

## **Selectica, Inc. v. Versata Enterprises, Inc.: Delaware Court of Chancery Approves Net Operating Loss Poison Pill**

On February 26, 2010, the Delaware Court of Chancery issued its decision in *Selectica, Inc. v. Versata Enterprises, Inc.*<sup>1</sup> holding that the adoption and implementation of a poison pill with a 4.99% trigger designed to protect a company's potentially valuable net operating losses ("NOLs") was a valid exercise of a board's business judgment. *Selectica* is a Delaware court's first application of *Unocal* outside of the hostile takeover context.

### **I. Background and Procedural History**

A corporation's NOLs generally may be carried forward for up to 20 years to offset the corporation's future taxable income, if any. However, under Section 382 of the Internal Revenue Code ("Section 382"), if a corporation with NOLs undergoes an "ownership change," the corporation generally will be limited in its ability to carry forward its "pre-change" NOLs. An "ownership change" generally is defined as a greater than 50% increase (by value) in the percentage of a corporation's outstanding stock that is owned in the aggregate by any one or more "five percent shareholders" (i.e., persons or public groups who, for U.S. federal income tax purposes, actually or constructively own five percent or more (by value) of the corporation's outstanding stock) over any running three year period. Only increases in ownership by five percent shareholders are taken into account—acquisitions by less than five percent shareholders generally cannot cause or contribute to an ownership change.

Section 382 imposes an annual limitation on the amount of pre-change NOLs that can be carried forward to offset taxable income in any "post-change" taxable year. Subject to certain adjustments, the annual limitation generally equals the product of (a) the fair market value of the corporation's outstanding stock immediately prior to the ownership change and (b) an interest rate set monthly by the Treasury Department that tracks the current yield on long term tax-exempt municipal obligations. For a corporation with significant NOLs and a relatively small market capitalization, an ownership change may lead to a severe restriction on the corporation's ability to carry forward its NOLs.

Selectica, a microcap enterprise software company, accumulated approximately \$160 million in NOLs since its IPO in 2000, almost seven times its \$23 million market capitalization. In 2008, Selectica received and rebuffed several offers to be acquired by Trilogy, Inc.,<sup>2</sup> its principal, and often litigious, rival. After Trilogy purchased over 6% of Selectica's shares in the open market, Selectica's NOLs became vulnerable because 40% of Selectica's shares had already changed ownership over a three year period; a change in 10% of the float would significantly impair the company's potentially valuable NOLs. In order to preempt an ownership change, Selectica's board amended its shareholder rights plan—or "poison pill," adjusting the plan's 15% threshold trigger to 4.99% and adding a 0.5% trigger applicable to existing 5% shareholders. Trilogy deliberately bought through the pill's trigger.<sup>3</sup> After Trilogy refused Selectica's requests to enter standstill negotiations, Selectica

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<sup>1</sup> C.A. No. 4241-VCN, 2010 WL 703062 (Del. Ch. Feb. 26, 2010).

<sup>2</sup> Trilogy is the parent of Versata Enterprises, Inc.

<sup>3</sup> An intentional trigger of a poison pill is a rare event. We believe that Trilogy's trigger of Selectica's pill is the first intentional trigger in over two decades. Trial testimony suggested that Trilogy triggered Selectica's pill with the intention to cause an ownership change under Section 382 and thus spoil its chief competitor's potentially valuable NOLs. 2010 WL 703062, at \*7 n.63.

instituted the pill's share exchange, diluting Trilogy's ownership from 6.7% to 3.3%. Selectica sought a declaratory judgment.

## II. Delaware Court of Chancery's Decision

In a post-trial memorandum opinion, the Delaware Court of Chancery held that the Selectica board's adoption and implementation of the NOL pill was a valid exercise of its business judgment under the Delaware Supreme Court's *Unocal* standard because the board reasonably believed that there existed a threat to a corporate objective, and the pill's low threshold was reasonable in light of Section 382's requirements.<sup>4</sup>

First, the court held that while "protecting NOLs is a distinct departure from the poison pill's originally intended use,"<sup>5</sup> the Selectica board showed that it had reasonable grounds to conclude that a threat to a corporate objective existed. At the outset, the court acknowledged "the somewhat unpalatable outcome" of expanding business judgment rule protection to low-threshold poison pills designed "to protect assets of questionable, even dubious, value."<sup>6</sup> Nonetheless, the court maintained that, despite the fact that "NOL value is inherently unknowable *ex ante*,"<sup>7</sup> a board may consider its NOLs a valuable asset worth protecting from threatened impairment if the board reached its conclusion reasonably and relied on experts. Noting that Selectica's board employed experts on several occasions to quantify the potential value of its NOLs and to analyze the prudence of taking steps to protect such potential value,<sup>8</sup> the court held that the board "was reasonable in concluding that Selectica's NOLs were worth preserving and that Trilogy's actions presented a serious threat to their impairment."<sup>9</sup>

Second, taking into consideration the unique circumstances that induced the Selectica board's amendment and implementation of its NOL pill, the court held that the board's defensive response was neither preclusive nor coercive and was reasonable in relation to the threat posed by Trilogy. The court held the NOL pill not preclusive or coercive because a successful proxy contest, while perhaps unlikely in light of Selectica's staggered board, was not "mathematical[ly] impossib[le] or realistic[ly] unattainable."<sup>10</sup> Moreover, the NOL pill was a reasonable response to Trilogy's stock purchases under the circumstances: Selectica's competitor in a narrow market, Trilogy, disclosed its intent to impair Selectica's NOLs. In addition, while the 4.99% pill trigger was low relative to more customary 15% triggers, it was not unprecedented, and it tracked an external standard beyond the board's control—Section 382 of the tax code.

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<sup>4</sup> In *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985), the Delaware Supreme Court declared that, with regard to a board's adoption of a poison pill, "[i]f a defensive measure is to come within the ambit of the business judgment rule, it must be reasonable in relation to the threat posed." 493 A.2d at 956.

<sup>5</sup> 2010 WL 703062, at \*15.

<sup>6</sup> *Id.*

<sup>7</sup> *Id.*

<sup>8</sup> Selectica sought advice from an accountant who specialized in NOL analysis, an investment banker and the company's Delaware counsel.

<sup>9</sup> 2010 WL 703062, at \*19.

<sup>10</sup> *Id.* at \*21.

### III. Significance of the Decision

In *Selectica*, the Delaware Chancery Court confirmed that in appropriate circumstances a Board of Directors can satisfy the *Unocal* standard and adopt, and refuse to defuse, a poison pill.<sup>11</sup> In this case, the plan was designed to protect the company's potentially valuable net operating losses.

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If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or email Charles A. Gilman at 212.701.3403 or [cgilman@cahill.com](mailto:cgilman@cahill.com); Jon Mark at 212.701.3100 or [jmark@cahill.com](mailto:jmark@cahill.com); John Schuster at 212.701.3323 or [jschuster@cahill.com](mailto:jschuster@cahill.com); Craig Horowitz at 212.701.3856 or [chorowitz@cahill.com](mailto:chorowitz@cahill.com); Doug Horowitz at 212.701.3036 or [dhorowitz@cahill.com](mailto:dhorowitz@cahill.com); or Andrew Jacobs at 212.701.3866 or [ajacobs@cahill.com](mailto:ajacobs@cahill.com).

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<sup>11</sup> See *id.* at \*15 n.136, quoting *Paramount Comm'cs, Inc. v. Time, Inc.*, 571 A.2d 1140, 1153–54 (Del. 1990), “The usefulness of *Unocal* as an analytical tool is precisely its flexibility in the face of a variety of fact scenarios.”