Hunton & Williams
Corporate Law Update

October 2010

Use of NOL Rights Plan Affirmed by Delaware Supreme Court

On October 4, 2010, the Delaware Supreme Court unanimously upheld the Court of Chancery's prior decision approving the use of an "NOL rights plan." The decision, *Versata Enterprises, Inc. v. Selectica, Inc.*, involved the first modern-day triggering of a rights plan in which a stockholder intentionally crossed a plan's 4.99 percent threshold, which was designed to protect the corporation's net operating losses ("NOLs"). The Supreme Court affirmed each of the lower court's rulings under *Unocal*, including the target board's decision to adopt the NOL rights plan, dilute the acquiring person's share ownership and "reload" the rights plan to prevent subsequent stock accumulations.

Background

Our earlier client alert on the Court of Chancery's February 26, 2010, opinion provides a greater overview of the facts. In short, Selectica, Inc., adopted a rights plan with a 4.99 percent trigger to prevent it from experiencing an "ownership change" under Section 382 of the Internal Revenue Code, which would have severely limited Selectica's ability to use its NOLs to offset future taxable income.[1] Over the years, Selectica had accrued an estimated $160 million in NOLs that could be used to offset future taxable income. Trilogy, Inc., a stockholder and competitor of Selectica, intentionally triggered the rights plan in December 2008. The Selectica board attempted unsuccessfully to negotiate a standstill with Trilogy and ultimately invoked the exchange feature of the rights plan, which diluted Trilogy's share ownership from 6.7 percent to 3.3 percent by issuing one Selectica share for each right held by Selectica stockholders (other than Trilogy). The parties brought litigation in Delaware and, following a full trial, the Court of Chancery ruled in favor of Selectica and its board of directors.

[1] In very general terms, an "ownership change" occurs if the percentage of stock owned by one or more "5-percent shareholders" has increased by more than 50 percentage points over the lowest percentage of stock owned by such shareholders at any time during the relevant testing period (generally three years). To avoid a Section 382 "ownership change," many companies in recent years have adopted shareholder rights plans, commonly referred to as "NOL pills," which discourage any stockholder from accumulating approximately 5 percent or more of the company's shares and discourage any existing "5-percent shareholders" from acquiring additional shares.

Supreme Court's Opinion

The Supreme Court affirmed that the board's actions were subject to the two-pronged test set forth in *Unocal*. The *Unocal* test requires that (1) the directors must have had reasonable grounds for believing that a danger to corporate policy and effectiveness existed and (2) their response must have been reasonable in relation to that threat, meaning that it was neither preclusive nor coercive and fell within a range of reasonableness.

In applying the first prong of *Unocal*, the Supreme Court found that the record demonstrated that Selectica's board had reasonable grounds to believe Trilogy posed a threat to corporate policy and effectiveness. The Supreme Court agreed that the board had demonstrated a reasonable and good faith investigation into the threat, which was evidenced by numerous board meetings to discuss the potential value and impairment of the NOLs and by relying on advice from outside tax, financial and legal advisors.

The Supreme Court then turned to the second prong of *Unocal*. It held that the proper standard for determining whether a defensive measure is "preclusive" is whether it renders a proxy

contest "realistically unattainable."[2] With respect to Selectica's NOL rights plan, the court noted expert testimony from a proxy solicitor indicating that a 4.99 percent trigger was not an insurmountable barrier to winning a proxy contest, especially in light of Selectica's concentrated ownership. The Supreme Court also noted broadly that "[t]he key variable in a proxy contest would be the merit of the bidder's proposal and not the magnitude of its stockholdings."

The Supreme Court concluded its analysis by finding that Selectica's aggregate response — i.e., its adoption of the NOL rights plan, its decision to dilute Trilogy and the subsequent "reloading" of the poison pill — fell within a "range of reasonableness." The court noted that Selectica attempted unsuccessfully to negotiate with Trilogy and that its board minimized the dilution by using the plan's exchange feature rather than its flip-in provisions. In sum, the court found that "[t]he record indicates that the Board was presented with expert advice that supported its ultimate findings that the NOLs were a corporate asset worth protecting, that the NOLs were at risk as a result of Trilogy's actions, and that the steps that the Board ultimately took were reasonable in relation to that threat."

Conclusion

As we noted in our earlier client alert, this litigation involved a highly unusual set of facts in which, according to the Delaware Supreme Court, "a longtime competitor sought to increase the percentage of its stock ownership, not for the purpose of conducting a hostile takeover but, to intentionally impair corporate assets, or else coerce Selectica into meeting certain business demands under the threat of such impairment." The board's actions were reviewed and approved under *Unocal* on the basis of this specific threat. The Supreme Court made clear that its decision "should not be construed as generally approving the reasonableness of a 4.99% trigger in the Rights Plan of a corporation with or without NOLs." It further emphasized that a board's refusal to redeem a rights plan cannot be arbitrary and is subject to the "same fiduciary standards any other board of directors would be held to in deciding to adopt a defensive mechanism." Thus, corporations considering NOL rights plans should understand the context-specific nature of the defensive measure and rely on outside advisors to analyze the value and potential impairment of the NOLs.

If you have questions about this or other corporate law matters, please contact Gary E. Thompson, Steven M. Haas or your Hunton & Williams LLP contact.

[2] In this regard, it is notable that the Delaware Supreme Court did not address dicta in *Yucaipa Am. Alliance Fund II, L.P. v. Riggio*, which was the subject of an earlier client alert and suggested that the test for preclusion should be whether the dissident is left with a "fair chance for victory" or whether the defensive measure "unfairly tilts the electoral playing field against an insurgent."

Hunton & Williams Offices

Atlanta
Bank of America Plaza
Suite 4100
600 Peachtree Street, NE
Atlanta, Georgia 30308-2216
(404) 888-4000

Austin
111 Congress Avenue
Suite 1800
Austin, Texas 78701-4068
(512) 542-5000

Bangkok
34th Floor, Q.House Lumpini Building
1 South Sathorn Road
Thungmahamek, Sathorn
Bangkok 10120
Thailand
+66 2 645 88 00

Beijing
517-520 South Office Tower
Beijing Kerry Centre
No. 1 Guanghua Road
Chaoyang District
Beijing 100020
PRC
+86 10 5863 7500

Brussels
Park Atrium
Rue des Colonies 11
1000 Brussels, Belgium
+32 (0)2 643 58 00

Charlotte
Bank of America Plaza
Suite 3500
101 South Tryon Street
Charlotte, North Carolina 28280
(704) 378-4700

Dallas
1445 Ross Avenue
Suite 3700
Dallas, Texas 75202-2799
(214) 979-3000

Houston
Bank of America Center
Suite 4200
700 Louisiana Street
Houston, Texas 77002
(713) 229-5700

London
30 St Mary Axe
London EC3A 8EP
United Kingdom
+44 (0)20 7220 5700

Los Angeles
550 South Hope Street
Suite 2000
Los Angeles, CA 90071-2627
(213) 532-2000

McLean
1751 Pinnacle Drive
Suite 1700
McLean, Virginia 22102
(703) 714-7400

Miami
1111 Brickell Avenue
Suite 2500
Miami, Florida 33131
(305) 810-2500

New York
200 Park Avenue
New York, New York 10166-0091
(212) 309-1000

Norfolk
500 East Main Street
Suite 1000
Norfolk, Virginia 23510-3889
(757) 640-5300

Raleigh
One Bank of America Plaza Suite 1400
421 Fayetteville Street
Raleigh, North Carolina 27601
(919) 899-3000

Richmond
Riverfront Plaza, East Tower
951 East Byrd Street
Richmond, Virginia 23219-4074
(804) 788-8200

San Francisco
575 Market Street
Suite 3700
San Francisco, California 94105
(415) 975-3700

Washington
1900 K Street, NW
Washington, DC 20006-1109
(202) 955-1500

© 2010 Hunton & Williams LLP. Attorney advertising materials. These materials have been prepared for informational purposes only and are not legal advice. This information is not intended to create an attorney-client or similar relationship. Please do not send us confidential information. Past successes cannot be an assurance of future success. Whether you need legal services and which lawyer you select are important decisions that should not be based solely upon these materials.