

M&A Commentary

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Implications for the Next Generation of Poison Pills: *Selectica, Inc. v. Versata Enterprises, Inc.*

Highlights

- In *Selectica*, the first Delaware decision involving the triggering of a modern poison pill, the Delaware Court of Chancery reaffirmed the value of the poison pill in protecting and maximizing stockholder value.
- *Selectica* demonstrates that independent directors acting in good faith, on an informed basis and with the advice of outside experts, should be afforded substantial latitude to use new defensive technologies to respond to modern threats. These technologies include:
 - Synthetic equity trigger—including derivatives, swaps and other synthetic equity positions in the definition of beneficial ownership to address threats from equity derivatives that allow separation of economic and voting interests.
 - “Acting in concert” trigger—treating investors participating in a coordinated “wolf-pack” attack as a group for purposes of determining beneficial ownership.
 - NOL poison pill—lowering the trigger threshold to just under five percent to address the threat to a corporation’s NOL asset from stock accumulations.
- *Selectica* also provides practical guidance for boards considering the adoption of poison pills.

Introduction

At a time when the number of corporations with stockholder rights plans—“poison pills”—is declining sharply and poison pills are heavily criticized by stockholder governance proponents and proxy advisory firms, the Delaware Court of Chancery, in *Selectica, Inc. v. Versata Enterprises, Inc.*,¹ reaffirmed the value of the poison pill to boards seeking to protect and maximize stockholder value. In upholding a poison pill used outside the hostile offer context to protect an asset of the corporation, the court also reaffirmed the flexibility of Delaware law to respond to modern threats facing corporations. *Selectica* demonstrates that independent directors acting in good faith, on an informed basis and with the advice of outside experts, should be afforded substantial latitude to use new defensive technologies to respond to modern threats. *Selectica* also provides practical guidance for boards considering the adoption of poison pills.

Background

Selectica is a micro-cap sales execution and contract management software provider that accrued approximately \$160 million in net operating losses (NOLs). Generally, NOLs can be used to offset future taxable income. Their use may be impaired, however, if an “ownership change” occurs pursuant to Section 382 of the Internal Revenue Code. Concerned that additional trading by Selectica’s five percent stockholders might cause an ownership change, Selectica’s board engaged experts to analyze the threat of impairment and possible defensive responses, including the adoption of an NOL poison pill. In response to the perceived threat, the board lowered the trigger threshold of its poison pill from 15 percent to 4.99 percent to deter

both new 5 percent stockholders and additional purchases by existing 5 percent stockholders. One of Selectica's competitors, Versata, and its parent company, Trilogy, triggered Selectica's NOL poison pill, apparently to pressure Selectica to resolve an ongoing business dispute.

After the trigger, Selectica's board had 10 days to exempt Versata's purchases from the trigger if the board determined that the purchases did not jeopardize Selectica's NOL asset. During this time, the board reexamined the likelihood of an ownership change and made repeated efforts to secure a standstill agreement from Versata. The board determined that incremental additional purchases by Versata could cause an ownership change and that Versata remained a threat, evidenced by its refusal to enter into a standstill. Selectica's board also determined that the traditional "flip-in" could itself potentially cause an ownership change and impair the NOL asset, in addition to imposing massive dilution on Versata. Therefore, the board decided to use the exchange feature of its poison pill to dilute Versata's holdings in Selectica from 6.7 percent to 3.3 percent and also adopted a new NOL poison pill to continue to protect the NOL asset.

Selectica brought an action in the Delaware Court of Chancery seeking a declaratory judgment confirming that its NOL poison pill was valid and that its board of directors acted properly in using the poison pill against Versata. In response, Versata asserted that the NOL poison pill was invalid on its face and that the actions of Selectica's board constituted a breach of fiduciary duties. The *Selectica* court held a five-day trial in late September 2009 and issued its opinion in favor of Selectica on February 26, 2010. A more extended discussion of the background of *Selectica*, including lessons for the mechanics of poison pills, can be found in our *M&A Commentary* published in March 2009.²

The *Selectica* Decision

The legality of a traditional poison pill was not seriously questioned in *Selectica*. Indeed, the court states that the Delaware Supreme Court has sent "a strong signal that the legitimacy of the poison pill is settled law."³ The *Selectica* court instead focused on the board's process in adopting and using its NOL poison pill, including the validity of the board's determination that its NOL asset was worth protecting.

The *Selectica* court expressed considerable skepticism about the value of Selectica's NOL asset, referring to it as having "speculative," "questionable" and "dubious" value.⁴ Indeed, Selectica itself determined, for financial accounting purposes, that it was more likely than not that Selectica would be unable to use its NOLs.⁵ Despite its skepticism, the court found that the board properly determined that the NOLs had potential value worth protecting, principally because the court found that the board reasonably relied on outside experts to analyze the potential value of the NOLs and the potential threat that an ownership change presented to the NOL asset.

Under the enhanced *Unocal/Unitrin* standard applied to defensive measures, poison pills must (1) not be preclusive or coercive and (2) be reasonable in relation to an identified threat.⁶ The *Selectica* court first noted that the coercive standard was inapplicable on the facts of the case. The court then stated that the preclusive standard "operates to exclude only the most egregious defensive responses."⁷ For a defensive measure to be invalidated on preclusive grounds, the court found that the measure must make a proxy contest nearly impossible or utterly moot.⁸ Citing Selectica's concentrated stockholder base and expert testimony examining successful proxy campaigns by stockholders holding less than 5.5 percent, the court determined that Selectica's adoption of its NOL poison pill was not preclusive.

Turning to the reasonableness prong of the test, the court stated that "[u]ltimately, *Unocal* and its progeny require that the defensive response employed be a proportionate response, not the most narrowly or precisely tailored one"⁹ and quoted the Delaware Supreme Court's explanation of the reasonableness standard:

[A] court applying enhanced judicial scrutiny should be deciding whether the directors made a *reasonable* decision, not a *perfect* decision. If a board selected one of several reasonable alternatives, a court should not second guess that choice Courts will not substitute their business judgment for

that of directors, but will determine if the directors' decision was, on balance, within a range of reasonableness.¹⁰

Applying this standard, the court reviewed as a whole the board's decision to adopt the original NOL poison pill, to use the exchange feature to dilute Versata and subsequently to adopt a new NOL poison pill. After noting the potential impairment of Selectica's NOL asset, the contentious history between the two companies, Versata's recognition that it could harm Selectica by continuing to acquire shares and Selectica's use of the less dilutive exchange feature, the court determined that Selectica acted reasonably in relation to the threat posed by Versata's continuing stock accumulations.

Implications for Boards Considering New Defensive Technologies

When the poison pill was first challenged in Delaware in the mid-1980's, the Delaware Supreme Court noted the flexibility of the state's corporate law, stating that it "must grow and develop in response to, indeed in anticipation of, evolving concepts and needs."¹¹ Although the freewheeling takeover environment of the 1980's is now a distant memory, corporations today face continued threats of abusive takeover transactions, as well other more modern threats from activist and other event-driven investors. In concluding that a low-trigger threshold poison pill can be used to protect an NOL asset, *Selectica* demonstrates the flexibility of Delaware corporate law and suggests that independent directors acting in good faith, on an informed basis and with the advice of outside experts, should be afforded substantial latitude to use new defensive technologies to respond to modern threats.

Notwithstanding the unique factual background in *Selectica* and the inherent uncertainties in drawing broad conclusions from one decision, we believe the implications of *Selectica* lie in its recognition that the poison pill, as a defensive measure, remains a flexible tool for boards of Delaware corporations. We are currently developing and recommending—and boards are implementing—the next generation of poison pills to respond to evolving threats facing corporations. A number of prominent large corporations, including Citigroup Inc., Ford Motor Company and Pulte Homes, Inc., have adopted NOL poison pills to protect against perceived threats to their NOL assets. In light of the changing nature of equity ownership in the U.S., other corporations have modified their poison pills to capture derivatives, swaps and other synthetic equity positions in the definition of "beneficial ownership." Still other corporations have sought to address coordinated "wolf-pack" campaigns by activist and other event-driven investors by modifying their poison pills to treat parties acting in concert as having formed a group for purposes of determining beneficial ownership. These modern technologies represent important advances in defensive measures.

In initial reactions to *Selectica*, commentators have focused on language that the court quoted from *Unitrin* characterizing the preclusive prong of the *Unocal/Unitrin* test as requiring invalidation of defensive measures only if they render a successful proxy contest "mathematically impossible" or "realistically unattainable."¹² Some commentators lament that this high bar represents the apparent death of the preclusive prong of the *Unocal/Unitrin* test. We believe *Selectica*'s reasoning is consistent with the Delaware courts' long-held view that a defensive measure will not be deemed preclusive if a stockholder vote remains available as a "safety valve" against board entrenchment.

We also believe that the court's analysis of the preclusive prong, and its finding that an NOL poison pill with a 4.99% trigger was not preclusive, lends strong support to the "acting in concert" poison pill trigger. As we noted in our previous article examining new poison pill technologies, there are numerous examples of successful destabilization campaigns led by hedge funds and other activist investors with relatively small (often less than five percent) stakes in corporations based in large part on parallel investing and other seemingly coordinated activities.¹³ These "wolf-pack" campaigns threaten stockholder value while eluding many of the traditional early warning mechanisms on which corporations rely, including Williams Act filings. The acting in concert poison pill trigger that we recommend updates the definition of "beneficial ownership" to capture coordinated wolf-pack tactics but excludes proxy and consent solicitations and tender offers that are otherwise conducted in accordance with applicable law. *Selectica*

suggests that, with this exclusion, the acting in concert trigger should survive scrutiny under the preclusive prong of the *Unocal/Unitrin* test.

When we recommend new poison pill technologies to boards, after determining that the technology is not preclusive, we advise directors of their duties under the *Unocal/Unitrin* standard, describing how the technologies are designed to be reasonable in response to evolving threats. Our advice comes with the caveat, however, that the new poison pill technologies have not been blessed by Delaware courts and represent an extension of existing law. By embracing one iteration of the next generation of poison pills, *Selectica* provides comfort that, in Delaware, independent directors acting in good faith, on an informed basis and with the advice of outside experts, should be afforded the protection of the business judgment rule in adopting new poison pill technologies. For this reason, when boards implement new poison pill technologies—whether they be the existing synthetic equity or acting-in-concert triggers, or some new technology responding to a yet-to-be-determined threat—*Selectica* provides comfort that Delaware courts should respect their actions.

Practical Guidance for Boards Considering Defensive Measures

In addition to *Selectica*'s recognition of the flexibility of Delaware corporate law to accommodate the next generation of poison pills, the decision provides the following practical guidance for boards considering the adoption and use of poison pills:

- *Demonstrate Leadership of Independent Directors.* Independent directors should have a leading role in the board's review and evaluation of poison pills and other defensive measures. Management directors, or other directors with a potential interest in the transaction, could be characterized as using takeover defensives to entrench themselves in office, a concern that is substantially mitigated by use of independent directors. As a technical matter, proof of the board's good faith and reasonable investigation is "materially enhanced" if a poison pill is approved by a majority of outside independent directors. Simply put, a Delaware court will provide substantial deference to actions taken by well-informed independent directors acting in good faith.¹⁴
- *Rely upon Outside Financial, Legal and Other Expert Advisors.* Directors are entitled to rely in good faith on the advice of outside financial, legal and other expert advisors, assuming that the advice received is reasonably believed to be within the advisors' areas of expertise and that the advisors are selected with reasonable care.¹⁵ The *Selectica* court highlights the board's reliance on outside advisors in considering the potential value of *Selectica*'s NOLs, even though the court viewed the NOLs to be of speculative, questionable and dubious value.¹⁶ While this high level of deference to a board may have been a product of the unique facts in *Selectica*, the case demonstrates that expert advisors are particularly important if the board is considering decisions in highly technical or specialized areas, such as applying the ownership change rules applicable to NOLs.
- *Obtain Information to Understand the Specific Threat.* The traditional poison pill is geared to a 1980's-style hostile tender offer, which is a different threat than the potential loss of an NOL asset. Directors should define and understand the specific threat to which the defensive measures they are considering are geared. To adopt an NOL poison pill, a board should consider (1) the corporation's current ownership change position and the risk that an ownership change could occur in the future, given the corporation's current stockholder profile, and (2) the impact of an ownership change on the corporation's ability to use its NOLs and the corresponding loss in value. Ideally, a board would consider the probability of using its NOLs based on the corporation's projected financial performance. With respect to modern threats from the abuse of synthetic equity and "wolf-pack" activities by activist investors, a board should understand the nature of the threats in its stockholder base and consider the potential impact of these threats on the corporation and its stockholders in the context of other situations in which these threats have materialized.
- *Tailor Defensive Measures to the Specific Threat.* Defensive measures should be tailored to the specific threat and not be overly broad or otherwise unreasonably restrictive of activities that do not raise the specific threat. To be effective under the Internal Revenue Code, NOL poison pills typically have a 4.99 percent trigger to address the 5 percent threshold for

determining which stockholders count against the ownership change analysis. The 4.99 percent trigger threshold was upheld in *Selectica*, although it likely would not be upheld in the context of a traditional poison pill. As noted in our prior *M&A Commentary*, NOL poison pills typically have additional flexibility so that boards may waive the lower trigger threshold if a potential stock accumulation does not threaten the NOL asset.¹⁷ Like the tailoring of the NOL poison pill, we recommend that synthetic equity triggers not dilute hedge shares held by counterparties to synthetic equity positions, as courts could view dilution of hedge shares to be unreasonable when imposed upon investment banks or other counterparties engaged in ordinary course hedging strategies.¹⁸ Similarly, we recommend that acting-in-concert triggers exclude proxy and consent solicitations and tender offers that are otherwise conducted in accordance with applicable law.

- *Demonstrate Good Faith and Proportionality.* Delaware courts are courts of equity and, as a result, consider all the facts and circumstances on a case-by-case basis, seeking to reach a fair and equitable result. *Selectica*'s board made repeated efforts to secure a standstill agreement from Versata, and then elected to use the poison pill's exchange feature, which was significantly less dilutive to Versata than the potential dilution under the traditional "flip-in" device. We believe this record of good faith and proportionality is an important factor in the outcome in *Selectica*.

Conclusion

Selectica demonstrates the flexibility of Delaware to accommodate new defensive measure technologies in response to modern threats. Boards seeking to protect and maximize stockholder value should carefully consider the threats faced by their corporations and, in consultation with their outside advisors, determine whether features from the next generation of poison pills, including the NOL poison pill and the synthetic equity and acting-in-concert triggers, afford additional protection from those threats.

Endnotes

- † The views expressed in this *M&A Commentary* are those of the authors alone and do not necessarily represent the views of Latham & Watkins or its clients.
- ¹ No. 4241-VCN, 2010 WL 703062 (Del. Ch. Feb. 26, 2010).
- ² *M&A Commentary—Lessons from the First Triggering of a Modern Poison Pill: Selectica, Inc. v. Versata Enterprises, Inc.*, Mar. 2009, [hereinafter *Lessons from the First Triggering of a Modern Poison Pill*]. For a more extended discussion of new poison pill technologies and trends, see *The Resurgent Rights Plan: Recent Poison Pill Developments and Trends*, Apr. 2009, [hereinafter *Resurgent Rights Plan*].
- ³ *Selectica*, 2010 WL 703062, at *12 (citing *Leonard Loventhal Account v. Hilton Hotels Corp.*, 780 A.2d 245, 250–51 (Del. 2001)).
- ⁴ *Id.* at *11, 15.
- ⁵ *Id.* at *16.
- ⁶ See *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 955 (Del. 1985); see also *Unitrin Inc. v. Am. Gen. Corp.*, 651 A.2d 1361, 1387 (Del. 1995).
- ⁷ *Selectica*, 2010 WL 703062, at *21.
- ⁸ *Id.*
- ⁹ *Id.* at *24.
- ¹⁰ *Id.* (quoting *Paramount Commc'ns., Inc. v. QVC Networks, Inc.*, 637 A.2d 34, 45 (Del. 1994)) (first alteration in original).
- ¹¹ *Id.* at *15 (quoting *Unocal Corp.*, 493 A.2d at 957).
- ¹² *Unitrin Inc.*, 651 A.2d at 1388–89; see *Selectica*, 2010 WL 703062, at *20 (quoting *Carmody v. Toll Bros. Inc.*, 723 A.2d 1180, 1195 (Del. Ch. 1998)).
- ¹³ *Resurgent Rights Plan*, *supra* note 2, at 11–16.
- ¹⁴ *Selectica*, 2010 WL 703062, at *12 (quoting *Unocal Corp.*, 493 A.2d at 955).
- ¹⁵ *Id.* at *17 (quoting Del. Code Ann. tit. 8, §141(e) (2010)).
- ¹⁶ *Id.* at *11, 15.
- ¹⁷ *Lessons from the First Triggering of a Modern Poison Pill*, *supra* note 2, at 6.
- ¹⁸ *Resurgent Rights Plan*, *supra* note 2, at 17–21.

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