eALERT
hugheshubbard.com

The 5% (Yes, 5%) Poison Pill

In *Selectica, Inc. v. Versata Enterprises, Inc.*, the Delaware Chancery Court recently upheld a board's decision to adopt a poison pill rights plan with a 4.99% flip-in trigger. Given the specific facts of the case, it is unclear how big an impact the Chancery Court's decision will have. Nevertheless, the case highlights the continued significance of stockholder rights plans as well-established defense mechanisms — 25 years after the Delaware Supreme Court's *Household* decision — and raises some new considerations.

The low flip-in trigger incorporated in Selectica's rights plan apparently resulted from the board's desire to avoid impairment of net operating losses (NOLs) that might result from further ownership shifts in the company. After a stockholder triggered the pill, both parties sought relief in the Delaware Chancery Court. The Chancery Court concluded that the board's actions were valid exercises of business judgment and upheld the low flip-in threshold, as well as the implementation of the "forced exchange" described below.

- Return to Fundamental Issue. The focus of legal issues concerning poison pills has largely shifted over the past 25 years — from whether poison pills are *per se* invalid defense mechanisms, to whether directors in a particular case acted properly in deciding whether or not to redeem a pill. In recent years, there has also been a lot of shareholder activism and pressure on boards to terminate or modify existing rights plans, or not put new plans in place when existing plans expire. Because the triggering percentage in Selectica's poison pill was unusually low compared to most poison pills (15% would be a typical triggering percentage), this case circled back to the fundamental issue of whether adopting a low-threshold pill is *per se* an invalid defense mechanism.

- The "NOL Pill." Under the *Unocal* standard adopted by the Delaware Supreme Court, in order to be afforded the protection of the business judgment rule with respect to the adoption of a defensive measure, the directors must establish that (1) they had reasonable grounds for believing that a danger to corporate policy and effectiveness existed and (2) the defensive response was reasonable in relation to the threat posed. In *Selectica*, the Chancery Court acknowledged that the case presented "unique grounds for establishing [the] first part of the *Unocal* test as employing a poison pill for the ostensible purpose of protecting NOLs is a distinct departure from the poison pill's intended use: the prevention of hostile takeovers." The Court also expressed concern that "[g]ranting judicial sanction to low-threshold poison pills employed for the purpose of protecting NOLs guarantees the 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." However, based on the particular facts of this case, the Court concluded that the low-threshold pill satisfied the first prong of *Unocal* because, among other things, the board reasonably and in reliance upon expert advice concluded that the NOLs were company assets worth protecting. "Indeed, 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."

- 5% Trigger is Not Inherently Preclusive. The Chancery Court stated that although a 5% pill might make proxy contests considerably more difficult, such a defensive measure is *per se* preclusive (and thus automatically disproportionate under the second prong of *Unocal*) only if it "render[s] a successful proxy contest a near impossibility or else utterly moot." Based on the particular facts of this case, the Court did not find that the 4.99% pill was preclusive.

- Board Used Exchange Feature Rather than Letting Flip-In Provision Kick In. Rather than using the plan's flip-in mechanism, which would have enabled stockholders (other than the stockholder whose purchases triggered the flip-in) to purchase additional shares in the company at a favorable price, the board decided to use the plan's exchange feature, which resulted in each stockholder (other than the triggering stockholder) receiving one additional share in the company. Although the exchange feature produces less dilution than the maximum potential dilution under the flip-in provision, the dilution is predictable and automatic and, importantly, does not rely upon stockholders paying cash to exercise their poison pill rights. The Chancery Court found that the combination of the 4.99% trigger and the exchange was a proportionate response under *Unocal*.

- The Threat of a Poison Pill May Not Matter to All Buyers. All things being equal, the potential dilution (financial and voting) to a bidder resulting from a triggered pill may be more onerous to a bidder seeking control than one who has other goals and/or seeks only a minority position. For the bidder seeking control, the "conventional wisdom" has been that the risk of dilution is unacceptable and that a successful bidding strategy must include dismantling the pill before it is triggered (through litigation, removal of the board in a proxy contest, or "friendly" negotiations possibly during a hostile tender offer). In this case, it appears that the buyer, who purchased only 6.7% of the shares of the company in total, triggered the poison pill not to acquire control of the company, but in an effort to obtain leverage in an unrelated business dispute. Thus the case serves as an important reminder that the benefits and consequences of a poison pill can vary depending on the particular facts and circumstances.

Although it is unclear how the Chancery Court's decision may be applied beyond the facts of this case, the *Selectica* decision reaffirms the continuing importance of stockholder rights plans as defense mechanisms. As the Court notes, "poison pills remain a common feature of the corporate landscape."

For more information on this subject or Hughes Hubbard's M&A practice, please feel free to contact us.

Ellen Friedenberg
(212) 837-6465
frieden@hugheshubbard.com

Kenneth Lefkowitz
(212) 837-6557
lefkowit@hugheshubbard.com

Charles A. Samuelson
(212) 837-6454
samuelso@hugheshubbard.com

Avner Ben-Gera
(212) 837-6366
bengera@hugheshubbard.com

M&A Group
March 2010

Hughes Hubbard
Critical matters. Critical thinking.®