NOL Pill Reloaded: *Selectica, Inc. v. Versata Enterprises, Inc.*

*By Robert T. Miller**

The poison pill is the paradigm anti-takeover device. As everyone involved in corporate law knows, under the terms of a typical pill, if a hostile acquirer purchases more than a designated percentage (usually fifteen percent) of the target company's stock without the board's consent, then all the other shareholders of the target receive new shares of the target's stock, thus massively diluting the acquirer's stake in the target. The acquirer thus fails to obtain voting control of the target and loses a significant part of its investment as the dilution transfers wealth from it to the other target shareholders.[1] Although the mechanics of a typical poison pill are much more complex than such a summary indicates,[2] the general effect of the pill is well-known: potential acquirers facing a target protected by a pill do *not* trigger the pill. They either negotiate with the target board to reach a friendly deal, or, failing that, they couple a tender offer conditional on the withdrawal of the target's pill with a proxy contest to replace the target's board with nominees pledged to complete a deal with the acquirer. In practice, although pills thus afford target boards significant time and leverage to negotiate with acquirers, a determined acquirer willing to pay a price that the target shareholders find attractive and bear the additional costs and delays involved in waging a proxy contest can be reasonably certain of eventually obtaining control of the company. Despite continuing criticism from academics and shareholder organizations like RiskMetrics, poison pills are still widely used by public companies in the United States, and the Delaware Supreme Court regards the legal validity of conventional poison pills as settled law.[3]

The poison pill can also be used for a quite different purpose, however—namely, to protect a company's net operating losses. This requires some background explanation.

Under applicable provisions of the Internal Revenue Code, when a company experiences a loss because its expenses exceed its income, it generally becomes entitled to use the loss to shelter future income from taxation.[4] Such net operating losses (NOLs) can generally be carried forward for twenty years, and so NOLs can be a valuable asset, lowering the company's tax liability and increasing its cash flow. NOLs are a contingent asset, however, because they have value only if the company has profits to shelter with them. If they are unused at the end of their twenty-year life, they expire and provide no value to the company. In general, only companies that have been consistently *unprofitable* over several years accumulate large quantities of NOLs. Valuing these NOLs is thus very difficult, for the question becomes whether a company that has consistently lost money for a considerable period will be able to generate profits in the future and, if so, how great will those profits be.

An obvious strategy for a money-losing company with accumulated NOLs would be to sell itself to a profitable acquirer that could then use the NOLs to shelter the income from its own profitable operations. Precisely to prevent such tax-driven transactions, Section 382 of the Internal Revenue Code severely limits the use of NOLs following an "ownership change." The definition of "ownership change," not surprisingly, is very complex, but the basic idea is that a company experiences an ownership change under Section 382 if more than fifty percent of its shares change hands within a three-year period, counting for such purposes only those shares in the hands of shareholders holding more than five percent of the company's shares. A straightforward acquisition of the company by another entity would, therefore, generally result in an "ownership change." That said, there may be certain kinds of strategic transactions in which the value of NOLs can be preserved. Hence, at least for certain counterparties, a target company's NOLs may be a source of value in a potential business combination.

For our purposes, however, the important point is that under Section 382, even relatively small changes in share ownership by the company's major shareholders can, at least by their aggregate effect, cause an ownership change. Hence, a company with a significant amount of NOLs that it wishes to protect against an unintended ownership change may well want to prevent parties owning less than five percent of the company's stock from becoming five-percent shareholders and want to prevent existing five-percent shareholders from increasing their stakes in the company. We thus come back to the relevance of a poison pill. A pill with a five-percent (or slightly lower) trigger will deter the kinds of transactions that could imperil the company's NOLs.

So-called NOL pills are thus in common use among companies with significant amounts of NOLs. Mechanically, they work substantially like conventional poison pills. They have, however, at least two important differences. First, if honestly adopted by the board to preserve the company's NOLs, an NOL pill will have a substantial anti-takeover effect even though the board may not in any way intend such an effect. The effect will be *foreseen*, but not *intended*. Second, by setting the triggering threshold at five percent (or slightly lower)—and thus well below that used in the typical pill—NOL pills have a significantly greater anti-takeover effect than conventional pills. Such pills are thus rather anomalous: not intended to deter takeovers, they in fact do deter takeovers even more than conventional poison pills. Nevertheless, because of their value in protecting NOLs, many public companies with significant NOLs have adopted them, and RiskMetrics has announced that in making recommendations to shareholders it will consider NOL pills on a case-by-case basis, taking account of such factors as the triggering threshold, the value of the NOLs, the term of the pill, and any sunset or similar features.[5]

In this context, it may seem fairly clear that, at least in general, NOL pills would be legal under Delaware law. This proposition was tested in the Delaware Court of Chancery (Vice Chancellor Noble) in *Selectica, Inc. v. Versata Enterprises, Inc.*[6] Under facts quite favorable to the target company, the Court

* *Robert T. Miller is an Associate Professor of Law at the Villanova University School of Law.*

of Chancery upheld the NOL pill in all respects, not only as to its adoption but also as to its implementation when triggered *and* its re-adoption after implementation. *Selectica* is thus the first case in the modern era in which a potential acquirer has triggered a pill and suffered the attendant dilution. The holding of the case, however, has relatively limited precedential value other than in connection with NOL pills, not only because NOL pills are always significantly different from typical pills but also because of facts peculiar to the case highly favorable to the target company. In this brief article, I shall (a) summarize the key facts in the case, (b) describe Vice Chancellor Noble's straightforward application of the *Unocal* doctrine[7] to uphold the NOL pill, and then (c) make some observations about the implications of the case for Delaware take-over law generally. I note in addition that an appeal in the case is currently before the Delaware Supreme Court. The conclusions expressed here are, therefore, merely tentative, pending the decision of that court.

I. Facts in Selectica v. Versata Enterprises

Selectica, Inc. (Selectica) is a Delaware corporation and micro-cap company whose common shares trade on the Nasdaq Global Market, and it is in the business of providing enterprise software solutions for contract management and sales configuration systems.[8] Since becoming a public company in 2000, Selectica has never had an annual profit and had thus accumulated approximately $160 million in NOLs.[9] At the time of the relevant events, its market capitalization was only about $23 million, and by its own admission its value consisted primarily of its cash reserves, its intellectual property, its customer base, and its NOLs.[10]

Trilogy, Inc. (Trilogy) is a private company and a competitor of Selectica, and Versata Enterprises, Inc. (Versata) is a subsidiary of Trilogy. Even prior to the events in the case, Trilogy and Selectica had a contentious relationship. In particular, over several years leading up to the events at issue in the case, Trilogy had successfully sued Selectica for patent infringement, securing a $7.5 million judgment; had repeatedly offered to acquire the company and been rebuffed; and had called attention to the fact that Selectica had back-dated certain stock option grants,[11] with the result that the company's chief executive officer, who had been its chief financial officer at the time of the backdating, resigned.[12] In addition, Trilogy had again sued Selectica for patent infringement, but this time the suit was settled with Selectica agreeing to pay Trilogy $10 million immediately and another $7.5 million over time.[13] Trilogy was thus a major creditor of Selectica. Although Trilogy had owned a significant number of Selectica shares at various times prior to the events in the case, after the settlement of this last dispute between the companies, Trilogy sold off all of its holdings in the company.[14]

In July of 2008, with the company still losing money, the Selectica board decided that the company needed to change course, and it terminated the chief executive officer and eliminated a number of other senior management positions in its key sales configuration business.[15] After receiving several unsolicited acquisition proposals in the course of a few weeks,[16] the board announced that it was exploring strategic alternatives and engaging a financial advisor to assist it in so doing.[17] Also in July of 2008, Trilogy offered to acquire the company, either by purchasing all of Selectica's sales configuration assets in exchange for cancelling the $7.1 million debt Selectica still owed Trilogy, or else by purchasing all of Selectica's assets for the cancellation of the same debt plus $6 million in cash.[18] Trilogy indicated that it was not interested in Selectica's NOLs and that, in both cases, Selectica's NOLs would remain behind with the historic Selectica entity so that they could be utilized in a subsequent transaction by that entity.[19] The Selectica board rejected both of these proposals.[20]

In October of 2008, Selectica's financial advisor began actively canvassing the market.[21] About the same time, Trilogy made another proposal to acquire all of Selectica's assets, this time for $10 million in cash plus the cancellation of debt, but the Selectica board rejected this proposal as well.[22] Although Selectica invited Trilogy to participate in the sales process it was conducting,[23] Trilogy declined to sign the non-disclosure agreement that Selectica was requiring of all participants in its process.[24] Also, unknown to the Selectica board, Trilogy began making open-market purchases of Selectica stock.[25] Meanwhile, Selectica's sales process continued, with several parties showing varying degrees of interest, many of them apparently quite serious.[26]

On November 10, Trilogy informed Selectica that it had accumulated more than 5 percent of Selectica's common stock and that it would shortly be filing a Schedule 13D with the Securities and Exchange Commission. A representative of Trilogy explained to a representative of Selectica that Trilogy was accumulating Selectica shares because it believed that Selectica "should work quickly to preserve whatever shareholder value remained and [Trilogy was] interested in seeing this process that [Selectica] announced . . . accelerate."[27] Soon thereafter, Trilogy purchased additional shares representing an additional one percent of the Selectica common stock, bringing its total stake to just over six percent.[28]

The Selectica board then inquired of its tax and other advisors about the potential effects on Selectica's NOLs of Trilogy's crossing the five-percent threshold.[29] Its advisors concluded that, because of other transactions by other shareholders in the past, after Trilogy's recent purchases, Selectica had already experienced a forty-percent change in ownership for Section 382 purposes, and thus if there were another ten-percent change, the company would undergo an ownership change within the meaning of Section 382 and the value of the company's NOLs would be impaired.[30] After extensive consultation with its advisors, the board unanimously resolved to amend its existing shareholder rights plan, which had a conventional fifteen-percent trigger, in order to reduce the trigger to 4.99 percent. The amendments to the plan also grandfathered existing five-percent shareholders, including Trilogy.[31] The board simultaneously established a committee of independent directors to review the rights agreement periodically, including the triggering percentage, and to determine whether the agreement continued to be in the best interests of the company.[32]

Just days later, Trilogy sent Selectica a letter asserting that Selectica had violated the settlement agreement from their prior dispute and seeking a meeting to discuss the purported breach.[33] At trial, Selectica contended that Trilogy then threatened to trigger Selectica's NOL pill unless Selectica agreed to Trilogy's efforts to extract additional money from the company.[34] Although Vice Chancellor Noble did not expressly say whether he credited this contention, it appears that he did.[35] On December 18 and 19, Trilogy purchased additional Selectica shares, bringing its total ownership to 6.7 percent and thus becoming an "Acquiring Person" under Selectica's NOL pill.[36] Trilogy's controlling shareholder would later testify that in intentionally triggering Selectica's pill, Trilogy was trying to "bring accountability" to the Selectica board and "expose" what he characterized as its "illegal behavior" in adopting a pill with such a low trigger.[37] Soon thereafter, a Trilogy representative proposed that Selectica repurchase all of Trilogy's stock in Selectica, accelerate the repayment of the debt owed to Trilogy, make certain other commercial concessions, and pay Trilogy $5 million in cash to settle all outstanding issues between the parties.[38] Trilogy's representative also indicated that Trilogy had triggered the NOL pill "to get [Selectica's] attention" and "force the [Selectica] board to make a decision."[39]

Under the terms of the NOL pill, the Selectica board had ten days to determine whether a party triggering the pill would not endanger the availability to the company of the NOLs. If it made such a determination, the board could declare that party an exempt person, and the pill would not go into effect. If it failed to make such a determination, the board would have two options.[40] Either, it could implement the pill by exchanging each outstanding right for one newly issued share of Selectica common stock (the Exchange) or else allow the rights to "flip-in," in which case each right would become an exercisable option to purchase $36 worth of newly-issued common stock at a price of $18 per right.[41] During the ten-day period, Selectica repeatedly attempted to negotiate a standstill agreement with Trilogy but was rebuffed.[42]

Also during this ten-day period, the board met repeatedly with its advisors. Its tax advisors discussed the amount of its NOLs, the risk of a Section 382 ownership change, and the likely tax effects of implementing the pill through the Exchange or through the flip-in.[43] Its financial advisors discussed the value of the NOLs in connection with various potential strategic transactions the company was pursuing and reiterated its opinion that an ownership change would reduce the value of the company.[44] The board also discussed Trilogy's demands and found that they were "highly unreasonable."[45] The board concluded that Trilogy's actions were "very harmful to [Selectica]" and that implementing the NOL pill was "reasonable in relation to the threat imposed by Trilogy."[46] After Trilogy once again refused to enter a standstill agreement, the board determined that the pill should be implemented and that employing the Exchange was preferable to allowing the pill to flip-in.[47] On January 2, the board delegated authority to the committee of independent directors to determine whether the pill should be implemented; whether, if implemented, the company should employ the Exchange option or the flip-in; and whether the company should declare a new dividend of rights reloading the pill.[48] The committee then met and received presentations from the company's advisors reiterating that the NOLs were a valuable corporate asset, that the NOL pill would help protect the NOLs, and that Trilogy's actions posed a threat to the NOLs.[49] The committee then concluded that Trilogy should not be deemed an exempt person under the pill, that the company should exercise the Exchange option to exchange one common share for each right, and that the company should declare a new dividend of rights substantially similar to the rights being redeemed.[50] In this way, the Exchange doubled the number of shares outstanding owned by the company's shareholders other than Trilogy, thus reducing Trilogy's interest in the company from about 6.7 percent to about 3.3 percent.[51]

Selectica then sued Versata and Trilogy, seeking a declarative judgment that its actions in adopting the NOL pill, implementing it through the Exchange option, and then reloading the pill were legal.[52] Trilogy counterclaimed, alleging that all these actions were invalid, void, and unenforceable and seeking monetary damages for alleged breaches of fiduciary duty by members of Selectica's board of directors, as well as orders enjoining or rescinding the Exchange and requiring Selectica to redeem the rights dividended to reload the pill.[53]

II. Vice Chancellor Noble's Legal Analysis

After noting that Delaware law has long recognized the validity of conventional poison pills,[54] Vice Chancellor Noble reviewed under *Unocal*[55] the Selectica board's actions in connection with the NOL pill. That is, he inquired whether the directors had shown that (a) "they had reasonable grounds for believing that a danger to corporate policy and effectiveness existed,"[56] and (b) their "defensive response was reasonable in relation to the threat posed."[57] Interpreting *Unocal* in accordance with *Unitrin*,[58] he noted that "a defensive measure is disproportionate (i.e., unreasonable) if it is either coercive or preclusive" or else otherwise disproportionate to the threat posed.[59]

As to the first part of the *Unocal* inquiry, in determining whether the Selectica board had reasonable grounds for concluding that Trilogy's actions posed a threat to the corporation, the court understood this question as turning on whether the NOLs had value—i.e., whether they were a legitimate asset of the company. Here, Vice Chancellor Noble first noted that the value of NOLs depends on the company's having income in the future that the NOLs can shelter and thus, since the future profitability of the company is unknowable, the "NOL value is inherently unknowable ex ante."[60] Nevertheless, "a board may properly conclude that the company's NOLs are worth protecting where it does so reasonably and in reliance on expert advice,"[61] and so the court concluded that "the protection of company NOLs may be an appropriate corporate policy meriting a defensive response when threatened."[62] Indeed, observing that NOL pills, in contradistinction from conventional pills, are aimed at protecting a particular corporate asset and only incidentally at deterring takeover efforts, the Vice Chancellor even stated that "the protection of corporate assets against an outside threat is arguably a more important concern of the Board than restricting who the owners of the Company might be."[63]

As to the second part of the *Unocal* inquiry, in determining whether the Selectica board's response to the perceived threat was reasonable, Vice Chancellor Noble followed the usual *Unocal-Unitrin* inquiry by first determining whether the NOL pill was preclusive or coercive.[64] Since Trilogy did not allege that Selectica's NOL pill was coercive,[65] this inquiry reduced to whether the pill was preclusive—that is, whether it "makes a bidder's ability to wage a successful proxy contest and gain control either 'mathematically impossible' or 'realistically unattainable.'"[66]

On this issue, the parties produced conflicting expert testimony. Professor Allen Ferrell (for Trilogy) argued that the low (4.99 percent) trigger of an NOL pill, coupled as it was in Selectica's case with a classified board, made winning a proxy contest realistically unattainable because the effort would have to be sustained through two annual elections of directors and the low ownership interest of the potential acquirer would make the potential acquirer appear less credible in the eyes of other shareholders and exacerbate the free-rider problem[67] faced by all insurgent investors fielding slates of candidates for the board.[68] Professor Ferrell further noted that, as of the time of the case, there had been no instance of a dissident shareholder with less than a five-percent stake successfully obtaining control of a micro-cap company with a classified board.[69] On the other hand, Peter C. Harkin of the D.F. King & Co. proxy solicitation firm (for Selectica) identified fifteen proxy contests at microcap companies in which the challenger held a less than 4.99 percent stake, and among these the challenger successfully obtained board seats in ten, including five in which the target company had a classified board,[70] though in none of these had the insurgent gained control of the board. Furthermore, although Trilogy's expert testified that an NOL pill coupled with a classified board "has a substantially preclusive effect," he nevertheless had to admit that it was "not 100 percent preclusive" and that there remained a "theoretical possibility"[71] of an acquirer winning a proxy contest. In the end, therefore, Vice Chancellor Noble held that Selectica's NOL pill, even coupled with its classified board, was not preclusive within the meaning of *Unitrin*. "To find a measure preclusive . . . the measure must render a successful proxy contest a near impossibility or else utterly moot, given the specific facts at hand."[72]

The Vice Chancellor then turned to the reasonableness of the NOL pill in relation to the threat posed. As to the adoption of the NOL pill, the Vice Chancellor observed that "Trilogy . . . failed to suggest any meaningfully different approach that the [Selectica] Board could have taken . . . to avoid the seemingly imminent impairment of Selectica's NOLs by Trilogy."[73] As to Selectica's actions after Trilogy had chewed through the pill, the court noted that Selectica repeatedly sought a standstill agreement with Trilogy and was rebuffed,[74] and that implementing the pill through the Exchange rather than the flip-in "was a more proportionate response" that caused Trilogy to "experience[] less dilution in its position than a poison pill is traditionally designed to achieve."[75] Finally, as to reloading the NOL pill by declaring a new dividend of rights, since, after the Exchange, Trilogy could have purchased additional shares in order to cause Selectica to suffer a Section 382 ownership change absent additional action by Selectica, "the implementation of the Reloaded NOL Pill was a similarly reasonable response in the context of Selectica's other defensive measures."[76]

The court concluded that "the combination of the NOL Pill, the Exchange, and the Reloaded NOL Pill was a proportionate response to the threatened loss of Selectica's NOLs."

III. Observations on the Implications of the Case

Any definitive interpretation of the *Selectica* case must await the opinion of the Delaware Supreme Court in the pending appeal, but subject to that qualification, I think we can draw several conclusions. First and foremost, the *Selectica* case stands for the proposition that NOL pills, like conventional poison pills, are legal in Delaware—a result that surprised probably no one.

That said, the inquiry involved in the case was a *Unocal* inquiry—that is, one concerning the reasonableness of the board's actions, and so one dependent on the totality of the facts and the circumstances. In *Selectica*, those facts and circumstances inclined strongly in favor of the target company. For, not only did the Selectica board use impeccably good procedure in deciding to adopt, implement, and reload its NOL pill, but the Vice Chancellor apparently also concluded that Trilogy was a bad actor. Although this is not perfectly explicit in his findings of fact, at the very end of the opinion the Vice Chancellor is brutally clear about his understanding of Trilogy and its motives. He writes that "the record demonstrates that a longtime competitor sought to employ the shareholder franchise intentionally to impair corporate assets, or else to coerce the Company into meeting certain business demands under the threat of such impairment."[77] The picture of Trilogy that emerges from the opinion is that of a predatory company that was interested primarily in exacting value from Selectica, preferably in the form a cash payment and other commercial concessions, and was willing to impair Selectica's NOLs to do so at a time when Selectica was shopping itself in large part on the strength of those NOLs. Trilogy appears, in other words, to be a corporate extortion artist. If this is really what happened, then it is easy to see how Selectica's adopting, implementing, and reloading the pill were emphatically in the best interest of Selectica and its shareholders.

It is worth contrasting this scenario with another quite different one. Imagine that a target company is protected by an NOL pill even though the company is currently profitable, and its NOLs, though valuable, are but a small fraction of the value of the company. Imagine further that a potential acquirer has made a seemingly attractive proposal to the board and been summarily rebuffed. The acquirer then launches an all-shares, all-cash tender offer at an even higher price and couples that offer with a proxy contest. Even holding a stake in the target below the NOL pill threshold, a well-monied and determined acquirer could probably prevail in such circumstances.[78] If, however, its small position in the company was hindering its take-over efforts, it is hard to believe the holding in *Selectica* would have much weight in the mind of a Delaware chancellor or vice chancellor considering a *Unocal* challenge to the target's pill. Indeed, in such circumstances, it would not escape the court's notice that, while the putative purpose of the pill is to protect the company's NOL assets, if the offer is successful the only party harmed by the resulting Section 382 ownership change would be the acquirer itself as the new owner of the company.

The contrast between this scenario and the facts in *Versata* highlights again the key point that an NOL pill honestly adopted to protect NOLs is not exactly an anti-takeover device. That is, although such a pill has a strong anti-takeover effect, the board in adopting it need have no *intention* to limit takeover attempts at all; if the board really is acting solely to protect the company's NOLs, then the anti-takeover effect is a foreseen but unintended byproduct of such protection. This seems to have been the case in *Selectica*, and so this fact too significantly undercuts the precedential value of the case for future cases that really do concern takeovers.

There is one respect, however, in which *Selectica* may be relevant to more conventional takeover scenarios, and that concerns the reloading of the poison pill. Even with a conventional pill, the board's right to reload the pill after it is triggered and implemented is essential to its functioning. For example, imagine a company with 100 million shares outstanding trading at $10 per share (and thus a market capitalization of $1 billion) protected by a conventional fifteen-percent pill, and imagine further that a raider, rebuffed by the board, decides to acquire the company by chewing through the pill. Conventional wisdom notwithstanding, if the target's pill is not reloadable, this could well be a financially viable strategy for the raider. For instance, the raider could close on a tender offer for fifteen million shares of the target—just enough to trigger the pill—spending, say, $170 million (a 13.3 percent premium to market). If the pill then flips-in, just how much the raider will be diluted will depend on the details of the pill, but the raider cannot be diluted below zero, and so its financial loss at flip-in is necessarily less than its total investment of $170 million. If the company's board cannot reload the pill, the raider could then launch a second tender offer to acquire the rest of the company, which had a pre-deal market capitalization of $1 billion, at a twenty-percent premium. In the absence of a pill, this offer would likely succeed, and if it does, the raider will have spent about $1.37 billion for the company.[79] In effect, the raider will have paid a thirty-seven-percent premium for the target, which would hardly be extraordinary. To stop the raider from gaining control in this way, the target board would have to be able to reload the pill. The lesson, implicit in the *Selectica* case, is that the deterrent power of a poison pill ultimately depends on whether the board may reload it after it is triggered and implemented. If the pill is valid, then reloading the pill after it has been triggered should generally be valid as well. *Versata* so held for NOL pills. Assuming that this key aspect of the Chancery Court's opinion is upheld on appeal, then, when and if the time comes, Delaware courts will likely hold the same for conventional pills as well.

Endnotes

1 *See generally* Stephen M. Bainbridge, Corporation Law and Economics 680-690 (2002) (describing poison pills); Ronald J. Gilson & Bernard S. Black, The Law and Finance of Corporate Acquisitions 740-748 (1995) (same); The Law and Finance of Corporate Acquisitions, 2003-2004 Supplement 58-95 (2003) (reproducing large portions of the typical poison pill recommended by Wachtell, Lipton, Rosen & Katz).

2 *See generally* William J. Carney & Leonard A. Silverstein, *The Illusory Protection of Poison Pills*, 78 Notre Dame L. Rev. 179 (2003).

3 Leonard Loventhal Account v. Hilton Hotels Corp., 780 A.2d 245, 248 (Del. 2001) (holding on *stare decisis* grounds that it "is settled Delaware law that a corporation chartered under the laws of this State may adopt shareholder rights plans").

4 NOLs may also be carried back for two years to shelter past income from taxation.

5 RiskMetrics Group, 2010 U.S. Proxy Voting Guidelines Summary 26 (Dec. 31, 2009, updated Feb. 25, 2010), *available at* http://www.riskmetrics.com/sites/default/files/RMG_2010_US_SummaryGuidelines20100225.pdf.

6 Selectica, Inc. v. Versata Enterprises, Inc., 2010 WL 703062 (Del.Ch.).

7 Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985).

8 *Selectica*, 2010 WL 703062 at *2.

9 *Id.*

10 *Id.*

11 *Id.*

12 *Id.* at *2 n.14.

13 *Id.* at *2.

14 *Id.* at *2 n. 16.

15 *Id.* at *4.

16 *Id.* at *5.

17 *Id.*

18 *Id.*

19 *Id. But see also id.* n.43, indicating that at some times in the past Trilogy had studied Selectica's NOLs and their potential value.

20 *Id.* at *5.

21 *Id.*

22 *Id.*

23 *Id.*

24 *Id.* It is unclear from Vice Chancellor Noble's opinion whether this was a simple confidentiality agreement related to the non-public information about the company that the company was supplying to potential bidders or whether the agreement was more extensive. In any case, it seems that other potential bidders were willing to sign the agreement, which raises a suspicion that Trilogy's declining to do so was perhaps pretextual.

25 *Id.*

26 Several months later, in February of 2009, there would be at least six parties that had come forward with letters of intent and that were actively conducting due diligence on the company. *Id.* at *5.

27 *Id.* at *5.

28 *Id.*

29 *Id.* at *6.

30 *Id.*

31 *Id.* at *7.

32 *Id.*

33 *Id.*

34 *Id.*

35 *See id.* at *23, where Vice Chancellor Noble states that "the record demonstrates that [Trilogy] sought to employ the shareholder franchise intentionally to impair corporate assets, or else to coerce [Selectica] into meeting certain business demands under the threat of such impairment."

36 *Id.* at *8.

37 *Id.*

38 *Id.*

39 *Id.*

40 *Id.*

41 *Id.* Presumably because the Selectica board ultimately decided to exercise the Exchange and not allow the pill to flip-in, the Vice Chancellor does not note how radical a flip-in event would have been. Recall that, at the time, Selectica's market capitalization was about $23 million, and it had about thirty-two million shares outstanding. If the rights flipped-in, then each of about 29,856,000 rights would become exercisable. To exercise these rights, their holders would need to pay into the company, in the aggregate, about $537,408,000, a sum about 23.4 times the current market capitalization of the company. The company would then issue to the former holders of the rights participating preferred shares essentially equivalent to about 1.822 billion common shares, thus effectively reducing Trilogy's interest in the company well below one percent. Of course, whether the company's shareholders could finance the exercise of their rights, and what the market would make of a consistently unprofitable microcap company suddenly sitting on cash reserve in excess of half a billion dollars is anyone's guess. Such considerations very likely figured into the Selectica board's decision to exchange the rights one-for-one for new shares of Selectica common stock rather than allowing them to flip-in. In addition, the flip-in event might itself have triggered a Section 382 ownership change. *See id.* at *9.

42 *Id.*

43 *Id.*

44 *Id.*

45 *Id.*

46 *Id.*

47 *Id.*

48 *Id.* at *10.

49 *Id.*

50 *Id.* at *11.

51 *Id.*

52 *Id.*

53 *Id.*

54 *See id.* at *12 (citing Moran v. Household Int'l, Inc., 500 A.2d 1346 (Del. 1985); Leonard Loventhal Account v. Hilton Hotels Corp., 780 A.2d 245 (Del. 2001)).

55 Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985).

56 *Selectica*, 2010 WL 703062 at *12 (quoting *Unocal*, 493 A.2d at 955).

57 *Id.* (quoting Unocal, 493 A.2d at 955).

58 Unitrin, Inc. v. Am. Gen. Corp., 651 A.2d 1361 (Del. 1995).

59 *Selectica*, 2010 WL 703062 at*12 (citing *Unitrin*, 651 A.2d at 1387).

60 *Id.* at *15.

61 *Id.*

62 *Id.*

63 *Id.*

64 *Id.* at *19-*21.

65 *Id.* at *20 n.169.

66 *Id.* at *20 (quoting Carmody v. Toll Bros., Inc., 723 A.2d 1180, 1195 (Del. 1998)).

67 The free-rider problem is that, although the insurgent investor bears the full costs of the proxy contest, all the shareholders share the benefits of the take-over pro rata according to their interests in the company. Of course, if the company has to reimburse the expenses of shareholders victorious in a proxy contest, this problem is somewhat abated (but not completely, because the insurgent still bears its own costs if it loses the contest). *See id.* at *21 n.183.

68 *Id.* at *20-21.

69 *Id.* at *21.

70 *Id.*

71 *Id.* at *21 n. 189.

72 *Id.* at *21.

73 *Id.* at *22.

74 *Id.* at *23.

75 *Id.*

76 *Id.* at *24.

77 *Id.* at *23.

78 As the Delaware Supreme Court stated in *Moran*, the "key variable in proxy contest success is the merit of an insurgent's issues, not the size of his holdings." Moran v. Household Int'l, Inc., 500 A.2d 1346, 1355 (Del. 1985). Or, in other words, the other shareholders can be counted upon to vote in their perceived financial self-interest. Indeed, the very free-rider problem that deters an insurgent from launching a proxy contest helps the insurgent win those contests that it does launch.

79 Assuming the pill was implemented through a flip-in event, the situation is more complicated than the text implies because, in the typical flip-in, the rights become options to purchase a certain dollar amount of the target's stock for an exercise price equal to half of that amount (e.g., $200 dollars worth of stock for $100). Assuming all or most of the rights are exercised (and there would be no reason for their holders not to exercise them immediately, except perhaps for difficulty in financing the exercise price), the company would experience a tremendous influx of cash, perhaps aggregating many times its pre-transaction market capitalization. What the board would do with this cash, of course, is impossible to say, but if it remained in the company, the raider, in tendering for the shares of the target, would have to increase its offering price dollar-for-dollar to reflect the value of this cash. Assuming the raider acquired the company with the cash still in it, however, there would be no net increase in the acquirer's costs of completing the acquisition. *See generally* Carney & Silverstein, *supra* note 2.