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Selectica Decision

Delaware Court Upholds 4.99 Percent Trigger Rights Plan to Protect Corporate Assets

In a case of first impression in Delaware, the Delaware Court of Chancery was asked to determine whether the actions of Selectica, Inc.'s Board of Directors and special committee in adopting and implementing a shareholder rights plan with a 4.99 percent trigger and adopting a reloaded NOL pill in order to protect the value of Selectica's net operating losses ("NOLs") was valid and proper. On February 26, 2010, the Court resolved this issue in Selectica's favor. Applying the *Unocal* test, the Court held that "the protection of company NOLs may be an appropriate corporate policy meriting a defensive response when threatened."

Background

Selectica, a provider of contract management and sales configuration software solutions, had approximately US\$160 million in NOLs for federal income tax purposes. Understanding that these NOLs could have substantial potential value, Selectica's Board engaged various experts to determine the value of such NOLs and their availability to lower future tax payments. Section 382 of the Internal Revenue Code generally restricts the amount of NOLs that may be used to offset future income where a company undergoes an "ownership change."

Trilogy, Inc., a privately-held corporation that competes with Selectica, approached Selectica in 2008 with multiple acquisition proposals. All of these proposals were rejected by Selectica's Board. Trilogy responded by purchasing 6.1 percent of Selectica's stock in the open market. In an effort to deter Trilogy from making further purchases that could jeopardize the potential value of the NOLs, Selectica's Board amended Selectica's existing shareholder rights plan by lowering the trigger from 15 percent to 4.99 percent and grandfathered in, on a limited basis, existing five percent stockholders.

Undeterred, Trilogy purchased additional shares of Selectica stock and thereby became an "Acquiring Person" under the amended rights plan. Concerned that Trilogy would make further purchases, the special committee of outside independent directors charged with implementing the amended rights plan, instituted the plan's exchange feature which doubled the number of shares of Selectica common stock owned by each stockholder, with the exception of Trilogy. The exchange feature and not a traditional flip-in mechanism



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was used because of concern over the uncertain effect that a flip-in mechanism would have on subsequent ownership levels. The special committee also adopted a reloaded NOL pill.

Due to the exercise of the exchange feature, Trilogy's ownership interest in Selectica was diluted from 6.7 percent to 3.3 percent and trading in Selectica stock was halted for nearly a month.

The Court's Ruling

Selectica sought a declaratory judgment from the Court that the actions taken by its Board and special committee in response to Trilogy's stock purchases were valid and proper. Trilogy sought, among other things, a declaration to the opposite effect. In adjudicating the dispute, the Court applied the *Unocal* test, which cloaks directors with the protections of the business judgment rule with respect to defensive measures they adopt in response to outside threats, where directors (i) have reasonable grounds to believe that a threat to corporate policy existed and (ii) can demonstrate that their "response was reasonable in relation to the threat posed."

Reasonable Grounds

In order to show that they have "reasonable grounds," directors must demonstrate good faith and reasonable investigation. Proof of directors' good faith and reasonable investigation is materially enhanced where the defensive actions are taken by a majority of outside independent directors. The Court determined that two of Selectica's four directors could not be considered outside directors for material enhancement purposes because of the compensation they received as Co-Chairs of Selectica and their functional role as interim Co-CEOs.

Even though material enhancement was not available in this case, Selectica was able to prove the reasonable grounds standard. Under Section 141(e) of the Delaware General Corporation Law, a board's reliance on expert advice evidences good faith and the overall fairness of the process. Selectica's directors were found to have acted with good faith and reasonable investigation as the Court says "the Board was presented with expert advice on numerous occasions that supported its ultimate findings that the NOLs were a company asset worth protecting...[and] that the NOLs were at risk as a result of Trilogy's actions...."

Reasonable Response

Under the second prong of *Unocal*, courts evaluate whether a board's defensive response to an outside threat was "preclusive or coercive and, if not, whether it was reasonable in relation to the threat identified." Under *Unitrin*, a response is preclusive where it "makes a bidder's ability to wage a successful proxy contest and gain control either 'mathematically impossible' or 'realistically unattainable.'" The Court found that while the amended rights plan and reloaded NOL pill made a proxy contest more difficult, they did not rise to the level of preclusive under the standard.

The Court then applied the reasonable response analysis, which evaluates, among other things, the importance of the corporate objective threatened, alternative methods for protecting that objective and the impact of the defensive action. It noted that the reasonableness of Selectica's response would be considered in relation to the specific threat that Trilogy, a longtime competitor, sought to intentionally impair Selectica's corporate assets, or else force Selectica into meeting certain business demands under the threat of impairing its NOLs.

In finding that the adoption and implementation of the amended rights plan was a proportional response to the threatened loss of the NOLs, the Court underscored the fact that (i) Selectica's Board discussed the impact the exchange feature would have on the stockholders, (ii) Selectica's Board established a special committee of outside and independent directors to authorize the use of the exchange feature, (iii) there were no other meaningful alternatives that Selectica's Board could undertake to prevent the impairment of the NOLs and (iv) given the time constraints, seeking stockholder approval of the amended rights plans would have been ineffective.

The Court also found the adoption of the reloaded NOL pill by the special committee of outside independent directors to be a proportional response. While the exercise of the amended rights plan's exchange feature temporarily rebuffed Trilogy's immediate threat to the NOLs, the general threat of a Section 382 change of control still loomed over Selectica's head as it had experienced roughly a 40 percent ownership change. With no pill in place to discourage additional acquisitions, the Court found the adoption of the reloaded NOL pill by the special committee to be a necessary defensive measure.

Takeaways

In contrast to “traditional” poison pills, which are intended to prevent hostile takeovers, the Court noted that the NOL pill’s primary function is to “prevent the inadvertent forfeiture of potentially valuable assets, not to protect against hostile takeover attempts.” A likely consequence of the recession, NOL pills have recently gained increased prominence. According to Professor Coates, Selectica’s expert at trial, “more than 50 publicly held companies...have implemented NOL pills with triggers at roughly five percent, including several large, well-known corporations....”

The triggering of Selectica’s amended rights plan by Trilogy is the first intentional triggering of a modern shareholder rights plan. Given the highly unusual nature of the case (e.g., Selectica’s small market capitalization and cost of exercising the exchange feature being immaterial), it is not expected that many companies will follow Trilogy’s footsteps in intentionally seeking to trigger a NOL pill. Nonetheless, there are certain lessons for all shareholder rights plans that companies can take away from the case:

- The exchange feature found in Selectica’s amended rights plan operated as expected. The exchange feature, unlike the flip-in mechanism, provides more certainty as to dilution and is not subject to the actions of stockholders. Furthermore, payment is not required and less dilution results making directors’ actions appear more reasonable.
- Because of the uncertainty regarding the mechanics required to implement the exchange feature, trading in Selectica’s stock was halted for nearly a month. In order to avoid the risk of such trading freezes, companies that incorporate an exchange feature in their shareholder rights plans should also consider simultaneously incorporating procedures that address stockholder eligibility for an exchange.
- After consulting counsel, companies may wish to adopt shareholder rights plans to protect other corporate assets in addition to NOLs. The Court appeared to be open to this possibility as it says “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.”

With the Court’s decision in *Selectica, Inc. v. Versata Enters., Inc.*, Delaware public companies that have accumulated NOLs should consider, after seeking the advice of outside experts, the adoption of a low-threshold shareholder rights plan by a special committee of its outside independent directors in order to protect the value of their NOLs.

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