "valuable corporate asset and that they remained at a significant risk of being impaired." Thus, Selectica's special committee refused to declare Trilogy an "exempt person" under the rights plan, and the rights plan was triggered.

The special committee utilized the exchange feature in the rights plan, pursuant to which each Selectica stockholder (other than Trilogy) received one share of Selectica stock for each outstanding right. Although trading in Selectica's stock was halted for a month while the rights were exchanged for new Selectica shares, the result was to dilute Trilogy's holdings from 6.7 percent to 3.3 percent. The directors then declared a new dividend of rights under an amended rights plan with a three-year term to guard against subsequent accumulations that might threaten the NOLs.

Selectica filed suit in Delaware, seeking a declaratory judgment that the directors' actions were valid, while Trilogy counterclaimed, challenging the operation of the rights plan and alleging that the Selectica directors breached their fiduciary duties.

## Court of Chancery's Opinion

Noting that the "legitimacy of the poison pill is settled law," the court upheld the Selectica board's actions in defending against Trilogy. The court reviewed the directors' actions under the intermediate scrutiny test set forth in *Unocal*. The *Unocal* test requires that (1) the directors must have had reasonable grounds for believing that a danger to corporate policy and effectiveness existed and (2) their response must have been reasonable in relation to that threat and neither preclusive nor coercive.

### Threat to the Corporation

Under the first prong of *Unocal*, the court held that the potential loss of NOLs caused by an "ownership change" under the Internal Revenue Code constituted a legitimate threat to the corporation. In doing so, the court reviewed the process employed by the directors, including their frequent consultation with outside financial and legal advisors. It found that "the Board had ample reason to conclude … that the NOLs were an asset worth protecting and, thus, that their preservation was an important corporate objective." The court rejected Trilogy's argument that Selectica was unlikely to capitalize on the NOLs such that the board's actions were unjustified or that the board should have fixed a "precise value on the NOLs." "In order to conclude that a serious threat existed," the court explained, "the Board needed only to reasonably conclude that the NOLs were a legitimate asset worth protecting."

### Reasonable and Proportionate Response

The court then turned to whether the board's adoption of the rights plan and subsequent exchange to dilute Trilogy was a reasonable and proportionate response to the threat. As part of its analysis, the court had to determine whether the rights plan was "coercive or preclusive." It explained that this is a high standard that "operates to exclude only the most egregious defensive responses." It continued that:

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

Based in part on testimony from expert witnesses, the court found that the NOL pill did not meet that standard. Although Selectica had a staggered board of directors, the court found that a 4.99 percent ownership limitation would not unduly impede a proxy contest.

The court then proceeded to find that the board's actions fell within a "range of reasonableness" under *Unocal*. It rejected Trilogy's suggested alternatives that Selectica could have taken, finding that many were impractical in light of the impending threat posed by Trilogy. It also noted that, by utilizing the exchange feature rather than the traditional "flip-in" provision in the rights plan, Selectica's directors minimized the dilution inflicted upon Trilogy. More importantly, however, the court rejected the argument that the Selectica board adopt "the most narrowly or precisely tailored" approach possible:

> once a siege has begun, the board is not constrained to repel the threat to just beyond the castle walls.

The court concluded that "[w]ithin this context, it is not for the court to second-guess the Board's efforts to protect Selectica's NOLs."

## Implications

*Selectica* provides judicial validation of the increasing use of NOL plans. NOL plans differ markedly from standard rights plans in that, rather than guarding against a hostile or creeping takeover, they safeguard a valuable corporate tax asset. The value of NOLs was thus recognized as a legitimate interest of the corporation and one deserving of protection. Nevertheless, the court made clear that due to their low triggering threshold, NOL pills "could provide a convenient pretext for perpetuating a board-preferred shareholder structure."

For that reason, "shareholder rights plans, such as the ones adopted by Selectica, must be subject to careful review." In that regard, *Selectica* and prior Delaware decisions have focused closely on the ability of stockholders to conduct a proxy contest if they disagree with the board's decisions. They have also looked for the close involvement of outside directors in the decision making process.

*Selectica* also provides confirmation of the board's actions in diluting a person who intentionally trips a rights plan. With the exception of several accidental trips, only two rights plans have ever been intentionally triggered prior to *Selectica*: Sir James Goldsmith's 1985 attempt to acquire Crown Zellerbach and Amalgamated Sugar's 1986 attempt to acquire NL Industries. Thus, *Selectica* is the only modern illustration of a rights plan at work.

Implementing the exchange after the triggering event posed several logistical hurdles, with trading in Selectica's shares on NASDAQ being halted for nearly a month. During that period, the company had to implement a process to verify that the rights held by stockholders, including in "street name," were not held by Trilogy or its affiliates. The company also formed a trust to hold the rights on behalf of persons who did not provide the requested verification. Ultimately, however, the plan worked as intended to dilute the acquiring person. The plan also revealed the benefits of using an exchange feature, which permits a cashless exercise by stockholders, minimizes the number of shares that the company must issue, and immediately dilutes the acquiring person. In this case, the Selectica directors were also aware that the exchange feature offered a more measured response to the threat.

It bears noting that *Selectica* involved very unusual facts. The court was mindful that Trilogy was "a longtime competitor [that] sought to employ the shareholder franchise intentionally to impair corporate assets, or else to coerce the Company into meeting certain business demands under the threat of such impairment." While this is precisely the type of threat that a board should guard against, the facts illustrate that rights plans are not always effective deterrents, especially where the economic dilution was based on a 6.1 percent ownership of a company whose stock is trading at a low price. In addition, these facts are quite distinct from a structurally non-coercive tender offer for all of a company's outstanding shares. Practitioners have been closely watching several recent takeover battles to see whether the Delaware courts might force a board to redeem a rights plan to let stockholders tender, but none of those takeovers have produced a definitive ruling on the matter.

Boards considering the adoption of rights plans should rely extensively on outside advisors. An NOL plan, in particular, should be adopted after fully examining the value of the NOLs, the potential loss of the NOLs based on changes in the stockholder base, and the effects of adopting a rights plan, including limiting stockholders' liquidity and preventing third parties from accumulating large, non-controlling blocks. In finding that the directors met their burden under the *Unocal* test, the court focused extensively on the expert advice provided to the board on "numerous occasions" as the directors decided both to adopt the plan and to dilute Trilogy.

If you have questions about this decision or other matters of corporate law, please contact Gary Thompson at (804) 788-8787, Steve Patterson at (202) 419-2101, Steven Haas at (804) 788-7217 or your Hunton & Williams LLP contact.

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