

Delaware Court Upholds Use of NOL Rights Plan

The Delaware Chancery Court's recent decision in *Selectica, Inc. v. Versata Enterprises, Inc.* approved the adoption and use of a shareholder rights plan specifically designed to protect a company's net operating loss carryforwards ("NOLs").¹ *Selectica* is the first Delaware decision to uphold, under proper circumstances, the adoption of an NOL rights plan and provides guidance with respect to the substantial latitude that boards of directors are granted under Delaware law in adopting defensive measures.

NOL Rights Plans

Shareholder rights plans, commonly referred to as poison pills, were developed more than 25 years ago to discourage hostile takeover attempts. A typical rights plan imposes substantial ownership dilution upon any person who acquires an ownership interest in a company in excess of a specified threshold (generally 10%-20%) without the approval of the company's board of directors. In *Moran v. Household International, Inc.*, the Delaware Supreme Court first upheld the adoption of a rights plan as a proper exercise of a board of directors' business judgment, but warned that use of such a defensive measure would be closely scrutinized by the Court.²

Unlike traditional rights plans, NOL rights plans are designed to protect a specific asset of a company: NOLs that under U.S. federal income tax rules may be used to offset future income that would otherwise be taxable.³ Section 382 of the Internal Revenue Code of 1986, as amended (the "Code"), provides an annual limitation (the "Section 382 limitation") on the ability of a "loss corporation" (as defined in Code Section 382(k)) to use NOLs that arose before an "ownership change"⁴ to offset income that arises after such ownership change.⁵ The idea is that the amount of income that the NOLs may offset should be no greater than the

income stream that the old loss corporation could have produced.

For purposes of Code Section 382, one way that an "ownership change" may occur is when the percentage of stock beneficially owned by one or more of a loss corporation's large shareholders (defined for these purposes as shareholders who own 5% or more of such corporation's shares) increases by more than 50 percentage points at any point over a three-year rolling testing period.⁶ For example, an ownership change would be deemed to have occurred if, during any three-year period, 10 new shareholders of a loss corporation acquire stock of such corporation resulting in each shareholder owning more than 5% of the loss corporation's shares.

NOL rights plans have an ownership triggering threshold of 4.99%, which is significantly lower than the triggering threshold generally used in traditional rights plans. The reduced threshold discourages additional shareholders from becoming 5% shareholders, which limits the number of shareholders that are counted for purposes of the Section 382 limitation. NOL rights plans also typically limit the number of additional shares that can be acquired by existing 5% shareholders without triggering the rights plan. Accordingly, NOL rights plans may prevent a loss corporation from undergoing an ownership change for purposes of Code Section 382.

In an effort to protect the full potential value of unused NOLs (which for some companies may constitute a significant portion of their total assets, particularly in light of the recent economic downturn), a growing number of companies have adopted NOL rights plans. According to one study, since 2007, 58 companies have adopted NOL rights plans or have amended existing plans to incorporate NOL provisions.⁷

Background

Selectica, Inc., a micro-cap software company based in California, struggled to turn a profit following its initial public offering in March 2000. By the end of March 2009, Selectica had generated approximately \$160 million in unused NOLs. Trilogy, Inc., a stockholder of Selectica, was also a competitor with an often adversarial relationship with Selectica.⁸ Trilogy had twice sued Selectica for patent infringement, and Selectica owed Trilogy millions of dollars as a result of a judgment and settlement related to that litigation. Trilogy expressed interest in acquiring Selectica in January 2005. It pursued the acquisition of Selectica off-and-on through 2008, but was continuously rebuffed by Selectica's board of directors. By early November 2008, Trilogy had purchased more than 5% of Selectica's outstanding shares.

At the time of Trilogy's purchases in November 2008, Selectica had in place a traditional rights plan with a 15% triggering threshold that it had adopted several years earlier. In the wake of mounting losses, the discovery that prior ownership changes had resulted in an impairment of approximately \$24.6 million in unused NOLs and Trilogy's increased ownership stake, Selectica's board decided to amend its rights plan to reduce the triggering threshold from 15% to 4.99%.⁹ The amended rights plan contained a grandfather clause permitting existing 5% shareholders, including Trilogy, to purchase an additional 0.5% without triggering the rights.

Very shortly after Selectica's rights plan was amended to reduce the triggering threshold to 4.99%, Trilogy increased its ownership stake in Selectica to 6.7%, knowing that its purchases would trigger the rights plan. In purposefully swallowing Selectica's poison pill, Trilogy sought to "expose" what it perceived to be "illegal behavior" on the part of Selectica's board.¹⁰ Selectica's board unsuccessfully attempted to negotiate a standstill agreement with Trilogy to allow for further negotiations between the parties in exchange for the board taking actions to stop the dilutive effect of the rights plan being implemented to Trilogy's detriment. Upon concluding that the NOLs were "an important corporate asset that could significantly enhance stockholder value" and that Trilogy's actions could materially impair the value of Selectica's NOL assets, a special committee of Selectica's board

established for such purpose implemented the rights plan's exchange feature, doubling the number of outstanding shares held by other Selectica shareholders and diluting Trilogy's beneficial holdings from 6.7% to 3.3%. The special committee also adopted a "reloaded" NOL rights plan. Selectica then sought declaratory judgment in the Delaware Chancery Court that the actions of Selectica's board and special committee were valid and proper.

The *Selectica* Decision

Prior to turning to the merits of the case, Vice Chancellor Noble first discussed the continued validity of poison pills in Delaware jurisprudence, noting how in prior cases the Delaware Supreme Court had sent a strong signal that "the legitimacy of the poison pill is settled law." The Vice Chancellor continued by applying the first prong of the long-established *Unocal* test: determining whether there were reasonable grounds for Selectica's board to conclude that a threat to corporate policy and effectiveness existed. While acknowledging that NOLs are "assets of speculative and questionable value," the Vice Chancellor nevertheless rejected Trilogy's claim that "NOLs cannot be viewed as assets worth protecting absent a reasonable expectation of their probable future use." Although a board of directors cannot blindly accept that the value of unused NOLs is worth protecting without considering the probability of that value being realized, Vice Chancellor Noble noted that a board of directors relying reasonably on the expert advice of its advisors could conclude that NOLs are significant corporate assets worth protecting. The Vice Chancellor also noted that, in certain cases, the protection of corporate assets from outside threats may be more important than "restricting who the owners of the company might be."

Under the second prong of *Unocal*, a board of directors' response to a perceived threat must not be preclusive and must be reasonable in relation to the threat identified. In responding to Trilogy's assertion that a 4.99% NOL rights plan, coupled with a staggered board and other defensive characteristics, necessarily precludes effective shareholder action under *Unocal*, the Vice Chancellor noted that the *Unocal* standard "operates to exclude only the most egregious defensive

responses.” Citing the Court’s opinion in *Gaylord*, the Vice Chancellor emphasized that “preclusive measures are those that are insurmountable or impossible to outflank.”¹¹ In order to be preclusive, the Court concluded that the defensive measure would need to render a successful proxy contest “a near impossibility or else utterly moot.” Citing recent examples of 5% shareholders who waged successful proxy contests to secure seats on classified boards, the Vice Chancellor dismissed Trilogy’s claim that the actions of Selectica’s board exceeded the substantial latitude granted to boards of directors in protecting the corporation from perceived threats.

The Vice Chancellor also rejected Trilogy’s argument that the Selectica board failed to take a measured and proportionate response to the threat of NOL impairment. Specifically, the Vice Chancellor recounted the numerous meetings conducted by Selectica’s board in evaluating potential alternatives to adopting the NOL rights plan and the impact that the plan would have on Selectica shareholders. The Vice Chancellor also noted that the special committee of Selectica’s board elected to implement the exchange feature of the NOL rights plan, an action that was a proportionately more measured response and less dilutive to Trilogy than the “flip-in” mechanism that would have been triggered had the board done nothing in the ten-day period following the trigger. The Vice Chancellor ultimately concluded that *Unocal* does not require a defensive response to be the most narrowly or precisely tailored response. Rather, a defensive response need only be reasonable in light of the specific facts and circumstances of the case. The response need not be perfect, and a court will not attempt to substitute its judgment for that of the directors.

Implications of *Selectica*

Protection of NOLs. While the number of companies that maintain traditional rights plans has generally declined in recent years in the wake of increased shareholder activism,¹² a growing number of companies are adopting NOL rights plans to protect what are perceived to be significant assets. However, NOLs by their very nature are difficult to value, and the realization of tax benefits can often be speculative at best. For this reason, boards that adopted rights plans designed to protect NOLs prior to the *Selectica*

decision were navigating relatively uncharted waters from a fiduciary duties standpoint. The *Selectica* decision not only reaffirms the status of rights plans generally under Delaware law, but also expressly validates a board’s decision to adopt NOL rights plans under the proper circumstances.

High Degree of Deference. Vice Chancellor Noble acknowledged that some commentators view rights plans as being “detrimental to shareholder interests because they help perpetuate existing management, preclude value-adding transactions from taking place, and destroy shareholder wealth.” Casting these concerns aside, the Court reaffirmed the use of rights plans as being consistent with the proper exercise of a board of directors’ fiduciary duties and business judgment. Discussing the substantial latitude that boards are granted in adopting defensive measures, the Court noted that defensive measures, as a general matter, are held to be unreasonable under Delaware law only if they are draconian. In applying this rule, the Court found that the implementation of Selectica’s rights plan would have been unreasonable only if it made Trilogy’s ability to wage a successful proxy contest “mathematically impossible” or “realistically unattainable.”¹³ Although Vice Chancellor Noble repeatedly emphasized that the validity of Selectica’s rights plan hinged, in part, on the desire to protect NOL assets from impairment, the strong reaffirmation of rights plans in *Selectica* and the high degree of deference shown by the Court to the board’s decision to adopt the NOL rights plan could lead companies to consider adopting more aggressive defenses outside of the NOL context.

Early and Often, with Expert Advice. An important lesson of the *Selectica* decision and a key tenet of Delaware law generally is the significance of process in assessing the reasonableness of a board of directors’ actions. The *Selectica* opinion emphasized the frequent meetings of Selectica’s board to discuss strategic alternatives and the impact of the NOL rights plan on Selectica shareholders. In relying on the expert advice of its financial, accounting and legal advisors, the Selectica board buttressed itself against attacks that it was not properly informed or advised in its decision-making process. The evaluation of unused NOLs and the implementation of defensive measures to protect them are complex matters, and the Vice Chancellor

pointed to the board’s consultation with, and reliance on, its outside advisors as important factors in determining that the board’s adoption and implementation of the Selectica NOL rights plan were valid exercises of the board’s business judgment. By building a complete and detailed record of its deliberations, a board of directors can create a formidable defense against claims that it failed to satisfy its duty of care.

Defending the Corporate Bastion. A key issue in *Selectica* was whether a board’s defensive posture needs to be narrowly tailored to the specific threat at hand under the proportionality analysis required by the *Unocal* test. Following Trilogy’s triggering of Selectica’s NOL rights plan, the special committee of Selectica’s board severely diluted Trilogy’s ownership stake in Selectica and then implemented a new “reloaded” NOL rights plan, effectively redoubling the defensive measures already in place to protect against Trilogy’s tactics. In arguing that the special committee of Selectica’s board exceeded the permissible boundaries of its business judgment, Trilogy noted how Selectica’s other defensive measures, including the presence of a staggered board, effectively rendered the reloaded NOL rights plan unreasonable and excessive. Rejecting this argument, and alluding to medieval siege warfare, the Court noted that a “board is not constrained to repel the threat to just beyond the castle walls.” While the immediate threat to Selectica’s unused NOLs had passed following Trilogy’s intentional triggering of the NOL rights plan, Vice Chancellor Noble concluded that the reloading of Selectica’s NOL rights plan to address the continued threat of NOL impairment was a valid exercise of business judgment. The actions of Selectica’s board also demonstrate how defensive measures should be reviewed and continuously monitored in light of the status of perceived threats.

Conclusion

The Delaware Chancery Court’s decision in *Selectica* is significant in several respects. Although *Selectica* is largely a restatement of relatively settled Delaware law, it signified the Court’s willingness to uphold novel applications of traditional rights plans outside of a takeover context and reflected an application of Delaware law by the Court in a manner that was

highly deferential to the board. Before the *Selectica* decision, it was unclear whether the Court would uphold an NOL rights plan given the speculative nature of valuing potential future tax benefits of unused NOLs and the 4.99% triggering threshold that is designed to protect them. The Court endorsed the preservation of NOLs as an important corporate asset meriting the use of defensive measures under the proper circumstances. The *Selectica* decision also provides further guidance as to the substantial latitude boards of directors are granted under Delaware law in adopting defensive measures.

Endnotes

- ¹ *Selectica, Inc. v. Versata Enters., Inc.*, C.A. No. 4241-VCN (Del. Ch. 2010).
- ² *Moran v. Household Int’l, Inc.*, 500 A.2d 1346 (Del. 1985).
- ³ Unused NOLs can be carried forward for 20 years. The estimated present value of an unused NOL largely depends on a company’s expectation as to how much, and when, future taxable income is projected and the company’s effective tax rate. Accordingly, the present value of an unused NOL typically is significantly less than the amount of the unused NOL itself.
- ⁴ Code Section 382(g).
- ⁵ Code Section 382(a).
- ⁶ Code Section 382(g).
- ⁷ John Laide, *Companies Taking Steps to Preserve Net Operating Loss Carryforwards (NOLs) - 382 Poison Pills and Charter Ownership Limits*, https://www.sharkrepellent.net/request?an=dt.getPage&st=1&pg=/pub/rs_20091103.html&Companies_Taking_Steps_to_Preserve_Net_Operating_Loss_Carryforwards&rnd=612540.
- ⁸ All references to Trilogy, Inc. include Versata Enterprises, Inc., a wholly owned subsidiary of Trilogy, Inc. and co-defendant in the *Selectica* litigation.
- ⁹ Selectica’s Chief Financial Officer delivered a Section 382 analysis to Selectica’s board on November 15, 2008 showing that the cumulative acquisition of stock by Selectica shareholders, including Trilogy, over the past three years stood at 40%, roughly unchanged from a calculation undertaken prior to Trilogy purchasing enough Selectica shares to exceed the 5% ownership change limitation applicable to the impairment of NOLs.
- ¹⁰ Testimony at trial indicated that Trilogy triggered the rights plan in a calculated effort to put pressure on Selectica to settle its debt to Trilogy from the patent infringement litigation and other outstanding issues between the companies.
- ¹¹ *In re Gaylord Container Corp. S’holder Litig.*, 753 A.2d 462 (Del. Ch. 2000).
- ¹² According to SharkRepellent.net, the use of traditional shareholder rights plans has decreased every year since 2002.
- ¹³ *Carmody v. Toll Bros., Inc.*, 723 A.2d 1180 (Del. Ch. 1998).

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