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Corporate M&A Advisor

Modernizing the Poison Pill

Lessons from *Selectica, Inc. v. Versata Enterprises, Inc.*

In today's potentially hostile deal environment,[1] the Delaware Court of Chancery recently issued an opinion clarifying the use, implementation and justification of poison pills. In *Selectica, Inc. v. Versata Enterprises, Inc. and Trilogy, Inc.*,[2] the Delaware Court of Chancery reaffirmed the value of the poison pill, provided guidance on the practical implementation of poison pills, and affirmed that independent directors acting reasonably and in proportion to perceived threats have the ability to use unique defensive measures to respond to such threats under the business judgment rule. The boards of public companies and private companies considering going public should reflect on the *Selectica* decision in reviewing their current or proposed shareholder rights plan.

Background

- Selectica, Inc. is a software provider that accrued approximately $160 million in net operating losses (NOLs), an amount far greater than Selectica's market capitalization.
- Selectica's board engaged various experts to calculate the effect of a change of control on the value and usefulness of those NOLs.
- To protect the NOLs and deter further purchases of stock by a competitor (Versata Enterprises, Inc. and its parent company, Trilogy, Inc.) that could adversely affect the NOLs, the board reduced the trigger under Selectica's poison pill from 15% to 4.99%.
- Versata triggered the poison pill, which diluted its ownership from 6.7% to 3.3%.
- Selectica sought a declaratory judgment that the board's actions were proper and that the NOL poison pill was enforceable. Versata countered that the NOL poison pill was invalid and that Selectica's board had breached its fiduciary duties.
- The Delaware Court of Chancery affirmed the actions of Selectica's board as valid exercises of the board's business judgment.

The *Selectica* court articulated business lessons regarding: (i) the validity of protecting a valuable corporate asset as justification for adopting a poison pill; (ii) the latitude allowed to a board of directors in adopting poison pills under the business judgment

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MergerStat, LLC (August 2009)

[1] Bloomberg.com, April 1, 2010 "M&A Creeps Higher on Cross Border, Hostile Deals."

[2] C.A. No. 4241-VCN (Feb. 26, 2010).

rule; and (iii) the process a board of directors should follow in implementing a poison pill to receive the protection of the business judgment rule.

Protection of Valuable Corporate Assets

Until the decision in *Selectica*, Delaware courts had considered and enforced poison pills only in the context of a hostile takeover. In *Selectica*, the Delaware court held that preventing the forfeiture of a potentially valuable corporate asset was a valid corporate objective. In so doing, the court broadened its acceptance of poison pills and upheld the implementation of a poison pill to protect valuable corporate assets. The *Selectica* court determined that potentially valuable NOLs were corporate assets worth protecting, and that a poison pill designed to protect the NOLs was a reasonable method of protection.[3] The *Selectica* court expressed reservations regarding the actual value of the NOLs, given that NOLs are contingent assets whose value depends on future taxable income or gain. Nevertheless, the *Selectica* court found that the NOLs had value, given that the Selectica board has used and relied upon various experts to analyze the value and potential impairment of such NOLs upon a change of control.

Protection of NOLs is a timely corporate objective in today's economic environment. The court in *Selectica* predicted that, as a result of the current economy, the number of companies employing NOL pills to protect valuable NOLs would increase. This holding reflects the flexibility that may be afforded to poison pills not solely designed to prevent a hostile takeover, but to protect valuable corporate assets.

Latitude in Protecting Companies against Perceived Threats

In *Selectica*, the court upheld the poison pill due in part to the board of directors building a record that evidenced its actions in accordance with the reasonableness test of *Unocal*.[4] As noted above, the Delaware courts had not previously considered the protection of corporate assets as a valid objective of a poison pill. The use of the *Unocal* test by the *Selectica* court (as described below) lends predictability and visibility regarding how a Delaware court may assess a board's actions in implementing a unique poison pill. The Delaware courts have been applying the *Unocal* test since 1985.

Under the guidance of the *Selectica* court, a board of directors will generally be afforded the protection of the business judgment rule in the adoption of a poison pill under the *Unocal* test if the poison pill is (i) reasonable in relation to the threat posed and (ii) not preclusive of effective shareholder action.

*"Reasonableness" in Relation to the Posed Threat (*Unocal *Prong 1)*

A poison pill adopted by a board of directors may be deemed to be "within the range of reasonableness," based on an evaluation of (i) the importance of the corporate objective threatened, (ii) alternative methods of protecting that objective and (iii) the impact of the defensive action on the company and its shareholders. In implementing a "reasonable" poison pill, a board of directors must show it acted in good faith and after reasonable investigation. This is evidenced via approval of a poison pill by a majority of independent directors, a board's use of experts and its reliance upon that expert advice (as further discussed below).

[3] To prevent corporate taxpayers from benefiting from NOLs of other entities, the Internal Revenue Service has placed limitations on the use of NOLs following an ownership change. An ownership change is deemed to occur when more than "50% of a firm's stock ownership changes over a three-year period." The only shareholders considered in calculating such ownership change are those who hold 5% or more of the firm's outstanding shares. Thus, to prevent an ownership change and protect the value of NOLs, an NOL pill is generally triggered when any one shareholder acquires 4.99% of a firm's outstanding shares.

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

Using this "reasonableness" standard, the court examined the Selectica board's actions with respect to its determination that the NOLs were a valuable corporate asset and the adoption of the NOL poison pill to protect such asset. Focusing on the historically litigious relationship between Selectica and Versata, the apparent attempt by Versata to use the triggering of the poison pill to aide in its negotiations with Selectica and the potential impact of further purchases by Versata on the NOLs, the Selectica court determined that the board had acted reasonably in relation to the threat posed.

*A Poison Pill That Is Not Preclusive (*Unocal *Prong 2)*

A poison pill that prevents an effective shareholder action by making that shareholder action mathematically impossible or realistically unattainable is preclusive. This is a high standard that affords flexibility to boards of directors considering poison pills.

The *Selectica* court held that the NOL poison pill was not preclusive, since the dilutive issuances would not make a shareholder proxy contest a meaningless exercise.

Process—Building a Record

The *Selectica* court stated that a board of directors will be given latitude in adopting and implementing poison pills when such board's conclusions are made reasonably, in reliance on expert advice and reasonable in relation to a threat. The *Selectica* court emphasized the importance of building a record to evidence the board of directors' adherence to such practices.

In its record, a board of directors should provide evidence of its measured approach to a posed threat. The record should include evidence of the board of directors' discussion regarding (i) the perceived threat, (ii) meaningful alternatives to protect against the threat, (iii) the impact of all alternative measures on the shareholders of the company and (iv) the choice of the most proportional response. The court noted that a proportional response is not necessarily the most narrowly or precisely tailored response, thereby granting additional latitude to a board.

A company should seek the advice and analysis of qualified experts at each stage of the decision-making process regarding the adoption and implementation of a poison pill, and evidence the same in its record. The court in *Selectica* noted that Selectica, Inc.'s board was well advised at every major decision and relied heavily on expert advice. Reliance on an expert is justified when the person is (i) an expert in the specific field about which he or she is advising the board of directors and (ii) selected with due care.

Decision-making by independent directors also creates a record that evidences good faith and reasonableness. The *Selectica* court emphasized this by noting that the committee of directors that made the final decision to adopt the NOL poison pill and implement the share exchange in connection with the triggering of the NOL poison pill was composed solely of independent directors.

Conclusion

The *Selectica* court has provided a road map to ensure a board of directors is afforded the protection of the business judgment rule in connection with adopting and implementing a poison pill. This road map can be used to navigate the fiduciary duty landscape, whether a poison pill is designed to protect valuable corporate assets, to thwart a hostile takeover attempt or for a novel purpose.

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