
Highlights

- Versata Enterprises triggered Selectica’s poison pill in December 2008, becoming the first stockholder to have intentionally swallowed a modern poison pill.

- Selectica’s NOL poison pill was designed to protect its NOL asset against the threat that changes in share ownership could limit Selectica’s ability to use its NOLs in the future. An NOL poison pill is different from a traditional poison pill, which protects against abusive takeover transactions, and NOL poison pills may become increasingly relevant due to the impact of the recession.

- The triggering of Selectica’s poison pill offers several important lessons for all rights plans:
  - The exchange feature used by Selectica has a number of advantages over the traditional “flip-in” feature, and should be included in all rights plans.
  - To mitigate the risk of disruptive trading halts like the one experienced by Selectica, all rights plans should provide the “back-office” mechanics required after a trigger event.
  - A post-trigger “safety valve” permitting negotiation with the triggering shareholder may make the board susceptible to increased pressure. For NOL poison pills, we propose that they be non-redeemable after they have been triggered and that they contain a pre-clearance procedure to provide flexibility to the board.
  - The threat of dilution from a poison pill may not deter all acquirers, particularly for corporations with low market capitalizations or in financial distress.

Introduction

Stockholder rights plans, commonly referred to as “poison pills,” were developed more than 25 years ago to fend off opportunistic “hostile” offers and other abusive takeover transactions. Poison pills traditionally have been designed to deter unauthorized share accumulations by imposing substantial dilution upon any stockholder who acquires shares in excess of a specified ownership threshold (typically 10 percent–20 percent) without prior board approval, rendering the unauthorized share acquisition prohibitively costly. More recently, rights plans with a lower trigger threshold of 4.99 percent have been deployed to protect a corporation’s net operating loss carry forwards, commonly referred to as “NOLs,” against the threat that changes in share ownership could inadvertently limit the corporation’s ability to use the NOLs to reduce future income taxes.
Until the end of 2008, the risk of economic dilution created by the poison pill had its intended deterrent effect. No stockholder had ever swallowed a modern poison pill, and the mechanics of a poison pill trigger were purely an academic exercise.

This is no longer the case. In December 2008, Versata Enterprises, Inc. and certain affiliates triggered an NOL poison pill adopted by Selectica, Inc. in what appears to have been a calculated effort by Versata to obtain leverage in an unrelated business dispute. Selectica's board used its poison pill to dilute Versata's position (exercising the feature that allows the board to exchange rights held by stockholders other than Versata for common stock on a one-for-one basis). Due to uncertainty regarding the issuance and ownership of Selectica shares following the rights exchange, trading in Selectica's common stock was suspended for more than four weeks while the important “back-office” mechanics to implement the exchange were developed and implemented by Selectica and its advisors. In addition, the case of Selectica, Inc. v. Versata Enterprises, Inc. pending in the Delaware Court of Chancery presents for the first time the question of the validity of the NOL poison pill and the board's decisions to use the poison pill against Versata. These events provide lessons applicable to all forms of rights plans.

**An Overview of NOL Poison Pills**

NOL poison pills have recently gained prominence due to the impact of the recession, as a result of which an increasing number of corporations are generating significant NOLs that may be used to reduce future income taxes. Particularly for a corporation in financial distress, its NOL asset may have value far in excess of the corporation's current market capitalization. In this context, and in other situations when NOL assets may be at risk, an increasing number of corporations are adopting NOL poison pills in an effort to protect their NOL assets against the threat that changes in share ownership could limit their ability to use NOLs in the future. According to SharkRepellent.net, more than 30 corporations had adopted NOL poison pills as of March 19, 2009. The potential merits of NOL poison pills have been recognized by a proxy advisory firm, RiskMetrics Group, which recently signaled acceptance of NOL poison pills from a corporate governance perspective when it revised its policy position to accommodate NOL poison pills on a case-by-case basis. On the basis of this policy, RiskMetrics recommended a vote “For” Hovanian Enterprises, Inc.’s NOL poison pill when it was submitted for stockholder approval.

By way of background, the tax laws applicable to NOLs provide that, if a corporation experiences an “ownership change” for tax purposes, the ability to use its pre-change NOLs in a post-change period could be substantially limited and delayed. These limitations can significantly impair the value of the NOL asset. An “ownership change” generally occurs if the percentage of the corporation's shares owned by one or more five percent stockholders increases by more than 50 percentage points over the lowest percentage of stock owned by those stockholders at any time during the prior three-year period, or if more recent, since the date of the last ownership change. Only changes in ownership by five percent stockholders will cause an ownership change, and this may occur inadvertently as a result of normal trading activity.

An NOL poison pill differs from a traditional poison pill in a number of important respects:

- **An NOL poison pill is intended to protect a corporation's NOL asset, while the traditional poison pill is intended to deter abusive takeover tactics.** The primary rationale for an NOL poison pill is to protect a valuable tax asset of the corporation, not to deter opportunistic “hostile” transactions. Like a traditional poison pill, an NOL poison pill deters share accumulations above the trigger threshold and may present the same board entrenchment-related concerns as traditional poison pills. Therefore, an NOL poison pill is likely to be viewed as a defensive measure and should be evaluated as such when a board considers whether to adopt one. We believe entrenchment-related concerns for NOL poison pills can be mitigated by the pre-clearance procedures discussed below.

- **An NOL poison pill has a lower 4.99 percent trigger threshold, as compared to the 10 percent–20 percent trigger threshold typical in a traditional poison pill.** The lower 4.99 percent trigger threshold is required in an NOL poison pill both to deter additional
An NOL poison pill has additional “safety valves” to avoid an unnecessary trigger if there is no threat to the NOL asset. NOL poison pills are not uniform by any means, but many NOL poison pills have additional “safety valves” designed to avoid an unnecessary trigger. For example, many NOL poison pills terminate automatically if the board determines that the NOLs have been fully used or are no longer available. Other NOL poison pills, such as the one adopted by Selectica, permit the board to exercise discretion to waive the trigger after the applicable ownership threshold has been reached, if the board determines that the share acquisition is not likely to impair or limit the value of the NOL asset. We believe it is preferable that NOL poison pills be non-redeemable and contain a pre-clearance procedure, as discussed below.

An NOL Poison Pill is Not an Adequate Substitute for Traditional Takeover Defenses. Under Delaware law, a board's actions with respect to an NOL poison pill should be reasonable in relation to its expressed purpose—protecting against threats to a corporation's NOL asset. The Delaware courts may view skeptically any attempt to adopt or use an NOL poison pill for traditional defensive purposes, where no bona fide threat to a corporation's NOL asset exists. A board considering whether to adopt an NOL poison pill should inform itself as to the nature and extent of the threat to the corporation's NOL asset by considering, among other things, the financial value of the NOL asset, the potential loss of value that the corporation would suffer if an ownership change occurred and the likelihood of an ownership change. Where the board also perceives a bona fide threat from abusive takeover transactions, the board may consider adopting a “second level” 10 percent–20 percent trigger threshold in the NOL poison pill, which would allow the NOL poison pill also to serve as a traditional poison pill at the higher trigger threshold.

An NOL poison pill does not offer complete protection for a corporation's NOL asset. It cannot prevent an ownership change for tax purposes or prevent a potential acquirer from purchasing more than the 4.99 percent trigger threshold. It merely serves as a deterrent. Even an inadvertent acquisition can cause an ownership change to occur, but would not likely trigger the poison pill, as NOL poison pills, like most traditional poison pills, have an exception for inadvertent acquisitions. In addition, in certain circumstances, sales by existing stockholders who historically held a five percent ownership position can result in an ownership change under applicable tax laws. An NOL poison pill will not prevent or restrict stock sales, so it will not protect against an ownership change due to stock sales.

An NOL poison pill is not the only, or even the most effective, means to protect a corporation's NOL asset. An alternative, more effective protection is to embed ownership limitations in the corporation's certificate of incorporation. This has become a fairly standard protection for corporations with significant NOL assets emerging from bankruptcy, as the bankruptcy process facilitates adoption of a certificate of incorporation that includes ownership restrictions. Amendments to the certificate of incorporation to impose ownership restrictions are difficult to implement outside of bankruptcy; however, because they require stockholder approval under Delaware law and may only be enforceable against stockholders who vote in favor of the ownership restrictions or become stockholders after the ownership restrictions have been approved.

Triggering Selectica's NOL Poison Pill

Selectica is a California-based sales execution and contract management software provider that accrued an NOL asset valued at approximately $150 million. This value far exceeded Selectica's market capitalization. According to Selectica's complaint in the pending litigation, by November
2008, the acquisition of approximately 10 percent of Selectica's common stock by new or existing five percent stockholders would have resulted in an ownership change for applicable tax purposes and significantly impaired the value of Selectica's NOL asset.

On November 13, 2008, Versata and certain of its affiliates filed a Schedule 13D with the SEC disclosing that Versata had acquired 5.1 percent of Selectica's common stock and indicating that Versata was considering purchasing additional shares. Versata is one of Selectica's primary competitors. Since 2005, Versata has made periodic overtures indicating an interest in purchasing Selectica, all of which were declined by Selectica's board. Selectica has alleged that Versata used its share acquisitions to seek leverage to force Selectica to accept a lower price for the company and to settle unrelated intellectual property disputes.

On November 17, 2008, in response to Versata's share accumulations, Selectica's board implemented an NOL poison pill by reducing the trigger threshold of its existing rights plan from 15 percent to 4.99 percent. Selectica's existing five percent stockholders, including Versata, were grandfathered under the NOL poison pill, subject to a trigger threshold of 0.5 percent above their pre-adoption ownership. Each existing stockholder was contacted and advised of the new trigger threshold. Selectica's board also formed a committee of independent directors to monitor and administer the NOL poison pill.

On December 19, 2008, Versata notified Selectica that it had increased its position in Selectica to 6.7 percent, triggering the NOL poison pill. Selectica entered into discussions with Versata based upon the discretion available to Selectica's board under the poison pill to determine whether to grant a waiver if Versata's share acquisitions would not jeopardize or endanger Selectica's NOL asset. The board concluded that it could not grant a waiver because Versata was unwilling to agree to limit future purchases of Selectica's common stock as a condition for receiving a waiver.

Selectica had two options for using its NOL poison pill—allow a traditional flip-in event to occur, or exchange the rights held by all Selectica stockholders (other than Versata) for common stock. The flip-in event could have been substantially more dilutive to Versata, but relied upon holders paying cash to exercise the rights, could have resulted in a separate trading market in Selectica rights and may have further increased the risk of an ownership change (by increasing the percentage ownership of stockholders who exercised rights relative to other stockholders). On January 2, 2009, Selectica decided to exercise the exchange feature, declaring that all stockholders (other than Versata) would receive one share of Selectica common stock for each existing right. Because Versata and its affiliates were excluded from the exchange, Versata's ownership was diluted from 6.7 percent to approximately 3.4 percent. Selectica's board also adopted a new NOL poison pill to maintain future protection for the NOL asset.

Selectica initially brought an action seeking a declaratory judgment to confirm that its poison pill was valid and that the board of directors acted appropriately in using the poison pill against Versata. In response, Versata asserted that Selectica's NOL poison pill is invalid on its face and that, even if the poison pill is facially valid, the manner in which Selectica's board used the NOL poison pill constituted a breach of fiduciary duties.

**Lesson: The Exchange Feature Offers Advantages over a Traditional Flip-In**

Instead of allowing the traditional flip-in to occur, Selectica's board exercised the exchange feature in its poison pill and exchanged the rights on a one-for-one basis for common stock. As a general matter a company should not signal to the market in advance that it intends to use the exchange feature rather than the traditional flip-in (as this could reduce the deterrent effect of the poison pill). However, particularly in the context of an NOL poison pill, the exchange feature offers a number of practical and compelling advantages over the traditional flip-in:

- *Dilution is Certain and Automatic.* After a traditional flip-in, rights would be "in-the-money," trade separately from the common stock and be exercisable until the expiration of the poison pill. It is difficult to predict when the holders of rights would exercise. Standard options theory suggests the rights might not be exercised until their expiration date, although a holder’s desire to vote or receive dividends on the common stock could create
incentives to exercise sooner. The rights would create massive overhang until they were exercised, complicating the corporation's capital structure and impairing the corporation's ability to complete alternative transactions. In contrast, the exchange provision is effective immediately, requires no action by stockholders and eliminates any overhang issues.

- **No Cash Required for Exercise.** To exercise following a traditional flip-in, the holder must deliver the exercise price in cash, making a decision to invest additional capital in the corporation. Particularly in the current capital market environment, financing for the cash exercise price is uncertain. The holder's investment decision would be somewhat analogous to that in a conventional rights offering to raise equity capital in which not all investors will commit new money in order to avoid dilution in that context. Although the scale of dilution would be substantially larger in the poison pill context, it is far from clear that all holders will recognize the difference, have the required cash and be willing to make the new investment decision. It is also unclear whether the corporation would need, or reasonably could deploy, the additional capital it would receive. In contrast, the exchange feature does not require cash and instead exchanges each right for one share of common stock.

- **May Have Less Impact on the NOL Asset.** Unexercised rights may not be deemed to create beneficial ownership of the underlying common stock for tax law purposes. As a result, exercises of the rights after the traditional flip-in could change the stockholders' relative ownership percentages in the corporation (by increasing the percentage ownership of stockholders who exercised rights relative to non-exercising stockholders), which could impact the ownership change calculation and itself threaten the value of the corporation's NOL asset. The results of the exchange provision are predictable and should have less impact on the corporation's NOL asset.

- **Results in Less Dilution.** Unless a poison pill's exercise price is very low in relation to the underlying stock’s trading value, a one-for-one exchange is likely to be significantly less dilutive than the traditional flip-in. A board's determination to exercise this restraint by using the exchange provision instead of the traditional flip-in, may bolster the argument that directors acted reasonably. We anticipate that the decision in the Selectica litigation may provide guidance on this specific question.

**Lesson: Technical Improvements Should Be Made to Poison Pills After Selectica**

When Selectica's board determined to exercise the exchange feature, there was significant uncertainty as to important “back-office” mechanics to complete it. The procedures in the modern poison pill for a traditional flip-in event, which require that holders certify their eligibility as a condition to exercising their rights, were not workable in the exchange initiated by Selectica. Due to this uncertainty, trading in Selectica's common stock on the NASDAQ was suspended from January 5 until February 4 of this year, while mechanics were developed and implemented by Selectica and its advisors. These mechanics included the following process to verify that rights being exchanged, including rights held in "street name" through The Depository Trust Company, were not beneficially owned by Versata or its affiliates:

- **Procedures for Shares Held Directly.** Stockholders holding shares registered in their names with Selectica's transfer agent were requested to verify that they were not an "acquiring person" for purposes of the poison pill. Selectica then issued shares to stockholders who submitted the required verification.

- **Procedures for Shares Held in "Street Name."** At Selectica's request, The Depository Trust Company requested that its participating brokers electronically verify the number of shares held on behalf of clients who were not "acquiring persons" for purposes of the poison pill. Selectica then credited shares to the accounts of the participating brokers in the amounts covered by the verifications that were received.

- **Trust Funded with Residual Exchange Shares.** For shares where the required verification was not received, Selectica issued exchange shares into a trust (representing
approximately three percent of the exchange shares), to be held pending receipt of the required verification.

We believe that all poison pills should be revised to incorporate these or similar mechanics in order to expedite the implementation of an exchange and minimize (or even eliminate) the time during which trading would be suspended.

Lesson: Reconsidering a Board’s Post-Trigger "Safety Valve"

Many NOL poison pills, such as the one in Selectica, permit the board to exercise discretion to waive the trigger after the applicable ownership threshold has been exceeded, if the board determines that the share acquisition does not impair or limit the value of the NOL asset. Under this post-trigger “safety valve,” the board must consider whether to dilute an acquirer who already crossed the ownership threshold. The “after the fact” nature of the waiver may make the board susceptible to increased pressure because its decision will result in an immediate detrimental impact to the acquirer, will cause disruption to the corporation when the poison pill is used, and will likely result in litigation challenging the board’s actions. Moreover, for an NOL poison pill, the corporation may suffer an ownership change when the poison pill threshold is crossed, in which case the corporation would have already suffered harm to its NOL asset. In this circumstance, the board may find it difficult to justify the implementation of a poison pill to the detriment of the acquirer when no further threat to the corporation’s NOL asset exists.

We believe it is preferable that an NOL poison pill be non-redeemable after the ownership threshold has been crossed so that no post-trigger waivers can be granted. As with traditional poison pills, this incentivizes a potential share purchaser to engage in a pre-purchase discussion to request a waiver from the board. The board can then consider the waiver in advance without undue pressure and grant it if the proposed share purchase does not threaten the value of the NOL asset.

To provide a formal procedure for pre-clearance, the board could establish procedures for stockholders to submit requests for waivers (by way of a board policy or in the NOL poison pill itself), which would encourage share purchasers to consult with the board in advance and provide a process for the full board or a committee of independent and disinterested directors to consider and evaluate waiver requests. Although not required by law, we believe that a waiver evaluation process led by independent and disinterested directors may provide additional protection for all of the directors. The procedures employed in the evaluation process could, for example, require share purchasers to notify the board in writing and provide information about proposed purchases and plans with respect to future purchases. The procedures would provide a reasonable period of time for the board or committee to evaluate and respond to the waiver request. The board or committee could then grant or deny the request after considering all the facts and circumstances, including, among other things, the potential current and future impact on the NOL asset and the desire of other stockholders to purchase additional shares. A waiver approval could be subject to certain conditions, such as an agreement by the share purchaser to limit future share purchases that could threaten the NOL asset.

The board’s consideration of an advance waiver request is likely to be subject to the same fiduciary standards as consideration of a request for a post-trigger waiver, but we believe a formal pre-clearance process may better position the directors to discharge their fiduciary responsibilities and subsequently defend their actions in litigation. Instituting a formal pre-clearance process helps demonstrate that the board has adopted the NOL poison pill for the purpose of protecting the corporation’s NOL asset, not for entrenchment or other improper motives, and frames the board’s consideration of waiver requests in this context. This is particularly important in light of the lower 4.99 percent trigger threshold in an NOL poison pill.

Assuming the formal pre-clearance process is reasonable and not unduly burdensome, a share purchaser who does not pursue an advance waiver, but who instead seeks to invalidate the poison pill post-trigger, may carry a heavier burden in explaining its actions in litigation. Finally, the formal pre-clearance process also increases the likelihood that the board will have advance notice of potential acquisitions, providing an opportunity for the board to respond before the corporation has suffered harm.
Lesson: The Threat of Dilution from a Poison Pill May Not Deter All Acquirers

A poison pill is ultimately an economic deterrent, with the deterrent effect measured by the cost to the acquirer of economic dilution. The deterrent is less effective for corporations with low market capitalizations or in financial distress. With NOL poison pills, the deterrent effect is further impacted by the lower 4.99 percent trigger threshold, as the dilution is applied against a relatively small stake held by the acquirer. In the current economic environment, the deterrent effect of a poison pill will depend to an even greater extent on the specific facts and circumstances of the particular corporation.

Versata was not deterred by the cost of triggering Selectica’s NOL poison pill or, put another way, Versata may have valued the opportunity to gain leverage in an unrelated business dispute with Selectica more than these costs. Given the 4.99 percent trigger threshold and the relatively low Selectica stock price at the time (approximately $1.00 per share), Versata appears to have suffered a loss in value of approximately $1 million due to the dilution caused by triggering the NOL poison pill. Selectica, however, also suffered cost and uncertainty, including a suspension in trading of its common stock, the substantial equivalent of a two-for-one stock split (excluding shares held by Versata), legal and administrative expense and disruption to its board, management and operations.

The facts in Selectica are unique, and the uncertainty of implementing its response was in part a function of being the first US corporation ever to suffer the trigger of a modern poison pill. In the future, corporations will have the lessons of Selectica as a model for mechanics and implementation, with the result that there may not be a trading halt, or, if there is, one of less duration and lower legal and administrative costs. It is probable that Versata concluded, as other future acquirers might conclude, that under certain circumstances the costs to the target company of a poison pill trigger exceed the costs to the acquirer and, therefore, the threat of triggering the poison pill could be used as leverage. This relative cost analysis is highly fact-specific, with outcomes that may be difficult to predict. Yet in situations involving companies with low market capitalizations or in financial distress, one can imagine a poison pill trigger being threatened by either strategic acquirers seeking leverage for a traditional hostile takeover, or activist stockholders or hedge funds seeking leverage in support of "event driven" strategies. NOL poison pills are particularly susceptible to this relative cost analysis because of the lower 4.99 percent ownership threshold. In any event, if an acquirer decides to swallow another modern poison pill, the corporation’s board should be prepared to adopt a new poison pill, like Selectica’s board did, to maintain the protection sought to be obtained by the swallowed poison pill.

CONCLUSION:

The triggering of Selectica’s poison pill offers several important lessons for corporations and their advisors when developing and implementing rights plans:

- Every poison pill should include an exchange feature, which offers a number of practical and compelling advantages over the traditional flip-in feature. An exchange feature provides certain and automatic dilution, requires no cash outlay by stockholders, may have less impact on an NOL asset and offers (in the case of NOL poison pills) the board a response that can be viewed as more restrained and thus more defensible.

- To mitigate the risk of disruptive trading halts like the one experienced by Selectica, all rights plans should provide the “back-office” mechanics required after a trigger event. With respect to the exchange feature, we recommend the addition of a trust mechanic to permit post-exchange verification that stockholders are not affiliated with the triggering stockholder.

- Particularly for NOL poison pills, a post-trigger “safety valve” may make the board susceptible to increased pressure. We recommend that NOL poison pills be
non-redeemable after they have been triggered and that they contain a pre-clearance procedure to provide flexibility to the board.

- For corporations with low market capitalizations or in financial distress, the threat of dilution from a poison pill may not deter future acquirers. If an acquirer decides to swallow another modern poison pill, the board should be prepared to adopt a new poison pill to maintain the protection sought to be obtained by the first poison pill.

As the recession continues, the NOL poison pill will continue to merit attention. As previously robust corporations generate significant and potentially valuable NOLs, corporations should implement systems to monitor share ownership changes, with the assistance of qualified outside experts. This monitoring can identify whether their cumulative ownership change percentages are approaching the applicable 50 percentage point threshold. In circumstances in which a bona fide threat exists to a corporation’s NOL asset, the board and its advisors should consider whether it is prudent to seek protection for these tax assets using an NOL poison pill.

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Endnotes


2 No. 4241 (Del. Ch. filed Dec. 21, 2008).


4 The rules governing “ownership changes” and the use of NOLs are contained in Section 382 of the Internal Revenue Code of 1986, as amended, and related Treasury Regulations. The application of these rules to any particular situation can be complex, and should be evaluated in consultation with outside tax counsel. Determining who is a five percent stockholder for these purposes may be complex as various special rules may apply, including those that result in a “public group” or entities acting in concert being treated as five percent stockholders if they own in the aggregate five percent or more of the shares.


6 John Hull, Options, Futures, and other Derivates 211–12 (7th ed. 2009).

7 The standard poison pill already contains the legal mechanics to implement the distribution of the rights and the traditional flip-in, including determination of the equivalent of a record date for distribution and a verification procedure in the rights exercise process, so it should not raise comparable problems. The "back-office" procedures to give effect to these legal mechanics would need to be discussed with The Depository Trust Company, including the process to ensure that the requisite verifications are obtained each time a right is transferred in "book entry" form. These procedures would be consistent with the procedures used by The Depository Trust Company to implement transfer restrictions for shares that are restricted or held by affiliates.

8 We believe the customary exception for bona fide inadvertent share acquisitions is likely to remain in NOL poison pills, notwithstanding that even an inadvertent trigger can result in an ownership change for applicable tax purposes.

9 See Moran v. Household Int'l, Inc., 500 A.2d 1346, 1354 (Del. 1985) (stating that when boards are faced with a tender offer and a request to redeem a poison pill, “[t]hey will be held to the same fiduciary standards as any other board of directors would be held to in deciding to adopt a defensive mechanism, the same standard as they were held to in originally approving [a rights plan]”).

10 In the three months prior to triggering Selectica’s NOL poison pill, Versata and its affiliates purchased 1,913,072
shares of Selectica’s common stock at an average price of $1.00 per share. The value of these shares at the
resumption of trading in Selectica’s common stock on February 4, 2009 was approximately $920,000. Triggering
Selectica’s pill cost Versata just under one million dollars in lost value. This cost could have been substantially
greater if Selectica had used the traditional flip-in.

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