Delaware Supreme Court Approves Poison Pill Trigger Below 5 Percent

By Henry R. Chalmers, Litigation News *Associate Editor*

The Delaware Supreme Court recently allowed a corporation to defend itself against a hostile takeover bid by implementing a poison pill with a trigger of less than 5 percent of the corporation's stock. *Versata Enterprises, Inc. v. Selectica, Inc.* The ruling continues that highest court's deferential attitude toward aggressive shareholder rights plans, so long as the corporation implementing the plan can reasonably explain the low ownership threshold.

NET OPERATING LOSSES AS A CORPORATE ASSET

The target company in *Versata*—defendant Selectica, Inc.—had never turned a profit but had accumulated approximately $160 million in net operating losses (NOLs), which it could offset against future profits for tax purposes. These losses represented Selectica's single most valuable asset. But they were a fragile asset.

For example, to prevent corporations from benefitting from NOLs accumulated by other companies, federal tax law limits a corporation's ability to use the losses following an "ownership change."

The bidder, Trilogy, Inc., was a competitor, creditor, and shareholder of Selectica. Trilogy had made offers in the past to acquire Selectica, but they had all been rebuffed. Instead, Trilogy began acquiring Selectica stock. This raised concerns among Selectica's board that the stock purchases could effect an "ownership change," thereby destroying much of the value of the NOLs.

TRIGGERING THE POISON PILL

In response, the Selectica board reduced the trigger for the poison pill in its shareholder rights plan from 15 percent to 4.99 percent. As soon as that threshold was breached, the poison pill would severely dilute all existing shares, thus driving down the raider's ownership percentage.

Despite learning of the amendment to Selectica's shareholder rights plan, Trilogy continued purchasing shares, elevating its ownership interest to 6.7 percent, and thereby triggering the poison pill. Selectica then revised its shareholder rights plan again to implement a "share exchange," upon the triggering event, essentially doubling the number of shares owned by each Selectica shareholder except the raider—Trilogy.

Selectica filed suit in the Delaware Court of Chancery, seeking a declaration that the poison pill was valid and that the board properly implemented its "share exchange." Trilogy and its subsidiary Versata counterclaimed that the poison pill and exchange were unlawful. After the trial court granted Selectica's motion for declaratory judgment, Trilogy and Versata appealed.

THE *UNOCAL* TEST

In considering the propriety of Selectica's poison pill, the Delaware Supreme Court applied its well-known *Unocal* test.

In *Unocal Corp. v. Mesa Petroleum Co.*, the Delaware Supreme Court considered whether a corporation's board could attempt to avoid a hostile takeover by employing defensive measures that could benefit some shareholders and the board members themselves over the interests of the other shareholders attempting the hostile takeover. The court found that a board could do so as long as it acts in good faith, upon a reasonable investigation, and pursuant to a clear duty to protect the corporation. If the defensive measure chosen is reasonable in relation to the threat posed by the hostile takeover effort, then the board's action will be subject to the business judgment rule.

Once this standard is met, the party opposing the board's action must show by a preponderance of the evidence that the action was primarily based on perpetuating the directors in office, or some other breach of fiduciary duty. Absent such a showing, the court will not substitute its judgment for that of the board.

APPLYING *UNOCAL* TO *VERSATA*

The *Versata* court found that Selectica's board satisfied the first part of the *Unocal* test by showing that it had reasonable grounds for concluding that a threat to the corporate enterprise existed. Selectica satisfied this prong by conducting lengthy board discussions and relying in apparent good faith on the advice of experts. These experts confirmed that Selectica's NOLs were worth preserving and that Trilogy's actions presented a serious threat of their impairment.

"The primary message to take away from this is to build your record before the litigation begins," says Stephen C. Norman, Wilmington, DE, cochair of the Section of Litigation's Committee on Corporate Counsel's Subcommittee on Corporate Governance. "Especially if you're going to do something as unusual as lowering your trigger below 5 percent," he advises.

The second prong of the *Unocal* test requires an initial evaluation of whether a board's defensive response to the threat was preclusive or coercive, and, if neither, whether the response was reasonable compared to the threat identified. A coercive response is one that "crams down" on shareholders a management-sponsored alternative. A defensive measure is considered preclusive when it makes a bidder's ability to wage a successful proxy contest and gain control either mathematically impossible or realistically unattainable.

The Delaware Supreme Court found that Selectica's 4.99 percent trigger was not preclusive because "[t]he key variable in a proxy contest would be the merit of the bidder's proposal and not the magnitude of its stock holdings."

The court then found that, despite Trilogy's arguments to the contrary, Selectica's defensive maneuvers were "reasonable in relation to the threat identified." The court did note, however, that a reasonable shareholder rights plan could become unreasonable as facts change. "[I]t is the specific nature of the threat that sets the parameters of the range of possible defensive tactics at any given time," the court instructed. "It may be inappropriate for a Rights Plan to remain in place when those specific circumstances change dramatically."

"The fact that the NOL Poison Pill was reasonable under the specific facts and circumstances of this case should not be construed as generally approving the reasonableness of a 4.99 percent trigger in the Rights Plan of a corporation with or without NOLs," the court warned.

CONTINUING FLEXIBILITY FOR CORPORATE BOARDS

According to Norman, the court's decision is a reflection of the continuing flexibility with which Delaware law considers corporate decision making. "Delaware law is flexible in responding to situations like this, and I think it is the right decision," says Norman. "It's important for corporations to have that kind of flexibility in responding to different circumstances like this."

LIMITS OF *VERSATA*

The decision should not be used too broadly as precedent beyond its limited facts, cautions Lynda J. Grant, New York, cochair of the Section's Securities Litigation Committee. "The NOL poison pill should be limited to those circumstances in which the company has a real and valuable asset, which it has taken steps to value," Grant says. "I would not want to see the *Versata* decision used to support circumstances in which a bad management team gets to use a poison pill to entrench themselves even though their poor skills caused the NOLs in the first place."

Regardless, says Grant, the decision "will make proxy battles more difficult, if shareholders cannot amass more than 5 percent of a company's outstanding shares." Grant advises plaintiffs' counsel fighting such a move to "drill down on the circumstances of the NOLs in discovery to determine whether it can be used by the company in the future and what its real value is."

Norman does not think we have heard the last of this issue. "We're seeing a resurgence of takeover activity, so more and more companies will be resorting to pills to protect shareholders," Norman predicts.

RESOURCES

- Versata Enters, Inc. v. Selectica, Inc., 5 A.3D 586 (Del. 2010).
- Unocal Corp. v. Mesa Petro. Co., 493 A.2d 946 (Del. 1985).

Source: "A New Era for Raiders," Harvard Business Review, Nov. 2010, www.hbr.org

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