IN THE SUPREME COURT OF THE STATE OF DELAWARE

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

**APPELLANTS' REPLY BRIEF AND**
**CROSS APPELLEES' ANSWERING BRIEF**

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## SUMMARY OF ARGUMENT

## TRILOGY'S REPLY TO SELECTICA'S SUMMARY OF ARGUMENT ON TRILOGY'S APPEAL

In an effort to avoid enhanced scrutiny, Selectica argues that *Unocal* is inapplicable, despite its previous repeated agreement that it was the appropriate standard of review. Even if not waived, Selectica's argument is incorrect. Its adoption of a 4.99% pill following Trilogy's emergence as a significant shareholder was a measure that was adopted in response to a purported threat to corporate policy and effectiveness which touched on issues of control.

To defend the Board's failure to consider, prior to adopting the NOL Poison Pill, whether there was a likelihood that Selectica's NOLs would be utilized or whether any such use would be impacted by an "ownership change" under the Internal Revenue Code, Selectica takes the position that such information was both immaterial and unknowable. This position defies common sense, contradicts the record, and ignores the seriousness of adopting a low-threshold pill. The likelihood of utilizing the NOLs and whether an ownership change would impact any such use are basic issues that are essential to a reasonable investigation prior to adopting a poison pill for the purported purpose of deterring such an ownership change. This information was both material and reasonably available. The Board's failure to consider these issues before taking drastic action was a breach of fiduciary duty. Selectica's strained effort to show that the Board did consider these issues only highlights the inadequacy of the Board's investigation.

Selectica's response as to the preclusiveness of the NOL Pills overlooks that in order to preserve the safety valve of the shareholder ballot box, Delaware law requires that a successful proxy contest for control be a realistic possibility, not merely a theoretical one. Trilogy's evidence demonstrated that the NOL Pills, in combination with a charter-based classified board, rendered realistically unattainable a successful proxy contest for control. Selectica's argument to the contrary ignores empirical data, relies solely on anecdotal testimony from a proffered expert who admittedly has no experience with a proxy contest involving a 4.99% pill, attempts to redefine a "successful" proxy contest under this Court's prior pill holdings, and overstates the significance of Selectica's purportedly concentrated shareholder base. The record fully supports a finding that the NOL Pills are preclusive and therefore invalid.

## TRILOGY'S ANSWER TO SELECTICA'S SUMMARY OF ARGUMENT ON CROSS APPEAL

Denied. The Court of Chancery correctly denied Selectica's request for an award of attorney's fees. Trilogy's decision to buy additional stock in Selectica, its refusal to accept a standstill, and its efforts to achieve a global settlement are the very events that gave rise to this lawsuit. As such, these events cannot support a fee award under the "bad faith" exception to the American rule, as interpreted by this Court. The Court of Chancery made no finding of bad faith, express or implicit, and even if it had done so, such a finding would not have precluded the Court from declining to award attorneys' fees in its exercise of discretion. In all events, the record does not support Selectica's contention that Trilogy has acted in bad faith at any time.

## COUNTER-STATEMENT OF FACTS TO SELECTICA'S CROSS APPEAL

### A. Trilogy's Prior Investments in and Offers to Acquire Selectica.

Trilogy is in the business of developing enterprise software solutions for large corporations. (A2158 (Tr. 1113-14)). As part of its business, Trilogy has from time to time bought, sold, or invested in other enterprise software and technology companies, in particular those with a history of underperformance. (A2159 (Tr. 1115-18)). Over the years, Trilogy has invested in Selectica and has made prior offers to acquire the Company. (A2159-60 (Tr. 1118-19); A2160-63 (Tr. 1121-34)).

In 2004, Trilogy began investing in Selectica stock with the belief that Selectica might be a good acquisition target. (A 2160 (Tr. 1121-22)). Trilogy purchased up to approximately 7% of Selectica stock in the years between 2004 and 2006. (A2160 (Tr. 1121)); AR128; AR152-53). In 2005, Trilogy also made two offers to acquire Selectica at an approximately 20% premium to Selectica's then-trading share price. (A2159-60 (Tr. 1118-19)). Selectica rejected the first offer, and the second offer failed during the parties' efforts to negotiate a consensual merger agreement. (A2814; AR131; A2159-60 (Tr. 1118-19)).

In connection with its review of Selectica in Trilogy's capacity as an investor, Trilogy discovered what appeared to be a number of suspicious stock option grants. (A2161 (Tr. 1123)). In September 2006, while still a large Selectica shareholder, Trilogy sent a letter to the Company's Audit Committee questioning the propriety of certain prior stock option grants. (AR 147-48). A resulting internal investigation at Selectica revealed that certain options granted to Selectica officers and directors during fiscal years 2001-2005 had in fact been backdated to falsely show an earlier grant date. (AR161; AR181-82; AR217-19). After this investigation, Selectica was required to record additional stock-based compensation expenses and related tax effects for past option grants and to restate its financial statements. (A3260-61). It incurred "professional fees" associated with the investigation exceeding $6.2 million. (A3449).

Trilogy sold its Selectica stock in 2006 based on Trilogy's understanding that Selectica was not interested in selling itself, and taking into further consideration Selectica's mismanagement problems and apparent intellectual property improprieties. (A2160-61 (Tr. 1122-23); AR165-66).

B. Selectica's Infringement Upon Trilogy's Intellectual Property and Its Settlement-Related Obligations to Trilogy.

Selectica and its Board have repeatedly permitted patent infringements on Trilogy's intellectual property. Between 2004 and 2007, Trilogy was forced to bring two separate suits to end Selectica's patent infringements. (A2176 (Tr. 1185-86); AR142, AR146; A3383, 3386; Opening Appeal Brief at 9). In January 2006, the first suit was settled, with Selectica agreeing to pay Trilogy $7.5 million. (AR142, AR146; A1958 (Tr. 322-23); A2997). The second suit was settled in October 2007, with Selectica paying $10 million and agreeing to future quarterly payments up to a total of $7.5 million. (A1958-59 (Tr. 323-25); A2176-77 (Tr. 1186-88); A3383, 3386). The future payments were pursuant to a joint marketing agreement between Trilogy and Selectica as part of the settlement. (A2177-78 (Tr. 1187-92)). Under this agreement, Selectica agreed to make quarterly base-level payments to Trilogy or to pay a percentage of Selectica's configuration revenue, whichever was higher. (A2177 (Tr. 1187-88), A2178 (Tr. 1192)). In other words, the amount of the quarterly payments to Trilogy depended upon the success of Selectica's configuration business. (A2178 (Tr. 1193)). The agreement was the idea of Selectica's then-CEO, Robert Jurkowski, who wanted Trilogy and Selectica to "work together to revitalize the configuration market." (A1958 (Tr. 324); A2177-78 (Tr. 1187-93); A3386 ).

The second patent settlement also involved a cross licensing agreement, wherein Selectica was explicitly prohibited from licensing to two Trilogy customers: SAP and Sun Microsystems ("Sun"). (A2177 (Tr. 1190)). On November 10, 2008, Selectica publicly announced that it had licensed its software to Sun, giving Trilogy concrete evidence that Selectica was once again in violation of Trilogy's patents. (AR222; A2181 (Tr. 1203-04)).

C. Trilogy's Offers to Acquire Selectica in the Summer of 2008.

After terminating CEO Jurkowski in June of 2008 (A1954 (Tr. 305); A3542), Selectica's Board, run by Co-Chairs and acting CEOs Brenda Zawatski and James Thanos, essentially abandoned Selectica's configuration business, thereby effectively ending the possibility of Trilogy receiving future payments above the minimum payments set forth in the October 2007 joint marketing agreement. (A2178-79 (Tr. 1194-1197); AR221); Opening Brief at 8).

Notwithstanding these developments, Trilogy believed Selectica might be willing to consider an acquisition proposal, based upon communications with CEO Jurkowski prior to his termination. (A2161 (Tr. 1123-24)). Moreover, it appeared to Trilogy that the new interim management at Selectica was making preparations to sell the Company in an expedited manner. (A2161 (Tr. 1124)). On July 30, 2008, Trilogy extended alternative acquisition proposals to Selectica (A3569; A2161-63 (Tr. 1124-27)). Within days, Selectica summarily rejected both proposals, made no counterproposal, and there were no follow-up discussions. (A2162-63 (Tr. 1130-31)).

D. Trilogy's Investments in, and Offers to Acquire, Selectica in the Fall of 2008.

Trilogy began purchasing Selectica stock again in the first week of October 2008. (A2160 (Tr. 1120)). At that time, Selectica's stock price had declined to the point that it met Trilogy's profile for investment opportunities in underperforming companies. (A2160 (Tr. 1120-21)). Also, Trilogy believed that Selectica had not given sufficient attention to Trilogy's prior offers to acquire Selectica's assets. (A2160 (Tr. 1120-21)). Additionally, although Selectica had been conducting a strategic alternatives process since August 2008, no one from Selectica had reached out to Trilogy to participate in this process, despite the fact that Trilogy was among a small group of potential acquirers of Selectica and had recently attempted acquisition discussions. (A2163 (Tr. 1131-32); A2106 (Tr. 912); AR252-61). Thus, Trilogy invested in Selectica with the hope that an equity position might help Trilogy in its attempts to engage in a dialogue with Selectica regarding a potential acquisition. (A2160 (Tr. 1121)).

At the time of Trilogy's acquisitions, while Selectica had privately shared detailed information with investor Steel Partners regarding the status of its NOLs under §382, the Company had never made any such public disclosures, and had consistently recorded a full valuation allowance against its NOLs in its financial statements. (Opening Brief at 6-7). Therefore, Trilogy was not aware of any potential issue at Selectica with respect to these matters, and there is no record evidence that Trilogy's October 2008 purchases pertained in any way to Selectica's NOLs.

Trilogy made another proposal to acquire all of Selectica's assets on October 10, 2008. (A2163 (Tr. 1131); A1920 (Tr. 169-70)). The offer was materially increased over the July offer that had been summarily rejected by Selectica. (A2163 (Tr. 1132); A1920 (Tr. 169-70)). This offer was made by Sean Fallon, Trilogy's then CFO, to Selectica's Co-Chair Zawatski. (A2163 (Tr. 1131-32); A1920 (Tr. 169-70)).

Meanwhile, Trilogy continued to purchase Selectica stock throughout October and into November of 2008. (A2160 (Tr. 1120-21); A3686). On November 10, 2008, Trilogy's purchases in Selectica exceeded the 5% ownership level. (B52; A3680-81 ). On November 13, 2008, Trilogy filed a Schedule 13D with the Securities and Exchange Commission, thus disclosing its status as a 5% shareholder. (A2163-64 (Tr. 1134-45); A3675-92).

Upon Trilogy's acquisition of a 5% position in Selectica, Mr. Fallon called Ms. Zawatski to inform her of Trilogy's pending Schedule 13D filing. (A2164 (Tr. 1135)). It had been approximately one month since Trilogy had made its offer to acquire all of Selectica's assets, and Selectica had not responded. (A2164 (Tr. 1135)). Ms. Zawatski said that Selectica would not accept Trilogy's offer and made no counterproposal. (A2164 (Tr. 1136-37)).

E. Selectica's Announcement of the NOL Poison Pill and Trilogy's Decision to Expose the Selectica Board's Fiduciary Breach.

On November 17, 2008, just four days after Trilogy had disclosed its status as a 5% shareholder, Selectica announced that it had adopted the NOL Poison Pill. (AR227, AR240-41). Though the primary stated reason for the Pill was to protect the Company's NOLs (AR240), Selectica had never previously made any public disclosures regarding its NOLs other than listing their aggregate size and recording a full valuation allowance (reflecting Selectica's determination that it was more likely than not that its NOLs would never be used). (A3489; A3340; A3064; A2907; A2796; A2571; A2415-16; A1200-01; *see also* Opening Brief at 6-7).

Selectica's purported justification for and the timing of the adoption of the NOL Poison Pill was suspicious in light of (i) Trilogy's disclosure just a few days before the Pill's adoption that Trilogy had become a 5% shareholder; (ii) Selectica's apparent favoritism for its largest shareholder, Steel Partners, who had repeatedly increased its holdings without any defensive reaction by Selectica; (iii) Trilogy's previous shareholder activism in 2006 when it had caused Selectica to restate its financial statements with respect to its false stock option grant practices; (iv) Trilogy's and Selectica's status as competitors; (v) Selectica's disclosure a week before adoption of the NOL Poison Pill that it had breached the parties' 2007 patent settlement; and (vi) the Company's consistent history of losses and no realistic opportunity to ever utilize its NOLs. (A2180-81 (Tr. 1201-02, 1205-06); A2166 (Tr. 1145-46); *supra* at Sections A, B; *see also* Opening Brief at 8-10).

On November 18, 2008, Mr. Fallon instructed Trilogy's broker to cease any further purchases of Selectica stock while Trilogy evaluated the Pill. (A2165 (Tr. 1140-42); B104). That same day, Trilogy's CEO Joe Liemandt was attempting to make sense of Selectica's purported justification for the Pill (*i.e.*, avoiding an "ownership change" under §382 of the Internal Revenue Code). (A2190-91 (Tr. 1242-1244)). Mr. Liemandt sent an e-mail to Trilogy's Director of Financial Planning, Andrew Price, which asked "What percentage of SLTC would we need to buy to ruin the tax attributes that steel partners is looking for?" (B119). Mr. Liemandt wanted to know how much Selectica stock would need to be purchased to trigger §382, not so that Trilogy could cause an "ownership change," but to understand whether there was really an imminent threat of an "ownership change" (or whether Selectica's purported justification for the NOL Poison Pill was a pretext for another purpose). (A2190-01 (Tr. 1242-44)). Mr. Price responded to Mr. Liemandt that, according to his calculation, Selectica was 28% from an ownership change under §382. (B119). Mr. Liemandt noted that there had been a Schedule 13D filed by another new 5% shareholder, in response to which Mr. Price revised his answer to 23%. (B119). Mr. Price's rough calculation revealed that a substantial margin remained before Selectica would experience an "ownership change" under §382, thereby strengthening Trilogy's belief that the NOL Poison Pill was a pretext and that Selectica's NOLs were not a valuable asset at risk. (A2191 (Tr. 1243-44)).

In December of 2008, Trilogy elected to purchase above 0.5% of additional Selectica shares, which increased its ownership slightly above the limits permitted by the NOL Poison Pill. (A2166 (Tr. 1145); A2181 (1205-06); A3867-68). Faced with Selectica's pretextual justification for the NOL Poison Pill, Trilogy decided to buy through the Pill's fractional limitation in order to "bring accountability and transparency" to the conduct of Selectica's Board and its adoption of the Pill. (A2181 (Tr. 1205)). Trilogy's purchase, while in excess of the new Pill's trigger level, was nowhere near the amount that Mr. Price had suggested might cause an "ownership change" under §382.

### F. Trilogy's Refusal to Agree to a Standstill in Exchange for an Invalid Exemption Under the NOL Poison Pill.

After Trilogy purchased Selectica shares slightly above the limits imposed by the NOL Poison Pill, Selectica requested Trilogy to enter a standstill agreement in exchange for an exemption under the Pill. (A2166 (Tr. 1146)). Trilogy declined this demand because it understood valid post-purchase exemptions to be permissible only in the case of an inadvertent triggering of the Pill. (A2166-67 (Tr. 1146-47)). Notwithstanding its refusal to agree to a

standstill, Trilogy did not purchase additional Selectica shares following its December 2008 purchases that triggered the Pill.

## ARGUMENT

### I. TRILOGY'S APPELLATE ISSUES ARE SUBJECT TO *DE NOVO* REVIEW.

Many of the cases Selectica cites on the standard of review affirm that the Chancery Court's application of legal principles to findings of fact is reviewed *de novo*. *Cede & Co. v. Technicolor, Inc.*, 884 A.2d 26, 36 (Del. 2005); *Volair Contractors, Inc. v. AmQuip Corp.*, 829 A.2d 130, 133 (Del. 2003); *Broz v. Cellular Info. Sys., Inc.*, 673 A.2d 148, 154 (Del. 1996) ("In all events, if it can be shown that the court erred in formulating *or applying* legal precepts, this Court's review is plenary." (emphasis added)); *see also Yiannatsis v. Stephanis*, 653 A.2d 275, 278 (Del. 1995) (citing deferential standard for factual findings but noting that "[appellants] do not argue . . . with the court's application of the test to the instant facts").

Another case cited by Selectica, *Nixon v. Blackwell*, 626 A.2d 1366 (Del. 1993), demonstrates precisely why Trilogy's appellate issues require *de novo* review. In *Nixon*, the Chancery Court's ultimate conclusion of breach of fiduciary duty had two components: (1) factual findings relevant to the issue of breach, and (2) a determination of the legal significance of those findings. *Id.* at 1375 ("The trial Court made findings of fact upon which its conclusion that the defendants had violated their fiduciary duties was predicated."). Trilogy acknowledges that the first component – the findings of fact – will be upheld unless not sufficiently supported by the record or not the product of an orderly and logical deductive process. Opening Brief at 15. However, the second component – determining the legal significance of these facts – involves application of the law to the facts and thus requires *de novo* review. As the Court of Chancery noted, (Ex. A to Opening Brief at 3 n.5), the parties largely agree on the relevant underlying facts, including: (1) Selectica's financial history; (2) its full valuation allowance on its NOLs; (3) what was said at the relevant Board meetings; (4) the written materials the Board received; (5) what the Board considered before adopting the NOL Pills; (6) the Board's understanding of NOLs and § 382, etc. The legal significance of these undisputed facts, as they relate to the first prong of *Unocal* for example, requires application of law, a judicial determination that is subject to *de novo* review.

## II. SELECTICA'S BELATED EFFORT TO AVOID ENHANCED JUDICIAL SCRUTINY UNDER *UNOCAL* SHOULD BE REJECTED.

Despite having agreed pre-trial that adoption of the NOL Pills is subject to enhanced scrutiny under *Unocal*, Selectica now asks this Court to instead apply the traditional business judgment rule. Selectica's belated effort to avoid enhanced scrutiny, even if not waived, should be rejected. The Board's adoption of the NOL Pills was a defensive measure adopted in response to a perceived threat touching on issues of control.

Selectica's claim that it "argued below . . . [that] *Unocal*'s enhanced scrutiny has no application" (Answering Brief at 27) is a gross overstatement of the position Selectica actually took in the Court of Chancery. Throughout the discovery period, Selectica apprised the Court of Chancery that it agreed that enhanced scrutiny under *Unocal* was the appropriate standard of judicial review.[1] Selectica maintained that position in its pre-trial brief, which it incorporated into the parties' Joint Pretrial Order, arguing that the Board's actions were "Appropriate Exercise[s] Of Fiduciary Responsibility Under *Unocal*." (A382-96; A471). Following the trial, Selectica could not have been clearer about its position in the text of its opening post-trial brief: "The parties agree that the Court should review the Board's decision to adopt the NOL Pill under the 'enhanced scrutiny' standard described in *Unocal* and its progeny." (A689 (internal citations omitted)). It was only in a *footnote* in this post-trial brief that Selectica for the first time suggested that the Court of Chancery "may" (not "should," but "may") alternatively employ a business judgment rule analysis. (A689 n.40).

The appropriate standard of judicial review is an issue of key importance in breach of fiduciary duty litigation. *Mills Acquisition Co. v. Macmillan, Inc.*, 559 A.2d 1261, 1279 (Del. 1989). If Selectica was attempting to reverse positions on that key issue in a post-trial footnote, it was too little and too late to adequately raise the issue below. *See Commonwealth Constr. Co. v. Cornerstone Fellowship Baptist Church, Inc.*, 2006 WL 2567916, at *19 (Del. Super. Aug. 31, 2006) (party waived its right to assert an argument that it put forth "for the first

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[1] *See* AR116 ("To satisfy its obligations under *Unocal*...[the] board... will be required to demonstrate...."); AR70 ("the question...is going to be whether a threat was reasonably perceived and whether there was action taken which was proportional to that threat.").

time ever in its second post trial brief"),[2] *amended on other grounds*, 2006 WL 2901819 (Del. Super. Oct. 3, 2006); *see also Alexander v. Cahill*, 829 A.2d 117, 128-29 (Del. 2003) (defense is waived where party does not give notice of such a defense before or in the final pretrial stipulation; a "trial judge's focus should be on whether the issue could have been, but was not, raised pretrial in some form and whether or not the failure to do so caused prejudice to a party without notice of the defense by making it difficult, if not impossible, to fairly face the issue for the first time during trial."). This is particularly true here, where the attempted post-trial change in position would implicate the placement of the burden of proof. Trilogy appropriately framed its trial strategy based on Selectica's acknowledgement that it had the burden of proof under *Unocal*, meaning that the absence of evidence – for example, gaps in the Board's decision-making process with respect to the adoption and implementation of the NOL Poison Pill – would bolster Trilogy's position. Had this been a business judgment rule case, wherein Trilogy bore the burden of proof, Trilogy might have developed and presented its case differently. *In re PNB Holding Co. S'holders Litig.*, 2006 WL 2403999, at *22 n. 117 (Del. Ch. Aug. 18, 2006) (an argument first raised in a pre-trial brief was waived because discovery was closed and the parties had already shaped their trial plans at the time the issue was first raised).

Even if considered, Selectica's belated argument that *Unocal* is inapplicable is wrong. Application of *Unocal* is not limited to cases involving a pending takeover attempt. *See Moran v. Household Int'l, Inc.*, 500 A.2d 1346 (Del. 1985) (applying *Unocal* to preemptive poison pill adopted without reference to a specific takeover threat). Rather, enhanced scrutiny under *Unocal* applies to any measure adopted in response to a "perceived threat to corporate policy and effectiveness which touches upon issues of control" or that has "implications for corporate control." *Unitrin, Inc. v. Am. Gen. Corp.*, 651 A.2d 1361, 1372 n.9 (Del. 1995); *In re Santa Fe Pac. Corp. S'holder Litig.*, 669 A. 2d 59, 72 (Del. 1995).

Selectica's adoption of an NOL Poison Pill, like the adoption of any poison pill, touches on issues of control. A poison pill is inherently entrenching no matter the motivation for its adoption, because it makes it more difficult for shareholders to change the board of directors or the direction of the company – as conceded by Selectica in its public disclosures. (A3254; A824-25). While the parties dispute the degree to which a 4.99% pill restricts shareholders' ability to

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[2] Unreported cases are included in the Compendium of Unreported Opinions Cited in Appellants' Reply Brief and Cross Appellees' Answering Brief filed contemporaneously herewith.

effect change at the board level through the ballot box, there is no dispute that the impact is more pronounced than in the case of previously upheld pills. (*See* A699 (conceding that it is "obvious, that . . . a company with a 5% pill is more difficult to take over than a company with a 15% pill or no pill.")). That impact by itself mandates application of *Unocal* enhanced scrutiny. Selectica's NOL Poison Pill further touches on issues of control because it (i) was adopted in response to large stock purchases by Trilogy, which had previously made two offers to purchase Selectica or its assets; (ii) bars Trilogy and other shareholders from increasing their ownership and voice in the Company's direction, absent the Board's permission; and (iii) freezes the existing equity ownership hierarchy in place. (A3569; A2161-63 (Tr. 1124-31); A2145-49 (Tr. 1061-75); *see also* A2166 (Tr. 1145-46); A2179 (Tr. 1198-1202)). If the NOL Poison Pill were merely "an inexpensive insurance policy," as Selectica attempts to characterize it, (Answering Brief at 29), it would carry no such collateral consequences.[3]

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[3] Selectica's reliance on its exploration of a possible sale of the Company or its assets in an effort to avoid *Unocal* is misplaced. Adopting a poison pill to protect a strategic alternatives process is a defensive measure triggering *Unocal*. *See n* . In addition, the existing Board would remain following an asset sale, meaning that the entrenchment effect of the pill would not be erased, as it might in a sale of the entire Company.

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

### A. Selectica's position that directors can adopt an NOL Poison Pill without considering the likelihood that the existing NOLs will ever be utilized or weighing the impact of an "ownership change" is without merit.

Selectica's Answering Brief confirms that the parties' dispute with respect to the "reasonable investigation" prong of *Unocal* does not turn on what the Board did and did not do. As the Court of Chancery recognized, "[t]he facts evidencing 'what happened' are largely uncontested." (Ex. A to Opening Brief at 3 n.5). Rather, Trilogy's appeal turns on a question of application of law to facts. Is it reasonable for directors to adopt an NOL pill without considering the likelihood that the existing NOLs would be utilized and whether such use would be impacted by the ownership change under §382 of the Internal Revenue Code that the NOL pill is intended to prevent?[4] Selectica's extreme position that a board adopting an NOL pill need not consider these issues defies common sense and ignores the seriousness of adopting low-threshold pills like those in question here.

The basic inquiries that the Selectica Board failed to make – the likelihood of the existing NOLs being utilized and the impact on such potential use of a §382 ownership change – cannot be brushed aside as merely "formulated after the fact by Trilogy for litigation purposes." (Answering Brief at 31). They are essential questions that any person acting reasonably would ask before taking extreme action to protect a contingent asset like NOLs. How can a board decide to impose restrictions on shareholders in order to protect an asset that may or may not be usable in the future, without considering the likelihood of that asset really being used? How can a board decide to adopt a 4.99% pill for the purpose of preventing a §382 ownership change without considering whether an ownership change would adversely impact any reasonably expected use of the

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[4] Selectica is incorrect to suggest that reasonableness is a finding of fact entitled to deference on appeal. (Answering Brief at 30) A determination of the legal significance of facts involves an application of law to fact and is subject to *de novo* review. *See Scharf v. Edgcomb Corp.*, 864 A.2d 909, 916 (Del. 2004) (a determination of how the law bears on established facts is reviewed *de novo*).

NOLs? If there is no reasonably expected value, or if the value (if any) will not be materially affected by a possible ownership change, then there is no "threat" to which to respond.

By arguing that the Board was required to consider this information before adopting the NOL Poison Pill, Trilogy is not asking the Court to "substitute its judgment for the Board's." (Answering Brief at 31). This failure is one of process. The Board simply failed to consider the information needed to make a reasonably informed decision on whether to adopt the NOL Poison Pill for the purpose the Board put forth to justify this extreme measure. Regardless of what the Board might have decided if it had conducted a reasonable investigation, the Board members breached their fiduciary duties by acting on a grossly uninformed basis.

Selectica's claim that such information was "unknowable" is meritless. Trilogy has never suggested that the Board was required to determine with 100% certainty the precise amount of future tax savings that could be generated by using the NOLs. Moreover, directors and management of public companies constantly make judgments involving assessments of the likelihood and magnitude of future events. Here it is undisputed that the Board was given no information about – and raised no question regarding – the Company's realistic potential ability to use any or a portion of the NOLs in the future. That information as to likely future events may be imprecise provides no excuse for failing to even consider it. In fact, the parties' experts uniformly testified that the likelihood of NOLs being utilized in the future *could* be assessed, despite the lack of one particular authoritative methodology for valuing NOLs. (A2012 (Tr. 539); A2214-15 (Tr. 1332-36); A2216-19 (Tr. 1341-53)). Moreover, Selectica itself presumably conducted some sort of analysis to reach its repeated conclusion – reflected in its full valuation allowance against the NOLs in SEC filings – that it is more likely than not that it will never utilize any portion of its existing NOLs. Information about the likelihood of using the NOLs and the impact of a §382 ownership change was therefore reasonably available to the Board.

Contrary to Selectica's repeated suggestion, requiring the Board to consider these issues before adopting the NOL Poison Pill does not "go back on the teaching of *Time Warner* and *Unitrin*." (Answering Brief at 31, 33, 36). This Court's statements that the *Unocal* analysis is not a "structured, mechanistic, mathematical exercise" were made in the context of recognizing the flexibility afforded directors in considering different types of relevant information. *Unitrin*, 651 A.2d at 1373-74; *Paramount Comm'ns, Inc. v. Time, Inc.*, 571 A.2d 1140, 1153 (Del. 1990). Neither case suggests that a board may ignore information of

fundamental importance or avoid attempting to quantify values and risks when necessary as part of a reasonable investigation merely because that exercise may involve some form of a "mathematical" calculation.

Selectica's position also ignores the importance of its decision to adopt a low-threshold pill. "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." *In re Fort Howard Corp. S'holders Litig.*, 1988 WL 83147, at *1 (Del. Ch. Aug. 8, 1988). Selectica argues that adoption of the NOL Pills "was nothing more than a business decision to buy an inexpensive insurance policy." (Answering Brief at 29). This flawed analogy ignores both the Court of Chancery's recognition that "the 5% trigger necessary for an NOL pill to serve its function imposes a *far greater cost* on shareholders than the pill thresholds traditionally employed and held acceptable by our courts" (Ex. A to Opening Brief at 42 (emphasis added)), as well as the record evidence demonstrating the serious impact of Selectica's NOL Poison Pill.[5] Only by pretending that the Pill has no detrimental side effects can Selectica argue that the Board was not required to investigate the likelihood of the NOLs being utilized and the impact on such potential use of an ownership change before rushing to action.

Perhaps recognizing the weakness of its position that the Board was not required to even consider the likelihood that the NOLs would be utilized,

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[5] The impacts of the NOL Pills include: (i) it is realistically unattainable for Trilogy or another challenger below 5% to launch a successful proxy contest for control; (ii) shareholders below 5% are barred from increasing their voice in the Company, absent Board permission; (iii) the equity ownership structure is frozen, indefinitely securing the largest shareholder position for hedge fund Steel Partners; (iv) 5% shareholders are unable to sell their interest as a single block, absent Board permission, impacting the liquidity of their investment; (v) the pills' low trigger deters any future significant investors, including institutional buyers who would bring new liquidity to the Company's stock; (vi) the issuance of new stock as a result of the implementation of the pill halved the stock price and increased the risk of Selectica being delisted for non-compliance with Nasdaq minimum bid price requirements; and (vii) trading in the Company's stock was halted for over four weeks, impacting the liquidity of all shareholders' investments. (Ex. A at 24-30; A2079 (Tr. 803); A2145 (Tr. 1062); A2148-49 (Tr. 1074-75); A2179-80 (Tr. 1198-1200); NASDAQ Rule 5450; A824-25; A3747 at § 1(a); A3991 at § 1(a)); A4135).

Selectica also argues that the Board "reasonably believed that the NOLs were sufficiently likely to be used at some point, and that the value to be derived from using them was sufficiently large, that some steps to protect the NOLs were appropriate." (Answering Brief at 33).[6] Even setting aside the inconsistency with Selectica's primary position that such information was "unknowable," a review of the evidence pointed to by Selectica amply demonstrates that there is *no record support* for the Board having conducted any such investigation.

First, Selectica cites the testimony of one of its trial experts, Dr. Erickson. (Answering Brief at 33). Dr. Erickson, of course, was hired well *after* the Board adopted the NOL Poison Pill. Selectica cannot justify the Board's investigation on the basis of information obtained after the Pill was adopted. *Chesapeake Corp. v. Shore*, 771 A.2d 293, 334 (Del. Ch. 2000) ("post hoc analyses prepared for trial should be not able to buttress a board's *Unocal* showing in a situation where the board's own deliberations were grossly inadequate").[7]

Selectica next cites Zawatski's trial statement: "The way I look at this if it's worth $160 million, why would I just throw it away if it has potential use at some point?" (Answering Brief at 33). This statement actually *undermines* Selectica's argument that the Board conducted a reasonable investigation. Zawatski's testimony incorrectly equates the *size* of the NOLs with their worth (*see* Opening Brief at 4), a fundamental error that reflects a complete and utter

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[6] Selectica does not even argue that the Board considered if potential use of the NOLs would be impacted by an ownership change. (Answering Brief at 36-37). Instead, it attempts to flip the burden of proof by arguing that the evidence does not definitively prove that an ownership change would *not* impact use of the NOLs. (*Id.*) Again, the issue is deficient process, not the conclusion the Board might have reached had it considered appropriate information. Moreover, Selectica ignores the testimony of Dr. Porter, who described scenarios under which an ownership change would *not* impact potential use of the NOLs. (A2214-19 (Tr. 1332-1352); *see also* A4346-55)).

[7] Nor can the Board rely on Sems' "simple calculation" of the NOLs' value at "tens of millions of dollars." (Answering Brief at 33 (citing A2061-62)). Such a calculation was made before Sems even joined the Board (A2061-62) and had access to the Company's internal information. The Company's public forecasts of profitably have proven routinely unreliable. (Opening Brief at 5-6). In any event, there is no evidence that Sems ever shared any such "calculation" with other directors.

misunderstanding of what the Board was purportedly acting to protect – even months later at the time of trial.[8]

Selectica's argument that the view of outside investors "bolsters the reasonableness of the Board's *investigation* on the point" (Answering Brief at 34 (emphasis added)) presumes what did not exist: any actual investigation by the Board into the value of the NOLs. There was nothing for the view of outsiders to "bolster." Moreover, the opinions of one shareholder – which might hold a unique or self-serving agenda – is not a substitute for the Board conducting the required reasonable investigation as to what is in the best interest of the Company and all shareholders.[9]

Nor can the Board show it reasonably investigated the value of the NOLs by referencing advice from Reilly (Answering Brief at 35-36), for the reasons set out in Trilogy's Opening Brief at 19-20. Selectica's reliance on Reilly's status as an investment banker overlooks Reilly's testimony that *none* of the participants in the strategic alternatives process expressed any interest in the NOLs and that he had no basis for advising on Steel Partners' plans (Opening Brief at 20), as well as Reilly's express confession to 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)).[10] The Board cannot, consistent with its fiduciary duties, premise an

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[8] Zawatski was consistent in her misunderstanding. At trial, she testified no less than six times that she believed Selectica's NOLs were worth $160 million (A1934 (Tr. 225); A1969 (Tr. 365); A1972 (Tr. 379); A1978 (Tr. 402-03); A1979 (Tr. 405)). Selectica's Answering Brief attempts to cultivate this same misunderstanding, referring to "the Board's efforts to ascertain," "monitor," or "understand" the "value" of the NOLs (Answering Brief at 7, 8, 10) when the record reflects that what was being monitored was merely the *size* of the NOLs and how close the Company was to an ownership change. (A3563-65; A3640-46; A3873; A3231-35; B1-6).

[9] Nor can the Board somehow defend its investigation by pointing to any investigation that Trilogy may have done regarding the NOLs. (Answering Brief at 34).

[10] In its Counter-Statement of Facts, Selectica discusses two "categories" of likely bidders in the strategic alternatives process and then suggests, without citation, that a shift towards an asset purchaser somehow impacted the Board's analysis of adopting the NOL Pill. (Answering Brief at 10-11). Selectica cites no contemporaneous evidence for the Board having had such discussions. This story, first unveiled at trial, directly contradicts Zawatski's testimony that there had been no

(Continued . . .)

important transaction like adoption of an NOL Poison Pill based on the advice of someone who told the Board he was not in a position to provide such advice.

B. The Court Should Decline Selectica's Invitation To Rewrite *Unitrin* On When Material Enhancement Is Applicable.

As Selectica implicitly acknowledges, the Board does not meet the test for material enhancement because Thanos and Zawatski were not "outside" directors as defined by *Unitrin*. (Answering Brief at 38-39). Instead, Selectica asks the Court to eliminate that portion of *Unitrin* and make the test entirely subjective. (*Id.* at 38-39). Selectica's invitation should be rejected, and the Court should maintain the objective portion of the *Unitrin* definition of "outside independent directors." The *Unocal* framework recognizes the conflict of interest that directors face when considering matters touching on corporate control is "inherent" and "omnipresent." *Unitrin*, 651 A.2d at 1373. That is even more true in the case of insider directors earning compensation above and beyond normal director fees. But a purely subjective test can result in significant compensation earned by insider directors being ignored, as this case aptly demonstrates. Even though the Court of Chancery found that that the compensation paid to Thanos and Zawatski was so large as to be "material by any measure," the Court nonetheless found that it was subjectively immaterial. (Ex. A to Opening Brief at 39-40). This contradictory result demonstrates the ease with which a director can control the subjective test simply by offering self-serving testimony.[11] Trilogy respectfully urges that retaining the objective element of the "outside" director definition better comports with the "inherent" nature of an inside directors' conflicts of interest.

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(. . . continued)
discussions of becoming an NOL shell and merging in a profitable company as a way to use the NOLs. (A1968-69 (Tr. 364-65)).

[11] The apparent ease with which a director can through bare, conclusory testimony satisfy the subjective aspect of the inquiry is particularly perverse given that the burden of proof is on the Board to show independence. As previously briefed, Trilogy maintains that the evidence submitted by the Board was insufficient to carry that burden as to Thanos and Zawatski in light of the significant compensation they received and Selectica's admission that they are not independent within the meaning of applicable rules of the SEC and The Nasdaq Global Stock Market. (Opening Brief at 22-23).

To the extent the Court does reconsider *Unitrin*'s standard for enhancement of evidence, Trilogy re-urges that the Court hold that independence only enhances proof of good faith, not proof of a reasonable investigation. (Opening Brief at 23). Even independent directors may engage in a deficient deliberative process, and their "independent" status should not serve as a free pass under the enhanced scrutiny required by *Unocal*.

## IV. THE COURT OF CHANCERY ERRED IN HOLDING THAT SELECTICA'S NOL POISON PILL WAS NOT PRECLUSIVE.

### A. The Court of Chancery Recast the Test for Preclusiveness, Excluding Analysis of Real-World Outcomes.

Selectica argues that Trilogy has failed to identify any difference between (i) the standards for determining whether a pill "fundamentally restricts" shareholder access to the ballot box as enunciated by this Court in *Unitrin*, and (ii) the standards applied by the Court of Chancery in this case. (Answering Brief at 40). Indeed, Selectica asserts "there is no difference between the two." *Id.* Selectica is wrong on both counts. As Trilogy noted previously, Delaware law provides that a successful proxy contest to change board control at a company with a poison pill must be a *realistic* outcome, not just a hypothetically possible result. (Opening Brief at 25). In *Unitrin*, this Court set forth two standards by which a pill may be found preclusive – one focused on theoretical calculations ("*mathematically* impossible") and one focused on practical adverse impact ("*realistically* unattainable"). The Court of Chancery recited both tests, but its application and restatement of *Unitrin* focused exclusively on theoretical possibilities and ignored "things as they actually are."[12]

For example, by reference to the Court of Chancery's decision in *In re Gaylord Container Corp. S'holders Litig.*, 753 A.2d 462, 482 (Del. Ch. 2000), the Opinion defines "preclusive measures" as solely those that are "insurmountable or impossible to outflank." (Ex. A to Opening Brief at 55).[13] The Court of Chancery then restates the *Unitrin* tests for preclusiveness as

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[12] "Realistic" is defined as "[t]ending to or expressing an awareness of things as they really are," or "of or relating to the representation of objects, actions or social conditions as they actually are." American Heritage Dictionary, Third Edition, 1997.

[13] This language from *Gaylord* was not in reference to testing the preclusiveness of a poison pill but with respect to charter and bylaw amendments requiring that actions to take control of the board be taken at annual stockholders' meetings. Because the Chancery Court found that these amendments only required a potential acquiror to wait a brief time (noting that they were "far less preclusive than a staggered board provision, which can delay an acquiror's ability to take over a board for several years"), Vice Chancellor Strine found the amendments were not preclusive. 753 A.2d at 482.

"render[ing] a successful proxy contest" a "near impossibility" or "utterly moot." (*Id.* at 60).[14] However, both of these tests focus on theoretical outcomes assessed in absolute terms, as opposed to a consideration of the "real-world" effects of a 4.99% pill. Selectica has encouraged this absolute approach, repeatedly attacking Trilogy's expert for not testifying that the NOL Pills rendered a successful proxy contest "impossible" (A2151 (Tr. 1085-86); A696; Answering Brief at 41), even though that is not the standard for preclusiveness. This shift in emphasis led the Court of Chancery to ignore the most telling evidence of the practical effect of Selectica's NOL Poison Pill: the absence in the record of there *ever* having been a change in board control through successful proxy contests by a challenger under 5%, against a public company with staggered board terms pursuant to a corporate charter.

B. Under *Unitrin*, Selectica's NOL Pills Should Be Deemed Preclusive.

Whether under the Court of Chancery's revised test for preclusiveness, or pursuant to the *Unitrin* standard, Trilogy presented significant empirical data reflecting that a successful proxy contest for control of Selectica is "fundamentally restricted" by the Board's adoption of the NOL Pills. *Moran*, 500 A.2d at 1355.

Selectica challenges ineffectually the work and testimony of expert witness Professor Allen Ferrell with respect to the practical effects of a poison pill with a 4.99% trigger, particularly at companies with charter-based classified boards. *First*, as noted above, Selectica seeks to minimize the importance of Professor Ferrell's findings, on the grounds that he "admitted that the NOL Pill . . . does not make a takeover impossible," even though that is not the standard for preclusiveness. (Answering Brief at 41). *Second*, Selectica attacks Professor Ferrell's testimony for failing to employ the words "realistically unattainable" in his findings. (*Id.*). Professor Ferrell's restraint in this regard is hardly surprising: as an expert his role was not to reach a legal conclusion, but to provide evidence. *See United Rentals, Inc. v. RAM Holdings, Inc.*, 2007 WL 4465520, at *1 & n.10 (Del. Ch. Dec. 13, 2007) (holding legal opinion testimony was inadmissible). *Third*, Selectica labels Professor Ferrell "a law professor who has no practical experience in proxy solicitations or the practice of law" – ignoring that (i) Selectica did not move to exclude Professor Ferrell, (ii) the

[14] By "utterly moot," the Court of Chancery appears to mean "completely, absolutely, or entirely" ("utterly") "settled" or "irrelevant" ("moot"). *See* American Heritage Dictionary, Third Edition, 1997.

Court of Chancery was "satisfied that Professor Ferrell is qualified to give reliable testimony" and therefore admitted him as an expert (A2145 (Tr. 1060)), and (iii) Professor Ferrell has a Ph.D. in economics from the Massachusetts Institute of Technology and has written widely on matters related to corporate governance (A2143-44 (Tr. 1052-58); A4244).[15] *Fourth*, Selectica characterizes the work of Professor Ferrell as "admittedly qualitative," wrongly implying that his opinion lacked an empirical basis. (Answering Brief at 42.)

In fact, the empirical evidence before the Court of Chancery and this Court shows that Selectica's NOL Pills, when combined with the Company's staggered board terms, impose a preclusive effect on future proxy contests for control of the Company. "Real-world" data compiled and explained by Professor Ferrell demonstrated in multiple ways why such a 4.99% pill, adopted under these circumstances, impacts proxy contests far more severely than historical pills with triggers at the 15% or 20% level. (*See* Opening Brief at 26-29; *see also* A2145-49 (Tr. 1061-77); A4245-60). Selectica mischaracterizes the empirical analysis not only by Professor Ferrell but also by others cited by Trilogy (including Selectica's own proffered experts) – all of which are based on ***actual*** proxy contest results and shareholding levels, not speculation. (*See* AR245-49). That empirical data, as well as prior studies, demonstrates that there is a significant disparity in holdings between winning and losing challengers and shows a strong correlation between the size of a proxy challenger's holdings and the challenger's ability to succeed. In Professor Ferrell's own study, the ***single*** example of success by a challenger holding *below* 5% occurred where there were no staggered board terms by corporate charter, as compared to the situation at Selectica. (*See* A4251, A4262; A2152 (Tr. 1087)). Accordingly, in that rare

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[15] Selectica's impliedly pejorative characterization ignores that it also proffered expert testimony by a professor from Harvard Law School, where Professor Ferrell is the Harvey Greenfield Professor of Securities Law. (A2083 (Tr. 818) (Professor Coates); A2143 (Tr. 1052) (Professor Ferrell)). Selectica's witness, law professor John Coates, asserted that 5% poison pills are a "custom" in corporate America, because they have been adopted by approximately 40 companies. (A2086-87 (Tr. 830-33); A2089 (Tr. 843-44); A2090-91 (Tr. 848-52)). Given the thousands of public corporations in the United States, the fact that only 40 (or even 50) companies have adopted adopted a 5% poison pill does not make such pills a "custom." (*See* A2091 (Tr. 850); A2146 (Tr. 1063)); AR250). As the Court of Chancery noted, the fact that other companies have slashed the triggering percentage under their pills "is not proof that it is, in fact, permissible or justifiable." (Ex. A to Opening Brief at 58, n. 185).

instance of victory, the less than 5% stockholder faced lower hurdles than would a challenger to the Selectica Board.

The independent analysis by Professor Ferrell, and the prior empirical studies upon which he relies, stand in stark contrast to the unscientific opinion posited by Selectica's witness Harkins.[16] Selectica relies on Harkins's opinions that (1) there is purportedly no relationship between poison pill trigger levels and proxy contests, (2) a proxy contest at Selectica allegedly would not be prohibitively expensive for a shareholder under 4.99%, and (3) therefore, the combination of Selectica's staggered board with the 4.99% trigger level allegedly does not insulate the Board. (A2133-39 (Tr. 1013-36); B346-47). Unlike Professor Ferrell, Harkins relied on no empirical studies to support his conclusions. While Harkins boldly concluded that "[e]xperience indicates that such limitations [with regard to the 4.99% poison pill trigger] have little or no effect on the prospects for a successful proxy contest," (A4147), the witness acknowledged that he has never experienced a proxy contest involving a 4.99% beneficial ownership limitation under a poison pill. (A2242 (Tr. 1445)). Curiously, part of the academic literature to which Professor Ferrell cites, and which is dismissed by Harkins, was written by another of Selectica's experts, Professor John Coates. (A4255; AR245).

Similarly, while Harkins also opined that the 4.99% trigger, combined with Selectica's staggered board, does not insulate the Board from proxy challenges (B346-47), his conclusion was grounded on subjective categorizations and assumptions purportedly on "experience", and there are no empirical studies or academic literature supporting his conclusions. (A4138-88; B341-48); *see Empire Fin. Servs., Inc. v. Bank of New York (Delaware),* 2007 WL 1677580, at *4 (Del. Super. June 8, 2007) (holding that the expert's opinion was "entirely anecdotal" and contained "not data developed by the industry or from any reliable source to support this opinion.").

Selectica attacks as "misleading" and "irrelevant" the factually correct statement that "neither party located a single example where a shareholder below 5% succeeded through proxy contests in changing control of a charter-based staggered board." (Answering Brief at 43, n.34; Opening Brief at 27). Selectica points to six instances where shareholders "starting with less than 5%" had "some significant measure of success" (only three of which involved staggered boards). (Answering Brief at 43, n.34). Of course, Selectica does not explain what it means by its subjective characterization of "some significant measure of

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[16] (*See* A4138-88; B341-48; A2132-42 (Tr. 1008-50)).

success," and it does not and cannot claim that board control was changed in any of these instances. Selectica clearly seeks a new standard whereby a pill is not preclusive even if it prevents a challenger from winning control and removing the pill. *Id.* (arguing that "there is no policy reason to construe *Unitrin* in that mechanical fashion."). But access to the shareholder ballot box so that a pill can be removed is precisely the "safety valve" that has been repeatedly described by this Court. *See Moran*, 500 A.2d at 1355; *Carmody*, 723 A.2d at 1193; *Unitrin*, 651 A.2d at 1381.

Selectica tries to avoid the high costs associated with proxy contests by drawing attention to Selectica's concentrated shareholder base. (Answering Brief at 5, 16, 41 n.31, 43-44). However, Selectica's expert, Harkins, admitted upon cross examination that if only "some" of the largest 6 or 8 Selectica shareholders were opposed to an insurgent's position, then the insurgent would need to wage a proxy contest in the same way that one normally would (*i.e.*, by soliciting all of the Company's shareholders) and thus would incur all of the typical costs of waging a proxy contest. (A2142 (Tr. 1049-50)). The Vice Chancellor found that three of Selectica's largest shareholders – Steel Partners, Lloyd Miller and Sems (who held approximately 23.5% of Selectica's stock at the time that Selectica first adopted the NOL Poison Pill) – actively collaborated in trying to protect Selectica's NOLs. (Ex. A to Opening Brief at 46). Thus, an insurgent whose aim is to change control of Selectica's Board to redeem the NOL Poison Pill (the relevant success under *Unitrin*) could not, as Selectica suggests, merely call up a few shareholders by phone, but would need to wage a full-scale proxy contest and would incur all of the typical expenses.

Having conditioned the permissibility of poison pills on the absence of a "fundamental[] restrict[ion]" on "stockholders' rights to conduct a proxy contest," *Moran*, 500 A.2d at 1354-55, Delaware courts should not depart from that standard in assessing the new phenomenon of 5% NOL pills. In the context of an NOL pill, which has been adopted because the company has consistently lost money, it is even more important that shareholders retain the ability to replace those responsible for the erosion of shareholder value. (Ex. A Opening Brief at 68 n.216).

## V. THE COURT OF CHANCERY DID NOT ERR IN DENYING SELECTICA'S REQUEST FOR AN AWARD OF ATTORNEY'S FEES.

### A. Question Presented.

Did the Court of Chancery err in exercising its discretion to deny Selectica's request for an award of attorney's fees? (A1443-45).

### B. Scope of Review.

The Court of Chancery's denial of attorneys' fees under the bad faith exception to the American rule is reviewed for abuse of discretion. *M.G. Bancorporation, Inc. v. Le Beau*, 737 A.2d 513, 527-28 (Del. 1999). Selectica attempts to avoid this standard on the grounds that the Chancery Court did not explain why, in exercising its discretion, it denied Selectica's fee request. In support of this position, Selectica mistakenly relies on *Dover Historical Society, Inc. v. City of Dover Planning Commission*, 902 A.2d 1084 (Del. 2006). The *Dover* Court applied a *de novo* review of the Superior Court's denial of fees solely because the Superior Court had formulated an incorrect legal standard. *Id.* at 1093-94 (rejecting Superior Court's legal conclusion that post-litigation conduct occurring outside of the lawsuit could not, as a matter of law, support a fee award). Selectica can point to no error in the Chancery Court's formulation of the legal principles governing its fee decision. (A1785). Selectica has not cited – and Trilogy is not aware of – any authority suggesting that the absence of an explicit rationale for the denial of attorneys' fees subjects this discretionary decision to *de novo* review.

### C. Merits of Argument.

#### 1. Trilogy's Actions in Connection with the Events That Gave Rise to This Lawsuit Cannot Support a Fee Award.

The bad faith exception to the American rule for attorneys' fees "does not apply to conduct that gives rise to the substantive claim itself." *Johnston v. Abitrium (Cayman Islands) Handels*, 720 A.2d 542, 546 (Del. 1998); *see also Montgomery v. Cellular Holding Co.*, 880 A.2d 206, 228 (Del. 2005). Thus, "an award of fees for bad faith conduct must derive from either the commencement of an action in bad faith or bad faith conduct taken during litigation, and not from conduct that gave rise to the underlying cause of action." *In re Grupo Dos Chiles, LLC*, 2006 WL 2507044, at *2 (Del. Ch. Aug. 17, 2006) (citing *Johnston*); *accord Reserves Dev. LLC v. Severn Sav. Bank, FSB*, 2007 WL

4054231, at *21 (Del. Ch. Nov. 9, 2007), *aff'd*, 961 A.2d 521 (Del. 2008); *Kosachuk v. Harper*, 2002 WL 1767542, at *7 (Del. Ch. July 25, 2002). Although some Chancery Court opinions have suggested that pre-litigation bad faith conduct – regardless of whether it gave rise to the litigation – can provide a basis for awarding fees, *e.g*, *Nucar v. Doyle*, 2006 WL 1071533, at *3 (Del. Ch. Apr. 17, 2006), these cases fail to address this Court's contrary pronouncements in *Johnston* and *Montgomery*. In reaching its conclusion in *Johnson* that pre-litigation conduct giving rise to the lawsuit cannot serve as the bad faith conduct for purposes of fee shifting, this Court explicitly relied on *Shimman v. International Union of Operating Engineers, Local 18*, 744 F.2d 1226 (6th Cir. 1984) (en banc). *Johnston*, 720 A.2d at 546 n.29. Subsequently, most federal circuit courts have likewise followed *Shimman* in holding that the bad faith exception to the American rule must implicate the judicial process and cannot be based on pre-litigation conduct giving rise to the claim.[17]

In seeking to overturn the Court of Chancery's denial of fees, Selectica relies primarily on (1) Trilogy's decision to purchase shares beyond the NOL Poison Pill trigger, (2) Trilogy's refusal to agree to a standstill in exchange for an exemption, and (3) Trilogy's attempt to negotiate a global settlement with respect to its pending disputes with Selectica. (Answering Br. at 45-48). This is the very conduct that gave rise to this lawsuit. In direct response to Trilogy's insistence upon a global settlement of the parties' conflicts, Selectica determined to hire litigation counsel. (B125). And two days after Trilogy became an "acquiring person" under the NOL Poison Pill, Selectica filed a declaratory judgment lawsuit against Trilogy in the Court of Chancery on December 21, 2008. (A3867; A35-92). On January 3, 2009, Selectica amended its Complaint to add factual allegations of (1) Trilogy's deliberate decision to become an "acquiring person" under the NOL Poison Pill, (2) Trilogy's refusal to agree to a standstill,

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17 *Centex Corp. v. United States*, 486 F.3d 1369, 1372 (Fed. Cir. 2007); *Kelly v. Golden*, 352 F.3d 344, 352 (8th Cir. 2003) ("The power to award fees [under the bad faith exception] is exercisable only with respect to conduct occurring during the litigation, not conduct that gave rise to the cause of action."); *Zapata Hermanos Sucesores, S.A. v. Hearthside Baking Co.*, 313 F.3d 385, 391 (7th Cir. 2002); *Kerin v. United States Postal Serv.*, 218 F.3d 185, 195 (2d Cir. 2000) ("It is uncontroversial that business conduct that is entirely unrelated to the process of litigation may not form the sole basis of a bad faith fee award."); *Towerridge, Inc. v. T.A.O., Inc.*, 111 F.3d 758, 765-67 (10th Cir. 1997); *Sanchez v. Rowe*, 870 F.2d 291, 294 (5th Cir. 1989); *Woods v. Barnett Bank of Fort Lauderdale*, 765 F.2d 1004, 1014 (11th Cir. 1985) ("The bad faith or vexatious conduct must be part of the litigation process itself").

and (3) Trilogy's insistence that any settlement discussions relate to a global resolution of all disputes pending between the parties. (A94, A99-101). Because these facts constitute the substance of Selectica's claim for relief, they cannot also provide a basis to award fees under the bad faith exception. *Johnston*, 720 A.2d at 546; *Montgomery*, 880 A.2d at 228. Accordingly, the decision by the Court of Chancery was correct and should be sustained.

2. The Chancery Court Made No Finding of Bad Faith.

Selectica incorrectly characterizes the Chancery Court's opinion as containing an implicit finding of bad faith. (Answering Brief at 45-49). The Chancery Court's two statements concerning Trilogy's motives, (Ex. A to Opening Brief at 65, 69), were made in the context of the proportionality prong of the *Unocal* analysis, and thus were relevant only to the Selectica Board's perception of a purported threat. They do not entail a finding of bad faith.

3. A Finding of Bad Faith Does Not Necessitate a Fee Award.

Even if the Court of Chancery's opinion could be construed as containing a finding that Trilogy acted in bad faith, and even if that finding pertained to conduct occurring during the litigation – neither of which is the case – the Chancery Court still had discretion to deny Selectica's fee request. A finding of bad faith is the *sine qua non* for an award of attorneys' fees, but it does not *require* such an award. *See, e.g., Reserves Dev.*, 2007 WL 4054231, at *21 ("As an equitable exception to the American rule, this Court *may* grant attorneys' fees *if* it finds that a party brought litigation in bad faith or acted in bad faith during the course of the litigation." (emphasis added)); *Acierno v. Goldstein*, 2005 WL 3111993, at *4 (Del. Ch. Nov. 16, 2005) (denying attorneys' fees under the bad faith exception because the court had made a "finding of only two isolated instances of bad faith conduct," and the conduct was not sufficiently egregious). Thus, even assuming a finding of bad faith, the Chancery Court still had discretion to deny Selectica's fee request.

Selectica has also failed to articulate a viable theory of harm flowing from any alleged bad faith conduct. It has never argued that Trilogy's purchases effected an "ownership change" under §382 or damaged any likely usable NOLs. Selectica never acceded to any of Trilogy's settlement requests. The sole harm that Selectica cites is that it was forced to seek *expedited* litigation. (Answering

Brief. at 47).[18] Bad faith conduct that unnecessarily *prolongs* or *delays* litigation can under certain circumstances support fee shifting, *e.g.*, *Dover Historical Soc'y*, 902 A.2d at 1093; *Montgomery*, 880 A.2d at 227, but Selectica has cited no Delaware case shifting fees for conduct *shortening* eventual litigation.

4. Trilogy Did Not Act in Bad Faith.

In addition to the foregoing legal bases for upholding the Court of Chancery's denial of Selectica's fee request, the evidence in the record likewise does not support Selectica's assertion that Trilogy acted in bad faith.

a. Trilogy did not act in bad faith with respect to its conduct in connection with the events that gave rise to the lawsuit.

The record does not support Selectica's argument that Trilogy acted in bad faith in its purchases of Selectica stock. The record clearly demonstrates that Trilogy's purchases up to the 5% threshold were for investment purposes (consistent with Trilogy's prior investment practices) and were made with the hope that holding an equity stake in Selectica might help Trilogy in its attempt engage Selectica in a conversation to sell its business (consistent with Trilogy's purchases of Selectica stock prior to engaging Selectica in acquisition discussions in 2005). (A2160 (Tr. 1120-21)).

At the time of Trilogy's acquisitions, while Selectica had privately shared detailed information with investor Steel Partners regarding the status of its NOLs under §382, the Company never made any such public disclosures and had consistently recorded a full valuation allowance against its NOLs. (A3489; A3340; A3064; A2907; A2796; A2571; A2415-16; A1200-01; *see also* Opening Brief at 6-7). Therefore, Trilogy was not aware of any potential threat to Selectica's NOLs or any potential likelihood that Selectica would ever be able to utilize any of its NOLs.

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[18] While Selectica initially sought an expedited trial, it did not ask for expedited post-trial briefing, argument or decision from the Court of Chancery. Post-trial argument was held on October 2, 2009 – 5 months after the close of trial. The Court of Chancery issued its opinion on February 26, 2010 – almost 13 months after Selectica initiated the action.

Selectica adopted the NOL Poison Pill just a few days after Trilogy disclosed that it had become a 5% shareholder. (A3680-81; AR227, AR240-41; *see also* Opening Brief at 10). All of the evidence available to Trilogy at the time indicated that Selectica had adopted the Pill not to protect NOLs but to keep Trilogy – a long-time competitor who had previously taken Selectica's management to task – from having a stronger voice at Selectica and to secure Steel Partners' place as the largest shareholder. (AR147-48; A2180-81 (Tr. 1201-02, 1205-06); A2166 (Tr. 1145-46); *supra* at Counter-Statement of Facts, Sections A, B; *see also* Opening Brief at 9-10).

In the months leading up to the adoption of the NOL Poison Pill, Selectica's Board had also exhibited its hostility to Trilogy by: (i) abandoning Selectica's sales configuration business (thus effectively eliminating the possibility of Trilogy receiving future payments above the minimum base-level payments set forth in the October 2007 joint marketing agreement), (ii) refusing to engage Trilogy in acquisition discussions, (iii) failing to include Trilogy in Selectica's strategic alternatives process, and (iv) announcing on November 10, 2008 that Selectica had licensed to Sun in direct violation of the parties' October 2007 patent settlement. (A2178-79 (Tr. 1194-1197); A2162-64 (Tr. 1128-37); A2106 (Tr. 912); AR222; A2181 (Tr. 1203-04)).

Although Trilogy viewed Selectica's stated rationale for adopting the NOL Poison Pill as a pretext, it did not immediately purchase additional shares above the Pill's new trigger. Instead, Trilogy stopped purchasing Selectica stock while Trilogy conducted its own investigation to understand whether Selectica's NOLs were in imminent danger of being limited under Section 382 of the Internal Revenue Code. (A2191 (Tr. 1243-44)). Trilogy's investigation buttressed its suspicions that the NOL Poison Pill was a pretext. (A2191 (Tr. 1243-44)).

Given its belief that the Selectica Board had adopted the NOL Poison Pill for an improper purpose, Trilogy determined to purchase through the Pill for the purpose of "bring[ing] accountability and transparency" to the Board's adoption of the Pill. (A2181 (Tr. 1205)). However, even then, Trilogy elected only to purchase additional Selectica shares slightly above the 0.5% limitation for additional purchases by 5% shareholders. (A2166 (Tr. 1145)). There were never any discussions at Trilogy about acquiring shares in an amount that would trigger the Section 382 limitation with respect to Selectica's NOLs. (A2166 Tr. 1145)). The record directly contradicts Selectica's argument that Trilogy was attempting to impair the NOL.

Nor does the record support Selectica's argument that Trilogy acted in bad faith in refusing to agree to a standstill in exchange for an exemption under the Pill. There can be no inference of bad faith from Trilogy's refusal to give up its right to purchase additional Selectica shares given Trilogy's reasonable belief at the time that Selectica had adopted the NOL Poison Pill for an improper purpose. (A2166 (Tr. 1145-46); A2180-81 (Tr. 1202-06)). Moreover, Trilogy did not believe that an exemption granted by Selectica would be valid under the terms of the Pill because Trilogy had intentionally (as opposed to inadvertently) purchased through the Pill. (A2166-67 (Tr. 1146-47)). Notwithstanding Trilogy's refusal to agree to a standstill, it did not purchase Selectica shares following its December 2008 purchases that were slightly in excess of the Pill's limits for 5% shareholders.

Finally, although Selectica uses the word "greenmail," it is not bad faith for Trilogy to seek to resolve all of its then-pending disputes with Selectica as part of a global settlement. The parties' long, contentious history and the Board's ongoing mismanagement and mistreatment of its shareholders only confirm that Trilogy had a reasonable basis for seeking a global resolution of all their disputes so that the two companies could achieve a complete separation.

b. Trilogy did not act in bad faith in its litigation of this case.

Aside from Trilogy's pre-litigation conduct, Selectica relies on two other baseless grounds in its attempt to reverse the Chancery Court's discretionary denial of fees: (1) Mr. Liemandt's and Mr. Fallon's testimony concerning Trilogy's reasons for triggering the NOL Poison Pill and (2) Trilogy's supposed change in position in this lawsuit on whether Selectica's NOL Pills were *per se* illegal. (Answering Brief at 48-49). As an initial matter, Selectica has waived these two grounds as a basis to appeal the denial of attorneys' fees because Selectica never raised either of these issues below in support of its fee request. Nonetheless, these grounds are unfounded.

First, there is no basis in the Chancery Court's opinion for Selectica's accusation of perjury. That the Chancery Court adopted on the whole a version of the facts that was in some respects inconsistent with certain witnesses' testimony does not in any way imply perjury or an effort to intentionally mislead the court. Selectica's position would require a finding of bad faith in every instance of testimony that is not adopted by the trier of fact. This position is untenable and should be rejected. Additionally, as described above, there is ample record support for Mr. Liemandt's and Mr. Fallon's testimony concerning Trilogy's motives in buying through the NOL Poison Pill.

Second, throughout this litigation Trilogy has consistently taken the position that the NOL Pills are illegal and invalid under Delaware law because, in conjunction with Selectica's charter-based staggered Board, they are preclusive of a successful proxy contest for control of the Board. This is a version of a "*per se*" argument because facts pertaining to the Board's motivations and the Board's process (or lack thereof) are not the focus of the inquiry. Selectica merely quibbles over the semantics of "*per se*." Nevertheless, even if Trilogy's position on the *per se* illegality of the NOL Pills could somehow be construed as having changed, this is hardly the material for a finding of bad faith for purposes of shifting fees, which is reserved for "a high level of egregiousness." *In re Sunbelt Beverage Corp.*, 2010 WL 26539, at *15 (Del. Ch. Jan. 5, 2010).

Finally, Selectica's attempt to collect attorneys' fees on the basis of Trilogy's supposed change in position on the *per se* illegality of the NOL Pills is surprising given Selectica's blatant – and belated – shift in position on whether *Unocal* applies in this case. *See supra* at § II.

## CONCLUSION

For all of the foregoing reasons, Appellants respectfully request that this Court 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. Appellants further respectfully request that this Court affirm the ruling of the Court of Chancery's determination that Selectica is not entitled to any award of attorneys fees in this matter, and that the Court grant Appellants such other relied as it may be entitled.

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## CERTIFICATE OF SERVICE

It is hereby certified that on June 28, 2010, a copy of the foregoing Appellants' Reply Brief and Cross Appellees' Answering Brief was served on the following counsel of record in the manner indicated:

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