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# DELAWARE SUPREME COURT AFFIRMS USE OF NET OPERATING LOSS POISON PILLS

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In the recent case, *Versata Enterprises, Inc. and Trilogy, Inc. v. Selectica, Inc.,* the Delaware Supreme Court upheld the Delaware Chancery Court's ruling that the use of a net operating loss poison pill was valid.[1] This holding is significant because it is the first time the court has examined the validity of a net operating loss poison pill and, further, the first time the court has ruled on any pill that was actually triggered.

Poison pills are common anti-takeover devices used by public companies. They provide a mechanism by which an unwanted bidder suffers an extreme dilution of its equity position if it crosses a specified ownership threshold by having additional equity issued in exchange for "rights" granted to the company's stockholders other than the unwanted bidder. A net operating loss poison pill or 382 poison pill (NOL pill) is a variation on the general poison pill and is used to protect a company's net operating loss which can be used to shelter future income (or, generally speaking, income over the prior two years) from taxation. Under section 382 of the Internal Revenue Code, a company which experiences an ownership change (as described in the next sentence) in a three-year period is prevented from using any net operating loss occurring before that ownership change. Generally, an ownership change occurs for this purpose when more than 50 percent of a company's stock ownership changes; however, only those shareholders holding a 5 percent or greater block of the company's outstanding stock are considered in calculating this change.

Poison pills, including NOL pills, are among the most important anti-takeover defenses that public companies should consider. NOL pills should be considered by any company with substantial operating losses. There are a number of factors for a company to analyze when determining whether to institute an NOL pill or other forms of poison pills, including the control dynamics (ownership blocks, cash position, etc.) applicable to that company.

Throughout 2008, Versata, a competitor of Selectica and a wholly owned subsidiary of Trilogy made several proposals to purchase Selectica which were declined. On November 13, 2008, Versata disclosed that it had increased its stock ownership in Selectica to 5.1 percent. Four days later, Selectica's board met and voted to amend the trigger on its NOL pill from 15 percent to 4.99 percent. This change exempted any shareholders currently holding 5 percent of the company's stock and permitted them to acquire up to 0.5 percent additional stock without triggering the pill. After unsuccessful meetings between Versata and Selectica subsequent to this amendment on December 18, 2008, Versata purchased an amount of additional shares sufficient to exceed the 0.5 percent cushion provided by the amended NOL pill. The amended NOL pill permitted Selectica to grant an exemption to anyone who exceed the 4.99 percent ownership if they would not endanger the net operating losses of the company. This exempt status was offered to Versata three times, and three times it declined. As a result, Selectica's board decided to exercise the NOL pill's exchange provision, exchanging all rights (except those owned by Versata) for one share of common stock, thereby diluting Versata's ownership of stock to 3.3 percent.

The Delaware Supreme Court validated the amended NOL pill plan and the exercise of the exchange by Selectica, finding that the board's actions were a valid exercise of its business judgment under the *Unocal* standard. Under the *Unocal* standard, a company must show that it had reasonable grounds for believing there was a danger to the corporation and that the response to such danger was reasonable. The court explained that Selectica had reasonable grounds to

1 Versata Enterprises, Inc. and Trilogy, Inc. v. Selectica, Inc., No. 193, 2010 (Del. Oct. 4, 2010)

believe that Versata's action posed a threat to Selectica's use of its net operating losses, specifically pointing to the three failed negotiation attempts with Versata. Further, the court held that Selectica's decision to trigger the NOL pill was a reasonable reaction to achieve a valid corporate objective because the thorough investigation by Selectica demonstrated the net operating losses were an asset worth being protected. The court placed significant weight on the process the Selectica board followed in reaching its decision. Selectica had engaged outside experts, both tax and financial, to advise it on the value of its net operating losses and the risk Versata's actions posed. Additionally, the court found that Selectica's actions were not unlawfully preclusive, explaining that the NOL pill did not meet the standard of making a bidder's ability to wage a successfully proxy contest realistically unattainable. The court reasoned that, although it would have been more difficult for Versata to gain control of Selectica with the NOL pill terms, it was not unrealistic.

The holding in *Versata* establishes that, under the right factual setting, NOL pills will be upheld, even when triggered. Important consequences of this decision are:

- NOL pills with a trigger below 15 percent will not be automatically invalid under Delaware law, but will be examined closely and will be upheld so long as they respond to a specific corporate threat in a reasonable manner.
- NOL pills must not be so preclusive as to render a successful control contest reasonably impossible, but they can make such a contest difficult without being held invalid.
- When instituting an NOL pill, companies should engage in a thorough process of investigation and engage outside experts as appropriate.
- NOL pills amended in the face of a potential hostile bidder will not be held *per se* invalid.
- In considering the adoption of an NOL pill, companies should be aware that the Institutional Shareholder Services, a leading provider of corporate governance services, recommends against an NOL pill that has a term longer than the shorter of three years or the remaining life of the company's net operating losses.

Poison pills continue to be the subject of litigation in a number of aspects. For example, in the next few weeks the Delaware Chancery Court is expected to make a decision in a case relating to the attempted hostile takeover of Airgas, Inc. by Air Products & Chemicals, Inc. The issue in that case involves whether there is a point at which the board has the obligation to revoke an otherwise valid poison pill.



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