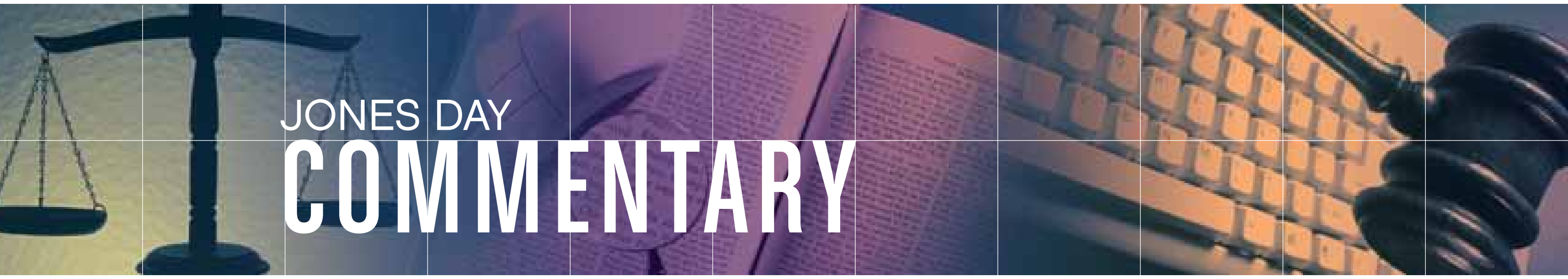
MAY 2010



SELECTICA DECISION UPHOLDS ADOPTION AND USE OF 4.99% NOL RIGHTS PLAN

Delaware Chancery Court decision:

- **reaffirms that "the legitimacy of the poison pill is settled law";**
- **endorses use of so-called "NOL rights plans"; and**
- **upholds the use of an exchange provision to dilute the proportionate ownership of an acquiror.**

On February 26, 2010, the Delaware Chancery Court upheld the adoption and use of a so-called "NOL rights plan," which is a shareholder rights plan designed to protect against the loss of certain tax assets. The decision, *Selectica, Inc. v. Versata Enters., Inc.,* C.A. No. 4241-VCN (Del. Ch. Feb. 26, 2010), arose out of the intentional triggering of Selectica's rights plan by a shareholder that acquired a sufficient number of its shares to become an "acquiring person" under the terms of Selectica's rights plan.

Selectica, a micro-cap software company, completed its initial public offering in 2000 and adopted a rights plan with a 15 percent trigger in 2003. Selectica never achieved profitability and, after years of operations, a significant part of its value was derived from its cash reserves, its intellectual property portfolio, and the potential tax benefits associated with its accumulated net operating losses, or NOLs. In mid-2008, Selectica's board of directors terminated the employment of its CEO and decided to explore strategic alternatives for the company with the assistance of an investment banker.

One of several companies that expressed an interest in acquiring Selectica was Trilogy, Inc., a Selectica competitor. Trilogy and Selectica had been adversaries in the past, and, in the mid-2000s, Trilogy had won multimillion dollar judgments against Selectica in two patent infringement suits. At that time, Trilogy also took a position in Selectica's stock and made several takeover proposals for Selectica that were rejected by the Selectica board. After Selectica began seeking acquisition proposals in mid-2008, Trilogy made several proposals to acquire Selectica or certain of its assets, none of which placed any significant value on Selectica's NOLs. Selectica's board rejected those proposals, and Trilogy refused to sign a non-disclosure agreement that would have entitled it to participate in the sale process overseen by the investment banker. Around the same time, Trilogy had been making open market purchases in Selectica's stock, and, in mid-November 2008, Trilogy and related parties filed a Schedule 13D disclosing that they owned more than five percent of the outstanding Selectica shares.

Shortly thereafter, Selectica's board amended its existing rights plan to reduce the triggering threshold to 4.99 percent of the outstanding common shares, in order to reduce the risk that its ability to use its NOLs would become restricted due to the occurrence of an "ownership change" (which would generally occur under the federal tax laws if cumulative changes in ownership by greater than 5 percent shareholders exceed 50 percent within a rolling three-year period). Rights plans that serve this purpose are known as "NOL rights plans," and have been established by dozens of public companies in recent years.

Selectica's NOL rights plan provided that individuals or groups who owned more than 4.99 percent of Selectica's shares at the time of the amendment would not trigger the plan unless and until they acquired an additional 0.5 percent of the outstanding Selectica shares. In mid-December 2008, the Trilogy parties purchased additional Selectica shares in excess of that limit, and disclosed the purchases and their purported status as an "acquiring person" under the terms of Selectica's NOL rights plan. Testimony cited in the Court's opinion indicated that Trilogy intentionally triggered the Selectica NOL rights plan in an attempt to force discussions with Selectica about the parties' relationship, including Selectica's unpaid indebtedness to Trilogy. In particular, the testimony indicated that Trilogy believed that the threat of the impending exercisability of the rights issued under the plan as a result of Trilogy becoming an "acquiring person" would accelerate discussions relating to a potential acquisition of Selectica by Trilogy. Because the Trilogy parties' investment in Selectica was worth only about $1 million, the cost to Trilogy of pursuing this strategy—in terms of the roughly 50 percent dilution that it experienced as a result of triggering the NOL rights plan—was relatively modest.

In early January 2009, Selectica announced that its board of directors had invoked the exchange provision of the rights plan, pursuant to which one Selectica common share would be issued in respect of each outstanding right issued pursuant to the plan, other than the rights held by the Trilogy parties, which would be void. As a result of the issuance of common shares pursuant to the exchange provision, the Trilogy parties' proportionate ownership of Selectica's common shares was diluted from approximately 6.7 percent to 3.3 percent. Further, since the rights issued pursuant to the existing plan expired upon the exchange, Selectica adopted a successor NOL rights plan with a three-year term and distributed the new rights to its shareholders.

Selectica's petition to the Delaware Chancery Court for declaratory judgment asserted that the actions of its board were valid under Delaware law and were appropriate exercises of its fiduciary duties under *Unocal*. Selectica asserted that its board acted reasonably in adopting and implementing the rights plans to preserve its NOLs, and that the rights plans were reasonable and proportionate responses to an identified threat to a potentially valuable corporate asset. Trilogy asserted that the Selectica board did not meet the *Unocal* standard, as it failed to establish that the NOLs were a valuable corporate asset and that Trilogy's purchases threatened their value.

The Chancery Court ultimately sided with Selectica. In its opinion, which was authored by Vice Chancellor Noble, the Court noted that "the legitimacy of the poison pill is settled law," and that "poison pills remain a common feature of the corporate landscape, and Delaware courts have repeatedly upheld their adoption as consistent with a board's fiduciary duties and business judgment." In applying the *Unocal* test to the facts at hand, the Court noted that the consideration of the employment of a rights plan for the ostensible purpose of protecting tax assets is an issue of first impression; previously, Delaware courts had only considered rights plans in the context of defense against unsolicited takeover bids. The Court acknowledged that the value of Selectica's NOLs was debatable, and that sanctioning an NOL pill would have a "somewhat unpalatable outcome of acquiescing to the expansion of the universe of reasonable takeover defenses in order to protect assets of questionable, even dubious, value." The Court determined, however, that Selectica had sufficient reason to conclude, based on the advice of experts, that the NOLs were an asset worth protecting, and that Selectica had reasonable cause to seek to protect the NOLs against the threat posed by Trilogy.

In evaluating whether the actions of the Selectica board were a reasonable response to the threat of impairment of the company's NOLs, the Court stated that while the five percent trigger for an NOL rights plan may impose a greater cost on shareholders than traditional pills, the low threshold was driven by the federal tax laws, and did not make the plan preclusive *per se*. The Court noted that preclusion is not warranted merely if "a defensive measure would make a proxy contest more difficult—or even considerably more difficult," but only if the measure would render "a proxy contest a near impossibility or else utterly moot, given the specific facts at hand." Ultimately, the Court concluded that the combination of Selectica's adoption of its rights plans and the use of the exchange provision was a proportionate response to the threatened impairment of its NOLs.

The *Selectica* case is yet another confirmation by the Delaware courts of the legitimacy of rights plans generally. The case also affirms the use of rights plans for a purpose other than defending against a contest for control, thereby expanding the breadth of the judicial sanction of these devices. Further, the Court specifically upheld the use of NOL rights plans, which have become increasingly popular as companies seek to protect tax assets associated with losses incurred during the recent economic downturn. In particular, by upholding the Selectica NOL rights plan, the Court acknowledged that the protection of an asset that is potentially valuable—but may ultimately be worthless—is a valid basis for the adoption of a defensive tactic. On that issue, the Court accorded considerable deference to the Selectica board's reliance on experts as to the value of its deferred tax assets, and cited the Selectica Board's careful and deliberative process in adopting the NOL rights plan as a defense to a threat to its corporate objectives.

While the case is most noteworthy for its affirmation of rights plans, it also provides useful commentary on takeover law generally and an interesting discussion of director independence. Among other matters, the Court considered whether proof of the board's good faith and reasonable investigation was "materially enhanced" under *Unocal* as a result of the defensive actions having been taken by a majority of outside independent directors. In this regard, Selectica asserted that each of its four directors was independent, while Trilogy claimed that three of the directors should not be considered independent. In particular, Trilogy claimed that one director's relationship with Selectica's largest stockholder, Steel Partners, tainted the director's independence, because Steel Partners was interested in preserving Selectica's NOLs for its own purposes. The Court disagreed, noting that the director held a significant portion of Selectica's stock, and concluding that there was not sufficient evidence to find that the director was dominated or otherwise controlled by Steel Partners.

Further, Trilogy asserted that two Selectica directors should not be considered independent, as they had been serving in a capacity similar to that of co-CEOs since the CEO's employment had been terminated several months before, and had been paid significant compensation in addition to their director fees for that service. Selectica responded that the management role for those directors was temporary in light of the company's expected sale, that neither of the directors desired to continue serving in a management role longer than was necessary, that the directors did not consider themselves to be Selectica employees, and that the additional compensation paid was not material to them. The Court concluded that while neither of these directors could be considered an "outside" director for purposes of material enhancement, each of them was independent under a subjective actual person analysis because they remained capable of making decisions based on the merits rather than on extraneous considerations and influences. Accordingly, although the Court declined to hold that that material enhancement applied, it appeared nonetheless to attach substantial evidentiary significance to the fact that the directors were independent. This deference to the decision-making process of directors who were determined to be independent is consistent with the emphasis placed by Delaware law on the involvement of disinterested, independent directors in a variety of contexts. As such, the *Selectica* ruling is another example of a logical outcome that results from the principle-based jurisprudence applied in the Delaware courts, which stands in sharp contrast to the prescriptive approach gripping federal legislators and regulators in the wake of the global financial crisis.

LAWYER CONTACTS

For further information, please contact your principal Firm representative or one of the lawyers listed below. General email messages may be sent using our "Contact Us" form, which can be found at www.jonesday.com.

Mark E. Betzen
+1.214.969.3704
mbetzen@jonesday.com

Lyle G. Ganske
+1.216.586.7264
lganske@jonesday.com

Jennifer C. Lewis
+1.216.586.1072
jclewis@jonesday.com

Robert A. Profusek
+1.212.326.3800
raprofusek@jonesday.com

Lizanne Thomas
+1.404.581.8411
lthomas@jonesday.com