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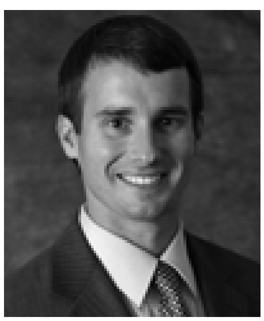
REPORT

MERGERS AND ACQUISITIONS

Poison Pills to Protect NOLs Win Acceptance



BY GARDNER DAVIS AND G. TYLER PARRAMORE

Shareholders Rights Plans—so–called ''poison pills''—have been an accepted anti-takeover defense to protect corporations against abusive hostile takeovers for more than a quarter century.[1] Recently, poison pills have received renewed attention as a tool to protect the corporation against the potential loss of net operating loss carryforwards (''NOLs'') resulting from a change in stock ownership.

NOLs are tax losses, realized and accumulated by a company, that may be applied retroactively for two years in order to obtain a refund of prior taxes paid and may be carried forward twenty years to reduce future tax liability.

In situations where companies have experienced significant losses, the NOLs may be a valuable corporate asset. However, the Internal Revenue Code limits a company's ability to use its NOLs if the company undergoes a ''change of ownership'' of more than 50 percent by one or more 5 percent shareholders within a three-year period.[2]

In order to guard against the loss of NOLs as a result of changes in stock ownership of more than 5 percent, companies with significant NOL assets are increasingly adopting so-called low-threshold poison pills, with stock ownership thresholds set at 4.9 percent, to prevent an acquirer from buying more than 4.9 percent of the Company's stock.

More than 50 publicly held companies have implemented NOL pills, including some among the Fortune

[1] *See Moran v. Household Int'l Inc.*, 500 A.2d 1346, 1357 (Del. 1985); *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 181-82 (Del. 1986); *Paramount Communications, Inc. v. Time, Inc.*, 571 A.2d 1140, 1153-54 (Del. 1990); *Leonard Leventhal Account v. Hilton Hotels Corp.*, 780 A.2d 245, 250-51 (Del. 2001).

[2] Internal Revenue Code Section 382.

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1000, according to Harvard Law School Professor John Coates. For example, in August 2008, Hovnanian Enterprises, a homebuilder listed on the New York Stock Exchange, adopted an NOL pill following a $637 million loss in 2007 resulting from the collapse of the housing industry.

RiskMetrics Group, a prominent shareholder advisory firm, supports management proposals to adopt NOL pills on a case-by-case basis to preserve the tax benefits associated with NOLs. The factors RiskMetrics will consider in determining whether to recommend adoption of an NOL pill include the value of the NOLs and whether the pill contains a sunset provision causing the pill to expire upon exhaustion or expiration of the NOLs.

However, a shareholder rights plan, by its nature, operates as an anti-takeover measure. Consequently, until a recent decision by the Delaware Supreme Court, questions existed about whether an NOL pill could withstand attack in the courts by a would-be acquirer on the grounds that it presented an unfair and impermissible obstacle in a takeover battle. However, the Delaware Supreme Court, in *Versata Enterprises, Inc. v. Selectica, Inc.*, 2010 WL 3839786 (Del. Supr. Oct. 4, 2010), has ruled that the protection of a company's NOLs may be an appropriate corporate policy that merits a defensive response when they are threatened. The Court upheld the Selectica, Inc. board of directors' decision to adopt an NOL pill.

Selectica, a Delaware corporation, had accumulated $160 million of NOLs. Trilogy was a competitor of Selectica in the software business. Trilogy had previously sued Selectica for patent infringement and made several unsuccessful offers to buy the company. Selectica's board adopted a low-threshold NOL pill to prevent Trilogy from buying its stock and thereby impairing the company's NOLs. Trilogy cried foul and sued the Selectica board for breach of fiduciary duty in Delaware Court.

In the wake of *Versata*, NOL pills will receive increased attention by corporate boards as a viable method of protecting valuable tax assets which could be lost as a result of large swings in stock ownership.

At the Chancery Court level, Vice Chancellor Noble, in a case of first impression, found that ''the protection of company NOLs may be an appropriate corporate policy meriting a defensive response when threatened. 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.''[3]

Vice Chancellor Noble's decision in the Chancery Court was clearly influenced by a set of facts very favorable to Selectica. The Selectica directors were free from conflict of interest. The board had previously put the company up for sale and actively solicited bids. The interest sought to be protected—the $160 million NOL—was the company's most valuable asset. The Selectica board relied on the opinions of outside experts and considered the issue over many meetings. The acquiring shareholder, a long-time competitor, appeared to be using the threat of impairing Selectica's NOL as the basis to coerce Selectica into making a variety of business concessions.

On appeal to the Delaware Supreme Court, Justice Holland, writing for a unanimous Court, ruled that even though the principal purpose of a NOL pill may be to prevent loss of valuable tax assets, ''any Shareholder Rights Plan, by its nature, operates as an anti-takeover device. Consequently, notwithstanding its primary purpose, a NOL poison pill must also be analyzed under *Unocal* because of its effect and its direct implications for hostile takeovers.''[4]

Under the *Unocal* standard,[5] courts apply enhanced scrutiny to the board's adoption of anti-takeover measures such as the adoption or exercise of a poison pill, because of the risk the board may be acting primarily to protect its own interests, rather than those of the corporation and its shareholders. Under *Unocal*, the directors must show they had reasonable grounds for believing that a danger to the corporation existed and that the response did not make a takeover impossible and was reasonable in relation to the threat.

Under the first part of the *Unocal* test, the board must show they had reasonable grounds for believing that a threat to the corporate enterprise existed. The Court sustained the Chancery Court's factual finding that ''the Board acted in good faith reliance on the advice of experts in concluding that the NOLs were an asset worth protecting an thus, that their preservation was an important corporate objective.''[6] The Delaware Supreme Court held the Selectica board carried its burden of proof that adoption of the NOL pill as a defensive action was a proportionate response to the threatened loss of the tax benefits and therefore the board's decisions would be upheld.

However, the Court cautioned that the ''fact that the NOL Poison Pill was reasonable under the specific facts and circumstances of this case, should not be construed as generally approving the reasonableness of a 4.99% trigger in a Rights Plan of a corporation with or without NOLs.''[7]

The primary lesson of *Versata* is that the board of directors, under appropriate circumstances, may adopt a low-threshold pill to protect the company's NOLs. However, the NOLs should be a material asset of the company in order to justify this extraordinary protection. Moreover, the board's independence and good faith and the quality of its decision-making process is critically important.

In the wake of *Versata*, NOL pills will receive increased attention by corporate boards as a viable method of protecting valuable tax assets which could be lost as a result of large swings in stock ownership.

[3] *Selectica, Inc. v. Versata Enterprises, Inc.*, 2010 WL 703062 (Del. Ch. Feb. 26, 2010) at * 15.

[4] *Versata Enterprises, Inc.*, 2010 WL 3839786 at * 12.

[5] *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 954 (Del. 1985); *see Unitrin v. Am. Gen. Corp.*, 651 A.2d 1361, 1387 (Del. 1995).

[6] *Versata Enterprises, Inc.*, 2010 WL 3839786 at * 12.

[7] *Versata Enterprises, Inc.*, 2010 WL 3839786 at * 18.

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