Milbank

October 25, 2010

Corporate Governance Group

Client Alert

Beijing Frankfurt Hong Kong London Los Angeles Munich New York São Paulo Singapore Tokyo Washington, DC

DELAWARE SUPREME COURT UPHOLDS VALIDITY OF "NOL" RIGHTS PLAN

But Cautions That, Under a Unocal Analysis, "Context Determines Reasonableness"

With the recent uptick in hostile takeover activity, corporate defenses such as shareholder rights plans (*a/k/a* "poison pills") – which generally can be adopted by a board of directors without shareholder approval – are receiving increased attention. Last month, the Delaware Court of Chancery upheld the use of a rights plan by Barnes & Noble to fend off a takeover bid by Yucaipa, a private equity fund.[1]

Earlier this year, the Court of Chancery approved the use of a rights plan by Selectica, Inc. in a different context – the protection of net operating loss carryforwards (NOLs), which can be used to shield future profits from federal income taxes, against a threatened ownership change.[2] The NOL rights plans differ from traditional rights plans by using a trigger of 4.99%, versus the 10% – 20% range used in rights plans that have been consistently upheld by Delaware courts over the years.

The Delaware Supreme Court recently affirmed the Court of Chancery's ruling in *Versata Enterprises, Inc. & Trilogy, Inc. v. Selectica, Inc.*[3] The Supreme Court agreed with the Court of Chancery that this particular rights plan was a "proportionate response to the threatened loss of Selectica's NOLs," despite the low triggering threshold and the fact that Selectica's board is classified. As in the *Yucaipa* decision, however, the Supreme Court emphasized that its approval of the Selectica board's actions in adopting and implementing its rights plan was predicated on the "specific facts and circumstances of this case."

Please feel free to discuss any aspect of this Client Alert with your regular Milbank contacts or with any of the members of our Corporate Governance Group, whose names and contact information are provided at the end of this alert.

In addition, if you would like copies of our other Client Alerts, please visit our website at www.milbank.com and choose the "Client Alerts & Newsletters" link under "Newsroom/Events."

[1] *Yucaipa American Alliance Fund II, L.P. v. Riggio,* C.A. No. 5465-VCS (Del. Ch. Aug. 11, 2010). For a discussion of this decision, *see* our Client Alert titled "Delaware Court of Chancery Upholds Rights Plan Adopted in Response to Open Market Stock Accumulation Program," dated September 7, 2010.

[2] For a discussion of the Court of Chancery's decision in *Selectica, Inc. v. Versata, Inc.,* C.A. No. 4241-VCN (Del. Ch. Feb. 26, 2010), *see* our Client Alert titled "Delaware Court Upholds Adoption and Triggering of NOL 'Poison Pill' with a 4.99% Threshold," dated March 22, 2010.

[3] C.A. No. 4241 (Del. Oct. 4, 2010) *(en banc).*

Background

Selectica, a NASDAQ-listed Delaware corporation headquartered in California, provides enterprise software solutions for contract management and sales configuration systems. Since becoming a public company in 2000, Selectica has failed to turn a profit. By Selectica's own admission, its value "consists primarily in its cash reserves, its intellectual property portfolio, its customer and revenue base, and its accumulated NOLs." In an effort to value those NOLs, the Selectica board of directors undertook three separate valuation studies, ultimately concluding that it had approximately $160 million in NOLs to offset future earnings (if any).

Not surprisingly, NOLs are heavily regulated. To discourage would-be acquirers from gobbling up unsuccessful entities to take advantage of their NOLs, the Internal Revenue Code includes a provision that restricts the use of NOLs following an "ownership change." This represents a "rather complex" determination that looks to shareholders who hold or have obtained a 5% or greater block of the corporation's shares outstanding during the review period. As part of these studies, Selectica was advised that if it underwent an "ownership change," a significant portion of its NOLs would be rendered unusable.

The preservation of Selectica's NOLs became a concrete issue in the context of a long–running dispute with Trilogy, Inc., a company that competes with Selectica in the market for enterprise software solutions. For many years, Selectica had an "often adversarial relationship" with Trilogy. This tension included multiple patent infringement cases brought by Trilogy against Selectica, as well as Selectica's rejection of two Trilogy offers to purchase Selectica at a not insubstantial premium.

In November 2008, following Trilogy's second rebuffed offer and subsequent open-market purchases that raised Trilogy's stake in Selectica to 6.7%, the Selectica board commissioned another study to value the NOLs and assess the potential impact of Trilogy's purchases on any potential ownership change. Based on the results of this study and other expert tax and legal advice, the Selectica board concluded that the company's shareholder rights plan should be amended to lower the triggering threshold from 15% to 4.99% in order to discourage any "ownership change" that would significantly reduce the value of the NOLs. The amendment grandfathered existing 5% shareholders, but permitted them to acquire only up to an additional 0.5%. At the same time, the board formed a standing committee of independent directors to periodically review the rights plan and "the appropriate trigger percentage."

In order to increase its leverage in settlement negotiations between the two companies over the patent claims, and perhaps even to force a sale of Selectica, Trilogy threatened an "ownership change" by purchasing sufficient additional shares to intentionally trigger the amended rights plan. Following failed negotiations for a stand-still agreement in exchange for a declaration that Trilogy was an "Exempt Person" for purposes of the rights plan, the Selectica board (i) concluded that Trilogy should not be deemed an "Exempt Person," (ii) authorized an exchange of Selectica shares for the rights, which was actually less dilutive to Trilogy than if the board had allowed the "flip-in" provision of the rights plan to operate, and (iii) declared a new rights dividend on substantially similar terms, thereby "reloading" the rights plan. As a result of the exchange, Trilogy's ownership stake was diluted from 6.7% to 3.3%. Selectica then sought a declaratory judgment from the Court of Chancery affirming the board's actions.

The Court of Chancery ruled in favor of the board on the basis that "the protection of company NOLs may be an appropriate corporate policy that merits a defensive response when they are threatened." In its appeal to the Supreme Court, Trilogy argued that the Court of Chancery erred in two respects: first, by applying the *Unocal*[4] standard in reviewing the actions of Selectica's board in amending and implementing the rights plan and, second, in determining that the rights plan "either individually or in combination with a charter-based classified Board, did not have a preclusive effect on the shareholders' ability to pursue a successful proxy contest for control" of Selectica.

The Supreme Court's Analysis

In response to Trilogy's contention that the *Unocal* standard of review was not applicable, the Supreme Court observed that the primary purpose of an NOL rights plan is "to prevent the inadvertent forfeiture of a corporation's valuable assets, not to protect against hostile takeover attempts." However, because such a rights plan "by its nature, operates as an anti-takeover device ... notwithstanding its primary purpose, a NOL poison pill must also be analyzed under *Unocal*." The focus of the Supreme Court's opinion then turned to application of the well-known *Unocal* standard to Selectica's rights plan. Based on the record before it, the Supreme Court concluded that the Court of Chancery's ruling was "not clearly erroneous" and rejected Trilogy's appeal.

Threat Reasonably Identified

The first prong of a *Unocal* review requires a board of directors to demonstrate that it had "reasonable grounds for concluding that a threat to the corporate enterprise existed." Trilogy argued that the Selectica board "failed to demonstrate that it conducted a reasonable investigation before determining that the NOLs were an asset worth protecting." The Supreme Court disagreed, noting that "the record supports the Court of Chancery's factual finding that the Board acted in good faith reliance on the advice of experts in concluding that 'the NOLs were an asset worth protecting and thus, that their preservation was an important corporate objective.'" Further, the Supreme Court found that "the record also supports the reasonableness of the Board's decision to act promptly," particularly in light of the facts that "Triolgy's ownership had climbed to over 5% in just over one month" and Trilogy had threatened to continue acquiring more stock. On this basis, the Supreme Court concluded that "the Selectica directors satisfied the first part of the *Unocal* test by showing 'that they had reasonable grounds for believing that a danger to corporate policy and effectiveness existed because of another person's stock ownership.'"

Rights Plan Not Preclusive

The second prong of a *Unocal* review "requires an evaluation of whether a board's defensive response to the threat was preclusive or coercive and, if neither, whether the response was 'reasonable in relation to the threat' identified." Citing Delaware precedent,[5] the Supreme Court characterized a "preclusive" defensive measure as one which "makes a bidder's ability to wage a successful proxy contest and gain control either 'mathematically impossible' or 'realistically unattainable.'" In this regard, Trilogy argued that Selectica's amended rights plan is preclusive "because a proxy contest can only be successful where the challenger has sufficient credibility" and "the 4.99% pill trigger prevents a potential dissident from signaling its financial commitment to the company so as to establish such credibility."

---

[4] *Unocal Corporation v. Mesa Petroleum Company,* 493 A.2d 946 (Del. 1985).

[5] *Unitrin, Inc. v. American General Corp.*, 651 A.2d 1361 (Del. 1995).

Rights Plan Does Not Preclude a Successful Proxy Contest. In response to this argument, the Supreme Court cited its seminal rights plan decision[6] for the proposition that "the assertion that a Rights Plan would frustrate proxy fights [is] highly conjectural." Rather, "[f]or a measure to be preclusive, it must render a successful proxy contest realistically unattainable given the factual context."
Here, although the 4.99% trigger is "a lower threshold than the Rights Plans thresholds that have traditionally been adopted and upheld," the Supreme Court observed that "there is no evidence that a challenger starting below 5% could not realistically hope to prevail in a proxy contest at Selectica." Then, after referencing various studies and expert testimony, the Supreme Court observed that "[t]he key variable in a proxy contest would be the merit of the bidder's proposal and not the magnitude of its stockholdings. The record reflects that Selectica's adoption of a 4.99% trigger for its Rights Plan would not preclude a hostile bidder's ability to marshal enough shareholder votes to win a proxy contest."

Staggered Board Does Not Change the Result. To bolster its argument as to the preclusivity of Selectica's amended rights plan, Trilogy suggested that the rights plan, with its 4.99% trigger, "in combination with Selectica's charter-based classified board, makes a successful proxy contest 'realistically unattainable.'" The Supreme Court rejected this argument as well, noting that if Delaware courts accept this line of reasoning, "it would apply whenever a corporation has both a classified board and a Rights Plan, irrespective of whether the trigger is 4.99%, 20%, or anywhere in between those thresholds." Mindful that "a classified board would *delay-but not prevent-a hostile acquirer from obtaining control of the board,*" the Supreme Court concluded that "[t]he fact that a combination of defensive measures makes it more difficult for an acquirer to obtain control of a board does not make such measures realistically unattainable, i.e., preclusive."

Range of Reasonableness

Because Selectica's rights plan was determined to be "neither coercive nor preclusive," *Unocal* next required an analysis of whether its terms and implementation fall within "the range of reasonableness." This is a question of the "proportionality" of the board's actions in relation to the perceived threat. Trilogy argued that the measures adopted by the Selectica board "were not a reasonable collective response to the threat of impairment of Selectica's NOLs." The Supreme Court disagreed, concluding that "[t]he critical facts do not support that assertion." Among those supportive facts were Selectica's attempts to negotiate with Trilogy, the board's serious deliberations and consultations with outside experts and, after the rights were triggered by Trilogy, the board's decision to implement the less dilutive exchange of shares for rights rather than allowing the highly dilutive flip-in to occur.

[6] *Moran v. Household International, Inc.,* 500 A.2d 1346 (Del. 1985).

Conclusion

Ultimately, in affirming the ruling of the Court of Chancery in *Selectica,* the Delaware Supreme Court cautioned that it reached its decision as to the reasonableness of the amended rights plan in the specific context of the long-standing hostile relationship between Selectica and Trilogy, and Trilogy's professed desire to increase the percentage of its stock ownership in Selectica "not for the purposes of conducting a hostile takeover but, to intentionally impair corporate assets, or else coerce Selectica into meeting certain business demands under the threat of such impairment. Only in relation to that specific threat have the Court of Chancery and this Court considered the reasonableness of Selectica's response." This reminds us that a *Unocal* analysis is essentially a fact-based one that must be conducted without the benefit of bright line rules. Consistent with this philosophy, the Supreme Court emphasized that its ruling "should not be construed as generally approving the reasonableness of a 4.99% trigger in the Rights Plan of a corporation with or without NOLs."

Furthermore, the Supreme Court instructed that its approval of the actions taken by Selectica's board *to date* does not permit the board "to arbitrarily reject" any future offer for the company. Rather, "[t]he Selectica board has no more discretion in refusing to redeem the Rights Plan than it does in enacting any defensive mechanism. Therefore, the Selectica board's future use of the [NOL rights plan] must be evaluated if and when that issue arises."

Please feel free to discuss any aspect of this Client Alert with your regular Milbank contacts or with any of the members of our Corporate Governance Group, whose names and contact information are provided below.

Beijing
Units 05-06, 15th Floor, Tower 2
China Central Place, 79 Jianguo Road, Chaoyang District
Beijing 100025, China

Anthony Root	+86-10-5969-2777	aroot@milbank.com
Edward Sun	+86-10-5969-2772	esun@milbank.com

Frankfurt
Taunusanlage 15
60325 Frankfurt am Main, Germany

Norbert Rieger	+49-89-25559-3620	nrieger@milbank.com

Hong Kong
3007 Alexandra House, 18 Chater Road
Central, Hong Kong

Anthony Root	+852-2971-4842	aroot@milbank.com
Joshua Zimmerman	+852-2971-4811	jzimmerman@milbank.com

London
10 Gresham Street
London EC2V 7JD, England

Stuart Harray	+44-20-7615-3083	sharray@milbank.com
Thomas Siebens	+44-20-7615-3034	tsiebens@milbank.com

Los Angeles
601 South Figueroa Street, 30th Floor
Los Angeles, CA 90017

Ken Baronsky	+1-213-892-4333	kbaronsky@milbank.com
Neil Wertlieb	+1-213-892-4410	nwertlieb@milbank.com

Munich
Maximilianstrasse 15 (Maximilianhöfe)
80539 Munich, Germany

Peter Nussbaum	+49-89-25559-3430	pnussbaum@milbank.com

New York
One Chase Manhattan Plaza
New York, NY 10005

Scott Edelman	+1-212-530-5149	sedelman@milbank.com
Roland Hlawaty	+1-212-530-5735	rhlawaty@milbank.com
Thomas Janson	+1-212-530-5921	tjanson@milbank.com
Robert Reder	+1-212-530-5680	rreder@milbank.com
Alan Stone	+1-212-530-5285	astone@milbank.com
Douglas Tanner	+1-212-530-5505	dtanner@milbank.com

São Paulo
Av. Paulista 1079, 8th Floor
São Paulo, SP
Brazil

Andrew Janszky	+55-11-2787-6280	ajanszky@milbank.com

Singapore
30 Raffles Place, #14-00 Chevron House
Singapore 048622

David Zemans	+65-6428-2555	dzemans@milbank.com
Naomi Ishikawa	+65-6428-2525	nishikawa@milbank.com

Tokyo
21F Midtown Tower, 9-7-1 Akasaka, Minato-ku
Tokyo 107-6221 Japan

Gary S. Wigmore	+813-5410-2840	gwigmore@milbank.com

Washington, DC
International Square Building, 1850 K Street, NW
Suite 1100
Washington, DC 20006

Glenn Gerstell	+1-202-835-7585	gerstell@milbank.com