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Case No. 4241-VCN

IN THE COURT OF CHANCERY OF THE STATE OF DELAWARE

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|---|---|---|
| **SELECTICA, Inc., a Delaware corporation** | ) | |
| | ) | |
| **Plaintiff,** | ) | |
| | ) | |
| **v.** | ) | |
| | ) | |
| **VERSATA ENTERPRISES, INC., a Delaware corporation, and TRILOGY, INC., Delaware corporation,** | ) | |
| | ) | |
| **Defendants** | ) | |
| | ) | |
| **and** | ) | **C.A. No. 4241-VCN** |
| | ) | |
| **VERSATA ENTERPRISES, INC., and TRILOGY, INC.,** | ) | **REDACTED – PUBLIC VERSION April 28, 2009** |
| | ) | |
| **Counterclaim-Plaintiffs,** | ) | |
| **v.** | ) | |
| | ) | |
| **SELECTICA, INC., JAMES ARNOLD, ALAN B. HOWE, LLOYD SEMS, JIM THANOS, and BRENDA ZAWATSKI,** | ) | |
| | ) | |
| **Counterclaim-Defendants** | ) | |

# PRE-TRIAL BRIEF OF DEFENDANTS AND COUNTERCLAIM-PLAINTIFFS VERSATA ENTERPRISES, INC. AND TRILOGY, INC.

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## INTRODUCTION

While "the passage of time has dulled many to the incredibly powerful and novel device" known as the poison pill, it remains a potent entrenchment mechanism that "alter[s] the structure of the corporation . . . and results in a fundamental transfer of power" from stockholders to directors. *Hollinger Int'l v. Black*, 844 A.2d 1022, 1083 (Del. Ch. 2004); *Moran v. Household Int'l, Inc.*, 490 A.2d 1059, 1076 (Del. Ch. 1985). That recognition was directed to pills triggered at stockholding levels of 20%. Here, the Board of Selectica, Inc. ("Selectica" or the "Company"), without reasonable investigation or basis, hastily adopted and then implemented an amended poison pill, with a trigger lowered from 15% to a much more arbitrary and preclusive 4.99% level (the "Nuclear Pill") – the legality of which has never been considered by any court – in reaction to stock acquisitions by Trilogy, Inc. ("Trilogy").

The purported purpose for this Nuclear Pill was to guard against a limitation on the use of Selectica's net operating loss carryforwards ("NOLs") under Section 382 of the Internal Revenue Code ("§ 382"). But the threat is false, because Selectica has never had a taxable profit against which to apply its NOLs, shows no signs of doing so, and therefore has no use for NOLs. The true motivations for the 4.99% trigger were: (1) the Board's animus toward Trilogy, a competitor and repeated offeror for Selectica's assets and/or equity, and (2) the singular interest in the NOLs shown by stockholder Steel Partners II, LP ("Steel Partners"), a fund with a vaguely-understood plan to gain control of the NOLs for tax avoidance purposes. In creating the Nuclear Pill, the Board's response was unreasonable and detrimental in its complete disregard for the sweeping impact on: (i) director entrenchment, (ii) stockholder interests, including a preclusive effect on the ability of a challenging stockholder to successfully pursue the multiple proxy contests against the staggered Board necessary to change Board control (and redeem the pill), (iii) the Company's ability to attract investors, and (iv) Selectica's share price. The Board compounded its errors

when it implemented the Nuclear Pill to dilute Trilogy and then immediately adopted another 4.99% pill (the "Reloaded Nuclear Pill").

The Board violated its fiduciary duties, *inter alia*, by (i) failing to conduct a reasonable investigation into whether the NOLs had value worth protecting, (ii) failing to conduct a reasonable investigation into whether any such value was threatened by Trilogy's purchases, (iii) acting out of animus towards Trilogy and a desire to entrench itself, (iv) adopting poison pills that impermissibly restrict Trilogy and other stockholders' rights to conduct a proxy contest, and (v) taking actions that were unreasonable and disproportionate to any threat posed by Trilogy.

**SUMMARY**

Selectica raised $120 million in its March 2000 initial public offering of shares priced at $30. Its subsequent performance has been replete with mismanagement, internal control failures, illegal stock option backdating, knowingly unreasonable projections, and persistent losses. It has never reported a profit. Its stock price has fallen to miserable levels, below one dollar per share.

Selectica has developed a bias against Trilogy and its subsidiary Versata Enterprises, Inc. ("Versata"), which are competitors, shareholders and creditors of the Company. Twice Trilogy has had to litigate to enforce patents infringed by Selectica, the result of which has obligated Selectica to pay Trilogy between $17.5 and $25 million and to refrain from pursuing certain customers. Trilogy has called Selectica's Board to account for participating in stock options backdating, which the Board later acknowledged had occurred. Trilogy also has attempted to engage Selectica in acquisition discussions, including when Selectica purported to be considering sale opportunities. Each time the Board has rejected the offers without consideration.

One of the consequences of Selectica's continuing business failures has been the accumulation of NOLs, an ever-increasing figure because Selectica has never reported a profit against which to apply them. By the end of fiscal 2006 (February 28, 2006), Selectica's federal

NOLs had grown to $163.4 million. Selectica's outside tax accountant determined that the amount of its NOLs were subject to limitations under § 382, due to multiple "ownership changes" in the Company's stock as defined by § 382's formula. The Board did not regard the NOLs as significant assets and they were only briefly mentioned in Selectica's financial statements, in which they were treated as likely to never be utilized.

The unusable NOLs caught the attention of Selectica investor Steel Partners, which was targeting companies with large NOLs, with the long-term objective of eventually gaining control in order to take advantage of the NOLs for tax avoidance purposes. When Steel Partners learned of the limitations on Selectica's NOLs under § 382, it brought Selectica a new tax advisor that had worked (and continues to work) with Steel Partners on other NOL "prospects." That firm, aided by Steel Partners, worked to reverse the prior determination of Selectica's tax accountant and concluded that the NOLs were completely unencumbered.

Steel Partners and two of Selectica's other major investors, Lloyd Sems and Lloyd Miller, had been communicating among themselves since 2007 regarding Steel Partners' long-term objectives for the NOLs. Sems was put on the Selectica Board in June 2008 (nominated by Miller and endorsed by Steel Partners). All repeatedly pressured the Board to quickly divest assets, buy back stock, dividend out cash to investors, and turn the Company into an NOL shell.

Selectica's then-CEO opposed the "fire sale" approach. He favored a longer-term strategy of building relationships with potential acquirers and growing value in the businesses. Coincident with Sems' arrival on the Board, however, a sudden reversal took Selectica down the path urged by Steel Partners. The Board fired the resistant CEO and eliminated the bulk of its business managers, placing the business in a bare-maintenance mode. As Steel Partners had sought, the Board moved toward dumping assets, at the worst possible moment economically, and engaged an investment bank in August 2008 to undertake a "strategic alternatives process."

Despite knowing that Trilogy was a natural acquiror of the Company or its assets, Selectica's animus drove it to keep Trilogy from the "strategic alternatives process" and to summarily rebuff Trilogy's offers to buy assets. When Trilogy began to purchase Selectica stock in October-November 2008, the Board's desire to entrench itself against any action by Trilogy converged with Steel Partners' interest in grabbing the NOLs. The Board hurriedly amended its 2003 poison pill in an attempt to discourage Trilogy from buying more stock, claiming that the purchases increased the risk of an "ownership change" under § 382 that would limit the hypothetical use of the NOLs. Without any discussion of any potential adverse impact, nor any meaningful analysis of whether the NOLs were worth "protecting," the Board slashed the triggering ownership percentage under the pill from 15% to 4.99% and prohibited virtually any further increase by stockholders then owning above 4.99%, absent a Board exemption. Among other things the Board ignored was the fact that the 4.99% pill trigger, when coupled with other entrenchment devices – particularly its staggered board established by Selectica's charter – rendered a successful proxy contest to change Board control realistically unattainable, whether launched by Trilogy (in an effort to redeem the pill) or any holder of less than 5% of Selectica stock who sought to change Board governance.

Ironically, had the Board undertaken a full independent analysis, it would have learned that by the time it adopted the Nuclear Pill, the NOLs had ***already*** been restricted by "ownership changes" under § 382. Because it had shown no prior interest in "protecting" the NOLs, and had ignored red flags that "ownership changes" had already occurred, the pretextual reason the Board used for the pill had already been rendered moot by earlier share acquisitions. When Trilogy bought additional stock in December 2008 and the Board implemented the pill to dilute Trilogy's stockholdings, it did so in furtherance of protecting a purported "asset" that had already been limited (putting aside the unexamined question of whether it had ever held significant value).

The question here is not whether any pill with a 4.99% trigger is consistent with Delaware law. It is whether the adoption by Selectica directors of the Nuclear Pill was consistent with their fiduciary duties. Given (i) the pill's preclusive effect on potential proxy challenges to the Board, (ii) the Company's other defensive "entrenchment" devices, and (iii) the directors' failure to examine and conduct an informed analysis of the benefits, risks and consequences of its actions, Trilogy submits that the evidence and law summarized herein demonstrate that the directors breached their fiduciary responsibilities, that judgment should be entered against Selectica on each of its claims and in favor of Trilogy and Versata on their counterclaims, that the 4.99% pill should be declared invalid and its implementation reversed to return Trilogy to its pre-dilution ownership interest.

## STATEMENT OF FACTS

### A. The Parties.

Trilogy is a Delaware corporation with its global headquarters in Austin, Texas. Trilogy provides technology-powered business services to its clients. Versata is a Delaware corporation, also with its principal place of business in Austin. Versata is a wholly-owned subsidiary of Trilogy and is a provider of enterprise software solutions. As of December 19, 2008, Trilogy and Versata beneficially owned 6.7% of Selectica's common stock. (Ex. 1).[1] Following the Selectica Board's January 2, 2009 decision to authorize the discriminatory exchange of shares under the Nuclear Pill, as detailed herein, Trilogy's and Versata's beneficial ownership of Selectica's common stock was diluted to approximately 3.3%. (Ex. 2).[2]

Selectica is a Delaware corporation and is headquartered in San Jose, California. Its common stock is listed on Nasdaq under the symbol SLTC. It purports to operate two businesses: sales configuration software and contract management software. Brenda Zawatski,

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[1] The exhibits cited herein are compiled in an Appendix filed with this Brief.

[2] Unless otherwise indicated, both Trilogy and Versata are referred to in this brief as "Trilogy."

Jim Thanos, James Arnold, Jr., Lloyd Sems, and Alan B. Howe are the current directors.[3] Since July 2008, Selectica has not had a CEO, but Zawatski and Thanos have served as Co-Chairs of the Board and have also been responsible for running the day-to-day aspects of the business. (Zawatski 18, 238, 316-17; Thanos 21).[4]

**B. Background: Selectica's Undistinguished History of Mismanagement.**

Selectica was founded as a "sales configuration" software company. (Ex. 4 ¶ 66). By early 2000, it claimed to have over one hundred customers. (*Id.*). It went public in March 2000, raising $120 million. (Ex. 5).[5]

The enthusiasm for Selectica was short-lived. The Company has never reported a profit and thus has steadily drained its cash – by far its largest asset.[6] Selectica is now a "nano cap" – a company trading with a negative enterprise value. It has a market capitalization of approximately $24.1 million as of December 31, 2008, with approximately $27.4 million in cash and $14.6 million in liabilities as of that date. (Ex. 9). Its share price has declined drastically. The stock now trades at $0.44 per share. In short, Selectica has shown a pattern of increasing losses, declining revenues, and plummeting stock value. Unsurprisingly, Selectica's investors have expressed their frustrations regarding the Company's lack of profitability and its steadily declining cash balance.[7]

1. ***Repeatedly Missed Projections.*** Selectica has attempted to secure stockholders' confidence, despite its consistent loss pattern, by issuing wholly unreasonable projections that go

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[3] Howe joined the Board on January 7, 2009. (Ex. 3). The other four directors were on the Board at the time of the adoption of the Nuclear Pill and Reloaded Nuclear Pill.

[4] Citations to a name and page number refer to deposition transcripts lodged with the Court.

[5] Selectica's IPO shares, priced at $30, traded as high as $154 in the following month. (Ex. 4 at ¶ 66; Ex. 6).

[6] (Exs. 5; 7; 8).

[7] (*E.g.*, Exs. 10; 11).

unrealized. Between May 2006 and November 2007, Selectica publicly stated on five separate occasions (May, August and November 2006, August 2007, November 2008) that it expected to be profitable by definite upcoming dates.[8] Each was unreasonable and each was proved wrong.[9] More recently, in February, April and May 2008, Selectica publicly projected that it would be profitable by the end of fiscal 2009.[10] Like its earlier projections, these forecasts will not be met.[11]

Indeed, in its fiscal 2009 projections Selectica's Board knowingly allowed unreasonable projections to go uncorrected. In February 2008, Selectica projected imminent improvement: it claimed it would reach $25 million in revenue for fiscal 2009 (ending March 31, 2009) – a ***56% increase in revenue*** over its fiscal 2008 revenue of $16 million (which in turn had been only 9% higher than fiscal 2007). (Ex. 88). Selectica repeated that statement in April and yet again in May 2008,

**REDACTED**

Exs. 23; 24). Through its first three quarters of fiscal 2009, Selectica has reported revenue of only $3.8, $3.1, and $4.2 million, respectively, all three below the same quarter last year.[13]

**2.** ***Internal Control Failures.*** Selectica's credibility has been further suspect due to

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[8] (Exs. 12-16).

[9] (Ex. 17 at p. 21; Ex. 7 at p. 16; Ex. 18 at p. 5; Ex. 19 at p. 5; Ex. 20 at p. 5; Ex. 21 at p. 5).

[10] (Exs. 22-24).

[11] Selectica has reported a net loss of nearly $7 million through its first three fiscal quarters. (Ex. 25 at p. 5; Ex. 26 at p. 5; Ex. 9 at p. 5).

[12]

**REDACTED**

Selectica waited until an August 14, 2008 earnings call to recalibrate its revenue projection to a lesser goal: matching the previous year's revenue of $16 million. (Ex. 28). But for six months innocent investors had been trading on false information.

[13] (Ex. 25 at p. 5; Ex. 26 at p. 5; Ex. 9 at p. 5).

its admitted internal control failures. In September 2006, the Audit Committee received a letter from a Trilogy subsidiary questioning the propriety of Selectica's prior stock option grants. (Ex. 4 at ¶ 76). A special committee investigation ultimately revealed that certain options granted to officers and directors during fiscal years 2001-2005 had in fact been backdated to falsely show an earlier grant date. (Exs. 29-31). This episode was costly: Selectica was required to record additional stock-based compensation expenses and related tax effects for past option grants and to restate its financial statements (Ex. 17 at p. 3). It incurred "professional fees" associated with the investigation that exceeded $6.2 million. (Ex. 7 at p. 16).

**3.** ***Infringement upon Trilogy's Intellectual Property.*** Selectica and its Board have permitted infringements on Trilogy and Versata's intellectual property. Between April 2004 and October 2007, Trilogy and Versata were forced to launch two separate suits to end Selectica's patent infringements. In January 2006, Trilogy and Selectica reached a settlement of the first dispute, in which (among other things) Selectica agreed to pay Trilogy $7.5 million. (Ex. 32). The second suit was resolved by a settlement in October 2007, in which Selectica paid Versata $10 million and agreed to pay an additional amount of not more than $7.5 million in quarterly subsequent payments. (Ex. 33).

### C. Selectica Fails to Consider Reasonably Trilogy's 2005 Offers.

While Selectica's share price has been in free-fall and its coffers have been depleted, its directors have resisted opportunities to achieve a premium for investors through potential sale transactions. For example, in January 2005, Selectica received a proposal from Trilogy to acquire all outstanding Selectica shares for $4 per share, when those shares were trading at $3.34, representing a premium of around 20%. (Ex. 34). Within the month, the Selectica Board summarily rejected that offer, claiming that it undervalued Selectica's shares. (Ex. 35). Meanwhile, Selectica's stock continued to wither on the open market. Trilogy made other

proposals for a business combination with Selectica on a friendly basis. Another proposal was put forward in the August – October 2005 time frame, in the range of a 16%-23% premium over existing market prices (Selectica's stock meanwhile dropped to $2.85 on October 31). Again, this acquisition proposal was rejected. Selectica's shares have never since traded anywhere near the price the Board was offered in 2005. As Selectica stockholders now know, they would have been better served had the Board accepted Trilogy's premium proposals.[14]

**D. Selectica's Entrenchment Devices.**

Selectica also has taken a series of governance actions motivated by a desire to entrench directors and management and to minimize the prospect of meaningful accountability to stockholders. Selectica has adopted charter and bylaw provisions that the Board concedes "may make it more difficult for or prevent a third party from acquiring control of us without approval of our directors" and "may have the effect of entrenching our board of directors and may deprive or limit [stockholders'] strategic opportunities to sell [their] shares." Those actions include (a) structuring a charter-based classified board of directors with staggered three-year terms; (b) imposing restrictions on the ability of stockholders to call special meetings; (c) prohibiting stockholder action by written consent; (d) creating complex requirements for nominations of directors or for proposing matters that can be acted on by stockholders at stockholder meetings; and (e) granting to the directors themselves, without stockholder approval, the ability to designate the terms of and issue new series of preferred stock, through the authorization of a "blank check preferred" provision of its charter. (Ex. 17 at p. 15).

In addition, in February 2003, the Board, without stockholder authorization, adopted a

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[14] As a stockholder noted in a February 2006 earnings call: "I think it's been five years since I've seen your revenue actually grow, and my question is what happened to Trilogy? It was a year ago that they offered $4 a share in cash, and what happened to them? I'd be happy to take $3.50 a share in cash right now." (Ex. 10).

poison pill (the "2003 Pill") (Ex. 37). Through the 2003 Pill, the Board declared a dividend distribution of one Preferred Share Purchase Right (a "Right") on each outstanding share of its common stock. (*Id.* at § 3). The Rights would be triggered and become exercisable if a person or group became the beneficial owner of 15% or more of the outstanding Selectica common stock or announced a tender offer for 15% or more of the outstanding common stock. (*Id.* at §§ 1, 3). The Board possessed the right to redeem the Rights at any time before either of such triggering events occurred. (*Id.* at §§ 2, 3). If not redeemed prior to becoming exercisable, these Rights would entitle stockholders (other than the triggering acquiror) to purchase, at the Right's exercise price, a number of shares of common stock having a market value of twice the Right's exercise price, thereby severely diluting the triggering acquiror's interest in Selectica.

**E. The Rise of Steel Partners.**

Steel Partners is an activist investment partnership

Howard 11-12; Ex. 42).

(Reilly 17-18; Brogan 31-33; Ex. 43).

**REDACTED**

(Reilly 17-18; Ex. 44).[15] (Ex. 45 at 16-20).

Prior to increasing its Selectica holdings, Steel Partners obtained non-public information from Selectica concerning its NOLs. (Chinn 27-29). Selectica had never viewed its NOLs as having any value, given that it had never reported taxable profits. (Brogan 69-70, 103). In 2006, at the urging of Steel Partners' Jack Howard, Selectica's then-CEO Stephen Bennion asked

[15] Along with Section 269, Section 382 was created to prevent the trafficking in companies for their NOLs by creating limits on the use of NOLs where there have been certain changes in the level of ownership by 5 percent (or greater) stockholders over a three-year period. *See, e.g.*, 26 U.S.C. § 382; Ex. 45 at 2-3. Notwithstanding these limitations, a "built-in-gain" from a sale of assets is not subject to NOL limitations, even where there has been an "ownership change" within five years. *See* 26 U.S.C. § 382(h); Ex. 45 at 14-15; Ex. 46 at 10-11.

Selectica's independent tax adviser Alan Chinn to analyze whether the NOLs were subject to limitations under § 382 (the "Chinn Study"). (Chinn 27-29). The Chinn Study was completed in the Fall of 2006

**REDACTED**

The conclusion of the Chinn Study was eventually reflected in a footnote to the Company's financial statements for fiscal year 2008. (Ex. 48).[16]

**REDACTED**

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16 The Company disclosed in this footnote that changes in ownership under § 382 had caused the forfeiture of $24.6 million of NOLs. (Ex. 7 at p. F-22). This disclosure has never been revised.

17

18

**REDACTED**

19 (Ex. 52, 54-57; Brogan 117; Howard 45-46; Zawatski 355).

**REDACTED**

**F. Steel Partners Increases NOL Pressure.**

By early 2008, Steel Partners was advocating a quick sale of the Company's assets followed by a protracted period during which it would slowly increase its holdings in order to somehow eventually take advantage of the Selectica's NOLs.

**REDACTED**

Jurkowski's desire to grow Selectica's businesses, his view that the NOLs were not of great value, and his resistance to Steel Partners' insistence on expenditures for further § 382 "ownership change" studies, all posed problems for Steel Partners. After an April 2008 meeting between Jurkowski and Jack Howard of Steel Partners, it was clear to Steel Partners that Jurkowski's plans for Selectica differed from Steel Partners' agenda. (Ex. 60).

Steel Partners then increased its pressure on the Board. **REDACTED**

**REDACTED**

In the same letter, Steel Partners worked to add an ally to the Board by supporting Lloyd Sems to fill an open seat. Sems and his funds owned approximately 5% of Selectica's stock. (Ex. 62). Steel Partners' recommendation of Sems was no coincidence.

**REDACTED**

(Exs. 63-66; Sems 189-91). Sems took his cues from Howard and Lloyd Miller, another large Selectica stockholder with ties to Howard and Sems.

**REDACTED**

In April 2008, Brogan resumed his § 382 work. (Ex. 54; Brogan 92).[22]

**REDACTED**

Within a week of its April 15 letter demanding a new course for Selectica, Steel Partners

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[20] Miller has beneficially owned in excess of 5% of Selectica stock since at least November 2006. (Ex. 67).

**REDACTED**

[21]

[22] (Ex. 53). Although Brogan had suspended work on the study in the Fall of 2007, he resumed work in April 2008 at the request of Selectica's then-CFO, Bill Roschlein, who desired the results of the study for the Company's financial disclosures. (Brogan 92; Ex. 68).

[23] (Exs. 52; 54-57).

disclosed that it had increased its stake to 10.2%. (Ex. 69). If it was not already clear to the Board that Steel Partners was serious about exerting its influence over the Company to push its "NOL shell" agenda, this disclosure removed any doubt.

**REDACTED**

Ex. 54).

Within 10 days of this reassurance, Steel Partners purchased another 119,756 Selectica shares. (Ex. 70).

Jurkowski continued to resist Steel Partners' immediate plans for a quick sale.

**REDACTED**

(Ex. 71 at 23578).

(*Id.*). Other directors, including Thanos and Zawatski, recognized and agreed with this longer-term approach. (Ex. 71 at 23577).

### G. The Board, Without Adequate Information, Abruptly Chooses to Sacrifice Growth in Favor of Steel Partners' Interests.

On June 4, 2008, Zawatski met with Steel Partners' Howard

**REDACTED**

(Zawatski 19).

(Zawatski 189-91).

The meeting purportedly concluded without discussion of next steps, but

**REDACTED** (Ex. 73).

By June 4, 2008, Sems was on the Board. (Ex. 74).[24] From his new vantage point,

**REDACTED** [25] Howard did the same..

(Ex. 79).

**REDACTED**

After getting his Board seat, **REDACTED**

(Ex. 80). On June 22, 2008, the directors – excluding Jurkowski – met. Despite it being his first Board meeting, Sems assumed the position of meeting chair.

**REDACTED** (Ex. 81). On June 30, 2008, the Board fired Jurkowski, claiming as one rationale that he was not moving quickly enough down the path of selling the Company's businesses. (Thanos 103; Zawatski 74).[26]

The firing of Jurkowski eliminated the remaining resistance to Steel Partners' interests, and Sems led the Board toward stripping the Company to an NOL shell. The Board began with the sales configuration business, firing the general manager, vice president of marketing, vice president of sales, and director of product management. (Shaw 7-10, 20-21, 29-31). The day

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24 Sems, nominated by Miller, was endorsed by Steel Partners. (Jurkowski 48; Ex. 61).

25 (Exs. 59; 75).
(Ex. 76 at 6206; Ex. 77 at 6181; Ex. 79 at 6176).

26 Sems continued to take his cues regarding the direction of the Company from Howard and Miller.

**REDACTED**

Selectica announced the firings – July 1, 2008 **REDACTED**

(Exs. 83; 84). None of these positions were refilled, putting the sales configuration business in a bare maintenance mode.[27] By virtually abandoning the sales configuration business, the Board further committed itself to a path towards becoming an NOL shell and further diminished any chance of making the Company profitable.[28]

The Board determined not to fill the CEO position. (Zawatski 18, 237-38). Instead it assigned oversight functions to two members – Zawatski and Thanos, who were to share the CEO duties and to operationally run the day-to-day aspects of the business.[29] (Zawatski 316-17; Ex. 77). [30]

**REDACTED**

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[27] (Shaw 11-12, 16-18, 20-21, 23-24, 30, 75-77.). In 2005, Selectica began focusing on its contract management business at the expense of its sales configuration business. (Shaw 26-27). As a result, the customer base of Selectica's sales configuration business dropped from over 100 customers to only 15 customers. (Shaw 26-29). In late 2007, Jurkowski attempted to rejuvenate Selectica's sales configuration business and hired the personnel necessary to effect this change. (Shaw 7-8, 21-30). However, the Board abruptly determined to again abandon its sales configuration business as of July 1, 2008. (Shaw 20-21, 23-25, 68-69, 104-05).

[28] Selectica also made public misleading statements about its sales configuration business. Through August to November 2008, Selectica lauded its sales configuration business as the "gold standard" (Exs. 28; 85), despite the fact that it had virtually no remaining leadership, no new customers, and existed as a

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Moreover, in the months after the Board fired much of its top-level management in July 2008, the Board publicly announced a number of "new contracts." (Exs. 86; 87). But these announcements did not disclose that the "new contracts" were in fact old deals that had been closed in the previous quarter by the prior (now terminated) managers. (Shaw 40-41; 69-74). The Board misrepresented these contracts as new and delayed reporting them to make it appear that the firings had helped rather than hurt the business. (*Id.*).

[29] The current Chief Financial Officer, Richard Heaps, has not executed a certification indicating whether he is acting as both the principal financial officer and principal executive officer. (Ex. 25 at p. 30; Ex. 26 at p. 31; Ex. 9 at p. 31). Because it failed to file the proper certifications of the principal executive officer under Sections 302 and 906 of the Sarbanes-Oxley Act for the fiscal quarters ended June 30, 2008, October 31, 2008 and December 31, 2008, the Company is not current on its public filings, nor has it been current since its Form 10-Q filed on August 19, 2008. (*Id.*).

[30]

**REDACTED**

**REDACTED** (Zawatski 237).

With Sems now in and Jurkowski forced out, the Board suddenly reversed course from its earlier resistance to a quick sale. In July 2008, just over a month after Zawatski and Thanos had agreed that the Board should not immediately shop the Company (Ex. 71), Selectica began interviewing investment banks for exactly that purpose. (Sems 217-20). By mid-August 2008, Selectica had retained Needham & Company. (Exs. 89; 90).[31]

Meanwhile, throughout the Summer of 2008,

**REDACTED**

[33] Steel Partners again made purchases, this time some 806,019 shares of Selectica

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[31] **REDACTED**

Reilly 16-17).

[32] (Exs. 52; 55-57; Brogan 117; Howard 45-46).

**REDACTED**

(Ex. 76 at 3).

[33] Steel Partners' Jack Howard

**REDACTED** (Howard 104).

with the Company's Form 10-K disclosures which reflected that it had experienced "changes in ownership" under § 382 that "could result in the forfeiture of approximately $24.6 million of net operating loss carryforward [sic] for federal income tax purposes." (Ex. 7 at p. F-22).

stock, increasing its stake to 13.9%. (Exs. 70; 91; 92).[34]

In October 2008, Zawatski, Thanos, and Heaps met with Howard in New York City.[35] Howard told them

**REDACTED**

(Zawatski 122-23, 257-58; Thanos 60-65).[36]

**H. Selectica Rejects Trilogy's Offers and Excludes It From the Strategic Alternatives Process.**

On July 30, 2008, Trilogy extended alternative acquisition proposals to Selectica:

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Within days, Selectica's Board summarily rejected both alternative proposals. The Board made no counterproposal and there were no follow-up discussions. (Fallon 101-03, 116-17; Zawatski 252).

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[34] Sems also coordinated private meetings between Steel Partners and Selectica management.

**REDACTED**

Sems at 200-02; Ex. 93).

[35] While Zawatski and Thanos have different recollections of when this meeting occurred, it appears to have been on October 1, 2008, given that Heaps, a participant at the meeting, did not join Selectica until September 2008. (Zawatski 123; Thanos 60; Heaps 16; *see also* Ex. 94).

**REDACTED**

(Ex. 95).

Selectica's rejection of Trilogy's offer and its refusal to pursue discussions was inexplicable given that (i) Selectica had effectively abandoned the configuration business in early July, and (ii) Selectica's former management has acknowledged that Trilogy "would be a natural acquirer for [Selectica]" (Jurkowski 63). Indeed, Trilogy is at the top of what is a very small list of prospective acquirers. (Shaw 41-46, 88-90). Such was the animus against Trilogy that the Board simply took a "no way" position. Michael Shaw, the former head of Selectica's sales configuration business, testified that co-chair Jim Thanos' general feeling (if not exact words) was that Selectica would sell to Trilogy "over my [Thanos'] dead body." (Shaw 43-44).

Despite being shut out of the strategic alternatives process, Trilogy made another bid during the first week of October 2008 to acquire all of Selectica's assets. (Fallon 113-14, 117). Although this offer was increased from Trilogy's July offer, the Board ignored Trilogy for over a month until it again summarily rejected the offer. Again Selectica refused to make a counteroffer, and again made no effort to engage Trilogy in discussions. (Fallon 141-46).

To date, Trilogy remains excluded from Selectica's strategic alternatives process. Selectica's financial advisor in the process, Needham & Company, has never followed up with Trilogy to discuss its prior offers or to investigate its continuing interest.[37] Indeed, Reilly testified he was never directed to do so. (Reilly 153).[38]

**I. The Board's Hurried Adoption of the Nuclear Pill.**

On November 13, 2008, Trilogy disclosed that it had acquired additional Selectica stock, increasing its ownership to 5.1%. (Ex. 98). In response, Sems and Howard quickly requested

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[37] A representative of Needham participated in the November 13, 2008 phone conversation in which Selectica rejected Trilogy's October offer. But this brief conversation was Needham's first and only communication with Trilogy. (Reilly 45-47; Fallon 141-47).

[38] (Fallon 106-08). Selectica attempts to jusitify this exclusion on the basis that Trilogy did not sign a proper non-disclosure agreement. (Ex. 4 ¶ 54). However, Trilogy had indeed signed Selectica's standard non-disclosure agreement in July 2008, and was never asked to sign another agreement. (Zawatski 244-47; Ex. 97).

Brogan to revise his § 382 analysis (Ex. 99; 100), which had not been updated since July (Brogan 125-26), despite Steel Partners' stock purchase during this period, to determine how close Selectica was to a "change in ownership." On November 15, Brogan sent Sems and Heaps the updated results. (Ex. 101)

**REDACTED**

Selectica's Board met on November 16, 2008 to discuss Trilogy's shareholdings. (Ex. 102).[39] The minutes state that Brogan reported

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At this same meeting, Needham's representative Jim Reilly purportedly indicated that

**REDACTED**

In response to this bare discussion,

[39] Selectica attempts to rely on unsigned copies of minutes of Board meetings dated between November 16, 2008 and January 2, 2009. In addition, many of the minutes from the critical Board meetings in which the Nuclear Pill and Reloaded Nuclear Pill provisions were discussed are marked as "draft" copies. (*E.g.*, Exs. 102-104). By referencing these draft minutes in its pre-trial brief, Trilogy does not intend to waive its objections to these minutes including, among other objections, lack of proper authentication and hearsay.

[40] The November 16 Board minutes purport to reflect that

**REDACTED**

the Board suddenly adopted the Nuclear Pill as an amendment to its 2003 Pill.[41]

The amendment contained provisions of unprecedented severity. The Nuclear Pill reduces the threshold at which a beneficial owner becomes a so-called "Acquiring Person" from 15% to 4.99%. (Ex. 38 at § 1(a)). The Nuclear Pill had a grandfather provision which provides that beneficial owners who held in excess of 4.99% as of the amendment do not trigger the Nuclear Pill, but will suffer the dilutive consequences of the pill if they increase their holdings by a mere 0.5%. (the "Grandfather Cap") (*Id.*). This device effectively guarantees the primacy of Steel Partners as the largest single stockholder of Selectica. The Nuclear Pill provides that a person may be "exempted" even if the person holds 4.99% or more of common stock, if the Board determines that such ownership "will not . . . jeopardize or endanger the availability to the Company of the NOLs." (*Id.* at § 1(n)).

Selectica's directors had grossly inadequate information at the time the Board rushed to adopt the Nuclear Pill.[42] They failed to realistically assess whether Selectica's NOLs had any certain or foreseeable value worth protecting, much less balance any such value against the drastic measures it was taking. For example, the Board failed to assess or consider: (i) how Selectica might be able to generate taxable income (Sems 70-71; Brogan 77-78, 104); (ii) how much taxable income might be generated (in order to know whether a limitation under § 382 would even impact the use of the NOLs) (Sems 70-71; Brogan 77-78, 104);[43] (iii) whether – and

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[41] The Board also established a review committee ("Pill Committee") to oversee matters related to the Nuclear Pill and appointed Sems and Arnold as the Pill Committee's members. (*Id.* at 17243-44).

[42] As an initial matter, the directors failed to recognize that a change in ownership under § 382 had already occurred prior to the adoption of the Nuclear Pill. Zawatski admitted as much in her deposition (Zawatski 112). In addition, Trilogy's expert confirms that a change in ownership occurred on November 14, 2008. (Ex. 45 at 12-13, 22; Ex. 105).

[43] A change in ownership under § 382 would only impact Selectica's ability to use its NOLs to the extent that the amount of taxable income to be generated was sufficiently large to exceed a § 382-limited amount. (Ex. 46 at 18-19).

if so, how – Steel Partners planned to use the NOLs;[44] (iv) whether the "built-in-gain" exception to § 382 might apply to any anticipated future profits (Thanos 203; Zawatski 345-46);[45] and (v) the discrepancies between the Chinn and Brogan studies, and the reasons Brogan believed Chinn's conclusions were incorrect. (Sems 87-88; Heaps 57-58). Sems conceded that the Board did not consider the consequences of adopting the Nuclear Pill, including any negative effects on the rights of Selectica's stockholders. (Sems 97; *see also* Arnold 203).

Neither Reilly nor Brogan provided advice to the Board on whether it should adopt the Nuclear Pill. (Reilly 58-59, 76-77; Brogan 214-215). Indeed, the Board did not understand Reilly to be an expert on NOLs or § 382. (Zawatski 417). Reilly only advised on two discrete issues with respect to adoption of the Nuclear Pill: **REDACTED**

(Reilly 58-59). He did not advise the Board regarding whether the trigger should be lowered to 4.99%, nor was he asked whether the Nuclear Pill should be implemented in response to Trilogy's stock purchases. (Reilly 76-77, 82-83).

As for Brogan, he only provided advice to the Board

He did not provide any advice on whether or how the NOLs might be used to generate value for Selectica. (Brogan 77, 104).

**REDACTED**

44 **REDACTED**

(Thanos 187-89).

45 As explained previously, any gain on the sale of an asset would not be affected by a § 382 limitation because § 382 does not restrict the use of NOLs for built-in-gains. *See supra* at n. 15.

[46]

## J. The NOL Pretext.

A review of the events surrounding the rushed adoption of the Nuclear Pill demonstrates that, except for Sems, no one on Selectica's Board had shown any interest in Selectica's NOLs prior to Trilogy's 13D filed on November 13, 2008. At no time prior to Trilogy's purchases did Selectica ever disclose that it regarded its NOLs to be a significant asset of the Company.[47] Indeed, Co-Chair Jim Thanos declared as recently as August 2008 that he did not think Selectica's NOLs had any value

(Thanos 39).

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(Reilly 14-15, 50; Zawatski 465).

While it jumped into action after Trilogy's acquisitions, the Board expressed no concern regarding Steel Partners' repeated purchases of stock in the months before the adoption of the Nuclear Pill (Sems 25-28), even though that firm appeared to have created exactly the same situation under § 382. At least as early as July 2008, Brogan and the Board believed that

[46] (Arnold 138-40; Heaps 42-43; Sems 31-32; Thanos 94; Zawatski 194-95; Exs. 44; 106-113).

**REDACTED**

[47] To the contrary, Selectica repeatedly reported a full valuation allowance against the entire tax savings available from its NOLs (Ex. 7 p. F-22; Ex. 17 p. 97; Ex. 120 p. F-28; Ex. 121 p. F-28; Ex. 122 p. F-30; Ex. 8 p. F-32; Ex. 123 p. F-26; Ex. 124 p. F-24; Ex. 5 p. F-20), (*See* Ex. 46.)

[48] And three times in the following months, Steel Partners filed Schedule 13Ds that disclosed an increase of nearly 4% in its holdings.[49] The Board did nothing in response to what they later proclaimed to be a situation of "jeopardy" (when Trilogy was involved).

Moreover, in October 2008 – just a month before the adoption of the Nuclear Pill -

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Despite notice of the foregoing ownership increases by Steel Partners, the Selectica Board did not ask Brogan to update his § 382 analysis (Sems 25-28; Brogan 125-26). The Board did not take any action to adopt the Nuclear Pill in response to Steel Partners' purchases. A 40% ownership change level under § 382 was not viewed as a "crisis" immediately ***before*** Trilogy's 13D filing, but the Selectica Board grabbed at the same percentage level to claim a "crisis" only days later. The only change in the equation was the identity of the acquiror – Trilogy as opposed to Steel Partners.

**K. The Nuclear Pill is Triggered and the Board Reloads.**

Trilogy announced in a Schedule 13D/A filed on December 22, 2008, that on December 18 and 19, 2008, it had slightly increased its ownership above the new limits imposed by the Nuclear Pill. It purchased an additional 154,051 shares of Selectica common stock, which brought its total ownership in Selectica to 6.7%. (Ex. 1).

**1.** ***The December 29th Board Meeting.*** In response to Trilogy's purchases, the Selectica Board met on December 29, 2008. (Ex. 103). The Board called Brogan back to this meeting to recite his newest conclusions. (Brogan 234-35).

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49 (Exs. 70; 91; 92).

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Ex. 125 at 1081). In other words, Selectica still had a 10% cushion – just as it thought it had for the prior six months, and just as it had when Steel Partners was acquiring its 14.9%.

Needham's representative, Reilly, was also present at this meeting. The minutes purport to reflect that Reilly stated

**REDACTED**

Based on this inadequate discussion, the Board granted its "Pill Committee" (composed of Sems and Arnold) complete authority and discretion to determine whether Selectica should declare Trilogy's purchases exempt from the effects of the Nuclear Pill, and whether to effect an exchange of the rights under the Nuclear Pill. (*Id.* at 17285).

2. ***The January 2nd Board Meeting***. The Board convened another meeting on January 2, 2009, at which it delegated authority to the Pill Committee to implement an exchange of shares under the Nuclear Pill, and to grant new rights under a Reloaded Nuclear Pill. (Ex. 104 at 17295). The Pill Committee met after the Board meeting adjourned. The minutes purport to reflect that Reilly flatly stated

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[50] As explained *supra* at n. 15 and n. 45, a "built-in-gain" from a sale of a corporation's assets is not subject to limitations under § 382.

**REDACTED**

Nevertheless, the Pill Committee declared Trilogy's purchases non-exempt, determined to exercise the exchange of shares under the Nuclear Pill,[51] and also adopted the Reloaded Nuclear Pill. (*Id.* at 17303-17308).

On January 5, 2009, Selectica announced that it had adopted the Reloaded Nuclear Pill (Ex. 41) effective after the exchange authorized on January 2. (Ex. 2). Like its predecessor, the Reloaded Nuclear Pill contains the 4.99% trigger, the "Grandfather Cap," and the discretionary "Exemption." (Ex. 41 at §§ 1(a), 1(q)). The Reloaded Nuclear Pill will expire on January 2, 2012, unless the expiration date is advanced or extended, or unless the New Rights are exchanged or redeemed earlier by the Board. (*Id.* at § 7(a)).

**3.** ***The Exchange of Shares Under the Nuclear Pill.*** Selectica's exchange of shares under the Nuclear 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). (Ex. 2). According to Selectica, after the exchange, the number of shares outstanding reached approximately 55.5 million. (Ex. 9, p. 1). The exchange resulted in the diminution of Trilogy's and Versata's beneficial interest from

[51] Under the Nuclear Pill, the Selectica Board claimed to have the ability to determine that purchases by Trilogy did not trigger the pill. Under its own interpretation, the Board had the obligation, prior to ordering an exchange of the Rights, to make an informed determination that such purchases actually threatened Selectica with harm. (Ex. 38 at § 1(n)). The Board did not appropriately consider this issue, much less determine that the Company or its NOLs were in fact threatened.

6.7% to 3.3%. The implementation of the exchange provisions of the Nuclear Pill led to a cessation of trading in Selectica common stock on Nasdaq as of January 5, 2009, with its stock price frozen at $.69. (Ex. 126). Trading did not resume until February 4, 2009. (*Id.*).

**L. The Attempted Ex Post Facto Justification For the Nuclear Pill.**

Other than Sems, who had been privately communicating with Steel Partners for years, the Board and its advisors did not begin to inquire until ***after*** the adoption of the Nuclear Pill and Reloaded Nuclear Pill as to whether and how Steel Partners might possibility utilize Selectica's NOLs at some point in the future. Needham's representative, Jim Reilly, with the consent of Zawatski and Thanos, met with Jack Howard of Steel Partners during the second week of January 2009. The meeting came approximately seven weeks after the Pill was adopted and approximately two weeks after Selectica commenced this litigation.

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Later in January 2009, Zawatski and Reilly met with representatives of SP Management, the Steel Partners entity

**REDACTED**

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**REDACTED** (*Id.* at 18-20; Ex. 127)

**M. Sems Attempts to Control the Pill Committee To Further Steel Partners' Plan.**

On January 7, 2009, Alan Howe was elected to the Selectica Board to fill a seat that had been open since the July 2008 firing of Jurkowski. (Ex. 3). Howe was nominated by Lloyd Miller (who, as described above, nominated Sems, has close ties to Howard and Sems, and is committed to Steel Partners' agenda). (Ex. 128).

**REDACTED**

. If Howe were appointed to the Pill Committee, Sems and Howe would constitute a majority of the Committee, given that its only other member is director James Arnold. Sems and Howe could thus control whether Steel Partners is granted an "exemption" under the Pill, as it continues to increase its ownership interest *en route* to gaining control of the NOLs.

## ARGUMENT

**I. The Nuclear Pill And Reloaded Nuclear Pill Should Be Declared Invalid Because They Preclude An Effective Proxy Contest**

The purpose of "poison pills," as originally conceived, was to "enable the target board of directors to prevent the acquisition of a majority of the company's stock through an inadequate and/or coercive tender offer. The pill gives the target board leverage to negotiate with a would-be acquiror so as to improve the offer as well as the breathing room to explore alternatives to and examine the merits of an unsolicited bid." *In re Gaylord Container Corp. S'holders Litig.*, 753 A.2d 462, 481 (Del. Ch. 2000); *Moran v. Household Int'l, Inc.*, 500 A.2d 1346, 1356 (Del. 1985). As stated by Selectica's proffered expert Professor Coates, "In practice . . . the pill

provides an impenetrable barrier to control acquisitions."[53] The ostensible purpose of the Nuclear Pill is different: purportedly to protect NOLs that the Company cannot presently use (and has no reasonable prospect of using), so that they may be "preserved" for Steel Partners (or some other unidentified entity) to control and use in some unspecified fashion in the future.[54]

While the Delaware Supreme Court has held the adoption of a pill to be *legal* in the abstract, that holding was premised on a pill not "fundamentally restrict[ing] 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) (affirming *Moran* and 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).[55] Conversely, a defensive measure such as a poison 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 v. Toll Bros., Inc.*, 723 A.2d 1180, 1195 (Del. Ch. 1998), citing *Unitrin, Inc. v. American Gen. Corp.*, 651 A.2d 1361, 1388-89 (Del. 1995); 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) (Ex. 132).[56]

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[53] L. Bebchuk, J. Coates & G. Subramanian, *The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence & Policy*, 54 Stanford L. Rev. 887, 904-05 (2002) ("Although in theory a hostile bidder could 'break through' a poison pill by triggering it, suffering the resulting dilution, and continuing to buy shares, no bidder has ever done so in our fifteen-plus years of experience with the pill.") (Ex. 130).

[54] The parties agree that the number of current public companies with poison pill triggers at approximately 5% is around 25, with approximately 9 former such pills. (*See* Ex. 131 at 8). None of these pills have ever been judicially reviewed or upheld.

[55] *See also Gaylord*, 753 A.2d at 481 (where potential acquiror may change board control through proxy contest, and then redeem the pill, the pill is not "preclusive"); *Unitrin, Inc. v. American Gen. Corp.*, 651 A.2d 1361, 1381 (Del. 1995) (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)).

[56] For example, in *In re Chrysler Corporation Shareholders Litigation*, 1992 WL 181024 (Del. Ch. July 27, 1992) (Ex. A), the Court declined to dismiss a shareholder challenge to the Chrysler Board's decision

Regardless of the Board's motivation for adopting the Nuclear Pill and Reloaded Nuclear Pill, they are invalid because they render a successful proxy challenge to change control of the Board "realistically unattainable." Unlike the pill upheld in *Moran*, with its 20% trigger, the effect of the Selectica pills on the potential for a proxy contest to change control of the Board is far more than "minimal." *Moran*, 500 A.2d at 1355. As explained in the Expert Report of Professor Allen Ferrell and Professor Ferrell's Rebuttal Report (and as he will testify at trial), the Nuclear Pill and the Reloaded Nuclear Pill – particularly in combination with Selectica's charter-based staggered board – have a substantial preclusive effect on the ability of a would-be challenger to run a successful proxy contest, for a number of reasons:

**(1) The Selectica 4.99% pills prevents a would-be challenging stockholder from gaining credibility by increasing its financial commitment to the Company's equity.** Selectica's 4.99% pill trigger makes it far less likely that a would-be challenger would be able to obtain the support of Selectica's stockholders in a proxy contest seeking a change in directors. Perhaps the most serious impediment to undertaking a successful director proxy contest is the need for a would-be challenger to convince fellow stockholders that its director nominees would do a better job managing the firm than the incumbent board's nominees.[57] 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. The more shares the challenger owns, the more likely it is that the challenger will be perceived by other stockholders as credibly

to lower the trigger thresholds on its poison pill from 20% to 10% in an "emergency session" after Kirk Kerkorian increased his Chrysler holdings to 9.8% of the Chrysler's outstanding common stock. *Id.* at *1. The court denied the motion to dismiss (in relevant part) because it found the poison pill could effectively eliminate the exercise of proxy rights. *Id.* at *6. Thus, a poison pill is invalid if it effectively eliminates the shareholders' ability to exercise their proxy rights.

[57] The need for a challenger to signal superiority was extensively discussed in J. Pound, *Proxy Contests and the Efficiency of Shareholder Oversight*, 20 Journal of Financial Economics 237 (1988) (Ex. 133).

believing that his slate of directors will do a better job of managing the firm for the benefit of all stockholders, given the challenger's economic interests in ensuring the right management team is in place. Empirical evidence cited by Professor Ferrell (and ignored by Selectica's proffered experts) is consistent with this explanation, and suggests that challenging stockholders in proxy contests for control, who hold less than 5% of a company's stock, will rarely succeed.[58] A challenger in a proxy contest for control at Selectica would not be able to signal credibly that its slate of board nominees was superior to that of the incumbent board's through increasing the challenger's ownership stake in the company beyond 4.99%.

**(2) The Selectica pills, when coupled with the Company's staggered board, render unrealistic a conditional takeover bid in conjunction with a director proxy contest.** A proxy challenger who wishes to signal credibly to fellow stockholders the superiority of its slate of director nominees – but who is precluded from increasing its holdings – might choose to make a bid for the company that is conditional on the opposition slate being elected. In so doing, the challenger clearly communicates to voters what they may expect economically if they vote for the opposition slate. Professor Ferrell notes that the provision of a conditional takeover bid can remove much of the uncertainty surrounding whether stockholders' situation will actually be improved if the opposition slate is elected, a position supported by empirical studies conducted

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[58] As reported by Professor Ferrell, average challenger holdings have been documented to be significantly higher in proxy contests where the challenger prevails. This finding is consistent with the importance of the challenger needing to signal credibly to other stockholders the superiority of its slate through its own equity position. Professor Ferrell cites a study, for example, which found that average challenger holdings are 14.32% when the challenger wins and 8.96% when management wins. (Ex. 134 at 9, citing Pound, *supra* note 57, at 252 and Table 2 (1988)). For proxy contests in 2008, Professor Ferrell found that the average holdings of challengers in successful proxy board contests was 9.17%, while the average holdings of challengers in unsuccessful board proxy contests was 5.68%. Of the nine successful board proxy contests in 2008, eight involved challengers with more than 5% ownership. (*See* Ex. 134 at 9).

by Selectica's own proffered expert, Professor Coates.[59]

Selectica's 4.99% pill trigger coupled with its charter-based staggered board removes the conditional tender offer/proxy contest combination as a viable alternative for a challenger to the Board to address stockholder uncertainty concerning the superiority of its slate.[60] Selectica's board is classified into three classes pursuant to Article VI of its corporate charter.[61] This means that approximately only one-third of Selectica's board can be replaced by stockholders in any given year with the result that stockholders can only replace a majority of the board after two annual stockholder meetings. In other words, in order to replace a majority of the Selectica board it would be necessary for a challenger to run two successful proxy contests, not one. *See Gaylord*, 753 A.2d at 482 (noting that "staggered board provisions . . . can delay an acquiror's ability to take over a board for several years.") (Ex. 4 ¶ 100). To win such contests by presenting a conditional tender offer, the takeover bid would have to be outstanding for a minimum of one year over two election cycles (and for as long as two years depending on the timing of the offer and the proxy vote) before stockholders can replace a majority of the board with members who would be willing to redeem the poison pill and allow the acquisition to proceed. Offering a takeover bid for such a long period of time would be dangerous for a challenger given the possibility of substantial market changes in the value of Selectica (and indeed any company) over such a long time period. *See Carmody*, 723 A.2d at 1194 (rejecting defendants' arguments

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[59] *See* Ex. 134 at 10-11, citing *inter alia* Bebchuk, Coates, Subramanian, *supra* note 53, at 920 ("[The] empirical evidence suggest[s] that proxy contests for control, without an accompanying tender offer, are seldom successful.").

[60] In announcing study results in 2002, Selectica's proffered expert, Professor Coates, stated "[W]e argue that a [ballot box] safety valve is illusory when the target has an [effective classified board]." Bebchuk, Coates, Subramanian, *supra* note 53, at 909 (2002).

[61] (Ex. 135). Selectica's corporate bylaws also provide that "the number of directors shall inititially be seven and shall be fixed from time to time thereafter by a majority of the Board of Directors." (Ex. 136, Article III, Section 3.2). The size of Selectica's board was subsequently reduced from seven to five. (Ex. 137).

"rest[ing] on the unlikely assumption that the hostile bidder will keep its offer open for more than one year. Given the market risks inherent in financed hostile bids for public corporations, it is unrealistic to assume that many bidders would be willing to do that.").

Nor can Selectica's stockholders get around this result by simply de-classifying the board and electing a new majority at the next annual stockholder meeting, since Selectica's board is classified in the corporate charter, which may only be amended with the approval of the board. Moreover, Selectica's stockholders cannot get around this result by changing the size of the board of directors given that the power to change the board's size is also vested by Selectica's charter in the Board.[62] And, finally, any vacancies on the board arising from "removal from office . . . may be filled only by the affirmative vote of a majority of the remaining directors."[63] Thus, the combination of the low 4.99% pill trigger and the staggered terms forecloses the routes by which a stockholder would customarily and realistically be able to attain a change in control of Selectica's Board. A study conducted by Selectica's own proffered expert Professor Coates supports such a conclusion. Out of 92 total hostile bids initiated and resolved between January 1996 and December 2000, Professor Coates found "not a single ballot box victory against [effective classified board] targets in our sample." L. Bebchuk, J. Coates & G. Subramanian, *supra* note 53, at 909, 927 (Ex. 130).

**(3) Selectica's staggered board and its 4.99% pill trigger decrease the probability that a would-be challenger (capped by the pill) would rationally incur the costs of a proxy contest for control.** Professor Ferrell explains that academic literature has long recognized the so-called "free rider" problem associated with an investor undertaking a proxy

[62] The power to change the number of directors is vested in the Board in Article VI of the charter.

[63] Ex. 136, Article III, Section 3.8.

contest for a change in control of a board.[64] The "free rider" problem resides in the fact that the investor must bear the non-trivial costs associated with undertaking a proxy contest in the event that the investor's board nominees fail to be elected, while the benefit of a better managed firm if the investor succeeds would accrue to the benefit of all stockholders, not only to the investor in question. As explained by Professor Ferrell, while the "free-rider" problem is a virtually universal one, it is significantly aggravated by Selectica's charter-based classified board and its adoption of a 4.99% trigger poison pill. Selectica's charter-based classified board will increase the costs faced by an investor who wishes to replace a majority of Selectica's board by forcing that investor to bear the costs of undertaking two proxy contests rather than just one. Professor Ferrell cites survey information filed with the SEC estimating, based on a review of firms' proxy statements over the 2003-2005 time period, that the average cost for an investor to conduct a proxy solicitation is at least $368,000.[65] In the case of Selectica, a challenging investor capped at 4.99% (at a value of approximately $1.2 million, based on the Company's current trading price) would have to incur a minimum of $736,000 over two proxy contest cycles. In addition, the probability of winning two proxy contests is likely to be lower than the probability of winning just one, thereby increasing the probability that this investor must risk bearing alone the entire costs of both proxy contests. (Ex. 134 at 16-17.) In addition, 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. (*Id.*). The cumulative effect of these consequences renders a proxy contest, coupled with a conditional tender offer, an unrealistic alternative for a Selectica stockholder.

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[64] Ex. 134 at 13-14.

[65] Richard Daly, Automatic Data Processing, Inc. Brokerage Services Group, Letter to Ms. Nancy Morris (April 20, 2006) (Ex. 139). Automatic Data Processing cautioned that this estimate is "likely to be lower than the actual costs incurred."

**(4) The 4.99% pill trigger significantly locks in the existing ownership structure of Selectica absent a board "exemption."** This increases the potential for the Board to base its discretionary decision on whether or not to grant an "exemption" from the 4.99% trigger on whether the stockholder in question is perceived to be likely to vote in favor of management in the event of a proxy contest. In addition, where the larger stockholders above 4.99% who are "grandfathered" under the pill are more supportive of existing directors in the event of a proxy contest, the 4.99% trigger would have the effect of significantly locking in the existing blockholding structure which is favorable to those currently in control. Moreover, the 4.99% pill limitation may potentially discourage institutional investors from acquiring Selectica stock, thus further locking in the current collection of large blockholders and shielding the Board from any new stockholder "activists." (Ex. 134 at 17-18.)

Thus, in summary, unlike the poison pill authorized by the Delaware Supreme Court in *Moran*, the Nuclear Pill and the Reloaded Nuclear Pill adopted by Selectica "fundamentally restrict[s] stockholders' rights to conduct a proxy contest." *Moran*, 500 A.2d at 1354-55. The circumstances set forth above make clear that changing control of Selectica's staggered Board, while the 4.99% pill trigger remains in place, is "realistically unattainable." *Carmody*, 723 A.2d at 1195. For these reasons, Selectica's preclusive pills should be found unlawful and invalid.

## II. The Nuclear Pill and Reloaded Nuclear Pill Are Invalid Because They Were Not a Reasonable and Proportionate Response to a Reasonably Perceived Threat

### A. The Adoption and Implementation of the Nuclear Pill and Reloaded Nuclear Pill are Subject to Enhanced Scrutiny Under Unocal

Enhanced scrutiny under *Unocal* applies when directors take defensive measures in response to a "perceived threat to corporate policy and effectiveness which touches upon issues of control." *Unitrin*, 651 A.2d at 1372 n.9. There is no dispute here that the Board's adoption and implementation of the Nuclear Pill and adoption of the Reloaded Nuclear Pill are subject to

this enhanced scrutiny: a pill is by definition a defensive measure and Selectica claims that the pills were adopted in direct response to Trilogy's stock purchases because the Board purportedly viewed those purchases as a threat to the NOLs.[66]

The Board therefore has the burden of showing that: (1) it had reasonable grounds for believing that a threat to corporate policy and effectiveness existed; and (2) its response to the threat was proportionate in the sense that it is (a) not preclusive or coercive and (b) within a range of reasonable responses to the perceived threat. *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 955 (Del. 1985); *Unitrin*, 651 A.2d at 1387. If the Selectica Board fails to make any of these showings then the Nuclear Pill and Reloaded Nuclear Pill should be invalidated and Trilogy restored to its former ownership position.[67]

### B. The Board Cannot Demonstrate That It Had Reasonable Grounds for Believing that a Danger to Corporate Policy and Effectiveness Existed

The first part of the *Unocal* test requires the Selectica Board to demonstrate that, after a reasonable investigation, it determined in good faith that Trilogy's stock purchases reflected in its November 13, 2008 13D filing created a valid threat to Selectica's NOLs justifying a defensive response. *Unitrin*, 651 A.2d at 1375.[68] The Board cannot make this showing. The

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[66] Selectica concedes that *Unocal*'s enhanced scrutiny applies. *See* Ex. 140 at ¶ 31 ("To satisfy its obligations under *Unocal*...[the] board... will be required to demonstrate...."); Ex. 141 at 70:19-22 ("the question...is going to be whether a threat was reasonably perceived and whether there was action taken which was proportional to that threat.").

[67] The Board's inability to carry its burden of showing reasonableness under *Unocal* means that it will also not be able to comply with the more exacting "entire fairness" standard under the *Unocal/Unitrin* burden-shifting approach.

[68] The Board is not entitled to any enhancement of its proof because the Board that approved the Nuclear Pill did not consist of a majority of outside independent directors. *Cf. Unitrin*, 651 A.2d at 1375. Two of the four directors that adopted the Nuclear Pill – Thanos and Zawatski – were serving as *de facto* co-CEOs **REDACTED** ') and neither had full-time work outside of their roles with Selectica. (Zawatski 22, 316-17). Neither qualifies as an "outside" director, "defined as a non-employee and non-management director." *Unitrin*, 651 A.2d at 1375. In addition, Sems was focused on the NOLs and acting in concert with Howard of Steel Partners. (Brogan 120; Exs. 65, 66, 80, 82, 84, 93, 106, 107, 119, 142-147). Therefore he was not "independent" with respect to decisions related to the Nuclear Pill and Reloaded Nuclear Pill.

issue is not met merely by arguing that the Board believed further purchases would create an "ownership change" under § 382. It requires a basis on which to believe also that any limitations would impact Selectica's reasonable prospects for using its NOLs. The evidence reflects that the Board failed to investigate whether the NOLs had value that was worth protecting and whether any such value was threatened by Trilogy's stock purchases. Instead of acting on an informed basis and in good faith as required by its fiduciary duties, the Board acted hastily, in ignorance of fundamental information, and out of animus towards Trilogy.

Not all NOLs are valuable assets. As experts for both sides agree, NOLs only have value in the form of future tax savings if the company has taxable income against which the NOLs can be offset. (Ex. 46, at 5-6; Erickson 73-75). If a company cannot generate taxable income, its NOLs (no matter how large) are worthless. The Board therefore could not make an informed decision about whether Trilogy's stock purchases posed a threat to the NOLs without first investigating and reaching informed conclusions as to whether and how Selectica might be able to generate taxable income. The Board would also need to investigate how much taxable income might be generated in order to know whether a change in ownership under § 382 would even impact use of the NOLs.[69] There is no evidence that the Board undertook any investigation into these issues, leaving it with no basis to know whether and how much value the NOLs might have and what threat to that value, if any, was posed by Trilogy's purchases. Rather than investigate the relevant considerations, the Board hastily adopted the Nuclear Pill at its November 16, 2008 meeting just three days after Trilogy filed its 13(D). The only written material distributed to the Board prior to this meeting were the draft resolutions. (Ex. 102).

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**REDACTED** (Thanos 194), a conflict which applies equally to Sems.

[69] If only a small amount of taxable income is generated, then a § 382 limitation on the use of some portion (but not all) of the NOLs would not prevent that income from being offset. In that situation, there would be no loss in the usable value of the NOLs despite an "ownership change." (Ex. 46 at 15-18).

The lack of information and investigation is illustrated by the testimony of Sems, the director most interested in the NOLs. (Brogan 120). Sems testified

**REDACTED**

To the extent the Board did discuss the value of the NOLs, such discussions demonstrate a belief that they had no value.

**REDACTED**

The Company's SEC filings reflect that the Board believed that Selectica would not be able to utilize its NOLs. In its Form 10-KSB filed on June 10, 2008, Selectica recognized no amount of deferred tax assets for its NOLs on its balance sheet. (Ex. 7, p. F-22).[71] Under applicable accounting rules this reflects a determination that it is more likely than not that it will

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[70] Sems appears to have understood that the NOLs could not be used if Selectica never had any profit. His fellow Board member Thanos, as co-chairman of the Board, did not have even that most basic understanding. (Thanos 40).

[71] Selectica made a similar disclosure in every 10-K it has ever filed (Ex. 17 p. 97; Ex. 120 p. F-28; Ex. 121 p. F-28; Ex. 122 p. F-30; Ex. 8 p. F-32; Ex. 123 p. F-26; Ex. 124 p. F-24; Ex. 5 p. F-20).

never be able to use any portion of its NOLs. (Ex. 46, at 22). Remarkably, the 10-Q for Q3 2009 – filed on February 17, 2009, after the Nuclear Pill had been implemented and the Reloaded Nuclear Pill adopted – similarly discloses that the Company thinks it is more likely than not that it will never utilize its NOLs. (Ex. 9, p. 9). The Board purports to have taken the major steps of creating and triggering the Nuclear Pill and Reloaded Nuclear Pill to protect an asset that the Company has consistently represented to its stockholders and the public that it will likely never use.

A consideration of the means by which a company can generate taxable income further demonstrates that the Board had no reason to believe that the NOLs had a value threatened by Trilogy's stock purchases. Taxable income can be generated in one of three ways: (i) from the company's operations; (ii) by the company selling an asset at a gain; or (iii) by acquiring an asset that generates taxable income. (Ex. 46, at 7-8).[72]

**No prospect for future taxable income from operations:** The Board knew that the first option for generating taxable income was not a realistic possibility. Selectica has never generated taxable income. It has had an average loss of over $20 million per year.[73] Its results for fiscal 2008 reflected a pre-tax loss of $23.5 million.[74] Nor did the Board have any reason to believe that the Company would suddenly become profitable. The Company abandoned its sales configuration business in July 2008

(Shaw 25-26, 60-61; Zawatski 35).

**REDACTED**

[72] An equity acquisition of Selectica by another company would trigger a § 382 limitation and an economically rational acquiror accordingly would not pay a premium for NOLs rendered unusable by virtue of this limitation. An equity acquisition of Selectica is therefore not a means by which Selectica could extract value from the NOLs. (Ex. 46 at 16 n.46).

[73] (Ex. 7 p. 16; Ex. 9 p. 28; Ex. 5 p. 23).

[74] (Ex. 7 p. 16).

The Board did not and could not have reasonably believed that there would be taxable income from operations against which the NOLs could be offset.

**No § 382 limits on asset sales:** The second option for generating taxable income – selling an asset at a gain – is not relevant to the Board's decision to adopt the Nuclear Pill or Reloaded Nuclear Pill. Taxable income from the sale of an asset is a "built-in gain" under the Internal Revenue Code which generally can be offset by NOLs regardless of whether any ownership changes under § 382 had occurred. (Ex. 46, at 10-11). No matter how much stock Trilogy bought, it would not reduce the value of NOLs used for this purpose. The Board, however, had no understanding of the built-in gain rule. (Thanos 203; Zawatski 345-46).

**Speculative, not reasonable, basis for use after acquisitions:** The third option for generating taxable income – acquiring a company or assets that generate taxable income – also does not provide any reasonable basis for the Board's actions. The Board has never seriously considered this as a potential way of utilizing the NOLs.

**REDACTED**

(Thanos 63, 65; Zawatski 368-69, 400-02; *see also* Heaps 44-46). It was not until January 2009 (after Selectica implemented the Nuclear Pill to dilute Trilogy and adopted the Reloaded Nuclear Pill)

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Even if the Board had received advice from Reilly about the NOLs, it would not have been justified in relying on him. Zawatski testified that she knew Reilly was not an expert on NOLs or § 382. (Zawatski 417). Zawatski was right – Reilly is not an expert on these matters, nor does he purport to be. (Reilly 58-59, 87, 112). The Board could not reasonably rely on someone who they knew to lack expertise in considering whether the NOLs had value.

Nor did the Board receive any advice from Brogan on the value of the NOLs.[77]

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**REDACTED**

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77 The Board claims to have also received advice from lawyers in connection with adopting the Nuclear Pill and Reloaded Nuclear Pill but it cannot rely on that advice to justify its actions because it chose to shield the substance of the advice during discovery. (Ex. 149 at 21-26).

His advice to the Board therefore provides no support for the Board's conclusion that the NOLs were worth protecting.

The Board was not justified in relying on Brogan's § 382 analyses because it knew that he was not delivering disinterested advice. As the Board recognized when Steel Partners' Howard requested a Board seat,

**REDACTED**

The Board also knew that Brogan's work was materially incomplete and not reliable.

**REDACTED**

Nor did the three-day period between the filing of Trilogy's 13(D) and the Board's hasty adoption of the Nuclear Pill provide Brogan with time to update and complete his study. Even after the Board adopted the Nuclear Pill, Brogan continued to gather information that was material to his analysis (in his

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[78] **REDACTED**

[79] (Zawatski 461; Arnold 138-40; Heaps 42-43; Sems 31-32; Thanos 94; Zawatski 194-95; Exs. 44; 106-113).

words, "fairly important"), including

**REDACTED**

The Board thus learned, prior to its decision to use the Nuclear Pill to dilute Trilogy, that (i) in adopting the Nuclear Pill it had acted on erroneous information that had overstated any perceived threat to the hypothetical use of the NOLs; and (ii) Brogan's analysis could be easily manipulated in ways that altered the outcome. Yet the Board did not pursue these "red flags" to ascertain whether Brogan's analysis was accurate and reliable.[81]

If the Board had invested the time and resources for a full study, it would have learned that "ownership changes" under § 382 had already occurred ***before*** the Nuclear Pill was adopted. A full and accurate § 382 study reveals that the most recent ownership change occurred on or

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[80] Sems is a member of the Board so there is no reason that Brogan could not have gathered that information from Sems prior to the Board deciding to adopt the Nuclear Pill.

[81] In addition, there were a number of other "red flags" that also should have alerted the Board to question Brogan's analysis: (i) Brogan's conclusions differed from those reached by Chinn, yet the Board never undertook to understand why (Sems 87-88; Heaps 57-58); (ii) Brogan's analysis was inconsistent with Selectica's own disclosures stating that there had been changes in ownership (Ex. 7 p. F-22); (iii) after Brogan updated his analysis for the Soundpost purchases, he purportedly discovered an error in his prior work that allowed him to maintain the same bottom-line conclusion (Exs. 99; 101; 119); and (iv) the Board did not inquire what it meant for Brogan to give a "more likely than not" opinion. (Ex. 125; *see also* Brogan 243-245).

before November 14, 2008 – ***before*** the Board adopted the Nuclear Pill – which substantially limited the use of the NOLs under § 382. (Ex. 45 at 12-13).

**REDACTED**

In other words, Zawatski voted to implement the Nuclear Pill to dilute Trilogy and voted to adopt the Reloaded Nuclear Pill despite knowing that such actions served no purpose. At best, the rest of the Board acted out of ignorance due to its inadequate investigation.[82]

Brogan's work for and communications with the Board in fact demonstrate that the Board did not reasonably perceive a threat to the NOLs from Trilogy's stock purchases and instead acted out of animus to Trilogy. Between July 2008 and Trilogy's 13D filing in November 2008, Brogan did not update his § 382 analysis. (Brogan 125-26). During this four month period with no § 382 updates, Steel Partners filed three 13Ds – the only 13Ds filed in this period – disclosing an increase in its holdings of Selectica of nearly 4%. (Exs. 70; 91; 92). Despite being on notice of several increases in ownership that would significantly impact Brogan's § 382 analysis, the Board did not think to have Brogan update his § 382 analysis in light of Steel Partners' new purchases. It was only when Trilogy – whom the Board viewed as Selectica's nemesis – filed a 13(D) that the Board suddenly began to express purported concern with the NOLs and asked Brogan to update his § 382 analysis. (Exs. 99; 150).

On November 15, 2008 – a day before Selectica adopted the Nuclear Pill – Brogan emailed Sems and Heaps the results of updating his § 382 analysis in light of Trilogy's recent

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[82] As a result of the discovery process during this litigation, the Board now knows (if it did not already) that an ownership change occurred in November 2008 and that the Reloaded Nuclear Pill, which is currently in place, accordingly serves no purpose. This is yet another reason why the Reloaded Nuclear Pill should be invalidated and rescinded. *See Mills v. MacMillan*, 1988 WL 108332, at *18-*19 (Del. Ch. Oct. 18, 1988) (Ex. B) (directors cannot maintain poison pill if it is no longer serving any corporate purpose) *rev'd in part on other grounds by* 559 A.2d 1261.

purchases. (Ex. 101).

**REDACTED**

Yet the Board still rushed into adopting the Nuclear Pill.

It is no coincidence that the Board sprung to action to purportedly protect the NOLs when Trilogy emerged as a large stockholder, in sharp contrast to the Board's utter lack of concern for the NOLs while Steel Partners accumulated a much larger stock position. A series of events appear to have given rise to animus by the Board towards Trilogy. One example of the Board's dislike for Trilogy is its view of the settlements that arose out of Selectica's infringement of Trilogy's intellectual property.

**REDACTED**

The treatment of Trilogy's acquisition proposals show the Board's determination to cast off legitimate offers at the expense of the Company's best interests. Trilogy, having made a number of offers to purchase some or all of Selectica's assets, was met with a rigid refusal to even engage in discussions. The exclusion of Trilogy, "a natural acquirer for [Selectica]" (Jurkowski 63), was well understood within Selectica: Thanos reportedly held the view that Selectica would engage in a transaction with Trilogy "over my [Thanos'] dead body." (Shaw 43-44). The Board allowed animus towards Trilogy to impact decision-making with respect to the strategic alternatives process. It did the same in adopting the Nuclear Pill, in a manner inconsistent with its fiduciary duties and its burden to show that it acted out of concern for the NOLs.

### C. The Board Cannot Demonstrate That Adoption of the Nuclear Pill and Reloaded Nuclear Pill was Reasonable in Relation to any Threat to the NOLs

Even had the Board reasonably found an actual threat to its business and governance associated with a real – not speculative – use of the NOLs, it must do more. It must also demonstrate that the Nuclear Pill and Reloaded Nuclear Pill were a reasonable and proportionate response to a real (and not imagined) threat. The Board cannot make this showing because (i) the Nuclear Pill and Reloaded Nuclear Pill preclude an effective proxy contest, and (ii) the Nuclear Pill and Reloaded Nuclear Pill are outside the range of reasonable responses to any threat perceived by the Board.

#### (i) The Board Cannot Demonstrate That The Nuclear Pill and Reloaded Nuclear Pill Are Not Preclusive

A response is "preclusive" under *Unocal* if it fundamentally restricts proxy contests. *Unitrin*, 651 A.2d at 1387; *Omnicare, Inc. v. NCS Healthcare, Inc.*, 818 A.2d 914, 935 (Del. 2003); *Carmody*, 723 A.2d at 1195; *In re Chrysler Corp.*, 1992 WL 181024, at *5. As set forth above, the Nuclear Pill (and Reloaded Nuclear Pill), particularly in conjunction with Selectica's charter-based classified board, have a substantial preclusive effect on the ability of a would-be challenger to run a successful proxy contest. The Nuclear Pill and Reloaded Nuclear Pill are therefore "preclusive" under *Unocal* and by definition an unreasonable response by the Board.

#### (ii) The Board Cannot Demonstrate That The Nuclear Pill and Reloaded Nuclear Pill are Within a "Range of Reasonableness"

Even if a defensive measure is not preclusive, it must be "reasonable in relation to the threat" identified by the Board. *Unocal*, 493 A.2d at 955. This "requires an evaluation of the importance of the corporate objective threatened; alternative methods for protecting that objective; impacts of the 'defensive' action and other relevant factors." *Paramount Commc'ns Inc. v. Time Inc.*, 571 A.2d 1140, 1154 (Del. 1990). As discussed above, Trilogy's stock purchases did not pose any threat to a valid corporate objective because the NOLs have no value

in light of Selectica's inability to generate taxable income and any value was not threatened by Trilogy's stock purchases. But even if the there was some valid threat, it was at most a mild one and speculative in nature.

The negative impacts of the Board's adoption and implementation of the Nuclear Pill (and Reloaded Nuclear Pill), on the other hand, are severe and disproportionate to any purported threat to the NOLs. First and foremost, the implementation of the Nuclear Pill has caused substantial economic harm to Trilogy. Trilogy's interest in Selectica has been reduced from 6.7% to 3.3 unless remedied by the Court. (Ex. 2).[83]

While the Board intended to inflict that harm on Trilogy (Sems 46-48), the Nuclear Pill and Reloaded Nuclear Pill have also hurt Trilogy and other stockholders in other ways, most of which were never even considered by the Board. As discussed above, the Nuclear Pill and Reloaded Nuclear Pill have a substantial preclusive effect on the ability of a would-be challenger to run a successful proxy contest. The Nuclear Pill and Reloaded Nuclear Pill also have the negative consequence of potentially deterring investments by institutional investors, which the Board has admitted is a desirable goal for a public company. (Ex. 134 at 17; Arnold 34; Thanos 37; Zawatski 63). In addition, the adoption and implementation of the Nuclear Pill caused trading in the Company's stock to be halted for over four weeks and caused the Board to decide to initiate costly litigation to seek judicial approval of its conduct. (Ex. 126).

These negative impacts of the Board's conduct are disproportionate to any mild valid threat to the NOLs. Even if the Nuclear Pill and Reloaded Nuclear Pill do not preclude a proxy contest, its impact on shareholders' fundamental right to replace the Board cannot be ignored.

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[83] The Board cannot justify its conduct by noting that it could have diluted Trilogy's interest more than it did by implementing the "flip-in" mechanism of the Nuclear Pill rather than the share exchange mechanism. The fact that the Board could have acted more unreasonably does not mean that its actions were reasonable.

*See Carmody*, 723 A.2d at 1993 (*Moran* and *Unocal* "reflect the fundamental value that the shareholder vote has primacy in our system of corporate governance because it is the ideological underpinning upon which the legitimacy of directorial power rests") (internal citations and quotations omitted).

Yet ignoring this impact is precisely what the Board did. The Board never considered the impact of the Nuclear Pill and Reloaded Nuclear Pill on proxy contests. (Sems 97). Nor did it consider the impact on the ability to attract institutional stockholders. (Arnold 203). The Board's failure to even consider these issues – much less balance them against any purported threat to the NOLs – further undercuts the reasonableness and proportionality of the Board's decision to adopt the Nuclear Pill in response to any perceived threat. *Chesapeake Corp. v. Shore*, 771 A.2d 293, 334 (Del. Ch. 2000) (faulting board for "simply ma[king] no judgment" or "even discuss[ing]" the impact of defensive response on stockholders' ability to amend bylaws); *Cf. Moran*, 490 A.2d at 1080 ("The Household Board was advised of the ramifications of the Plan on proxy contests").

The Board cannot claim to have relied on the advice of experts in arguing that its decisions to adopt the Nuclear Pill and Reloaded Nuclear Pill were reasonable ones. Neither Reilly nor Brogan provided advice to the Board on whether it should adopt the Nuclear Pill or Reloaded Nuclear Pill.[84] Reilly only advised the Board on two discrete issues with respect to adoption of the Nuclear Pill and Reloaded Nuclear Pill:

**REDACTED** He did not advise the Board regarding whether the threshold should be lowered from 15% to 4.99%, nor was he asked whether the Nuclear Pill should be implemented in response to Trilogy's stock purchases.

[84] Again, the Board cannot rely on any legal advice because it chose to shield the substance of any such advice during discovery. (Ex. 149 at 21-26).

(Reilly 58-59, 76-77, 82-84). **REDACTED**

The Board's failure to even consider the impact of the Nuclear Pill and Reloaded Nuclear Pill on a stockholder's ability to bring a proxy contest is particularly glaring in light of the availability of another method of protecting any perceived value of the NOLs that would have been more effective while respecting stockholders' rights. Rather than adopt poison pills, a number of other public companies with NOLs have amended their corporate charters to add limitations to the transferability of stock. (Ex. 45 at 21-22). This strategy is more effective than a poison pill in terms of preventing a change in ownership. Unlike a poison pill, which is designed merely to deter a stockholder from acquiring more than 5% of the company's stock, a corporate charter provision actually prevents a non-approved acquisition by rendering it void *ab initio*. (*Id.*).[85]

Even setting aside effectiveness in fulfilling the stated goal, a charter amendment has the more important advantage of giving stockholders a voice in the decision. Under Delaware law, such an amendment to a company's certificate of incorporation requires a vote of a majority of the outstanding stock. 8 *Del. C.* § 242(b). Proposing a charter amendment and explaining its rationale allows stockholders to decide whether protecting any value associated with the NOLs is worth the negative impacts wrought by restricting the ability to acquiring more than 5% of the company's stock. Rather than unilaterally imposing on stockholders limitations on their right to bring a proxy contest, stockholders would be able to make an informed choice. The availability of this more reasonable (and more effective) alternative method for effectuating the Board's

[85] Another advantage to a charter amendment as compared to a pill is that implementation of a pill (through either an exchange or a "flip-in") can itself lead to a change in ownership when additional shares are issued. (Ex. 45 at 21-22) A charter amendment also avoids the issue of an "inadvertent" triggering of a pill, which a Board may choose to exempt but will nonetheless constitute a purchase for § 382 purposes.

purported objective weighs against a finding that the Nuclear Pill and Reloaded Nuclear Pill were reasonable and proportionate responses by the Board.

## CONCLUSION

For all the foregoing reasons, and those that shall be presented at trial, Trilogy submits the Selectica directors breached their fiduciary responsibilities, that judgment should be entered against Selectica on each of its claims and in favor of Trilogy and Versata on their counterclaims, that the Nuclear Pill and the Reloaded Nuclear Pill should be declared invalid, that the implementation of the Nuclear Pill should be reversed to return Trilogy to its pre-dilution ownership interest, and that such other and further relief shall be ordered in favor of Trilogy as sought by its Counterclaims or to which it is otherwise found to be justly entitled.

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**CERTIFICATE OF SERVICE**

The undersigned hereby certifies that on April 28, 2009, the REDACTED PUBLIC VERSION OF PRE-TRIAL BRIEF OF DEFENDANTS AND COUNTER-CLAIM PLAINTIFFS VERSATA ENTERPRISES, INC. AND TRILOGY, INC. was caused to be electronically served via *LexisNexis File and Serve* on the following counsel of record:

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