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Corporate Governance Update: Takeover Defenses after *Selectica*

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In February 2010, the Delaware Chancery Court rendered its much-anticipated decision in *Selectica, Inc. v. Versata Enterprises, Inc*.[1] The case centered on actions taken by the Selectica board to protect the company's considerable net operating loss ("NOL") assets. Following an increase in ownership of Selectica stock by Trilogy, an entity that had tried to acquire Selectica in the past and with which Selectica had various pending business disputes, the Selectica board acted to lower the ownership trigger in the Selectica poison pill from 15 percent to 4.99 percent. Although 4.99 percent is certainly considered low for purposes of traditional poison pills (the threshold is typically 15 percent, although lower thresholds have been used), such a low threshold is typical for rights plans designed to protect NOL tax assets. Following amendment of the pill, Trilogy proceeded to acquire additional shares, intentionally triggering the pill, after which the Selectica board declined to exempt Trilogy from the pill and instead triggered the pill's exchange feature, thereby diluting Trilogy's ownership interest. To further protect the NOL assets, the Selectica board re-loaded the poison pill so that it would be available again in the future.

In light of the *Selectica* decision, and in the context of the current M&A environment, it is useful for boards of directors to understand its implications as they review and refresh corporate takeover defenses and other devices designed to protect corporate assets. Although the *Selectica* decision was not a surprising one, its emphasis on the wide latitude provided to boards of directors in the context of protecting corporate assets and shareholder value should give boards renewed confidence in their ability to shore up a corporation's takeover defenses. As boards conduct their review, they should be aware of some of the key tools that Delaware corporations may have at their disposal (depending on the flexibility provided in their corporate charter and bylaws), keeping in mind, of course, that not all actions a board may take will be viewed favorably by shareholder activists or those guided by proxy advisory services such as RiskMetrics Group.

Selectica *Reviewed*

In reviewing the Selectica board's actions, the court first noted that Delaware courts have repeatedly and recently upheld the adoption of poison pills as acceptable defensive measures and noted that the Delaware Supreme Court's invocation of *stare decisis* in the *Leonard Loventhal* case[2] is "a strong signal that the legitimacy of

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the poison pill is settled law." A full discussion of Delaware takeover defense caselaw is beyond the scope of this article; however, the *Selectica* case provides a good summary of those cases, and a few points are worth mentioning here. In first determining whether the business judgment rule applies, the court applied the *Unocal* test, evaluating whether the directors demonstrated that "'they had reasonable grounds for believing that a danger to corporate policy and effectiveness existed,'" noting that they may satisfy that burden by showing "'good faith and reasonable investigation.'"[3] The court also reviewed whether the response was reasonable in relation to the threat posed, noting that under *Unitrin*,[4] a defensive measure fails the reasonableness test if it is coercive or preclusive. The court noted that the reasonableness analysis requires "'an evaluation of the importance of the corporate objective threatened; alternative methods for protecting that objective; impacts of the 'defensive' action and other relevant factors.'"[5] In analyzing whether the board had reasonable grounds for believing that there was a valid corporate threat, the court noted the unique corporate objective of protecting NOLs, as compared to the typical objective of poison pills, which is to protect against hostile takeover attempts. After discussion, the court concluded that the protection of company NOLs "may be an appropriate corporate policy meriting a defensive response when threatened" and implied that protecting NOLs may be a more valid concern than protecting against hostile takeover attempts.

In determining whether the board's actions were preclusive, the court noted the high standard established by *Unocal*, which requires a determination that the measure taken was "draconian." The court heard expert testimony that, among other things, a less than five percent shareholder could stage a successful proxy contest and determined that the Selectica board's actions did not meet that standard. Following that determination, the court went on to review the board's actions under the *Unocal* proportionality test, determining whether the response was reasonable in relation to the threat posed, noting again that the reasonableness test requires a reasonable decision—not a perfect one—under *QVC/Paramount*.[6]

Board Considerations in Adopting Takeover Defenses

The *Selectica* case reiterates a long line of Delaware case law that provides boards of directors with a broad ability to establish takeover defenses without breaching their fiduciary duties. In determining whether to adopt certain takeover defenses, and in particular, poison pills, boards of directors should be aware of the proxy advisory services' position on these types of measures. Although boards may choose to take action that will result in a vote against the directors or a "withhold" vote, directors, and those advising directors, should be aware of the current proxy advisory service positions. For example, RiskMetrics will recommend a withhold vote or a vote against a board in the event that the board adopts a poison pill having a term greater than 12 months or renews a pill having a term of less than 12 months without shareholder approval. However, a commitment to put a new poison pill to a shareholder vote may offset an adverse recommendation. In the case of adoptions of poison pills having terms of less than 12 months, RiskMetrics will make case-by-case determinations, taking into account factors such as whether the company had the time to put the pill to a shareholder vote, the rationale for the poison pill and the issuer's corporate governance structure and practices.[7]

Although boards of directors will not want to disregard the opinions of the proxy advisory firms and certainly should be made aware of those views by board advisors, they may wish to proceed with an action that will result in a withhold vote or vote against in exchange for the right complement of shareholder and asset protection devices. These devices should not be used to entrench management but instead should be narrowly tailored to protect corporate or shareholder assets, such as NOLs or favorable tax status (*e.g.*, REITs), or shareholder control premiums. As a matter of good corporate governance, boards of directors should periodically review their respective corporations' takeover defenses and posture, identifying areas of vulnerability and assessing the costs and benefits of adding defenses to the corporate tool chest.

Companies preparing to go public are uniquely positioned to easily modify their takeover defenses. Pre-IPO companies generally do not feel the pressure of proxy advisory firms when they implement takeover defenses. Accordingly, a company preparing to go public is well-advised to anticipate those takeover defenses that it may wish to implement and implement those defenses prior to going public, as it is much easier from an investor relations perspective to weaken one's takeover defenses rather than strengthen them post-IPO. Of course, IPO marketing and other impacts of defensive measures should be considered prior to any board action. As an example, the proportion of companies going public in recent years with takeover defenses such as classified boards has tended to be significantly higher than in other groups, such as the S&P 500.

Takeover Defense Tools under Delaware Law

Whether pre- or post-IPO, any board that is reviewing a company's takeover defenses should be well-versed in the variety of tools that may be available to it under Delaware law:

> *Poison pills:* When drafted and implemented properly, poison pills can be effective takeover defenses that still provide the board of directors with flexibility. Features can be added to make poison pills more attractive to shareholder activists, including shorter lifespans, periodic review by independent directors, "chewable features" which require the pill to be redeemed in certain instances, and provisions subjecting the plans to shareholder ratification or approval. In the case of poison pills adopted to protect tax assets, which generally have very low ownership triggers, the poison pill should be narrowly tailored so as to address only those ownership changes that are problematic from a tax perspective, rather than inadvertently working as an anti-takeover measure.
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> *Classified boards:* Classified boards provide for the staggering of directors' terms so that two director election cycles are required for a new majority shareholder to appoint a majority of the board. This provision can be a powerful tool to delay changes in board control, providing valuable time to evaluate proposals and

alternatives and encouraging suitors to come to the bargaining table.

Limitation of shareholders' ability to act by written consent and to call a meeting: Requiring shareholders to act at meetings rather than permitting action by written consent can also serve to bring a bidder to the bargaining table and provide the board with more time to evaluate a proposal and seek other alternatives. Together with a restriction on the ability of shareholders to call meetings, shareholders are limited to bringing actions at the annual meeting unless otherwise determined by the board, thereby limiting the window of opportunity to initiate a proxy contest to once per year.

Limitations on ability to increase board size: To restrict a shareholder's ability to pack the board, companies often restrict the ability of the board or shareholders to increase the size of the board above a certain number.

Supermajority voting provisions: Charters and bylaws may contain supermajority voting provisions to amend or remove the company's existing takeover defenses. Supermajority voting provisions can, of course, be a double-edged sword in the event that a company later wants to make revisions to those provisions.

Following *Selectica*, boards should have renewed confidence in adopting anti-takeover measures. Increasingly, boards may face heightened criticism in their adoption of such measures, but boards should not necessarily be dissuaded from implementing a measure simply because of negative reactions by shareholder activists. Rather, views of proxy advisory firms and other groups are just one data point, and when determining whether to act, boards should continue to be guided by the underlying principle of doing what is in the best interests of *all* shareholders. For those companies that are private but contemplating an IPO, the time to implement takeover defenses is prior to an offering. It will only be more difficult to implement defenses over time, and it is much easier to eliminate, rather than add to, defenses. In taking any action, however, boards should be reminded not only of the flexibility provided by Delaware law but also of the important tenet in taking any action that may be viewed as deterring potential takeover bids: the overarching reasonableness requirement. Any action must not be preclusive and should be within the range of reasonableness, and the corporate record should reflect the board's identification of reasons why it feels the need to act, as well as documentation of consideration of various alternatives. Following these simple principles, boards should be well-equipped to navigate the sometimes choppy waters of takeover defenses.

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The views expressed in this article are their own and do not necessarily reflect the views of Sullivan & Cromwell LLP or its clients.

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[1] *Selectica, Inc. v. Versata Enterprises, Inc.*, C.A. No. 4241, 2010 BL 65838 (Del. Ch. Feb. 26, 2010).

[2] *Leonard Loventhal Account v. Hilton Hotels Corp.*, 780 A.2d 245 (Del. 2001).

[3] *Selectica*, 2010 BL 65838 at 34 (quoting *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 955 (Del. 1985)).

[4] *Unitrin, Inc. v. American General Corp.*, 651 A.2d 1361 (Del. 1995).

[5] *Selectica* at 53 (quoting *Paramount Communications, Inc. v. Time Inc.*, 571 A.2d 1140, 1154 (Del. 1990)).

[6] *Paramount Communications Inc. v. QVC Network Inc.*, 637 A.2d 34 (Del. 1994).

[7] RiskMetrics Group, 2010 U.S. Proxy Voting Guidelines Summary (Feb. 25, 2010).