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New Development in Poison Pills

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In an almost unprecedented action, Trilogy, Inc., a shareholder of Selectica, Inc., intentionally triggered Selectica's shareholder rights plan in December 2008. Shareholder rights plans, also known as "poison pills," are typically used by corporations to defend against hostile takeovers. The common poison pill, like the pill originally adopted by Selectica, is "triggered" when a shareholder acquires more than a specified percentage of a corporation's stock, typically 15 to 20 percent, without prior board approval. Once the pill is triggered, all of the corporation's existing shareholders, other than the acquiring shareholder, have the right to purchase additional shares of the corporation's stock at a discount. As a result of the increase in the number of shares issued and outstanding, the acquiring shareholder's ownership in the corporation is diluted and an acquisition of the corporation becomes more expensive.

Recently, poison pills also have been used to protect the value of corporations' tax assets. Under applicable tax law, if a company incurs a net operating loss, or NOL, the company may decrease its taxable income in the future by applying its NOLs to future income. However, if a company incurs an "ownership change," the amount of income that may be offset in the future by NOLs may be limited. An ownership change is generally defined as an increase in stock ownership of 50 percent or more over a three-year rolling period, by shareholders who own 5 percent or more of a company's stock. Lowering the threshold of a company's poison pill would help to prevent such an ownership change and preserve a company's NOLs.

On November 17, 2008, Selectica amended its shareholder rights plan to reduce its triggering threshold from 15 percent to 4.99 percent. Under Selectica's amended poison pill, if a shareholder acquired more than 4.99 percent of Selectica's common stock in the future, the poison pill would be triggered. Selectica justified the threshold reduction as necessary to protect its ability to utilize its NOLs. As of March 31, 2008, Selectica had NOLs of approximately $140.1 million.

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Two days prior to Selectica's poison pill amendment, Trilogy filed a Schedule 13D with the Securities and Exchange Commission, disclosing ownership of 5.1 percent of Selectica's stock. Trilogy's ownership at this level was "grandfathered" when the Selectica poison pill threshold was reduced. Despite stating that Trilogy's purchase of Selectica's stock was for "investment purposes only," Trilogy disclosed in its Schedule 13D that it had been attempting to negotiate an acquisition of Selectica since 2005.

For reasons not purely economic, after Selectica lowered the triggering threshold of its poison pill to 4.99 percent, Trilogy purchased an additional 154,061 shares of Selectica's stock, which brought its ownership to 6.7 percent and triggered Selectica's poison pill. On January 2, 2009, Selectica's board of directors announced that it was going to exercise the rights under the poison pill to exchange each outstanding right, other than rights held by Trilogy, for one share of common stock. The resulting issuance of Selectica's stock diluted Trilogy's position in Selectica from 6.7 percent to roughly 3.4 percent. Additionally, because the rights issued pursuant to the initial poison pill expired in the exchange, Selectica's board adopted a successor poison pill with a three-year term.

Selectica also filed suit in the Delaware Chancery Court, seeking a declaratory judgment that its amended shareholder rights plan is valid. Selectica asserts that Trilogy presents a takeover threat and that the shareholder rights plan was amended to preserve its NOLs. Trilogy has counterclaimed for injunctive and declaratory relief, asserting claims of breach of fiduciary duty against the company's directors, and seeking a declaratory judgment that the amended rights plan is per se invalid due to Selectica's low triggering threshold of 4.99 percent. Trilogy also asserts that Selectica amended its poison pill to block additional purchases of Selectica's stock by Trilogy and to entrench Selectica's management.

This matter is still pending in Delaware Chancery Court. If the Chancery Court determines that Selectica's amended shareholder rights plan is valid, it is likely that public companies will continue to use poison pills to protect NOLs, and possibly in other contexts, in the future.

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