IN THE SUPREME COURT OF THE STATE OF DELAWARE

VERSATA ENTERPRISES, INC. and TRILOGY, INC.,	)	
Defendants/Counterclaim Plaintiffs Below, Appellants/Cross Appellees	)	
v.	)	No. 193, 2010
SELECTICA, INC.,	)	On Appeal from the Court of Chancery C.A. No. 4241-VCN
Plaintiff Below, Appellee/Cross Appellant	)	
and	)	
SELECTICA, INC., JAMES ARNOLD, ALAN B. HOWE, LLOYD SEMS, JIM THANOS, and BRENDA ZAWATSKI,	)	
Counterclaim Defendants-Below, Appellees/Cross Appellants.	)	

APPELLANTS VERSATA ENTERPRISES, INC.'S AND TRILOGY INC.'S OPENING BRIEF

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NATURE OF THE PROCEEDINGS

On November 16, 2008 — three days after learning that its competitor Trilogy, Inc. ("Trilogy") had become a 5.1% shareholder — the Board of Directors of Selectica, Inc. ("Selectica") slashed the trigger of its shareholder rights plan from 15% to 4.99% ownership, and capped existing shareholders holding 5% or more to a further increase of only 0.5% (the "NOL Poison Pill"). Selectica's purported reason for taking such drastic action was to protect net operating loss carryforwards ("NOLs"). After Trilogy subsequently purchased shares above this cap, Selectica filed suit in the Court of Chancery on December 21, 2008, seeking a declaration that the NOL Poison Pill was valid. On January 2, 2009, Selectica implemented the dilutive exchange provision of the pill, reducing Trilogy's interest from 6.7% to 3.3%, and adopted another pill with a 4.99% trigger (the "Reloaded NOL Pill"). Selectica amended its suit to seek declarations with respect to the exchange and the Reloaded NOL Pill.

Trilogy and its subsidiary Versata Enterprises, Inc. ("Versata") counterclaimed that the NOL Pills and the exchange were unlawful on the grounds that, before acting, the Board failed to consider the usability of its NOLs or the need for such pills, which was particularly improper given Selectica's unbroken history of losses and doubtful prospects of annual profits. Trilogy and Versata also asserted that the NOL Pills were impermissibly preclusive of a successful proxy contest for Board control when combined with Selectica's staggered director terms. After a trial, the Court of Chancery held, in an opinion dated February 26, 2010, that the NOL Pills and the exchange were valid under Delaware law (*see* Memorandum Opinion, Exhibit A hereto; *see also* Order and Final Judgment, Exhibit B hereto). Trilogy and Versata now appeal that decision.

SUMMARY OF ARGUMENT

When this Court first permitted poison pills in *Moran*, it did so with the promise that a board's adoption and use of these inherently entrenching devices would be subjected to enhanced judicial scrutiny and the further promise that shareholders would retain the safety valve of the ballot box. The Court of Chancery's approval of Selectica's adoption of its NOL Pills leaves those promises unfulfilled.

1. The Court below erred in applying the first prong of *Unocal* enhanced scrutiny when confronting a question of first impression: what are the minimum requirements for a "reasonable investigation" before the board of a never-profitable company may adopt a 4.99% pill for the ostensible purpose of protecting NOLs from an "ownership change" under Section 382 of the Internal Revenue Code? The Court recognized that the ultimate value of NOLs is "contingent upon" and "subject to the timing and amount" of "future profit" and "that it is not sufficient to conclude that an asset with potential value is worth protecting without considering the probability of that value being realized." (Ex. A at 2, 52). It is undisputed, however, that Selectica's Board never considered if there was a reasonable likelihood that its NOLs would be utilized or whether the event it was trying to prevent — a limitation created by an "ownership change" — would adversely impact any likely usable portion of the NOLs. The Court nonetheless held that the Board conducted a reasonable investigation, based primarily on the Board's supposed reliance on an investment banker who admitted to the directors he "wasn't a tax expert and didn't have a basis to give a view of what the value of the NOL was." If not reversed, this minimal definition of what constitutes a "reasonable investigation" will permit boards to impose similar 4.99% pills based on little more than bare, hopeful, and objectively unreasonable speculation. Directors' fiduciary duties, and their burden under the "enhanced scrutiny" standard, require more.

2. The Court of Chancery further erred in holding that the NOL Pills, in combination with a charter-based classified Board, did not have an unduly preclusive effect on shareholders' ability to pursue a successful proxy contest for control of the Company. The Court found that "expert testimony suggests that a poison pill with a less than 5% trigger 'has a substantial preclusive effect.'" (Ex. A at 59). The Court nonetheless upheld the NOL Pills because it viewed a pill as preclusive only if it "render[s] a successful proxy contest a near impossibility or else utterly moot." (Ex. A at 60). This extremely narrow view is inconsistent with Delaware law. This Court stated in *Unitrin* that a pill is also preclusive if it renders a successful proxy contest "realistically unattainable." The record demonstrates that a 4.99% pill, in combination with a

charter-based classified board, has such an impermissible preclusive effect. In fact, no party cited any example in corporate history where a shareholder below 5% gained control through proxy contests against a charter-based classified board.

If not reversed, the Court of Chancery's ruling effectively forecloses the shareholders' safety valve of recourse to the ballot box at companies with staggered-board terms that have adopted an NOL pill. It is at consistently unprofitable companies that it is most imperative that shareholders retain the ability to replace those responsible for the erosion of shareholder value.

STATEMENT OF FACTS

A. Net Operating Losses.

Under federal corporate income tax law, a net operating loss ("NOL") occurs when deductions exceed taxable income in a taxable year. (A2198 (Tr. 1268)). Taxpayers may carry NOLs back two years to recover tax payments or carry them forward for 20 years to offset future profits and reduce tax payments. 26 U.S.C. § 172(b)(1)(A). The value of NOLs is not simply the number representing aggregate corporate losses: experts in this case agreed that any value that NOLs may have is derived from the occurrence of taxable income against which the NOLs may be utilized. (A2003 (Tr. 501-02); A2214 (Tr. 1331-32); A4314; A4354).

For example, if a corporation has NOLs of $10 million, and a tax rate of 30%, the *maximum* potential application of these NOLs in terms of tax dollars saved is $3 million. (A2004 (Tr. 505-06); A4315). If the corporation expects likely profits of only ten dollars over the life of those NOLs, the value of the NOLs is not $10 million, or even $3 million, but some time-value-discounted percentage of ten dollars. (A2214 (Tr. 1331-32); A4354).

A company records NOLs on its balance sheet as a deferred tax asset, to the extent such NOLs are not reduced by a valuation allowance. (A2008 (Tr. 523); A2221 (Tr. 1358-59)). If it is more likely than not that it will never use some portion of those NOLs before they expire, the company records a valuation allowance (an estimate of the portion not realizable because of insufficient future taxable income), thereby reducing (or eliminating) the amount of the asset. (A2008 (Tr. 523); A2011 (Tr. 536); A2221 (Tr. 1358-59); A4358-62). If a company records a "full valuation allowance," it has determined it is more likely that it will never use any portion of those NOLs before they expire. (A2011 (Tr. 536); A4320; A4362). Conversely, if a company believes it is more likely to use some portion of its NOLs before they expire, it *must* report that portion as an asset by recording only a partial valuation allowance. (A2008 (Tr. 523); A2009 (Tr. 527-28); A2221 (1358-59)). As discussed *infra*, at all relevant times, Selectica recorded a full valuation allowance for its NOLs, meaning that Selectica determined that it was more likely that it would never use any portion of its NOLs before they expire.

B. Internal Revenue Code Section 382.

Because Congress was concerned about the trafficking of companies purely for their NOLs, it enacted Section 382 of the Internal Revenue Code (along with I.R.C. § 269). H.R. Rep. No. 83-1337, at 4067 (1954). Section 382 limits (but does not eliminate) the use of NOLs where there has been a statutorily-defined "ownership change," i.e., a fifty percent change in ownership by those stockholders holding 5 percent or more of the company's equity over a three-year period. 26 U.S.C. §382; (A4276-77). An "ownership change" does not signal an irrevocable loss of usable NOLs, however.

First, only a portion of the NOLs may be rendered unavailable under §382's formula, with the rest fully applicable to any profit. (A1884 (Tr. 28); A2202 (Tr. 1283); A2217 (Tr. 1345-46)). The amount available each year — or "annual limitation" amount — is calculated by multiplying (i) the company's equity value at the time of the "ownership change" and (ii) a long term federal interest rate. (A1884 (Tr. 28); A2202 (Tr. 1283); A2217 (Tr. 1345); A4317; A4356). If unused, this annual limitation amount rolls over from year-to-year, increasing the amount of NOLs that can be used despite an "ownership change." (A2217-18 (Tr. 1345-46)). In addition, to the extent a company remains unprofitable, newly generated losses are unaffected by a prior "ownership change." (A2218 (Tr. 1349)).

Second, §382 contains an exception for an asset sale that creates a "built-in-gain" (the excess of fair market value over the aggregate adjusted tax basis), allowing NOLs to offset that gain even where a company has experienced an "ownership change" within five years. 26 U.S.C. §382(h); (A2202 (Tr. 1284-85); A2217 (Tr. 1343); A4288-89; A4349-50).

C. Selectica Accumulates Unusable NOLs Through Consistent Losses for Its Entire History.

The $120 million Selectica raised in its March 2000 initial public offering, (A1185)[1], has been steadily drained over succeeding years of persistent losses. (A3445-46, A3470; A3260, A3310; A3011, A3039; A2850, A2881; A2742, A2767; A2517, A2541; A2342, A2371; A2294-95). Despite repeated public forecasts of profitability, Selectica has never reported a net profit for any

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1 On July 15, 2009, Trilogy filed a motion requesting that the Court of Chancery take judicial notice of certain documents submitted to the Court and the facts reflected therein. (A799-805). The Court of Chancery entered an order on August 5, 2009 granting Trilogy's motion. (A1414-15). The documents for which judicial notice has been granted pursuant to the Court of Chancery's August 5th Order are located in Trlogy's Appendix at A806 to A1379.

fiscal year since going public. (A4520-30; A4536; A4554; A4564; A4575-88; A4567-74; A1210; A842; A3445-46, A3470; A3260, A3310; A3011, A3039; A2850, A2881; A2742, A2767; A2517, A2541; A2342, A2371; A2294-95). Selectica's federal tax NOLs have exceeded $100 million since at least the end of fiscal 2003 (March 31, 2003), and have remained unusable given its repeated failure to generate profits. (A3489; A3340; A3064; A2907; A2796; A2572).

Prior to the trial in April 2009, Selectica had reported accumulated federal NOLs of approximately $140 million, and an additional net loss of over $7 million through its first three fiscal quarters of 2009. (A3489; A3594; A3703; A4193). After trial, Selectica revealed a federal net operating loss carryforward of approximately $166.5 million, a fourth quarter loss of $1.5 million, and a cumulative net loss of $8.4 million for fiscal 2009 — Selectica's ninth consecutive unprofitable year. (A816; A836; A842; A994-1002). Selectica has conceded that it "may continue to incur significant losses" and that it would "need to generate significant increases in [] revenues to achieve . . . profitability." (A816). For fiscal 2010, the Company recently reported a tenth year of losses. (A4495-503).[2] Its reported NOLs remain unused and unusable.

D. Selectica Records a Full Valuation Allowance Reflecting its Determination of No Likelihood of Using its NOLs.

Selectica's regular outside tax accountant, Alan Chinn, determined in 2006 that its NOLs were subject to some limitations under §382 due to prior "ownership changes" (the "Chinn Study"). (A3085-199; A3635-73; *see also* A3489). As discussed *supra* at pp. 4-5, these "ownership changes" did not eliminate Selectica's NOLs, but only reduced the amount available to be used. (A2202 (Tr. 1283), A2217-18 (Tr. 1345-46)). In any event, even the partially-limited NOLs were not usable because Selectica was never profitable. (A3445-46, A3470; A3260, A3310; A3011, A3039; A2850, A2881; A2742, A2767; A2517, A2541; A2342, A2371; A2294-95).

Selectica's NOLs were never referenced as a significant asset in its financial statements. On the contrary, to date the Company has consistently

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2 Concurrent with the filing of this Opening Brief, Trilogy has filed a Motion for Judicial Notice requesting that this Court take judicial notice of certain documents submitted to the Court and the facts reflected therein. (Trilogy's Motion for Judicial Notice). The documents that Trilogy has requested this Court to take judicial notice of are located in Trilogy's Appendix at A4485 to A4519.

recorded a "full valuation allowance" for the NOLs, recognizing *no* amount of deferred tax asset on its balance sheet. (A862; A3489; A3340; A3064; A2907; A2796; A2571; A2415-16; A1200). As discussed *supra* at p. 4, under applicable accounting rules, these repeated disclosures reflected Selectica's continual determination that it was more likely than not that it would *never* be able to use any portion of those NOLs — not a single dollar. (A1932-33 (Tr. 220-21), A2009 (Tr. 525), A2221 (Tr. 1358-60); A4361).

E. Steel Partners Acquires Selectica Stock and Gains Unique Access to Information Regarding Its NOLs.

Hedge fund Steel Partners II ("Steel Partners"), among other things, invests in companies with large NOLs. (A1990 (Tr. 451-52)). Steel Partners has been a 5% or greater shareholder of Selectica since February 2007, (A3219-304), and held approximately 14.6% of Selectica's stock at the time of trial. (A4043-54). As it grew its stake, Steel Partners had unique access to information about the Company's NOLs and its proximity to an "ownership change" under §382. Steel Partners routinely requested and received non-public information such as the Chinn Study, which no other outside stockholder saw. (A3207-09; A3200-06; A4459-61). Indeed, Steel Partners was more familiar with the Chinn Study than Selectica's officers and directors, who were unaware of its central conclusions. (A1934-35 (Tr. 228-29); A1988 (Tr. 441); A1991-93 (Tr. 455-61); *see also* A2103 (Tr. 897)).

In March 2007, Steel Partners arranged for Selectica to hire John Brogan of the Burr Pilger & Mayer accounting firm to review the Chinn Study. (A2026-27 (Tr. 596-98); A3231-35; A3575-76; A4463-65). Brogan, although paid by Selectica, privately offered Steel Partners his conclusions; no other outside shareholder was provided this information. (A1934 (Tr. 227-28), A2030 (Tr. 611-12), A2031 (Tr. 615-16), A2034-35 (Tr. 628-30); A3417-18; A3421-22; A3423; A3547-48; A3561-65; A4466-67, A4469). Steel Partners was included on Brogan's correspondence even when Company directors sometimes were not. (A3417-18; A3421-22; A3423; A3547-48; A3561-65; A3566-68).

In the fall of 2007, Brogan and Steel Partners proposed further §382 analysis. (A4471-73). Selectica's then-CEO, Bob Jurkowski, opposed spending more money for such work because he believed the NOLs had no likely value to the Company given its pattern of no annual profits. (A4472-73; *see also* A1899 (Tr. 86-88)). The Board agreed and, in February 2008, voted against spending \$40,000-\$50,000 on an additional study of Selectica's NOL situation. (A3392; A1901 (Tr. 93-94)).

F. Steel Partners Increases its Holdings and the Board Expresses No Concern Regarding Selectica's NOLs.

In April 2008, Steel Partners disclosed it had increased its stake in Selectica to 10.2%. (A3403-14). Jack Howard of Steel Partners wrote to Jurkowski that same month to encourage that investor Lloyd Sems be appointed to the Board. (A3401). Howard and Sems, who had been communicating regarding Selectica since at least October 2007, had been strategizing about removing CEO Jurkowski and discussing privately Selectica's NOLs. (A3389; A3395-96; A3397; A3419; A2069 (Tr. 761-63); A2070-71 (Tr. 768-69). Sems took his cues from Howard and Lloyd Miller, another large stockholder. (A3389; A4481-82).[3] Howard's plan was to utilize Selectica's NOLs for the benefit of Steel Partners. (A2101-02 (Tr. 891-93); A4475-78; A3415; A4130; A3674).

After Sems joined the Board in June 2008, CEO Jurkowski was immediately fired, along with virtually every manager in the sales configuration business — positions which were not refilled. (A1954 (Tr. 305-07); A2062 (Tr. 733-34); A4436-44, A4446-47, A4449-57). That business was virtually abandoned, (A4451-52), reducing any possibility that the Company would become profitable. Steel Partners' Howard congratulated Sems on a "great job." (A3537; A3545-46). Co-Chairs Thanos and Zawatski took over as *de facto* co-CEOs, managing the Company in exchange for significant compensation in addition to their normal board fees. (A1886 (Tr. 34); A2074 (Tr. 783); A2111 (Tr. 930); A1933 (Tr. 222); A1938 (Tr. 243-44); A1987-88 (Tr. 440-41); A2118 (Tr. 957-59); A3570-71; A866, 868).

During the summer of 2008, with Sems' participation, Brogan continued to provide non-public information about the NOLs and Selectica's §382 status to Steel Partners. (A2032-35 (Tr. 620-32); A3417-18; A3421-22; A3423; A3547-48; A3561-65; A4466-67). Howard conceded that this information could have been material at the time his firm was buying more Selectica stock and widening its lead on all other shareholders. (A4468).

During this period, the Board was indifferent to Selectica's NOLs and Selectica was not monitoring for a potential "ownership change" under §382. Indeed, the new Co-Chair Brenda Zawatski testified that in July 2008 "the last thing on my mind was NOLs" and she did not know whether Brogan was doing any work on §382. (A1935-36 (Tr. 232-33); A1940 (Tr. 250); *see also* A1937

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[3] Miller has owned in excess of 5% of Selectica stock since at least November of 2006 (A3210-18) and now owns 17%. (A4509-19).

(Tr. 240)). Brogan testified that Selectica did not appear to care about the NOLs and that he did no substantial work on the issue between July and November 2008. (A2035-36 (Tr. 629, 633)).

If the Board had been monitoring for a potential 50% "ownership change" under §382, then as early as July 2008 it would have been aware that Selectica was in the 36-40% range. (A1996 (Tr. 473); A2037 (Tr. 637-638)). Meanwhile, Steel Partners made further stock acquisitions, and filed three Schedule 13Ds that disclosed that it had added nearly 4% of the Company's equity to its holdings, increasing its stake to 13.9%. (A3549-60; A3579-88; A3624-33; *see also* A3403-14 (listing percentage of Steel Partners' Selectica holdings prior to July 2008)). In October 2008, the new Co-Chairs of the Board, Brenda Zawatski and James Thanos, met with Howard, who told them Steel Partners would increase its ownership position still further — to 14.9% (just under the 15% trigger of Selectica's then-existing poison pill). (A1931 (Tr. 213-14); A1944-45 (Tr. 268-69)). Although Selectica was near 40% for purposes of a 50% "ownership change" under §382 (according to Brogan), (A2037 (Tr. 638)), and despite knowing that a 5% or greater shareholder (Steel Partners) would be *further* increasing its position (and adding to this 40% change level), the Board did not request a standstill from Steel Partners or take any other action with respect to "protecting" its NOLs. (A1943 (Tr. 261-62); A1944-45 (Tr. 266-271); A1993-94 (Tr. 464-65); A1995 (Tr. 469); A2071-73 (Tr. 771-72, 774-75, 777-78)). Indeed, in August 2008, Co-Chair Thanos had declared that he did not think Selectica's NOLs had any value and that he had been told as much by every investment banker with whom he discussed the matter. (A3572; A1933 (Tr. 222); A2112 (Tr. 933); A2127 (Tr. 990).

G. Trilogy Files its Schedule 13D and the Board Adopts the NOL Poison Pill Three Days Later.

On November 13, 2008, Trilogy filed a Schedule 13D disclosing a 5.1% ownership in Selectica. (A3675-92). Trilogy and Selectica had a contentious history. Trilogy had sought unsuccessfully on several occasions to engage Selectica in a dialogue concerning a possible acquisition. (A2159-64 (Tr. 1118-1137); A2808-15; A3569). In addition, between 2004 and 2007, Trilogy and Versata twice sued Selectica for patent infringement. (A1906 (Tr. 114-15), A1958-59 (Tr. 322-25); A2808-15). In January 2006, the first suit was settled, with Selectica agreeing to pay Trilogy $7.5 million. (A1958 (Tr. 322-23); A2997). The second suit was settled in October 2007, with Selectica paying Versata $10 million and agreeing to future payments of not more than $7.5 million. (A1958-59 (Tr. 323-25); A2176-77 (Tr. 1186-88); A3386-87).

In response to an inquiry from Sems and Steel Partners after they learned of Trilogy's purchases in the November 13, 2008 Schedule 13D (A3693-95; A3696), Brogan reported on November 15 that Selectica was "*still* at about 40% overall" under §382 (emphasis added). (A3733). According to Brogan, Trilogy's purchases did not create any increase in the perceived level of "ownership change." (A2036 (Tr. 635)).[4]

Despite this conclusion, the Board met the next day, on November 16, 2008, and amended its 2003 poison pill by lowering the triggering stock ownership threshold to 4.99% from the 15% level in the 2003 pill. (A3743-44; A3747-48 at § 1(a)). The Board's purported purpose for lowering the triggering stock ownership threshold was to help protect the Company's NOLs. (A3735). The pill, as amended, provided that existing owners in excess of 4.99% would be subject to dilutive consequences if they increased their holdings by 0.5%. (A3747-48 at § 1(a); A2451-52 at § 3). The pill had no time limit. It provided that the Board might in its discretion "exempt" a person from its provisions, but this discretion was delegated to a committee comprised of Sems and director Jamie Arnold. (A3750 at § 1(n); A3744-45). The NOL Poison Pill provisions effectively guaranteed the primacy of Steel Partners as the largest stockholder (A2148-49 (Tr. 1074-75); A2180 (Tr. 1199-1202)), absent the unanimous consent of these two directors.

H. The Board Fails To Conduct Any Reasonable Investigation.

The Board was not provided any written materials prior to the November 16, 2008 meeting. (A1996 (Tr. 474-75)). The only materials provided to the directors at that meeting were draft resolutions related to the pill's adoption. (A1908 (Tr. 122-23); A1996 (Tr. 474-75)). The Board made no assessment at the meeting (and requested none) regarding the reasonably expected value of the NOLs. (A1908 (Tr. 124); A1910 (Tr. 130-131); A1912 (Tr. 139); A1978 (Tr. 404); A2001 (Tr. 493-94); A2105 (Tr. 906); A2127 (Tr. 988)). There was no discussion at the meeting regarding how much taxable income Selectica could reasonably expect to generate against which to apply NOLs. (A3734-46; A2038 (Tr. 641-42)). There was no consideration of what tax savings Selectica could reasonably expect to achieve from offsetting any anticipated taxable income with any NOLs (or whether a §382 limitation would even affect any anticipated tax savings). (A1908 (Tr. 124); A1910 (Tr. 131); A1912 (Tr. 139); A1978 (Tr. 404); A2001 (Tr. 493-94); A2105 (Tr. 906); A2127 (Tr. 987-88)). The directors did

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4 Brogan explained that the lack of movement in the ownership-change percentage was due to corrections in prior calculations. (A3733).

not discuss how the "built-in-gain" exception to §382, *see supra* at pp.4-5, might apply to any sale of Selectica assets, even if an "ownership change" were to occur. (A1965 (Tr. 350-51); A2127-28 (Tr. 990-91); A4434).

The Board did not consider alternatives to the NOL Poison Pill, such as amending the corporate charter to add limitations to the transferability of Selectica stock. (A3734-46). It did not consider the consequences of adopting the pill, including any negative effects on the rights of Selectica's stockholders. (A1996 (Tr. 473-74); A2079 (Tr. 802)). Although Selectica had acknowledged the entrenchment potential of its 2003 15% pill, (A2514; A2738-39; A2845; A3004-05; A3254; A3439), there was no discussion at this meeting about the effect of a 4.99% pill trigger on stockholders' ability to achieve a change in control of the Company. (A1996 (Tr. 473-74); A2079 (Tr. 802)). There was no discussion of whether the NOL Poison Pill might lock in the existing equity ownership hierarchy or cement Steel Partners' status as the dominant shareholder. (A1970 (Tr. 372); A1996 (Tr. 473-474)). Nor was there any discussion of whether the 4.99% trigger might deter institutional investors from investing in Selectica (A1909 (Tr. 126); A2127 (Tr. 987)).[5]

I. The Board Received No Advice from Third Parties on the Usability of Its NOLs or the Effects of an NOL Pill.

None of the other parties attending the November 16, 2008 meeting supplied the Board with advice regarding the reasonably expected usability of the NOLs. Jim Reilly of Needham & Company (an investment banker engaged to explore potential strategic alternatives for Selectica) attended this meeting but never advised on what Selectica could reasonably expect to gain from potential utilization of the NOLs. (A2105 (Tr. 906)). The Board understood that Reilly was not an expert on NOLs. (A4484). Indeed, Reilly specifically cautioned the Board that he "wasn't a tax expert and didn't have a basis to give a view of what the value of the NOL was." (A2097 (Tr. 876)). While the Board's minutes recite that Reilly stated that Steel Partners had expressed interest in pursuing some sort of NOL-related transaction (A3738), Reilly testified that as of this meeting he had not yet actually spoken to anyone at Steel Partners. (A2105 (Tr. 907-08); *see also* A2101 (Tr. 890-91)). Reilly also did not advise the Board regarding whether the pill trigger should be lowered to 4.99%. (A2105 (Tr. 905-06)).

[5] This failure is notable given that earlier in 2008 Co-Chair Zawatski had told management, "we need more investors." (A1946-47 (Tr. 276-277); A3399-400).

The tax accountant previously hired at the recommendation of Steel Partners, John Brogan, also attended the meeting, but only repeated his earlier conclusion that under §382's formula Selectica was near the 40% "ownership change" level. (A3736-37). While the minutes state that Brogan told the directors that he usually recommends action where a company is at the 30% ownership-change level, there was no discussion by Brogan or the Board that Selectica had been near the 40% level since July 2008. (A1996 (Tr. 473); A2037 (Tr. 638)). Nor was there discussion of the fact that the Board had taken no action to protect the NOLs, including in response to Steel Partners' recent purchases. (A3734-46). Brogan provided no advice on whether or how any NOLs might generate value for Selectica or whether the Board should adopt the NOL Poison Pill. (A2036 (Tr. 635-36)).[6]

J. The NOL Poison Pill Is Implemented, Trilogy is Diluted, and the Board Adopts the Reloaded NOL Pill.

On December 22, 2008, Trilogy disclosed that it had purchased additional Selectica shares, bringing its total ownership to 6.7%. (A3860-69). In response, the Selectica Board met on December 29, 2008. (A3874-86). The only written material that the Board received (other than an agenda and minutes of a prior Board meeting) was a one-page summary by Brogan repeating his conclusions that Selectica remained at a 40% level of "ownership change." (A2000-2001 (Tr. 492-93); A3873; A3874-86).[7] In other words, under §382, Selectica remained in the same 40% range it had been in since July of 2008. (A1996 (Tr. 473), A2037 (Tr. 638)).

Reilly of Needham & Company was also present at this meeting and described it as "[e]ssentially the same general discussion as on . . . November 16th." (A2098-99 (Tr. 880-81)). Reilly had previously told the Board that he did not have the capacity to opine on the value of the Company's NOLs. (A2097 (Tr. 876)). Despite the minutes' recitation of a reference by Reilly to the use of the NOLs to offset future taxable income (A3877), there was no discussion of how or when Selectica could reasonably expect to actually generate taxable income. (A3874-86). Moreover, despite the minutes' recitation of a reference by

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6 Although certain of Selectica's minutes refer to the Company's counsel as present at Board meetings, Selectica has waived any reliance on advice of counsel. (A554-59).

7 Brogan's calculations kept Selectica at a 40% level by reclassifying Sems' interest in Selectica. (Tr. 481-82; A3757-60; A3761-857).

Reilly to the use of NOLs to offset taxable gains on a sale of its businesses (A3877), there was no discussion that the "built-in-gain" exception to §382 would render protection of the NOLs by a pill unnecessary in the event of such asset sales. (A3874-86; *see also* A2127-28 (Tr. 990-91); A4434 (testimony by Co-Chair Thanos that, at the time of his deposition in February 2009, he had never heard of the "built-in-gain" exception to §382)). There was also no discussion of Selectica acquiring a profitable business which might utilize the NOLs. (A1968 (Tr. 364)). Indeed, Co-Chair Zawatski testified that such a possibility was not considered. (A1968 (Tr. 364).

The Board confirmed its pill committee (Sems and Arnold) had complete discretion to determine whether to exempt Trilogy from the effects of the NOL Poison Pill or to implement an exchange of rights under the pill. (A3884).

On January 2, 2009, the pill committee met. (A3887-907). Although Reilly had previously told the Board that he was incapable of valuing the NOLs (A2097 (Tr. 876)), and Reilly was aware that no company contacted in connection with Needham's strategic alternative work for Selectica had ever expressed interest in the NOLs (A2105-06 (Tr. 908-09)), the committee minutes recite that Reilly baldly stated that the NOLs were "a valuable corporate asset of the Company in connection with the Company's ongoing exploration of strategic alternatives." (A3894).[8] While the committee minutes also reflect that Reilly referred to a purported "significant forecast growth in revenues and the transition to profitable operations in the fiscal year 2010," (A3893), there was no discussion at the meeting of how, in light of Selectica's poor historical performance and its accumulated NOLs, it could reasonably expect to transition to profitable operations as would be necessary to make use of the NOLs. (A3947-85). Nor was there any discussion of (1) the tax savings Selectica could reasonably expect from use of the NOLs, (2) whether a §382 "ownership change" would even jeopardize the use of any potentially needed portion of its NOLs, (3) whether the "built-in-gain" exception to §382 would render protection of the NOLs by a pill unnecessary in the event of an asset sale, or (4) any adverse consequences associated with a 4.99% pill trigger. (A3947-85).

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8 The statement in the minutes is puzzling, given that the one way in which NOLs might have value in a strategic alternatives process (apart from offsetting a built-in gain, which §382 would not jeopardize) would be selling assets and merging in a profitable business. But this was a topic never discussed by Reilly or the Board. (A1968 (Tr. 364)).

The committee declared Trilogy's share purchases non-exempt, determined to exercise the exchange provision under the pill, and further adopted the Reloaded NOL Pill. (A3986-A4042; A3897-902; A4055-129). Selectica's General Counsel testified that the committee "quickly" decided to implement the exchange and that there was no discussion on potential adverse effects. (A1999-2000 (Tr. 488-89)). Moreover, other than a slide that purported to show an increase in the number of proxy contests from 2004-2008 (*see* A3922), Reilly provided no analysis on the pill's impact on stockholders' ability to successfully wage a proxy contest, and no director inquired on that topic. (A2108 (Tr. 917-19)).

Selectica's exchange of shares under the NOL poison pill effectively doubled the number of shares of Selectica common stock owned by each stockholder of record as of the close of business on January 2, 2009, other than Versata, Trilogy and Joseph Liemandt (Trilogy's CEO). (A4055-129). The exchange resulted in the diminution of Trilogy's and Versata's beneficial interest from 6.7% to 3.3%. (A1910-11 (Tr. 132-33); A3860-69; A4055-129). The exchange led to a month-long cessation of trading in Selectica stock, with the price frozen at $0.69. (A4131-37; A4385).

K. Post-Ruling, Selectica Announces it Will Entertain "Indications of Interest" from Investors Seeking to Buy Shares in Excess of the Limits of the Reloaded Pill.

After the ruling by the Court of Chancery on February 26, 2010, Selectica issued a press release dated March 22, 2010 stating its NOLs were no longer in "jeopard[y]" under §382 and that "it may now be possible" for investors to increase their shareholdings "without threatening the value of the NOLs." (A4485-91). The press release said nothing with respect to when, if ever, Selectica believes it may utilize its NOLs. Rather than remove the Reloaded Pill and permit any shareholder to purchase, the Board said it would instead entertain "indications of interest" so that the Board could decide in its sole discretion which investors might be allowed to purchase Selectica shares beyond the trigger levels set in its Reloaded NOL Pill. *Id.* Subsequent filings have revealed that one of the investors allowed by the Board to increase his holdings was Steel Partners' and Lloyd Sems' collaborator, Lloyd Miller. (A4504-08; A4509-19; A3389; A4481-82; A3858-59; A3634; A3573; A3536).

ARGUMENT

I. THE COURT ERRED IN HOLDING THAT THE BOARD UNDERTOOK A REASONABLE INVESTIGATION IN ADOPTING AN NOL POISON PILL WITH A 4.99% TRIGGER.

A. Question Presented.

Did the Court of Chancery err in holding, under *Unocal*, that the Board undertook a reasonable investigation when it adopted NOL Pills for the purported purpose of protecting the Company's NOLs from an "ownership change" under §382 of the Internal Revenue Code (despite its prior determination that these NOLs would likely never be used), without considering (i) whether there was a reasonable likelihood that the NOLs would ever be utilized and (ii) whether the limitation created by an "ownership change" might still leave sufficient NOLs to offset any taxable income Selectica might reasonably achieve? (A765-76; A1424-36).

B. Scope of Review.

This Court reviews *de novo* mixed questions of law and fact and the Chancery Court's application of law to facts. *Scharf v. Edgcomb Corp.*, 864 A.2d 909, 916 (Del. 2004); *Brody v. Zaucha*, 697 A.2d 749, 753 (Del. 1997); *Zirn v. VLI Corp.*, 681 A.2d 1050, 1055 (Del. 1996). The Chancery Court's underlying factual findings are subject to reversal if they are not sufficiently supported by the record or are not the product of an orderly and logical deductive process. *Unitrin v. Am. Gen. Corp.*, 651 A.2d 1361, 1385 (Del. 1995). As set forth herein, the Chancery Court erred in its application of Delaware law to the facts of this case.

C. Merits of Argument.

The Board's adoption and subsequent use of an NOL Pill are subject to "enhanced judicial scrutiny" under *Unocal* and its progeny. *Moran v. Household Int'l, Inc.*, 500 A.2d 1346, 1356 (Del. 1985); *Unitrin*, 651 A.2d at 1372; *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 955 (Del. 1985). The Board claims to have adopted a 4.99% pill in response to a perceived threat posed by Trilogy's emergence as a 5% shareholder and a potential "ownership change" under §382. Under the first prong of *Unocal*, it was the Board's burden to prove it conducted a reasonable investigation into whether a potential "ownership change" under §382 posed a threat warranting a defensive response. *Unitrin*, 651 A.2d at 1375. The Court incorrectly applied Delaware law to the facts in its holding that the

Board fulfilled this burden. The record shows that the Board failed to conduct the most basic, fundamental inquiry of asking whether Selectica had a reasonable likelihood of utilizing its NOLs and whether an "ownership change" would have an impact on such potential use. Without this information, the Board could not reach a reasonably informed decision on whether an "ownership change" posed a threat warranting a defensive response.

1. The Court of Chancery erred in holding that the Board could conduct a "reasonable investigation" without considering whether there was a reasonable likelihood that the NOLs would ever be utilized.

As the Chancery Court recognized, NOLs are a "contingent asset" because "their value is contingent upon the firm's reporting a future profit (or having an immediate past profit)." (Ex. A at 2). For a company like Selectica that has no past profits, the value of its NOLs is dependent on whether it generates future profits. Without profits, the NOLs provide no benefit to the Company or shareholders.

The contingent nature of a company's ability to utilize its NOLs is fundamental to any reasonable inquiry into whether an "ownership change" is a "threat." In considering an NOL pill, a board must evaluate the reasonable likelihood of the company being able to utilize its NOLs. Will the company be able to use the NOLs by generating taxable income? How much of the NOLs might reasonably be used? When might these tax savings reasonably be generated? Without at least considering these issues, the directors cannot have a reasonably informed basis for evaluating whether the NOLs are worth protecting.

The Chancery Court appeared to agree in principle that a board must consider the probability of NOLs being utilized, but was unwilling to rule out the possibility that the Selectica Board may have somehow *tacitly* made such a determination:

> Trilogy is correct in pointing out that it is not sufficient to conclude that an asset with potential value is worth protecting without considering the probability of that value being realized, and that Selectica's failure to generate taxable income in prior years colors this probability. However, the absence of a formal study calculating such a value does not mean that the

> directors were unreasonable in concluding that a sufficiently material probability existed to merit the asset's preservation, or that such a determination was not implicit in their calculus.

(Ex. A at 52).

But *Unocal* and its progeny required the Selectica Board to prove at trial that it had affirmatively made a reasonable investigation. *Unitrin*, 651 A.2d at 1375. Unlike a business judgment rule case, the Board was entitled to no presumptions here. The Chancery Court's reliance on perceived "implicit" determinations, without record support, eviscerates the enhanced scrutiny standard.

More fundamentally, the shortcoming of the Board's investigation goes well beyond the "absence of a formal study," the lack of an "explicit plan" for how the NOLs will be used, or to the failure to attribute a "precise value" to its NOLs. (Ex. A at 32, 51-52). There is no evidence that the Board's decision-making included *any* consideration of whether Selectica might reasonably expect to utilize its NOLs to achieve tax savings, much less how much savings or when such savings might be realized. (A1908-09 (Tr. 124-25), A1910 (Tr. 131-320; A1912 (Tr. 139); A1978 (Tr. 403-404); A2001 (Tr. 493-94); A2105 (Tr. 906); A2127 (Tr. 988); A4431-32). That the Board did not consider the likelihood of the NOLs being utilized is not a matter in dispute. (A693-94; A1401). Indeed, Co-Chair Zawatski insisted at trial that there is no need for a board to assess the likelihood that the NOLs would be used in the future. (A1978 (Tr. 404)). Thanos, the other Co-Chair, did not even understand that the NOLs could not be used if Selectica never reports a profit. (A2127 (Tr. 988-89)).

The Board's failure to inquire into the likelihood of using the NOLs is particularly unreasonable given Selectica's circumstances and the information that was already known by the Board. As the directors well knew, despite repeated market guidance in the past predicting profitability, Selectica has never been profitable and has never had any profit against which to offset its NOLs. (A1884 (Tr. 26); A1899 (Tr. 87); A4520-30; A4536; A4554; A4564; A4575-88; A4567-74; A1210; A842; A3445-46, A3470; A3260, A3310; A3011, A3039; A2850, A2881; A2742, A2767; A2517, A2541; A2342, A2371; A2294-95). In light of this history, the Board could not merely assume that Selectica would generate taxable profits in the future as is necessary to make use of the NOLs.

The Chancery Court stated that "[i]f perhaps somewhat optimistic, [the Board] had rational expectations for the Company's near-term profitability," but cited no evidence in support. (Ex. A at 52). This bare reference to directors' purportedly "rational" hope of future profitability suggests a weakening of the *Unocal* enhanced scrutiny standard. Unlike a business judgment rule case, where a board's decision will be upheld if it has any *rational* business purpose, here the Board had the burden of proving that both its process and the substance of its decision were *reasonable*. In any event, there is no evidence in the record that the Board considered prospects for future profitability in connection with adopting the NOL Pill on November 16, 2008. For example, while Sems claimed at the 2009 trial that he thought he had seen forecasts of profitability for some point in 2010 or 2011, there is no evidence that any such forecasts were considered at the November 16, 2008 Board meeting. Moreover, in light of Selectica's history of making unreliable and unfulfilled public forecasts of profitability (A4520-30; A4536; A4554; A4564; A4575-88; A4567-74; A1210; A842; A3445-46, A3470; A3260, A3310; A3011, A3039; A2850, A2881; A2742, A2767; A2517, A2541; A2342, A2371; A2294-95), the Board also could not simply rely on internal management forecasts without assessing their reliability. Notably, Sems admitted months after the Pill's adoption, as of the time of his deposition, that he could not say when the Company might ever achieve profitability. (A2078-79 (Tr. 800-01)).

The Board also knew, or should have known, that the Company's SEC filings reflected that it was unlikely to utilize any of these NOLs before they expired. As discussed *supra* at pp. 6-7, Selectica consistently recorded a full valuation allowance for its NOLs, recognizing no value at all as a deferred tax asset on its balance sheet. (A862; A3489; A3340; A3064; A2907; A2796; A2571; A2415-16; A1200). Even after adopting the NOL pills and following the trial in this case, Selectica has continued to record a full valuation allowance for its NOLs. (A862). As such, Selectica has continually reported its determination that it is more likely than not that it will never use *any* portion of its NOLs.

The Board further knew that Co-Chair Thanos had declared in August 2008 that he did not think the NOLs had any value and that he had been told as much by every investment banker with whom he discussed the matter. (A3572; A2112 (Tr. 933)). The Board's knowledge of these facts makes it even more unreasonable for it to have assumed, without investigation, that the NOLs had a value worth protecting. Moreover, the vague suggestion that a large shareholder such as Steel Partners might have interest in the NOLs is not a substitute for the Board conducting the required reasonable investigation, particularly in the context of the important decision to adopt a 4.99% poison pill. *In re Fort Howard Corp. Shareholders Litigation*, 1988 WL 83147, at *1 (Del. Ch. Aug. 8, 1988) ("The more significant the subject matter of the decision, obviously, the greater will be the need to probe and consider alternatives. . . . the gravity of the transaction places a special burden upon the directors to make sure that they have a basis for an informed view.") (Ex. C).

The advice the Board received from third parties in attendance at its meetings (Brogan and Reilly) was insufficient to satisfy the Board's obligation to investigate the likelihood of utilizing the NOLs or to cloak the Board with the protections of § 141(e) of the Delaware General Corporation Law. Brogan's role was to calculate the *size* of the NOLs and to conduct a §382 analysis, which measures only the "ownership change" level and does not speak to the usability of the NOLs. (A3736-37). Brogan did not talk with the Company about its business or strategic plans and never advised the Board on how the NOLs might be used in the future to generate any value. (A2036 (Tr. 636); A2038 (641-42)). The information provided by Brogan does not provide a basis for the Board to have formed a conclusion on the likelihood of the NOLs being utilized.

Nor did Reilly, the investment banker, provide the Board with advice sufficient to fulfill their duty to reasonably investigate. Reilly expressly told the Board that he "wasn't a tax expert and didn't have a basis to give a view of what the value of the NOL was" (A2097 (Tr. 876)) and he never provided an estimate of what, if any, monetary value Selectica could reasonably expect to receive from the NOLs. (A2105 (Tr. 906)). Having been told by Reilly that he had no basis to provide a view of the value of the NOLs, the Board could not have reasonably relied on him on that issue. *Brehm v. Eisner*, 746 A.2d 244, 262 (Del. 2000) (§141(e) inapplicable if directors "did not reasonably believe that the expert's advice was within the expert's professional competence"). Indeed, the Board knew that Reilly did not have expertise on NOLs. (A4484).

Nor could the Board reasonably rely on Reilly's generic experience as an investment banker to fulfill their duty to investigate. Even if the recitations in the Board's meeting minutes are taken at face value,[9] the record as a whole reflects that, at most, Reilly provided the Board with the naked conclusion that the NOLs were a "valuable corporate asset" after previously admitting that he could not

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9 The trial testimony suggests that the Board's minutes are not accurate. For instance, although the November 16, 2008 minutes state that Reilly spoke of Selectica's NOLs as having "significant potential value" (A3738), Reilly testified that he did not believe he used the word "signficant" but only said they had "potential value." (A2105 (Tr. 906-07)). With respect to this same meeting, Reilly flatly denied that "other parties" had expressed interest in Selectica's NOLs, even though the minutes attribute this statement to him. (A4479; A3738).

speak to the value. (A2097 (Tr. 876); A3894). The Board could not blindly rely on such conclusory advice without supporting explanation, particularly on a significant matter like the adoption of a 4.99% poison pill. *Mills Acquisition Co. v. Macmillan*, 559 A.2d 1261, 1281 (Del. 1989); *Union Illinois v. Korte*, 2001 WL 1526303, at *11 (Del. Ch. Nov. 28, 2001) (Ex. D). Reilly testified that *none* of the participants in the strategic alternatives process expressed any interest in the NOLs. (A2105 (Tr. 908)). Anything Reilly may have said about Steel Partners having an interest in the NOLs was admittedly second-hand information (A2105 (Tr. 907-08)), hardly a basis for reasonable reliance. *Smith v. Van Gorkom*, 488 A.2d 858, 875 (Del. 1985) (had directors made the required inquiries, "the inadequacy of that upon which they now claim to have relied would have been apparent"). Nor could Reilly have offered any advice about how Steel Partners might structure a transaction to make use of the NOLs. Reilly first met with Jack Howard of Steel Partners during the second week of January 2009 – *after* adoption of the pills – for the admitted purpose of learning about how Steel Partners might navigate through the "minefield" of §382 issues. (A2101 (Tr. 890-91)). Reilly did not and could not have provided the Board with reasonable advice on utilization of the NOLs in December 2008.

2. The Court of Chancery erred in holding that the Board could conduct a "reasonable investigation" without considering whether any potential use of the NOLs would be impacted by a §382 ownership change.

The Board failed to make another fundamental inquiry: whether potential use of the NOLs, if any, would be affected by an "ownership change" under §382. Without considering this issue, the Board did not have an informed basis on which to conclude that Trilogy's (or anyone's) stock purchases posed a "threat" to the NOLs. As discussed *supra* at pp.4-5, NOLs are not lost or rendered completely unusable if there is an "ownership change." (A1884 (Tr. 28); A2202 (Tr. 1283); A2217-18 (Tr. 1345-46)). This impacts in two ways how reasonable directors would consider whether an "ownership change" under §382 poses a threat to important company interests.

First, the limitations imposed upon the occurrence of an "ownership change" do not apply to all uses of NOLs. As §382 expert Elliot Freier explained at trial, "built-in gains" recognized during the five years following an "ownership change" are not subject to the limitations imposed by §382. (A2202 (Tr. 1284-85)). If a company has appreciated assets and sells them for a taxable gain, it can use all of its NOLs to offset that taxable gain even if there has been an "ownership change" under §382. (A2202 (Tr. 1284-85); A2217 (Tr. 1343)). The

Board did not consider this issue at the time it adopted the NOL Pills, (A1965 (Tr. 350-51), A2127-28 (Tr. 990-91)), even though Board members later speculated at trial about offsetting gains on the sale of assets as a theoretical way of using the NOLs. (A1888 (Tr. 43); A1969 (Tr. 366-67)). Co-Chair Thanos was not even aware of the concept of the built-in gain exception. (A4434). Brogan was undoubtedly aware of the "built-in gain" rule, but because the Board never considered whether the NOLs might reasonably be used, it failed to inquire whether an "ownership change" would even matter under such circumstances. This information was both reasonably available and of fundamental importance: to the extent the Board believed that the NOLs might be used to offset a gain on the sale of assets as part of the strategic alternatives process, there would be no need to adopt a 4.99% pill because an "ownership change" does not impact use of the NOLs for this purpose. (A2202 (Tr. 1284-85); A2217 (Tr. 1343)).

Second, even if there is an "ownership change" under §382, a company will still be able to use some of its NOLs for any purpose. (A1884 (Tr. 28); A2202 (Tr. 1283); A2217-18 (Tr. 1345-46)). As explained *supra* at pp. 4-5, only a portion of the NOLs may be rendered unavailable under §382's formula, with the rest fully applicable to any profit.

At trial, Trilogy's expert Dr. Porter explained these concepts using an example corresponding to Selectica's circumstances in mid-November 2008. If a company had an equity value of $30.7 million at the time of an "ownership change" and the federal interest rate was 4.94%, that company would still be able to use approximately $1.5 million of its accumulated NOLs each year. (A2217-18 (Tr. 1345-46); A4357).[10] The annual limitation accumulates from year to year if it is not used, so that company would have approximately $3 million in usable NOLs in year 2, $4.5 million in year 3, etc., even though there was an "ownership change" under §382. (A2218 (Tr. 1346-48)). Significant profits (especially for a company like Selectica which has none to date) could thus be sheltered by NOLs even if there was an "ownership change." In addition, any losses incurred after the "ownership change" would not be subject to the limitation and would be usable in addition to the accumulating annual limitation amount. (A2218 (Tr. 1349)).

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10 Porter also found that, among companies that Selectica would be in a position to acquire in the event of an asset sale based on industry and market capitalization, the average profits per year is $1.565 million. (A4353-54; A4381).

While Dr. Porter used an example corresponding to Selectica's situation in mid-November 2008, what is important is that (i) a company may still have significant usable NOLs even if there is an "ownership change" and (ii) there are ways to assess whether an "ownership change" would be significant. (A2217-19 (Tr. 1345-52)). To determine whether an "ownership change" would even impact the use of Selectica's NOLs, all the Board needed to do was compare reasonable projections of Selectica's future profitability (or lack thereof) with the "annual limitation" amount available to Selectica in the event of an "ownership change" under §382. It is undisputed that the Board did not consider this issue. Its failure to do so means that it lacked an informed basis for concluding that an "ownership change" under §382 would result in any harm to the Company.

3. The Court of Chancery correctly held that the Board is not entitled to any "enhancement" of its evidence.

As the Court of Chancery found, the Board did not meet the requirement set forth in *Unitrin* for enhancement of its evidence because two of the four Board members, Co-Chairs Thanos and Zawatski, were not "outside" directors. (Ex. A at 34-40). In the context of enhanced scrutiny under *Unocal*, an "outside" director is "defined as a non-employee and non-management director." *Unitrin*, 651 A.2d at 1375. As shown at trial, Zawatski and Thanos took over as the co-CEOs of Selectica in July 2008 when the Board fired its CEO and decided not to hire a replacement. (A1886 (Tr. 34); A2074 (Tr. 783); A2111 (Tr. 930); A1933 (Tr. 222); A1938 (Tr. 243-44); A1987-88 (Tr. 440-41); A2118 (Tr. 957-59); A3570-71). After trial, Selectica confirmed this proof, admitting that Zawatski and Thanos "are acting in a capacity similar to that of a chief executive officer" and are members of management. (A866, A868). From July 2008, when they assumed these positions, through March 2009, the month prior to trial, Thanos was paid $164,125 and Zawatski was paid $274,273, apart from regular compensation as Board members. (A866). Their compensation and their management responsibilities demonstrate that Zawatski and Thanos cannot be considered "non-employee and non-management" directors. *Unitrin*, 651 A.2d at 1375. The Board is accordingly not entitled to any enhancement of its evidence.

As to the more fact-specific independence inquiry, the Court of Chancery found that the compensation paid to Thanos and Zawatski was "material by any measure." (Ex. A at 39). It nonetheless found that there was insufficient evidence to conclude that the compensation was material to Thanos and Zawatski. (A1748-49 (Ex. A at 39-40). While this conclusion was not a basis for the Chancery Court's decision (because no enhancement of evidence was applied), it was erroneous. Selectica has admitted that "Mr. Thanos and Ms.

Zawatski are not 'independent' directors within the meaning of applicable rules of the SEC and The Nasdaq Global Stock Market." (A866). The Chancery Court's willingness to accept Thanos' and Zawatski' bare testimony that the compensation was not material to them, in the absence of any evidence about their net worth, turns the enhanced scrutiny standard on its head. Under *Unocal* the burden of proof was on the Board to prove the reasonableness of its decision-making process. *Unitrin*, 651 A.2d at 1373. If the Board seeks an enhancement of its evidence, it properly bears the burden of proof on independence. The absence of evidence should be held against the Board, not against Trilogy.

Trilogy also respectfully suggests that while independence may have a bearing on directors' motivations and good faith, it is difficult to see how an evidentiary enhancement would apply to evidence of a board's decision-making process. The independence of a director cannot convert a Board's unreasonable decision-making process into a reasonable one.

II. THE COURT OF CHANCERY ERRED IN HOLDING THAT SELECTICA'S NOL POISON PILL WAS NOT PRECLUSIVE BECAUSE IT DID NOT RENDER A SUCCESSFUL PROXY CONTEXT "A NEAR IMPOSSIBLITY OR ELSE UTTERLY MOOT."

A. Question Presented.

Did the Court of Chancery err in holding that a poison pill with a 4.99% trigger, adopted by a Delaware corporation with staggered board terms pursuant to its charter, was permissible because it did not render successful proxy contests for change of control "a near impossibility or else utterly moot," where the evidence in the record demonstrated that a successful proxy contest was "realistically unattainable" by a shareholder owning less than 5% of the corporation's stock? (A776-85; A1436-43).

B. Scope of Review.

This Court reviews *de novo* mixed questions of law and fact and the Chancery Court's application of law to facts. *Scharf*, 864 A.2d at 916; *Brody*, 697 A.2d at 753; *Zirn*, 681 A.2d at 1055. The Chancery Court's underlying factual findings are subject to reversal if they are not sufficiently supported by the record or are not the product of an orderly and logical deductive process. *Unitrin*, 651 A.2d at 1385. As set forth herein, the Court of Chancery erred in its formulation of the legal standard and its application of Delaware law to the facts of this case.

C. Merits of Argument.

1. The Court of Chancery Applied an Unduly Restrictive Test for When a Poison Pill Is Preclusive.

This Court's approval of traditional poison pills with 15% or 20% triggers was premised in part on the conclusion that they do not "fundamentally restrict stockholders' right to conduct a proxy contest." *Moran*, 500 A.2d at 1355; *see also Leonard Loventhal Account v. Hilton Hotels Corp.*, 780 A.2d 245, 249 (Del. 2001) (characterizing *Moran* as based on the fact that "the rights plan would not have the *unauthorized effect* of restricting stockholders' rights to conduct a proxy contest") (emphasis added). While pills transfer power from the owners of a corporation to directors, the "safety valve. . . is that the shareholders always have their ultimate recourse to the ballot box." *Carmody v. Toll Bros., Inc.*, 723 A.2d 1180, 1193 (Del. Ch. 1998). Shareholders can launch a proxy contest to change control of the board and redeem the pill. *Unitrin*, 651 A.2d at

1381 (bidders "must launch and win proxy contests to elect new directors who are willing to redeem the target's poison pill") (quoting J. Grundfest, *Just Vote No: A Minimalist Strategy for Dealing with Barbarians Inside the Gates*, 45 Stanford L. Rev. 857, 859 (1993)); *see also In re Gaylord Container Corp. S'holders Litig.*, 753 A.2d 462, 481 (Del. Ch. 2000) (where potential acquiror may change board control through proxy contest, and then redeem the pill, the pill is not "preclusive").

Conversely, a defensive measure such as a pill is preclusive and invalid if it makes a challenger's ability to "wage a successful proxy contest and gain control *either* 'mathematically impossible' *or* 'realistically unattainable.'" *Carmody*, 723 A.2d at 1195 (emphasis added), quoting *Unitrin*, 651 A.2d at 1388-89; N. Gordon, *"Just Say Never" Poison Pills, Deadhand Pills and Shareholder Adopted Bylaws: An Essay for Warren Buffett*, 19 Cardozo L. Rev. 511, 541 (1997).

While the Chancery Court recited this Court's *Unitrin* standard (Ex. A at 54), the standard it actually applied was more restrictive. In the Chancery Court's view, "[t]o find a measure preclusive . . . the measure must render a successful proxy contest a near impossibility or else utterly moot." (Ex. A at 60)). The standard applied by the Chancery Court essentially eliminates the "realistically unattainable" portion of the *Unitrin* preclusiveness test in favor of a stricter impossibility (or near impossibility) standard, heretofore not recognized under Delaware law as the sole basis for determining preclusiveness.

The Chancery Court's treatment of Trilogy's expert testimony highlights the application of this erroneous standard. The Court recognized that "expert testimony suggests that a poison pill with a less than 5% trigger 'has a substantial preclusive effect,'" but minimized the import of that finding because that witness candidly conceded that the pill was "not 100 percent preclusive" and that a successful proxy contest was a "theoretical possibility." (Ex. A at 59). But Delaware law requires that a successful proxy contest be a *realistic* possibility, not just a theoretical one. For example, Vice Chancellor Strine has held that a supermajority bylaw was preclusive because the "expert evidence support[ed] the inference that victory is not realistically attainable" even though defendants could "demonstrate that it is theoretically possible" for the dissident shareholder to have obtained enough votes. *Chesapeake Corp. v. Shore*, 771 A.2d 293, 340-41 (Del. Ch. 2000). The Court of Chancery erred in applying an unduly restrictive standard for preclusiveness.

2. Selectica's 4.99% Poison Pill, in Combination With its Charter-Based Classified Board, Is Preclusive.

Under the correct standard, the Selectica Board failed to show that the 4.99% poison pill is not preclusive.[11] The trial testimony and expert reports of Trilogy's expert, Professor Allen Ferrell, demonstrate that a pill with a 4.99% trigger, in combination with Selectica's charter-based classified board, makes a successful proxy contest for control of the board "realistically unattainable." This conclusion is buttressed by the fact that Selectica, which has the burden of proof on lack of preclusiveness, has presented *no example in U.S. corporate history* where a holder of less than 5% of a company's stock succeeded in a proxy contest for control against a charter-based classified board.

a. Selectica's Pills Prevent a Challenging Stockholder from Gaining Credibility in a Proxy Contest Because They Cap Equity Ownership at a Low Level.

Empirical data demonstrates a strong correlation between the size of a proxy challenger's holdings and the challenger's ability to succeed. *See* A2146-47 (Tr. 1064-67), A2156-57 (Tr. 1105-09); A4250-52; J. Pound, *Proxy Contests and the Efficiency of Shareholder Oversight*, 20 Journal of Financial Economics 237, 252, and Table 2 (1988). In both 2008 and historically, average stockholdings were significantly higher for victorious challengers in proxy contests for board seats than for losing challengers. *Id.* In 2008, for example, the average holdings of challengers in successful contests was 9.17%, while the average holdings of challengers in unsuccessful contests was 5.68%. *Id.* As Professor Ferrell testified, an important mechanism for enabling a challenger to signal credibly to fellow stockholders that its slate of directors will improve the firm's performance is for the challenger to have more "skin in the game," *i.e.*, to own a significant block of shares in the company. (A2146-47 (Tr. 1064-670); *see also* J. Pound, Proxy Contests and the Efficiency of Shareholder Oversight, 20 Journal of Financial Economics 237 (1988)). With the exception of a handful

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11 The Board also failed to consider at all a 4.99% pill's impact on proxy contests (A2079 (Tr. 802)), (A1996 (Tr. 474)), providing an additional basis for invalidation. *Chesapeake Corp.*, 771 A.2d at 334 (faulting board for "simply ma[king] no judgment" or not "even discuss[ing]" impact of defensive response on stockholders' ability to amend bylaws); *Cf. Moran*, 490 A.2d at 1080 (Del. Ch. 1985) (the "Board was advised of the ramifications of the Plan on proxy contests").

of shareholders who are "grandfathered" at higher equity levels, a challenger in a proxy contest for control at Selectica cannot signal this belief by increasing his ownership stake above 4.99%.

Significantly, neither party located a single example where a shareholder below 5% succeeded through proxy contests in changing control of a charter-based staggered board. (A2141 (Tr. 1043)). While Selectica's expert, Mr. Harkins, presented data purporting to show that challengers with low holdings "prevailed" in six proxy contests at micro-cap companies, (A4142, A4180; A2140 (Tr. 1040-41)), his definition of "prevail" renders that data inapplicable to the inquiry at hand. Mr. Harkins considered a proxy challenger to have "prevailed" if even only one challenger-supported director was added to the board, even through a negotiated compromise, regardless of the fact that challenger failed to change board control. (A2139-41 (Tr. 1038-43)). The Court's opinion appears to adopt Harkins' overbroad definition of "prevail[ing] in a proxy contest." (Ex. A at 59 n.186). But the preclusiveness question focuses on whether a challenger could realistically attain sufficient board control to remove the pill. *Unitrin*, 651 A.2d at 1381. The absence of a single example where a challenger owning less than 5% was able to obtain control of a charter-classified board (A2141 (Tr. 1043)) is strong evidence that such an outcome is "realistically unattainable."

b. Selectica's NOL Pills, When Coupled with the Directors' Staggered Terms, Render Unrealistic a Conditional Takeover Bid by a Challenger in a Board Proxy Contest.

As both Professor Ferrell and Selectica's witness Professor John Coates have noted, a challenger in a proxy contest can also signal the superiority of its slate of director nominees by making a bid for the company that is conditional on its slate being elected. (*See* A4252-53, citing *inter alia* L. Bebchuk, J. Coates & G. Subramanian, *The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence & Policy*, 54 Stanford L. Rev. 887, 920 (2002) ("[The] empirical evidence suggest[s] that proxy contests for control, without an accompanying tender offer, are seldom successful."); *see also* A2147 (Tr. 1067-69)).

Selectica's charter-based classified board (A2252-65 at Ex. 3.1, art. IV), however, effectively forecloses a conditional takeover bid because it requires a proxy challenger to launch and complete two successful contests in order to change control. (A2147 (Tr. 1069-70); A4255; *Gaylord*, 753 A.2d at 482; *see also MM Companies, Inc. v. Liquid Audio, Inc.*, 813 A.2d 1118, 1122 (Del. 2003). Delaware courts recognize it is "*unrealistic* to assume" that a challenger would keep a tender offer open for more than a year, "[g]iven the market risks inherent in financed hostile bids for public corporations." *Carmody*, 723 A.2d at 1194 (emphasis added). Selectica's witness, Professor Coates, has previously "argue[d] that [a ballot box] safety valve is *illusory* when the target has an [effective classified board]." L. Bebchuk, J. Coates & G. Subramanian, *The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence & Policy*, 54 Stanford L. Rev. 887, 909 (2002) (emphasis added)). In fact, Professor Coates found that out of 92 hostile bids initiated and resolved in 1996-2000, there was "not a single ballot box victory against [effective classified board] targets." *Id.* at 909, 927.

In the case of Selectica, a challenger could not get around the classified board structure.[12] A challenger could not seek to declassify the Board because the corporate charter establishing the staggered terms may only be amended with the Board's approval. (A2147 (Tr. 1069)). Nor could a challenger pursue a change in Board size to overcome the staggered-term obstacle, since that power is also vested exclusively in the Board by Selectica's charter. (A2430, § 3.2).

c. Selectica's 4.99% Pill Trigger and Staggered Board Decrease the Probability that a Challenger Would Incur the Proxy Contest Costs Necessary to Seek Control.

Professor Ferrell testified that those studying proxy contests have long recognized the so-called "free rider" problem associated with an investor undertaking a proxy contest for a change in board control. (A2148 (Tr. 1072-73); *see also* A4255-56, citing Robert Clark, CORPORATE LAW 392-396 (1986)). The "free rider" problem arises from the fact that an investor must bear fully the costs associated with a proxy contest in the event that the investor's board nominees fail to be elected, while the benefits of successful challenge accrue to all stockholders. (A2148 (Tr. 1072); A4255-56).

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12 After trial, the Board amended the charter to eliminate staggered terms, recognizing "the added accountability to shareholders of holding all director elections annually." (A1608). On October 12, 2009, Trilogy filed a Seconed Motion for Judicial Notice requesting that the Court of Chancery take judicial notice of the Selectica proxy statement that referenced the foregoing charter amendment. (A1590-1639). The Court of Chancery entered an order on October 15, 2009 granting Trilogy's motion. (A1706-07).

As explained by Professor Ferrell, the "free-rider" problem is exacerbated by Selectica's charter-based classified board and 4.99% pill. The classified board doubles the costs a challenger must incur (while reducing the probability of success) by forcing the challenger to undertake two proxy contests rather than just one. (A2148 (Tr. 1073-74); A4258-59). By capping a proxy challenger's interest at 4.99%, Selectica's poison pill creates an economic disincentive to an effort to change control of the Board because it means that a challenger would have to spend a disproportionate amount of its equity investment to incur the cost of these two proxy contests.

The confluence of these two exacerbating factors is well-illustrated in the case of Selectica by using the estimated cost of two proxy contests and the size of a challenger's maximum equity holdings with a 4.99% cap, which at the time of the initial post-trial briefing was approximately $1,000,000. (A784). Trilogy presented evidence regarding customary and likely proxy contest costs (including legal fees for document preparation, communication costs and potential litigation costs) showing that a challenger would likely have to incur a minimum of $736,000 over two proxy contest cycles. (A2965-70; A4257-58.) Using this estimate, a challenger would have to spend at least 73.6% of its equity investment to fund a proxy battle for control. Even using Selectica's estimate of costs, a proxy challenger would likely have to spend 20% - 33% of its equity investment, plus litigation fees. (A2141-42 (Tr. 1043-49)).[13] Either is enough to create an economic disincentive to bringing a proxy challenge for control, and the 4.99% pill trigger blocks this investor from internalizing more of the benefits of changing control of the Company by increasing his share ownership above the 4.99% level. The cumulative effect is to reduce the likelihood that a potential challenger would find it economically rational to seek to change control of the Board.

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13 Selectica initially presented evidence that the cost of two proxy contests would be approximately $100,000-$130,0000, an estimate which increased to approximately $200,000-$330,000 upon cross-examination and which still excludes litigation fees which Mr. Harkins estimated are incurred in 40% of all proxy contests (A4147; A2141-42 (Tr. 1043-49). The Chancery Court made no factual finding regarding the estimated cost.

d. The 4.99% Pill Trigger Locks in the Existing Ownership Structure of Selectica Absent a Board "Exemption."

Selectica's 4.99% pill effectively locks the existing stock ownership hierarchy (dominated by Steel Partners, Lloyd Miller and director Lloyd Sems – who collaborate on a common agenda and control in excess of 36%). (A4259-60; A3389; A4481-82; A3858-59; A3634; A3573; A3536; A1623-24; A4509-19).

Moreover, the Board's power to exempt certain purchasers from the NOL Pill increases the potential for entrenchment, as directors can exercise their discretion to grant an "exemption" to stockholders who are perceived to be likely to vote in favor of management in the event of a proxy contest. (A2148 (Tr. 1074)). The potential ramifications are suggested by Selectica's recent announcement that it would accept "indications of interest" from investors wishing to increase their stake, which the Board would consider on a case-by-case basis. (A4485-91). Although suggesting that the Company's NOLs were no longer "jeopardized" by share acquisitions under §382, the Board did not revoke the Reloaded Pill, but rather remained as the "gatekeeper" of who, if anyone, might be allowed to increase their holdings above 5%. Selectica subsequently announced that the Board had decided to permit two shareholders to increase their stake to 20%, one of whom was later revealed to be Lloyd Miller. (A4492-94; A4504-08; A4509-19). (The identity of the second exempted shareholder has not been disclosed.) In addition, the 4.99% cap can discourage large institutional investors from acquiring Selectica stock, not only locking in the current group of large holders but also shielding the directors from any new institutional "activists" seeking accountability and change. (A2148-49 (Tr. 1074-75); A4259-60).

In sum, unlike the poison pill allowed in *Moran*, Selectica's 4.99% pill, in combination with its charter-based classified board, renders a successful proxy contest for control of the board "realistically unattainable." Selectica's 4.99% poison pill should accordingly be found preclusive, unlawful and invalid.

CONCLUSION

For all of the foregoing reasons, Appellants respectfully request that this Court reverse the Court of Chancery's February 26, 2010 Memorandum Opinion and render judgment declaring that (i) the Selectica Board did not undertake a reasonable investigation in adopting an NOL poison pill with a 4.99% trigger; (ii) Selectica's 4.99% NOL poison pill, in combination with its charter-based classified Board, is preclusive; and (iii) the implementation of Selectica's 4.99% poison pill should be reversed to return Trilogy to its pre-dilution ownership interest, and grant Trilogy such other relied as it may be entitled.

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CERTIFICATE OF SERVICE

The undersigned hereby certifies that on June 1, 2010, APPELLANTS VERSATA ENTERPRISES, INC.'S AND TRILOGY, INC.'S OPENING BRIEF was caused to be electronically served via *LexisNexis File and Serve* on the following counsel of record:

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