A few weeks ago, the Delaware Court of Chancery validated the shareholder rights plan (commonly known as a poison pill) implemented by Selectica Inc. in order to preserve its net operating loss carry forwards, or NOLs. Selectica is an enterprise contract management business that was a product of the dot-com boom. Despite never turning a profit, Selectica adopted an NOL poison pill to preserve $160 million of accumulated losses.

For the company, these losses became an important strategic asset because they could be carried forward to reduce future taxable income. NOLs are also attractive from an acquirer’s perspective for the same reason. A company’s ability to offset future taxable income using NOLs, however, is limited under Section 382 of the Internal Revenue Code if a company undergoes a “change of ownership” of more than 50 percentage points by one or more of its 5% shareholders within a three-year period.

Under a traditional poison pill, shareholders receive “rights” to purchase shares of a company’s capital stock at a substantial discount in the event that a third party acquires a certain amount of the target company’s stock (often between 15% and 20%). If triggered, the dilutive effect of a poison pill can make a hostile acquisition prohibitively expensive. As such, a poison pill can be an effective defensive measure to fend off unwanted suitors. A NOL poison pill operates in much the same way, except that the triggering threshold is set at 4.99% to limit the number of 5% shareholders for purposes of the Section 382 calculation.

On Nov. 13, 2008, Versata Enterprises Inc. announced that it had accumulated a 5.1% interest in Selectica and was contemplating a full takeover. This announcement followed a contentious history, including an unsuccessful 2005 bid by Versata to acquire Selectica. Selectica responded on Nov. 17, 2008, by lowering the triggering threshold of its existing poison pill from 15% to 4.99%, grandfathering existing 5% holders (including Versata) so long as such holders did not acquire more than an additional 0.5% stake.

Undeterred, Versata purchased an additional 154,061 shares of Selectica’s common stock on Dec. 18 and 19. By purchasing more than 0.5% of Selectica’s then-outstanding stock, Versata became one of the first shareholders to intentionally trigger and swallow a modern poison pill.

After negotiations between Selectica and Versata to limit future share purchases failed, Selectica proceeded to effect a cashless exchange of its outstanding rights for its common stock on a one-for-one basis, thereby diluting Versata’s ownership interest from 6.7% to 3.3%. Selectica also filed a lawsuit against Versata on Dec. 21, 2008, seeking a declaratory judgment that its actions were valid. In its answer, Versata argued, among other things, that Selectica’s board violated its fiduciary duties in adopting and enforcing the NOL poison pill and that the NOL poison pill was unreasonable, given Selectica’s inability to generate profits.

In its decision to validate the Selectica NOL poison pill, the Delaware Court, applying the Unocal standard, determined “the protection of company NOLs may be an appropriate corporate policy meriting defensive response when threatened.” This analysis is particularly striking because Selectica had never generated taxable income and the Selectica board did not have a specific plan for how the NOLs would be used in the future. Nonetheless, the court noted that while “NOL value is inherently unknowable ex ante, a board may properly conclude that the company’s NOLs are worth protecting where it does so reasonably and in reliance on expert advice.” The court further determined that the 4.99% threshold combined with a staggered board was not preclusive under the second prong of Unocal despite Versata’s assertion that such combination rendered a change in board control “realistically unattainable.” In reaching its decision, the court stated that in order to “find a measure preclusive (and avoid the reasonableness inquiry altogether) the measure must render a successful proxy contest a near impossibility or else utterly moot.” In evaluating the reasonableness of Selectica’s response relative to the threat posed by Versata, the court held that the adoption of the lower
threshold NOL poison pill, the dilutive rights exchange and the reloaded NOL poison pill together constituted a “proportionate response to the threatened loss of Selectica’s NOLs.”

Although a sound defensive tactic, the Selectica case illustrates that a shareholder rights plan is not a perfect deterrent to stock accumulations that jeopardize NOL assets. Moreover, once Selectica’s poison pill was triggered, navigating the poison pill mechanics caused a significant disruption in the stock’s trading. In fact, the stock stopped trading for several weeks while beneficial holders were identified and mechanics associated with the exchange feature of the poison pill were resolved. Therefore, practitioners ought to at least consider other options -- in addition to a NOL poison pill -- to discuss with clients seeking to insulate NOLs. For example, certain companies may consider adopting specific ownership limitations in their organizational documents, coupled with a mechanism designed to “sterilize” shares purchased in excess of the applicable threshold. To address corporate governance concerns, companies could incorporate a reasonable sunset provision in connection with any ownership limitations. Charter-mandated ownership restrictions are commonly used in the real estate investment trust context. To preserve favorable tax treatment, REITs limit the ownership stake that may be held by an individual or related group. If the ownership threshold is crossed, the violative transfer either becomes void ab initio or the charter provides for an immediate forced transfer of all shares in excess of the applicable threshold to a charitable trust. While amending organizational documents is more cumbersome because it requires a shareholder vote, ultimately, this approach may prove to be a stronger protection mechanism for several reasons. First, it would outline a clear sanction for any unsolicited acquirer that violates the ownership restrictions. Second, because the protective mechanism involves only one shareholder’s shares, it should cause minimal, if any, trading disruptions. And, lastly, voiding the impermissible transaction ab initio or providing for the immediate transfer of the excess shares to a charitable trust should ameliorate the Section 382 calculations. In addition, from a litigation perspective, the shareholder approval process required for a charter amendment obviates the need to live up to the heightened Unocal analysis currently in place for board-adopted shareholder rights plans.

A charter amendment, it is worth noting, may present challenges from a corporate governance perspective. Corporate governance watchdogs, as well as potential acquirers, can make sound arguments that tinkering with organizational documents may lead to entrenchment of arguably poor managers and a possible loss of shareholder value. Good arguments also exist on the other side, particularly if the NOL assets are significant and appropriate care is taken to limit the duration of any ownership restrictions. Ultimately, in the context of possible charter amendments, shareholders -- and potentially courts -- will need to weigh the relative value of preserving a company’s NOL assets against the issues surrounding ownership limitations.

For now, the Selectica decision reinforced that “the legitimacy of the poison pill is settled law” and extended the tradition of Delaware courts upholding poison pills into a new context -- NOL poison pills. Although the court noted that all shareholder rights plans “must be subject to careful review,” the Court stated “it is not for the court to second-guess the board’s efforts to protect Selectica’s NOLs.” Based on this decision and given the earnings damage done to many companies in light of recent economic events, a NOL poison pill is a measure certainly worth considering.

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