destroy shareholder wealth.[105] In spite of their rather contentious early history and the various arguments made against their use, poison pills remain a common feature of the corporate landscape, and Delaware courts have repeatedly upheld their adoption as consistent with a board's fiduciary duties and business judgment.[106] Indeed, the Delaware Supreme Court's invocation of the doctrine of *stare decisis* to reaffirm the central holding of *Moran* in the *Leonard Loventhal* case is a strong signal that the legitimacy of the poison pill is settled law.[107]

B. *Does the NOL Pill Meet the* Unocal *Standard?*

The Supreme Court in *Unocal* explained that the business judgment rule does not immediately apply to defensive actions taken by a board in the context of a possible change in control, such as the adoption of a poison pill, "[b]ecause of the omnipresent specter that a board may be acting primarily in its own interests, rather than those of the corporation and its shareholders. . . ."[108] Accordingly, "there is an enhanced duty which calls for judicial examination at the threshold before the protections of the business judgment rule may be conferred."[109] Such enhanced scrutiny operates to "ensure that a defensive measure to thwart or impede a takeover is indeed motivated by a good faith concern for the welfare of the corporation and its stockholders" and that the board did not act "solely or primarily out of a desire to perpetuate themselves in office."[110]

Thus, under the *Unocal* test, in order to be afforded the protection of the business judgment rule with respect to the adoption of a defensive measure, the "directors must show that they had reasonable grounds for believing that a danger to corporate policy and effectiveness existed . . . [T]hey satisfy that burden 'by showing good faith and reasonable

---

[105] *See, e.g.*, Lucian Arye Bebchuk, *The Case Against Board Veto Power in Corporate Takeovers*, 69 U. Chi. L. Rev. 973 (2002); Randall S. Thomas, *Judicial Review of Defensive Tactics in Proxy Contests: When is Using a Rights Plan Right?*, 46 Vand. L. Rev. 503 (1993); Michael Ryngaert, *The Effect of Poison Pill Securities on Shareholder Wealth*, 20 J. Fin. Econ. 377, 411 (1988) (concluding that poison pills do not benefit shareholders); Frank H. Easterbrook & Daniel R. Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 Harv. L. Rev. 1161 (1981).

[106] *See Moran v. Household Int'l, Inc.*, 500 A.2d 1346, 1357 (Del. 1985); *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 181-82 (Del. 1986); *Paramount Commc'ns, Inc. v. Time, Inc.*, 571 A.2d 1140, 1153-54 (Del. 1990); *Moore Corp. Ltd. v. Wallace Computer Servs., Inc.*, 907 F. Supp. 1545, 1563-64 (D. Del. 1995); *Leonard Loventhal Account v. Hilton Hotels Corp.*, 780 A.2d 245, 250-51 (Del. 2001).

[107] *See Leonard Loventhal*, 780 A.2d at 246.

[108] *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 954 (Del. 1985).

[109] *Id.*

[110] *Id.* at 955.

investigation. . . .'"[111] The board must also demonstrate that its "defensive response was reasonable in relation to the threat posed."[112] As explained in *Unitrin*, a defensive measure is disproportionate (*i.e.*, unreasonable) if it is either coercive or preclusive.[113] Trilogy asserts that the *Unocal* standard is not met here, as the Selectica directors established neither that the NOLs had a value worth protecting, nor that this value was threatened by Trilogy's purchases.

1. Should Selectica's Evidence Receive Material Enhancement?

Under *Unocal*, where the defensive actions were taken by "a majority of outside independent directors," proof of the board's good faith and reasonable investigation is "materially enhanced."[114] Furthermore, the presence of a majority of outside directors, coupled with a showing of reliance on advice by legal and financial advisors, "constitute[s] a *prima facie* showing of good faith and reasonable investigation."[115]

Selectica asserts that all of its directors were independent at the time that the decisions at issue were made; therefore the evidence showing the Board's good faith and reasonable investigation is entitled to material enhancement. Trilogy claims that three of the Company's then four directors were not outside independent directors and, consequently, that Selectica's proof of good faith and reasonable investigation should not be materially enhanced. Specifically, it argues that Zawatski and Thanos should not be considered "outside" directors due to their roles as Co-Chairs of Selectica during the events at issue, and that their independence is, likewise, compromised by the payment they received to carry out these assignments. Moreover, according to Trilogy, Sems should not be considered independent "with respect to the NOLs" because of an alleged undue influence of Howard and Steel Partners over Sems.[116]

An "outside" director has been defined by our courts as "a non-employee and non-management director"[117] that "receiv[es] no income other than usual directors' fees. . . ."[118] In contrast to this seemingly bright-line rule, Delaware courts apply a "subjective 'actual person' standard" in considering the question of director independence, making a determination

---

[111] *Id.* (quoting *Cheff v. Mathes*, 199 A.2d 548, 555 (Del. Ch. 1964)).

[112] *Unocal*, 493 A.2d at 955.

[113] *Unitrin, Inc. v. Am. Gen. Corp.*, 651 A.2d 1361, 1387 (Del. 1995).

[114] *Unocal*, 493 A.2d at 955.

[115] *Polk v. Good*, 507 A.2d 531, 537 (Del. 1986).

[116] Opening Post-Trial Br. of Defs. and Counterclaim-Pls. Versata Enterprises, Inc. and Trilogy, Inc. at 35.

[117] *Unitrin*, 651 A.2d at 1375 (citing *Grobow v. Perot*, 539 A.2d 180, 184 n.1 (Del. 1988)).

[118] *Moran v. Household Int'l, Inc.*, 490 A.2d 1059, 1074-75 (Del. Ch. 1985).

based upon individualized facts about the specific directors.[119] The contextual approach applied to such standard, which "tak[es] into account all circumstances," allows independence determinations to be "tailored to the precise situation at issue."[120] An independent director is one whose decision "is based on the corporate merits of the subject before the board rather than extraneous considerations or influences,"[121] while a director who is not independent is "dominated or otherwise controlled by an individual or entity interested in the transaction."[122] Control is established through facts that demonstrate that "through personal or other relationships the directors are beholden to the controlling person"[123] or so "under their influence that their discretion would be sterilized."[124]

Trilogy points to the emails between Sems and Howard,[125] as well as to the fact that Howard had recommended Sems to the Board as a candidate for director, as evidence that Sems was unduly influenced by Howard and, thus, not an independent director. According to Trilogy, because Steel Partners was seeking to turn the Company into an NOL shell for its own purposes, Sems cannot be considered independent with respect to decisions involving the Company's NOLs. Nevertheless, the record does not support Trilogy's assertions that Sems was controlled by Howard or Steel Partners. Sems, through his personal investmentand that of his fund, was Selectica's sixth-largest shareholder, and Selectica was one of Sems Capital LLC's largest positions.[126] Further, there is no evidence in the record that Sems had any reason to defer to Steel Partners's wishes to his own financial detriment. To the contrary, Sems testified that the value of Selectica's NOLs played into his investment rationale as a shareholder.[127] Although Howard did endorse Sems's candidacy, Sems was already favored as a director candidate before Howard's endorsement.[128] In addition, there is little evidence that Sems took any position that was unduly favorable to Howard at the expense of Selectica shareholders during his time on the Board. Indeed, Howard made several suggestions to the Board that the Board chose not to heed.[129] Howard, himself, twice asked to be named as a Selectica director, most

---

[119] *Cinerama, Inc. v. Technicolor, Inc.*, 663 A.2d 1156, 1167 (Del. 1995).

[120] *In re Oracle Corp. Deriv. Litig.*, 824 A.2d 917, 941 (Del. Ch. 2003).

[121] *Aronson v. Lewis*, 473 A.2d 805, 816 (Del. 1984).

[122] *In re MAXXAM, Inc.*, 659 A.2d 760, 773 (Del. Ch. 1995) (quoting *Grobow*, 539 A.2d at 189).

[123] *Aronson*, 473 A.2d at 815.

[124] *Rales v. Blasband*, 634 A.2d 927, 936 (Del. 1993).

[125] DX 227; DX 402; DX 416; DX 430; DX 549; DXs 609-10; DX 707; *see supra* text accompanying notes 27-36.

[126] Tr. 738.

[127] Tr. 732.

[128] Tr. 938-41.

[129] Tr. 209-14, 744; DX 170; DX 364; PX 42.

recently in November 17, 2008, after Sems had become a director, and was apparently turned down by an undivided board.[130] While there may be cause to suspect that Sems had something of a desire to ingratiate himself with Steel Partners, there is not sufficient evidence to find that Sems was not independent from Howard and Steel Partners.

Trilogy asserts that Zawatski and Thanos similarly cannot be considered outside independent directors with respect to the Board actions at issue due to their Co-Chair positions, which seemingly run afoul of various independence guidelines and which Selectica, itself, concedes was "a capacity similar to that of a chief executive officer."[131] Additionally, from July 2008 until March 2009, Thanos was paid $164,125 and Zawatski paid $274,273 to serve in this function, in addition to their standard compensation as directors.[132] Trilogy suggests that such a material level of compensation is beyond the customary bounds accorded directors and serves to preclude their independence, further noting that neither is considered independent under Securities and Exchange Commission ("SEC") and NASDAQ rules. Selectica responds that the position is a temporary one and that both Zawatski and Thanos have testified that they have no desire to continue serving in a management role beyond what will be necessary,[133] do not consider themselves Selectica employees,[134] and that the compensation that they receive as Co-Chairs is not material to them.

Given the nature of Thanos and Zawatski's duties, and the apparent bright-line rule for distinguishing between inside and outside directors, the Court concludes that neither can be considered an "outside" director for material enhancement purposes. However, although nominally not outside directors, the record suggests that both were, nonetheless, independent.

Admittedly, the compensation that Thanos and Zawatski have received in their capacity as Co-Chairs is material by any measure. Nevertheless, determining their respective independence under the "actual person" standard, this Court does not have enough evidence to conclude that such compensation was sufficiently material to either Thanos or Zawatski to preclude their independence. Both Thanos and Zawatski were retired and took on the Co-Chair position following successful careers in the private sector. Both serve on multiple boards and both have testified that the income they receive in these roles is not personally material to them, and that they

---

[130]PX 42; Tr. 936-37, 994-1000.

[131]RJN, Ex. A at 60.

[132]*Id.* Both are paid $250/hour for management work.

[133]Indeed, as noted above, Thanos has already since stepped down as Co-Chair, as of August 2009.

[134]Tr. 373-74; 966-67. In addition, Selectica points out that neither director receives a salary, both work, on average, fewer than twenty hours a week in this capacity, and neither signs the Company's periodic securities filings. Tr. 958; Zawatski Dep. at 237.

hope to be able to resign these positions in the near term.[135] While Trilogy characterizes such testimony as "self-serving," the Court has no reason to doubt either director's testimony on this issue, nor has Trilogy provided evidence as to why it should.

The rationale behind materially enhancing the proof of good faith and reasonableness of those decisions made by a majority of outside independent directors is directly related to the primary concern that enhanced scrutiny under *Unocal* is designed to address: that a board might adopt defensive measures simply to retain control, whether or not those measures are in the best interest of shareholders. Where decisions are made by outside independent directors instead of members of management who have a presumptive desire to retain their employment, the concern that the board's decisions are tainted by self-serving motives is mitigated, and there naturally follows a greater presumption of good faith and reasonable investigation. This is the essence of the material enhancement rubric in *Unocal* and its progeny.

In this case, while the Board does not meet the specific "requirements" for material enhancement, any concern that the Board's actions stem from a desire for entrenchment is seemingly groundless. At the time that the NOL Pill was adopted, the Company had been actively seeking suitors for nearly six months and the Board was receiving constant updates on the sale process. Both Zawatski and Thanos had previously been outside directors before taking over management duties and had only temporarily assumed these duties in lieu of hiring a new CEO in anticipation of the Company's proximate sale. Further, one may readily presume that, given the financial plight of the Company, attracting additional independent and qualified directors might be difficult. Finally, the Board ultimately delegated final decision-making authority over the adoption of the Reloaded NOL Pill and the implementation of the Exchange to the Committee, which was comprised only of outside independent directors. Nevertheless, regardless of whether or not the Board is technically entitled to "material enhancement" under *Unocal*, the Court concludes that there is sufficient evidence to find good faith and reasonable investigation by the Board here.

2. Were there Reasonable Grounds to Conclude that a Threat Existed?

[135]Tr. 215, 949-50. *See also* Tr. 153-54 (discussing family situation more generally).

a. *Is the Preservation of NOLs a Valid Corporate Objective?*

The first part of the *Unocal* test requires a board to show that it had reasonable grounds for concluding that a threat to a corporate objective existed. This case presents unique grounds for establishing this first part of the *Unocal* test as employing a poison pill for the ostensible purpose of protecting NOLs is a distinct departure from the poison pill's originally intended use: the prevention of hostile takeovers. Delaware courts have only considered the poison pill in the context of an anti-takeover device, and the *Unocal* test is one that analyzes the board's response to such an outside threat.[136] In contrast, an NOL pill's principal function is to prevent the inadvertent forfeiture of potentially valuable assets, not to protect against hostile takeover attempts.[137]

As a result of its unique objective, a pill designed to protect NOLs necessitates precluding a lesser accumulation of shares than might be appropriate for a pill designed to prevent a hostile acquirer from establishing a control position in the company. Consequently, the 5% trigger necessary for an NOL pill to serve its function imposes a far greater cost on shareholders than the pill thresholds traditionally employed and held as acceptable by our courts in the anti-takeover context. Not surprisingly, pills with a 5% trigger remain fairly uncommon,[138] though they have been employed with greater frequency in recent years.[139]

Trilogy argues that NOLs cannot be viewed as assets worth protecting absent a reasonable expectation of their probable future use. Unlike the corporate objectives traditionally being protected by boards mounting takeover defenses, all NOLs, by their very nature, have the potential of ultimately providing zero value to the company. Granting judicial sanction to low-threshold poison pills employed for the purpose of protecting NOLs guarantees the somewhat unpalatable outcome of acquiescing to the expansion of the universe of reasonable takeover defenses in order to protect assets of questionable, even dubious, value. However, expert testimony has been proferred that NOLs have a material value even absent an obvious mechanism for their use.[140] Trilogy has put forward

---

[136] *But see Paramount Commc'ns*, 571 A.2d at 1153 ("The usefulness of *Unocal* as an analytical tool is precisely its flexibility in the face of a variety of fact scenarios.").

[137] Typically, companies with large NOLs would not be at risk of takeover attempts if the NOLs are the company's principal asset, as the takeover would likely trigger a change in control and impair the asset.

[138] *See, e.g.*, DX 776 at 5 (expert report cataloging academic analyses on the frequency of various pill trigger percentages, reporting that pills with a trigger of 15% or 20% made up at least 90% of each sample studied, and concluding that pills with a trigger below 5% are "quite rare").

[139] Tr. 851-52.

[140] *See, e.g.*, PX 130 at 17 (expert report of Professor Merle Erickson, explaining that

contradictory testimony that, because NOLs derive their value from future taxable income, they are not always valuable.[141] Nevertheless, as NOL value is inherently unknowable ex ante, a board may properly conclude that the company's NOLs are worth protecting where it does so reasonably and in reliance upon expert advice. As the Court in *Unocal* recognized, "our corporate law is not static. It must grow and develop in response to, indeed in anticipation of, evolving concepts and needs."[142] Consequently, the Court concludes that the protection of company NOLs may be an appropriate corporate policy meriting a defensive response when threatened.[143] Indeed, the protection of corporate assets against an outside threat is arguably a more important concern of the Board than restricting who the owners of the Company might be.[144]

b. *Trilogy's Contentions Regarding Board Process*

Trilogy argues that, in order to establish the first prong of the *Unocal* test, the Selectica Board was obligated to have a plan for whether and how the NOLs could be used in the future prior to adopting the NOL Pill. NOLs can only be used upon the creation of taxable income, which occurs by one of three ways: through operations, through the sale of assets, or by way of an acquisition. Yet in Selectica's case, Trilogy argues, none of these would have established an asset worth protecting because (1) Selectica had never generated taxable income and the Board had no reason to think that it would in the near-term, (2) the limits placed on NOLs following a Section 382 change in ownership do not apply when using NOLs to offset a taxable gain achieved through the sale of assets, and (3) any basis for the NOLs' use after an acquisition was purely speculative.[145] In order to

---

NOLs are economically valuable assets and concluding that the Board had a rational basis for taking steps to protect the NOLs); Tr. 502-04 (expert testimony of Patricia W. Pellervo, asserting that NOLs are "always valuable" unless imminently about to expire, and equating the value of NOLs to that of out-of-the-money options).

[141]Tr. 1331-32; DX 788.

[142]*Unocal*, 493 A.2d at 957. As a result of the current economic environment, one might expect that the number of corporations with NOLs worth protecting will continue to increase, as will the number of corporate boards that opt for a 5% poison pill to protect them.

[143]With this conclusion, it is unnecessary to resolve the parties' debate over the import of 8 *Del. C.* § 202(d) and its possible reflection of legislative support for the use of poison pills to protect NOLs.

[144]Shareholder advisory firm RiskMetrics Group now supports rights plans with a trigger below 5% on a case-by-case basis if adopted for the stated purpose of preserving a company's net operating losses. PX 129 at 6-7. The factors it will consider in determining whether to support a management proposal to adopt an NOL pill are the pill's trigger, the value of the NOLs, the term of the pill, and any corresponding shareholder protection mechanisms in place (such as a sunset provision, causing expiration of the pill upon exhaustion or expiration of the NOLs). *Id.* at 7.

[145]Trilogy points out that the Board did not know whether or how Steel Partners might utilize the NOLs (Tr. 810, 991-93), and that Reilly did not have a meeting with Steel Partners regarding the means by which Steel Partners proposed to retain the NOLs until after the events in

determine whether the NOLs were assets worth protecting, the Board, according to Trilogy, needed to have conducted a formal analysis of when the Company could reasonably expect to receive tax savings from the use of its NOLs, as well as the amount of tax savings it could reasonably expect to obtain.

Furthermore, Trilogy claims that, to the extent that the Board did discuss the value of Selectica's NOLs, the discussions suggested that the Board believed they had no value. Trilogy points to Jurkowski's testimony that concedes that he did not believe the NOLs had much value,[146] and similar assertions by Thanos in August 2008,[147] as well as the fact that the Board voted against the more detailed Brogan study in February 2008.[148] Additionally, in Selectica's annual and quarterly filings with the SEC, the Company did not recognize any deferred tax assets for NOLs on its balance sheet—a determination that it was more likely than not that the Company would not use its NOLs—and continued to make such a representation even after the NOL Pill was adopted. Finally, Trilogy asserts that an ownership change occurred on November 14, 2008, prior to the adoption of the NOL Pill, that severely impaired the value of Selectica's NOLs and made the adoption of the NOL Pill unnecessary, a determination that the Selectica Board would have made before adopting the NOL Pill had it engaged Brogan in a more in-depth Section 382 analysis.[149]

However, the record is replete with evidence suggesting to the contrary that the Board had ample reason to conclude, and did conclude, that the NOLs were an asset worth protecting and, thus, that their preservation

---

question, which Trilogy characterizes as evidence that the Board could not have received any meaningful advice from him about the potential for such a transaction.

[146]Jurkowski Dep. at 45 (stating that his recommendation was not to move forward with additional study work by Brogan "because [he] did not understand what the value would be.").

[147]PX 80. Trilogy refers to a short reply email written in August 2008 by Thanos agreeing with the statement made by another Selectica employee that "NOL's [sic] do not appear to be of great value," and noting that the investment bankers he had spoken to "didn't put much emphasis on them." Thanos explained his email, stating that, at the time, these investment bankers expected the most likely buyers of Selectica to be more interested in the Company's intellectual property than its NOLs, which Thanos testified changed over time as such buyers dropped out of the process. Tr. 933-34; Thanos Dep. at 238-40.

[148]DX 255 at 3; Tr. 93-94. Trilogy also raises issue with the fact that the Board did not question the existence of discrepancies between the Chinn study and the Brogan study, or why Brogan disregarded Chinn's earlier conclusions.

[149]This conclusion comes from a report prepared by Trilogy's expert witness, Elliott G. Freier, a tax attorney specializing in Section 382 work with the firm of Irell & Manella, LLP. DX 777 at 12-13. Selectica disputes that an ownership change has occurred, and offered up Patricia W. Pellervo, a principal in the Mergers & Acquisition section of the Washington National Tax Services practice of PricewaterhouseCoopers, as a rebuttal witness asserting that a November 2008 Section 382 ownership change did not occur, that Freier's critiques of the Brogan study do not invalidate Brogan's conclusions, and that it was reasonable for the Board to conclude, based upon Brogan's advice, that Selectica was at risk of an ownership change at the time of the adoption of the NOL Pill. PX 123; PX 127. Freier's rebuttal is DX 787.

was an important corporate objective. The facts show that many of Selectica's largest shareholders, including Steel Partners, Lloyd Miller, and Lloyd Sems, who collectively owned nearly 30% of the Company's shares outstanding, all believed that the NOLs were one of Selectica's most significant assets, and actively worked with the Board to ensure that they were protected.[150] While the Board opted not to spend additional money on an in-depth report by Brogan in February 2008, it first analyzed the NOLs in September 2006, and sought updated Section 382 analyses from Brogan in March 2007, June 2007, July 2008, and November 2008.[151]

c. *DGCL § 141(e) and the Board's Reliance on Experts*

The record suggests that the Board placed considerable reliance on the advice of outside experts in making its determination as to the value of Selectica's NOLs and the importance of protecting them from the threat posed by Trilogy. The Delaware General Corporation Law Section § 141(e), states:

> A member of the board of directors, or a member of any committee designated by the board of directors, shall, in the performance of such member's duties, be fully protected in relying in good faith . . . upon such information, opinions, reports or statements presented to the corporation . . . by any other person as to matters the member reasonably believes are within such other person's professional or expert competence and who has been selected with reasonable care by or on behalf of the corporation.[152]

Under § 141(e), where a board has relied on an expert's advice in making a decision, a due care claim challenging that decision must establish such facts as would make reliance on the expert opinion unreasonable.[153] Trilogy would need to show either that: (a) the Board did not in fact rely on the experts; (b) such reliance was not in good faith; (c) the Board did not reasonably believe that the relevant expert's advice was within that expert's professional competence; (d) the experts were not selected with reasonable care, and the faulty selection was attributable to the directors; (e) the omitted information that the Board allegedly should have considered was so obvious

---

[150]Tr. 102, 465-67, 766-69, 810.

[151]PXs 1-6.

[152]8 *Del. C.* § 141 (e).

[153]A board's reliance on expert advice "evidence[s] good faith and the overall fairness of the process." *Cinerama, Inc. v. Technicolor, Inc.*, 663 A.2d 1134, 1142 (Del. Ch. 1994), *aff'd*, 663 A.2d 1156 (Del. 1995).

and reasonably available that it was gross negligence for the Board to fail to consider it, regardless of expert advice or lack thereof; or (f) the decision of the Board was so unconscionable as to constitute waste or fraud.[154]

The record indicates that the Board was presented with expert advice on numerous occasions that supported its ultimate findings that the NOLs were a company asset worth protecting, that the NOLs were at risk as a result of Trilogy's actions, and that the steps that the Board ultimately took were reasonable in relation to that threat. Outside experts were present and addressed the Board on these matters at both the November 16 meeting that established the NOL Pill and the Board's December 29 meeting, while the Committee heard from advisers a third time at the January 2 meeting prior to instituting the Exchange and adopting the Reloaded NOL Pill.

Trilogy argues that the Board and the Committee were not justified in relying upon Reilly for advice regarding the value of the NOLs in the context of determining whether they were worth preserving because he was not an expert in NOLs or Section 382. Trilogy claims that the Board and the Committee also could not have reasonably relied on advice from Brogan about the value of the NOLs and the threat that Trilogy's purchases posed, since Brogan only provided his opinion on the level of ownership changes and the amount of available NOLs, not on how the NOLs could be used to generate value.

Additionally, from Trilogy's perspective, any reliance on Brogan was unreasonable because the Board knew that he had been recommended by Steel Partners, had continued communicating with Steel Partners with respect to Selectica after he began work on his analysis, and was aware of the outcome desired by Steel Partners; therefore, his advice was not disinterested. Further, the Board should have known that Brogan had not completed the in-depth NOL study in February 2008 and did not have time to do such a thorough study between the filing of Trilogy's 13D and the adoption of the NOL Pill, thus, that such analysis was incomplete. In addition, Trilogy points out that Brogan's final refinement of his analysis that calculated an ownership change percentage between 38-39% was less than the 40% he had initially reported to management and included offsetting transactions which should have been a "red flag," that, Trilogy maintains, "should have alerted the Board to question Brogan's analysis."[155]

These allegations aside, there is no evidence in the factual record to conclude that the Board was unreasonable in relying upon expert advice in determining whether and how to respond to Trilogy's actions. Though Reilly

---

[154] *See Brehm v. Eisner*, 746 A.2d 244, 262 (Del. 2000).

[155] Pre-Trial Br. of Defs. and Counterclaim-Pls. Versata Enterprises, Inc. and Trilogy, Inc. at 43. Yet, Trilogy has also put forward expert testimony arguing that Brogan underestimated the proximity of a Section 382 ownership change and that Selectica suffered a change in control event as a result of Trilogy's November purchases. DX 777.

is not an expert in Section 382 and NOLs, as an experienced investment banker he was qualified to speak to which assets were worth preserving in the context of a potential company sale, whether or not he was personally qualified to place a specific value on them. Likewise, because Brogan's firm calculated the magnitude of Selectica's NOLs along with the magnitude and timing of the Section 382 ownership change that the Company had experienced, the Board could reasonably rely on Brogan's help in establishing the size of the asset under consideration and the risk of that asset being compromised.

That Steel Partners recommended Brogan's firm is of no consequence, and is not surprising, given Steel Partners's past experience with NOLs. It does not suggest anything untoward that should undermine Brogan's expert advice. In order to reasonably rely on Brogan, the Board needed only to find that Brogan was an expert in the matters to which he was providing advice and that he had been selected with due care. Brogan's work history as a tax attorney, CPA, and partner at several accounting firms specializing in tax accounting in the context of mergers and acquisitions, not to mention the dozens of Section 382 studies he had performed, gave the Board ample cause to consider him an expert qualified to speak on Selectica's NOLs and on the threat of their impairment.[156] Although it was theoretically possible for Brogan to have prepared a more thorough study that could have given the Board a more granular sense of the immediacy of the threat Trilogy posed, its absence did not render his advice unreliable. Within the context of the rushed timeline for determining and responding to Trilogy, the Court cannot conclude that any additional information was readily available but not presented to the Board, or that such information would have contradicted the expert advice that Brogan provided.

Trilogy raises issue with the fact that no expert provided advice as to the precise value of the NOLs to Selectica by estimating the probability of future taxable income, arguing that an expert could have been brought in to model their "potential value by considering various scenarios and assigning probabilities to assess the likelihood of the NOLs being monetized."[157] Yet, such analysis, although arguably helpful, was unnecessary in this case. In order to conclude that a serious threat existed, the Board needed only reasonably conclude that the NOLs were a legitimate asset worth protecting. The Board recognized that the NOLs were material relative to the then-market value of the Company,[158] and that the NOLs, if preserved, had a long

---

[156]Brogan is also a former chair of the Corporate Tax Section of the California Bar Association and serves on the faculty of the Graduate School of Taxation at Golden Gate University. Tr. 424, 548-51.

[157]Opening Post-Trial Br. of Defs. and Counterclaim-Pls. Versata Enterprises, Inc. and Trilogy, Inc. at 40.

[158]*See, e.g.*, Tr. 34-35, 379-80, 731-32, 737-38, 805.

window during which they would be available for use.[159] If perhaps somewhat optimistic, they had rational expectations for the Company's near-term profitability.[160]

Trilogy is correct in pointing out that it is not sufficient to conclude that an asset with potential value is worth protecting without considering the probability of that value being realized, and that Selectica's failure to generate taxable income in prior years colors this probability. However, the absence of a formal study calculating such a value does not mean that the directors were unreasonable in concluding that a sufficiently material probability existed to merit the asset's preservation, or that such a determination was not implicit in their calculus.[161] In connection with the expert advice it received, the Court is satisfied that the Board was reasonable in concluding that Selectica's NOLs were worth preserving and that Trilogy's actions presented a serious threat to their impairment.[162]

3. Were the Board's Actions a Reasonable Response to the Perceived Threat?

The second prong of *Unocal* requires an evaluation of whether a board's defensive response to the threat was preclusive or coercive and, if not, whether it was "reasonable in relation to the threat" identified.[163] It is the specific nature of the threat that "sets the parameters for the range of permissible defensive tactics."[164] A reasonableness analysis "requires an evaluation of the importance of the corporate objective threatened;

---

[159]*See, e.g.*, Tr. 42-43, 379-80, 402-03, Zawatski Dep. at 105.

[160]The Court received *in camera* testimony at trial from Zawatski as to then-upcoming, as yet unaudited quarterly financial results for Selectica, in which she predicted that Selectica would finally turn a profit. Counsel for Selectica advised the Court after trial, however, that Selectica had determined that its audited financial results for the quarter would show a GAAP basis loss and that, as such, there was no need to transcribe this testimony and that the Court should not rely upon it in deciding the matter. Letter, dated June 8, 2009, from Gregory V. Varallo, Esquire at 1.

[161]Similarly, Trilogy's argument that the full valuation allowance recorded for NOLs in Selectica's SEC filings suggests that the Board recognized that utilization of the NOLs was unlikely is unavailing. A company may simultaneously conclude that there is less than a 50% chance of recognizing the value of an asset while reasonably taking steps to preserve that asset.

[162]The Court acknowledges that it is easy to be skeptical about whether Selectica will ultimately be able to recognize all or any of the value of its NOLs. A comparison of Selectica's market capitalization ($22.8 million) to a highly optimistic calculated value of, say, $58 million in tax offsets as a result of the NOLs (based on accumulated federal NOLs of $166.5 million and an assumed tax rate of 35%, and presuming sufficient income to be offset and otherwise full availability of the NOLs) suggests such a skepticism in the market. RJN, Ex. A at 35, 53, 56. Nevertheless, there is sufficient evidence that the Board acted in good faith in concluding that the NOLs had a value worth protecting or, perhaps more importantly, that the directors relied in good faith on the advice of experts in coming to such a conclusion.

[163]*Unocal*, 493 A.2d at 955.

[164]*Unitrin*, 651 A.2d at 1384.

alternative methods for protecting that objective; impacts of the 'defensive' action and other relevant factors."[165] The court should evaluate the board's "overall response, including the justification for each defensive measure, and the results achieved thereby."[166] Where all of the defenses "are inextricably related, the principles of *Unocal* require that such actions be scrutinized collectively as a unitary response to the perceived threat."[167]

Trilogy asserts that the NOL Pill, the Exchange, and the Reloaded NOL Pill were not a reasonable collective response to the threat of the partial impairment of Selectica's NOLs. Trilogy asserts that the NOL Pill is preclusive, either per se or in conjunction with certain other factors unique to Selectica (most prominently, its staggered board). Trilogy also argues that the Board (1) failed to consider the negative consequences of the NOL Pill and Reloaded NOL Pill; (2) failed to consider any alternatives to these pills; and (3) failed to demonstrate that any benefit achieved by the pills outweighed their negative impact on Trilogy and other Selectica shareholders.

a. *Does the 5% Trigger Make the NOL Pill Preclusive?*

Under *Unitrin*, a defensive measure is disproportionate and unreasonable if it is draconian, being either coercive or preclusive.[168] A coercive response is one that is "aimed at 'cramming down' on its shareholders a management-sponsored alternative."[169] A defensive measure is preclusive where it "operate[s] to unreasonably preclude a takeover"[170] or "preclude[s] effective stockholder action"[171]—specifically, where the measure "makes a bidder's ability to wage a successful proxy contest and gain control either 'mathematically impossible' or 'realistically unattainable.'"[172]

---

[165] *Paramount*, 571 A.2d at 1154.

[166] *Unitrin*, 651 A.2d at 1386-87.

[167] *Id.* (citing *Gilbert v. El Paso Co.*, 575 A.2d 1131, 1145 (Del. 1990)).

[168] *Id.*

[169] *Id.* (citing *Paramount*, 971 A.2d at 1154-55). The parties do not dispute that the NOL Pill, Exchange, and Reloaded NOL Pill are not coercive.

[170] *Gaylord*, 753 A.2d at 482 n.72.

[171] *Chesapeake Corp. v. Shore*, 771 A.2d 293, 320 (Del. Ch. 2000) (quoting *Unitrin*, 651 A.2d 1388-89).

[172] *Carmody*, 723 A.2d at 1195. The Court in *Carmody* held that "dead hand" pills (poison pills that contain a provision that states that only the original directors that adopted the pill may vote to redeem it) met this standard, as they eliminate the use of a proxy contest as a possible means to gain control since any insurgent directors would be incapable of redeeming the pill. *Cf. Omnicare, Inc. v. NCS Healthcare, Inc.*, 818 A.2d 914, 936 (Del. 2003) (holding that the defensive measures employed by the board made it mathematically impossible and realistically unattainable for any insurgent proposal to succeed because they rendered the board-approved merger a "fait accompli," and therefore were coercive and preclusive).

The mere adoption of a garden-variety pill is not in itself preclusive under Delaware law.[173] This is despite the fact that a poison pill "dilutes the would-be acquirer's stake in the company and increases the costs of acquisition."[174] That a combination of defensive measures makes it "more difficult for an acquirer to obtain control" of a board does not make such measures preclusive; indeed "[i]t would . . . be surprising if defensive measures did not have this effect."[175] Preclusive measures are those that are "insurmountable or impossible to outflank."[176]

The Supreme Court in *Moran* found that a poison pill with a 20% trigger was not per se preclusive because it did not "strip[] stockholders of their rights to receive tender offers"[177] or "fundamentally restrict[] proxy contests."[178] The court recognized that, while a rights plan "does deter the formation of proxy efforts of a certain magnitude, it does not limit the voting power of individual shares."[179] More importantly, because the purpose of the poison pill was not to provide an impenetrable barrier to control acquisitions but to give the target board leverage over a potential acquirer, where a potential acquirer may secure board control through a proxy contest and thereafter redeem the pill, the pill will not be considered preclusive.[180] The *Moran* Court found the assertion that a poison pill would preclude proxy fights "highly conjectural" and pointed to "recent corporate takeover battles in which insurgents holding less than 10% stock ownership were able to secure corporate control through a proxy contest or the threat of one."[181]

Trilogy asserts that the NOL Pill and the Reloaded NOL Pill are distinctly more preclusive than those poison pills previously evaluated by Delaware courts and that, consequently, they should be declared invalid. Specifically, Trilogy claims that a 4.99% pill renders the possibility of an effective proxy contest realistically unattainable. Trilogy argues that, because a proxy contest can only be successful where the challenger has sufficient credibility, the 4.99% pill prevents a potential dissident from signaling its

---

[173] *Gaylord*, 753 A.2d at 481. However, the Court in *Unitrin* recognized the legal scholarship that argues that the poison pill "warrants special attention chiefly because its preclusive effect frequently exceeds that of other takeover defensive tactics. . . . [and] makes it effective even in circumstances where other defensive tactics may not work." *Unitrin*, 651 A.2d at 1379 n.25 (quoting Jeffery N. Gordon, *Corporations, Markets, and Courts*, 91 Colum. L. Rev. 1931, 1946 (1991)).

[174] *Unitrin*, 651 A.2d at 1369 n.6.

[175] *Gaylord*, 753 A.2d at 482.

[176] *Id.*

[177] *Moran*, 500 A.2d at 1357.

[178] *Id.*

[179] *Id.* at 1355.

[180] *Gaylord*, 753 A.2d at 481.

[181] *Moran*, 500 A.2d at 1355. The Court additionally noted that "many proxy contests are won with an insurgent ownership of less than 20%," and that "the key variable in proxy contest success is the merit of an insurgent's issues, not the size of his holdings." *Id.*

financial commitment to the company sufficient to establish such credibility. In addition, a pill with such a low trigger, in conjunction with a staggered board, renders a conditional takeover bid "unrealistic" since a proxy contest would have to be sustained over multiple years, decreasing the probability that a would-be challenger would rationally incur the costs of such a proxy contest. As a result, such a pill would significantly lock in the existing ownership structure absent a board "exemption."[182]

Professor Ferrell, Trilogy's expert witness, additionally testified that the existence of such a pill in conjunction with a charter-based staggered board removes the ability of challengers to issue a conditional takeover bid—a bid conditional on the election of a slate of insurgent directors—in order to improve the likelihood of a successful proxy fight under these constraints. Such a bid would be highly unlikely, according to Professor Ferrell, because the offer would have to remain outstanding across multiple director election cycles. In addition, the 5% cap on ownership exacerbates the free rider problem already experienced by investors considering fielding an insurgent slate of directors, and makes initiating a proxy fight an economically unattractive proposition.[183] Given all of the above, Trilogy asserts that the NOL Pill, particularly within the context of Selectica's other defenses, makes a change in board control "realistically unattainable."[184]

Selectica counters that the distinguishing feature of the NOL Pill and Reloaded NOL Pill—the 5% trigger—is not sufficient to differentiate them from other poison pills previously blessed by Delaware courts, and that there is no evidence that a challenger starting below 5% could not realistically hope to prevail in a proxy contest at Selectica. Selectica, primarily through Professor Coates's expert testimony, has identified more than 50 publicly held companies that have implemented NOL pills with triggers at roughly 5%, including several large, well-known corporations, including some among the Fortune 1000.[185]

---

[182]These were the findings of Trilogy's expert witness, Professor Allen Ferrell, who reviewed and analyzed eight academic studies, in conjunction with additional data he personally compiled. DX 776 at 3-4; Tr. 1061-62. Selectica's expert witnesses, Professor John C. Coates IV and Peter C. Harkins, dismissed Professor Ferrell's findings in rebuttal reports and in trial testimony. PX 122; Tr. 834-43.

[183]The free rider problem is that, even if an investor believes that replacing the board would result in a material benefit to shareholders, the investor has to bear the full cost of a proxy fight while only receiving her proportionate fraction of the benefit bestowed upon shareholders. Along with the reduced likelihood of success at a 5% position, the capped position would mean that the challenger would be unable to internalize more of the benefits by increasing her share ownership. Trilogy claims that the average cost of a proxy solicitation is roughly $368,000, or $746,000 across two cycles, yet the current value of a 4.99% share in Selectica is approximately $1,000,000, and that no investor would be willing to stake so much money in proxy fights given such a small investment and where they would only receive 5% of any benefits of a change in control.

[184]*Carmody*, 723 A.2d at 1195.

[185]PX 128, Ex. D; Plaintiffs' Third Motion for Judicial Notice at 3. Certainly, the fact that

Selectica expert witness Harkins of the D. F. King & Co. proxy solicitation firm analyzed proxy contests over the three-year period ended December 31, 2008, and found that, of the fifteen proxy contests that occurred in micro-cap companies where the challenger controlled less than 5.49% of the outstanding shares, the challenger successfully obtained board seats in ten contests, including in five contests involving companies with classified boards.[186] Selectica also asserts that Trilogy's calculations of the average cost of proxy fights do not take into account Selectica's unique shareholder profile that would considerably reduce the costs associated with such a fight.[187] Trilogy seeks to discount these findings by pointing out that Selectica has failed to indicate any examples where a dissident shareholder in a micro-cap company with less than a 5% stake successfully obtained control over a company with a classified board.[188]

Though Trilogy's expert testimony suggests that a poison pill with a less than 5% trigger "has a substantial preclusive effect,"[189] the Court cannot conclude that the NOL Pill, Exchange, and Reloaded NOL Pill were preclusive, and thereby draconian. Such a high standard operates to exclude only the most egregious defensive responses. As the court in *Unitrin* noted, "This Court's choice of the term draconian in *Unocal* was a recognition that the law affords boards of directors substantial latitude in defending the perimeter of the corporate bastion against perceived threats."[190] The requirement of either the mathematical impossibility or realistic

---

the adoption of pills with 5% triggers "is customary is not proof that it is, in fact, permissible or justifiable under the specific circumstances faced by the board." *San Antonio Fire & Police Pension Fund v. Amylin Pharm., Inc.*, 2009 WL 1337150, at *10 n.45 (Del. Ch. May 12, 2009) (citing *La. Mun. Police Employees' Retirement Sys. v. Crawford*, 918 A.2d 1172, 1181 n.10 (Del. Ch. 2007)). Likewise, "the fact that the combination [of defenses] might be unusual does not make the combination unreasonable." *Gaylord*, 753 A.2d at 480 n.64. Nevertheless, the presence of similar pills adopted outside the context of shareholder/control disputes or an imminent takeover offer lends considerable support to the conclusion that the NOL Pill was "a statutorily authorized form of business decision which a board of directors may routinely make in a non-takeover contest" to be considered as part of the reasonableness review. *Unitrin*, 651 A.2d at 1389.

[186]PX 121. There were eight such contests at micro-cap companies in which the challenging shareholder held less than 4.99% of the outstanding shares. Challengers prevailed in six of these contests, including at three companies that had classified boards. *Id.*

[187]Selectica points out that six investors control a majority of its outstanding shares, and that twenty-two investors collectively own 62% of the outstanding shares, making the likely cost of a proxy fight at Selectica considerably cheaper than the average cost asserted by Trilogy. PX 121 at 7-9; Tr. 1023-30. Of those investors, only Sems is an "insider." *Cf. Unitrin*, 651 A.2d at 1383 n.33 ("That institutions held a high percentage of Unitrin stock is not as significant as the fact that the relatively concentrated percentage of stockholdings would facilitate a bidder's ability to communicate the merits of its position.").

[188]Tr. 1043.

[189]Although Professor Ferrell testified that the combination of such a pill with a classified board had a "substantial preclusive effect," he conceded that it was "not 100 percent preclusive" and that it was a "theoretical possibility" for an insurgent to win a proxy contest under such circumstances. Tr. 1085-86.

[190]*Unitrin*, 651 A.2d at 1388 n.38.

unattainability of a proxy contest reinforces the exactness of the preclusiveness standard. It is not enough that a defensive measure would make proxy contests more difficult—even considerably more difficult.[191] To find a measure preclusive (and avoid the reasonableness inquiry altogether), the measure must render a successful proxy contest a near impossibility or else utterly moot, given the specific facts at hand. The NOL Pill and Reloaded NOL Pill do not meet this standard.

b. *Range of Reasonableness Review*

Upon a finding that a defensive measure is neither coercive nor preclusive, the *Unocal* proportionality test "requires the focus of enhanced judicial scrutiny to shift to 'the range of reasonableness.'"[192] Such a proportionality test is "inherently qualitative."[193]

Trilogy argues that the Board's review of the range of reasonable responses to the threat to Selectica's NOLs failed because there was an inadequate assessment of the impact that the adoption of these defensive measures would have, as seemingly required by the *Unocal* test. This impact includes that they: (1) make takeovers more difficult;[194] (2) effectively freeze the existing equity ownership structure in place;[195] (3) deter institutional investors from investing in Selectica;[196] and (4) prevent 5% holders from selling their interest as a single block, thereby impacting the liquidity of these investments,[197] while the implementation of the Exchange in this instance essentially cut Selectica's stock price in half, putting the Company at risk of being delisted for non-compliance with NASDAQ rules.[198] Trilogy argues that the Board failed even to consider these consequences, much less weigh their effects against the importance of protecting the NOLs and the likelihood of their impairment, otherwise. Finally, Trilogy asserts that the Board failed to consider whether there were alternative methods for protecting the NOLs other than those the Board ultimately employed. Trilogy asserts that the Board could have amended the corporate charter to add limitations on the transferability of stock—thereby rendering any non-

---

[191]It is not clear that a 5% threshold would have much of an affect on the ability of a dissident to wage a successful proxy fight. *See Unitrin*, 651 A.2d at 1383 ("The key variable in a proxy context would be the merit of [the challenger's] issues, not the size of its stockholdings.").

[192]*Id.* at 1388 (quoting *Paramount Commc'ns, Inc. v. QVC Network, Inc.*, 637 A.2d 34, 45 (Del. 1994)).

[193]*Unitrin*, 651 A.2d at 1373 n.13.

[194]DX 776 at 3.

[195]Tr. 1062, 1198-1200.

[196]Tr. 1074-75.

[197]Tr. 1198-99.

[198]Tr. 803-04. NASDAQ listing rules have a $1.00 minimum bid price requirement for listed companies. NASDAQ Rule 5450.

approved acquisitions void *ab initio*, lowered the poison pill threshold by shareholder vote, or simply diluted only the portion of Trilogy's interest that exceeded the threshold, instead of its entire holding.

There is sufficient evidence, however, that the Board met its obligation to evaluate the reasonableness of its response relative to the danger it faced. Sems testified about the Board's internal debate on how to proceed, noting, "We were trying to do everything to—do a measured approach to a fairly big threat."[199] In addition, Arnold testified that the Board "talked about the impact [of the NOL Pill] to the shareholders,"[200] testimony corroborated by Zawatski[201] and Sems.[202] Trilogy points to testimony that Board members did not specifically consider what effect lowering the pill threshold would have on certain of the consequences its experts have raised in trial, as listed above.[203] However, as Zawatski noted, the Board established the Committee in part to monitor the likelihood of a near-term ownership change and to increase the pill threshold if and when the burden of the Reloaded NOL Pill on shareholders outweighs its benefit in preserving Selectica's NOLs.[204]

Most importantly, Trilogy has failed to suggest any meaningfully different approach that the Board could have taken in November and December 2008 to avoid the seemingly imminent impairment of Selectica's NOLs by Trilogy.[205] The Board was put on notice of Trilogy's presence as a 5% holder and apparent intention to trigger a change in control on November 10.[206] Amending the charter would have required a vote of Selectica's shareholders,[207] which would have necessitated the filing of a proxy

---

[199]Tr. 753.

[200]Tr. 125.

[201]Tr. 369-71.

[202]Tr. 751-52 ("Being a shareholder, too, I was in some ways apprehensive about it, because you never want to limit what shareholders can do. . . . But, to me, the trade-off was important, because it was such a large asset compared to the value of the company, once again.").

[203]*See, e.g.*, Tr. 125-26, 473-74, 802-03.

[204]Tr. 370-72.

[205]When asked by the Court about what else Selectica could have done to protect its NOLs at the time in question other than employing the NOL Pill, counsel for Trilogy did not offer up any other specific options that would have been less preclusive. Instead, she merely suggested that "[t]here may be a device similar to the pill that has a duration measured to the threat, that has a penalty, if you will, geared to the violation in the first place—in other words, not diluting down, past or beyond the actual amount; and that does not affect the shareholder franchise in the way that this micro-cap company is affected in having a classified board. . . . Another thing they could have done, they said they didn't have enough time, was to ask the shareholders whether they wanted to do it." Post-trial Oral Arg. Tr., 89-90 (unofficial transcript).

[206]Indeed, Trilogy argues that a Section 382 change in control did occur almost immediately thereafter, on November 14. DX 777.

[207]Selectica's charter does not permit shareholder actions by written consent. PX 131 ("Second Amended and Restated Certificate of Incorporation of Selectica (March, 2000)"), Article VIII.

statement and delayed any defensive response for several months, making such action implausible as an immediate reaction to the threat that Trilogy posed. Seeking prior shareholder approval of the NOL Pill would have been likewise ineffectual.

Trilogy contends that Selectica's differing reaction to Trilogy's purchases, when compared to other shareholders' purchases in the past, including those by Steel Partners, suggests bias in favor of certain shareholders and animus toward Trilogy, and/or that preserving the NOLs was merely an excuse proffered by the Board in order to freeze out Trilogy.[208] In particular, Trilogy points out that Selectica only took action to protect its NOLs after Trilogy began buying, and had not done so in the immediately preceding months when Steel Partners increased its holdings to the 15% level allowed under the previous pill, which was the cause of the increase in the Section 382 ownership change calculation to 40%. Additionally, Selectica repeatedly sought a standstill agreement with Trilogy to prevent further share purchases following the filing of its 13D, but did not seek out similar agreements with other large shareholders during this same period. Trilogy maintains that the reasonableness of the Board's response should be assessed in light of the fact that the Board would have had considerably more, and less preclusive, options at its disposal in the months before a Section 382 ownership change was imminent, and that any precipitous threat arguably necessitating more draconian measures was the result of the Board's failure to act at an earlier date.

A board's timing in moving to protect NOLs through the adoption of a poison pill is certainly relevant to the question of whether the board reasonably perceived a legitimate threat to the corporation. However, under *Unocal*, the reasonableness of a board's response is judged in relation to the "specific threat" identified, at the time it was identified.[209] In this case, Trilogy posed a distinctly different threat to Selectica's NOLs than the general threat Selectica previously faced of an inadvertent change in ownership triggered by the actions of a careless or unknowing shareholder. Here, the record demonstrates that a longtime competitor sought to employ the shareholder franchise intentionally to impair corporate assets, or else to

---

[208] As evidence of this animus, Trilogy points to the testimony of Michael Shaw, former head of Selectica's sales configuration business, who testified that Thanos's general feeling was that Selectica would sell to Trilogy "over my [Thanos's] dead body." Shaw Dep. at 43-44. Likewise, Zawatski admitted at trial that she does not like Trilogy. Tr. 327. Trilogy asserts that Selectica's "well-known dislike for Trilogy" is evidenced by the statement made by an investor during Selectica's Second Quarter 2007 earnings call advocating for a sale to Trilogy, who noted, "I understand you probably hate them. You probably would prefer nothing than—you'd probably stick pins in your eyes rather than sell the Company to them. But that is what the right thing for shareholders is at this point." DX 163 at 6.

[209] *See, e.g.*, *Moran*, 500 A.2d at 1351; *Paramount Commc'ns, Inc. v. Time, Inc.*, 1989 WL 79880, at *30 (Del. Ch. July 14, 1989).

coerce the Company into meeting certain business demands under the threat of such impairment. It is in relation to that specific threat—and not a more general threat of impaired NOLs—that the Court must consider the reasonableness of Selectica's response.[210]

With respect to Trilogy's argument that Selectica should have more narrowly tailored the amount by which Trilogy's position was diluted by reducing the impact of the NOL Pill, there is no evidence in the record that this was even a plausible option. As it was, the implementation of the Exchange—seemingly the simplest mechanism for transferring the rights—caused trading in Selectica stock to halt for more than four weeks. Besides, taking Trilogy down to under 5% would not have eliminated the threat, at least in the absence of a standstill agreement. However, the Exchange employed by the Board was a more proportional response than the "flip-in" mechanism traditionally envisioned for poison pills. Because the Board opted to use the Exchange instead of the traditional "flip-in" mechanism, Trilogy experienced less dilution in its position than a poison pill is traditionally designed to achieve.[211]

Ultimately, *Unocal* and its progeny require that the defensive response employed be a proportionate response, not the most narrowly or precisely tailored one. The Supreme Court in *QVC* explained the nature of judicial function in applying the range of reasonableness inquiry to enhanced judicial scrutiny of board actions:

> [A] court applying enhanced judicial scrutiny should be deciding whether the directors made a *reasonable* decision, not a *perfect* decision. If a board selected one of several reasonable alternatives, a court should not second guess that choice even though it might have decided otherwise or subsequent events may have cast doubt on the board's determination. Thus, courts will not substitute their business judgment for that of the

---

[210] As Sems noted, "I kept on going through what was their rationale for purposefully tripping the pill. . . . [W]hy would you . . . ruin the value of an NOL that you, the shareholder, are part of that value. It's an asset to you as a shareholder. Why would you destroy your own asset?" Tr. 755.

[211] The Exchange reduced Trilogy's holdings from 6.7% to 3.3%. In contrast, employing the flip-in would have likely reduced the company's holdings to below 1.0%. PX 38 at 29 (Needham presentation estimating that a flip-in pill would reduce a 5.0% triggering stake to 0.7% after the rights were exercised). As Sems testified, "[o]ne of the things you could do, instead of a flip-in, you could do the exchange. We looked at the difference between doing both of those and came to the conclusion that exchange was not only better for shareholders, but better for Trilogy as well, too. We were trying to do everything to—do a measured approach to a fairly big threat." Tr. 753.

> directors, but will determine if the directors' decision was, on balance, within a range of reasonableness.[212]

The *Unitrin* court suggested that the reasonableness of measures ought to be construed broadly by courts and allow defenses to extend beyond an immediate threat: "[T]he board of directors is the defender of the metaphorical medieval corporate bastion and the protector of the corporation's shareholders. The fact that a defensive action must not be coercive or preclusive does not prevent a board from responding defensively before a bidder is at the corporate bastion's gate."[213] Likewise, once a siege has begun, the board is not constrained to repel the threat to just beyond the castle walls.

Finally, the implementation of the Reloaded NOL Pill was a similarly reasonable response in the context of Selectica's other defensive measures. Although the NOL Pill and the Exchange effectively rebuffed Trilogy's immediate threat to Selectica's NOLs, the general threat of a Section 382 change in control was not substantially lessened by their implementation. Following implementation of the Exchange, Selectica still had experienced a roughly 40% ownership change for Section 382 purposes and there was no longer a pill in place to discourage additional acquisitions by 5% holders.[214] As such, the Reloaded NOL Pill was reasonably considered as a necessary defensive measure. In addition, the Reloaded NOL Pill's three-year life is mitigated to an extent by the periodic review process to be employed by the Committee.[215]

Thus, the Court finds that the combination of the NOL Pill, the Exchange, and the Reloaded NOL Pill was a proportionate response to the threatened loss of Selectica's NOLs.

There is, of course, the risk that accumulated net operating losses could provide a convenient pretext for perpetuating a board-preferred shareholder structure.[216] For this reason, shareholder rights plans, such as the ones adopted by Selectica, must be subject to careful review. In this instance, however, the Board reasonably believed, based on the guidance of appropriate experts, that the NOLs had value, a value worth protecting. In its view of the actual value of the NOLs, the Board may have been incorrect. It

---

[212] *QVC*, 637 A.2d at 45 (emphasis in original).

[213] *Unitrin*, 651 A.2d at 1388.

[214] *See also Gaylord*, 753 A.2d at 485 ("[T]he board's decision to put into place seamless defensive coverage efficiently cannot be deemed an unreasonable approach to the situation it faced.).

[215] *See Unitrin*, 651 A.2d at 1378 ("[T]his Court has upheld the propriety of adopting poison pills in given defensive circumstances. Keeping a poison pill in place may be inappropriate, however, when the circumstances change dramatically.").

[216] Indeed, companies most in need of new management, new investment, new ideas, and the invigoration that shareholder democracy often brings may well be companies that have not achieved or maintained profitability and, accordingly, have accumulated sizeable NOLs.

is not for the Court, however, to substitute its judgment for the reasonable conclusions of the Board protected as they are by 8 *Del. C.* § 141(e). Moreover, the threat posed by Trilogy was reasonably viewed as qualitatively different from the normal corporate control dispute that leads to the adoption of a shareholder rights plan. In this instance, Trilogy, a competitor with a contentious history, recognized that harm would befall its rival if it purchased sufficient shares of Selectica stock, and Trilogy proceeded to act accordingly. It was reasonable for the Board to respond, and the timing of Trilogy's campaign required the Board to act promptly. Moreover, the 4.99% threshold for the NOL Pill was driven by our tax laws and regulations; the threshold, low as it is, was measured by reference to an external standard, one created neither by the Board nor by the Court. Within this context, it is not for the Court to second-guess the Board's efforts to protect Selectica's NOLs.

IV. CONCLUSION

For the foregoing reasons, the Court concludes that the adoption of the NOL Pill and the Reloaded NOL Pill and the implementation of the Exchange were valid exercises of the Board's business judgment. Selectica's declaratory relief is granted. It follows that Trilogy and Versata's claims fail. Counsel are requested to confer and to submit an implementing form of order.

CRAIG LONDON V. MICHAEL TYRRELL

No. 3321-CC

Court of Chancery of the State of Delaware, New Castle

March 11, 2010

David A. Jenkins, Esquire, Michele C. Gott, Esquire, and Kathleen M. Miller, Esquire, of Smith Katzenstein & Furlow LLP, Wilmington, Delawware, Attorneys for Plaintiffs.

Elizabeth M. McGeever, Esquire, and J. Clayton Athey, Esquire of Prickett, Jones & Elliott, P.A., Wilmington, Delaware; Of Counsel: John C. Hayes, Jr., Esquire, and Kimberly J. Jandrain, Esquire, of Nixon Peabody LLP, Washington, District of Columbia, Attorneys for Defendants.

Art C. Aranilla, Esquire, of Marshall, Dennehey, Warner, Coleman & Goggin, Wilmington, Delaware, Attorneys for Nominal Defendant.

CHANDLER, *Chancellor*

After a four-month investigation of plaintiffs' claims in this derivative action, a special litigation committee (the "SLC") formed by nominal defendant iGov has recommended dismissal of plaintiffs' suit. I deny the SLC's motion to dismiss because there are material questions of fact regarding (1) the SLC's independence, (2) the good faith of its investigation, and (3) whether the grounds upon which it recommended dismissal of this lawsuit are reasonable. Accordingly, plaintiffs may continue to pursue this action.

I. FACTS

This dispute springs from the approval and implementation of an equity incentive plan on January 30, 2007 (the "2007 Plan") by defendants in their role as iGov directors. To better understand the context of that approval, I begin our review of the facts at an earlier date and tell the story chronologically.

A. iGov Begins to Reinvent Itself and Wins the TACLAN Contract

In 1996, plaintiffs Craig London and James Hunt, defendants Patrick Neven and Walter Hupalo, and others founded MA Federal, Inc., which does business as iGov ("iGov" or the "Company"). iGov is a

government contracting firm that initially focused on the reseller market for information technology hardware, primarily selling to federal military and civilian agencies. After nine years in the low margin, highly competitive reseller market, however, the Company decided to change its focus from product sales to the higher-margin government services market. This shift in focus, which occurred in 2005, was driven by management's view that iGov could not sustain itself over the long term in the reseller business because of increasing competition from larger players.

In October 2005, iGov won its first government services contract with the United States Special Operations Command. iGov refers to this agreement as the TACLAN contract, which stands for Tactical Local Area Network Production. TACLAN units are portable centers capable of coordinating communications for special operations forces all over the world. Under the TACLAN contract, iGov was to engineer, manufacture, test, train, and support TACLAN units, something it had little to no previous experience doing. Plaintiffs' complaint alleges that the TACLAN contract was a 5-year, $300 million competitive contract that would likely provide iGov with a substantial stream of high-margin services revenue. The $300 million figure in the TACLAN contract was an expenditure ceiling that could not be exceeded without government authorization, not a guarantee that the government would actually spend $300 million. iGov's ongoing performance under the TACLAN contract would largely determine how much the government spent. iGov's gross profit margins on the TACLAN contract would, of course, depend on how well iGov managed its costs. Thus, profitability under the TACLAN contract was driven by the volume of government orders and iGov's cost management.

B. Tyrrell is Hired to Help Solve iGov's Financial Difficulties

iGov incurred substantial non-recurring expenses when it began to reinvent itself as a service provider in 2005. These expenses placed iGov in a financially precarious position. In an effort to lift the Company out of its fiscal doldrums, iGov's CEO, Neven, sought help from a professional "turn-around expert" called Tatum LLC. Tatum provided Michael Tyrrell for the job and Tyrrell began to work for iGov as a consultant in September 2005.

As a result of the financial difficulties iGov experienced in 2005, its relationship with its primary lender soured. By May 2006, iGov was searching for a new lender to supply it with an operating line of credit. Textron Financial ("Textron") emerged as a promising source of credit. To induce Textron to extend the needed credit, Tyrrell kept Textron apprised of iGov's financial condition on an ongoing basis. Tyrrell created and approved the financial information transmitted to Textron, which included monthly income statements, balance sheets, and forecasts for fiscal years 2006 and 2007.

C. The First Textron Forecast and the DHS Contract

On May 4, 2006, Tyrrell sent Textron an email with a fiscal year 2007 ("FY07") forecast reflecting an EBITDA of approximately $3.5 million (the "First Textron Forecast"). In the email Tyrrell explained that the First Textron Forecast assumed iGov "will be successful in winning the Department of Homeland Security (DHS) contract."[1] The DHS contract is a competitive contract under which multiple vendors compete to provide information technology hardware to the various agencies directed by the DHS. Tyrrell included $10 million in DHS contract revenue in the First Textron Forecast. Tyrrell explained to Textron that he was normally "very hesitant to put unawarded contracts into [iGov] forecasts" but nevertheless included $10 million in DHS contract revenue because he had "been pretty conservative in other areas" of the First Textron Forecast and felt that $10 million was "a reasonable figure."[2] He further noted that if iGov was awarded the DHS contract it would probably yield $30 – 50 million in first year business. Other important line items in the First Textron Forecast included $6 million in revenue for iGov's Air Force unit, $35 million in revenue for GCG (an iGov subsidiary), and $195 million in revenue for the TACLAN contract.

D. Tyrrell Becomes CFO after Textron Financing is Obtained

By July 2006 negotiations with Textron were nearing completion. To finalize a $12 million line of credit, London was asked to execute a personal guarantee required by Textron's lending guidelines. Defendants allege that on the due date of the guarantee, London demanded an employment contract in exchange for signing. Apparently Neven did not look favorably on this demand and decided to remove London from his position as CFO in response. Shortly thereafter, Neven asked Tyrrell to become iGov's full-time CFO. Neven signed the personal guarantee and the $12 million line of credit was obtained.

E. The Second Textron Forecast

On August 15, 2006, Tyrrell sent Textron an updated FY07 forecast showing an EBITDA of roughly $3 million (the "Second Textron Forecast").

---

[1]Pls.' Answer Ex. 12.
[2]*Id.*

The major differences between the Second Textron Forecast and the First Textron Forecast were that projected revenues for the GCG subsidiary were lowered to $25 million and projected revenues from the TACLAN contract were lowered to $183 million.[3]

F. The Original Chessiecap Forecast

At some point in 2006 defendants decided that it would be advisable to implement the 2007 Plan for the benefit of key members of management. Defendants caused iGov to retain Chessiecap Securities, Inc. ("Chessiecap") to value iGov stock for purposes of setting the exercise price of options under the 2007 Plan. Plaintiffs complaint alleges that defendants "secretly decided to implement [the 2007 Plan] at an unfair price to benefit themselves at the expense of the other stockholders."[4]

Chessiecap was to perform a valuation of iGov as of July 31, 2006. To support the valuation, Tyrrell sent Chessiecap a FY07 forecast on August 23, 2006 that showed an EBITDA of roughly $3 million (the "Original Chessiecap Forecast"). The Original Chessiecap Forecast was identical to the Second Textron Forecast.[5]

G. The Revised Chessiecap Forecast and the Final Valuation

On October 2, 2006, Chessiecap completed its Draft Valuation, concluding that iGov equity was worth $5.5 million. After reviewing the Draft Valuation, Tyrrell sent an email to Chessiecap expressing his view that it was "probably on the high side."[6] Tyrrell gave various reasons for this view. Three of these reasons are of note. First, Tyrrell asserted that the projected $10 million in revenue (and associated costs) for FY07 from the DHS contract should not be considered in the valuation because the DHS contract had not been formally awarded. Second, Tyrrell asserted that the projected $25 million in revenues (and associated costs) from the GCG subsidiary for FY07 should be removed because GCG would be closed before year-end. Third, Tyrrell asserted that most of the projected $6 million in revenues and associated costs from the Air Force unit for FY07 should be removed because iGov was also likely to close down that unit before year-

---

[3]Associated expenses were also lowered.

[4]Compl. ¶ 26.

[5]The Second Textron Forecast and the Original Chessiecap Forecast are important to our story because, as will be discussed, plaintiffs' valuation expert, the McLean Group, relied on these identical forecasts in conducting a separate valuation of iGov.

[6]SLC Report Ex. L-8.

end. On October 18, 2006, Tyrrell sent Chessiecap a revised forecast that eliminated the revenues and expenses from these three line items.[7] This updated FY07 forecast showed an EBITDA of $1.8 million (the "Revised Chessiecap Forecast"), 40% less than the $3 million EBITDA reflected in the Original Chessiecap Forecast.

Plaintiffs' complaint asserts that in preparing the Revised Chessiecap Forecast, Tyrrell made material changes based on developments that had occurred after the July 31, 2006 valuation date. For example, iGov did not announce that it was going to close down GCG until October 4, 2006, but Tyrrell incorporated this development into the Revised Chessiecap Forecast. Thus, Chessiecap's Final Valuation, of which more will be said momentarily, was not strictly an evaluation based on what was known or anticipated as of July 31, 2006. According to plaintiffs, this is problematic because, although the Revised Chessiecap Forecast accounted for negative developments that occurred after July 31, 2006, it did not reflect positive developments that occurred after the valuation date. Specifically, plaintiffs allege that iGov had been awarded a $7 million contract with the U.S. Patent and Trademark Office ("PTO") in September 2006, but this was not reflected in the Revised Chessiecap Forecast. Also, plaintiffs allege that by October 2006 the TACLAN contract was generating higher profits than management had originally expected but this was ignored when preparing the Revised Chessiecap Forecast.[8]

Plaintiffs contend that the Revised Chessiecap Forecast was never disclosed to Textron. Plaintiffs also allege that the Revised Chessiecap Forecast was never used by the Company in managing its business. Rather, the Revised Chessiecap Forecast was purposely designed to suppress the value of the Company and was only used by Chessiecap.

On October 31, 2006, Chessiecap certified its Final Valuation of iGov, which was partially based on the Revised Chessiecap Forecast. The Final Valuation placed the value of iGov equity at $4.7 million, approximately 15% lower than Chessiecap's Draft Valuation of $5.5 million. At the time the Final Valuation was issued, Chessiecap did not calculate the fair market value per share of iGov equity. This was done later to support approval of the 2007 Plan on January 30, 2007.

---

[7]Revenues from the Air Force unit were not completely eliminated. They were revised downward from $6 million to $900,000.

[8]As will be discussed, plaintiffs also allege that when the 2007 Plan was approved on January 30, 2007, defendants were certain the TACLAN contract was performing better than anticipated but made no efforts to have Chessiecap update the Final Valuation to reflect this.

H. The Third Textron Forecast

After the Final Valuation was issued, Tyrrell continued to update Textron on iGov's finances. Tyrrell's updates portrayed a brighter outlook on the EBITDA front than had been communicated to Chessiecap in the Revised Chessiecap Forecast. For example, on December 1, 2006, Tyrrell resent the Second Textron Forecast to a different Textron employee. In the accompanying email Tyrrell explained that iGov was in the process of further updating its FY07 forecast and that he expected the revised forecast to be "just as good, if not better."[9]

On December 8, 2006, as promised, Tyrrell sent Textron an updated FY07 forecast that showed an EBITDA of approximately $3.1 million (the "Third Textron Forecast"). The individual line items in the Third Textron Forecast differed in many respects from the Second Textron Forecast, though the overall EBITDA was substantially the same.[10] The important factual consideration for present purposes is the many respects in which the Third Textron Forecast differed from the Revised Chessiecap Forecast. For instance, the Third Textron Forecast included approximately $1.9 million in revenue for the Air Force unit (as opposed to $900,000), $950,000 in revenue for GCG (as opposed to $0), and $15 million in revenue for the DHS contract (as opposed to $0).[11] The Third Textron Forecast also reflected $7 million higher projected revenues for the Navy unit. Although TACLAN revenues were projected to be roughly $8 million lower, the projected gross profit from the TACLAN contract was $2 million higher. The net result of all these changes was a stark difference in EBITDA between the Third Textron Forecast and the Revised Chessiecap Forecast: $3.1 million versus $1.8 million.

I. The Tyrrell Baseline Forecast

Defendants allege that in December 2006 Tyrrell developed three additional forecasts, presumably for internal purposes. Each forecast was based on different assumptions about the future and accordingly yielded different results. The "Baseline Forecast" showed an EBITDA of $2.1 million (the "Tyrrell Baseline Forecast"). It was nearly identical to the Third Textron Forecast. The one major difference was that the $15 million in

---

[9]SLC Report Ex. L-16.

[10]Some of the individual line items in the forecast were markedly more positive and others were more negative. The net difference in EBITDA between the forecasts, however, was not especially pronounced: $3.1 million in the Third Textron Forecast versus $3 million in the Second Textron Forecast.

[11]Projected costs for these units were also higher.

revenue from the DHS contract and associated expenses were eliminated from the Tyrrell Baseline Forecast. The gross profit margin on the DHS contract accounted for most of the $1 million difference in EBITDA between the two projections.[12] In addition to the Tyrrell Baseline Forecast, Tyrrell allegedly developed a $4.3 million EBITDA forecast which he dubbed the "Better Forecast" and a $6.1 million EBITDA forecast which he dubbed the "Stretch Forecast." From the record, it is not entirely clear what, if anything, these latter two forecasts were used for.

J. iGov's Internal Forecasts Remain Higher than the Revised Chessiecap Forecast

In addition to showing that the First, Second, and Third Textron Forecasts were decidedly more positive than the Revised Chessiecap Forecast, plaintiffs proffered evidence that iGov continued to project a FY07 EBITDA of approximately $3-4 million internally *after* Chessiecap had been given the Revised Chessiecap Forecast showing an EBITDA of only $1.8 million. For example, in December 2006, a strategic management plan prepared by Hupalo included a goal to "exceed $3 million in EBITDA by year-end FY'07."[13] On December 15, 2006, Neven represented in an email to a stockholder that "iGov is financially healthy again, . . . we expect to be at $150 million this coming year with an EBITAD [sic] of $3 million..."[14] On January 7, 2007, Tyrrell sent the Third Textron Forecast to the incoming CFO Rich Marksberry[15] and informed him that it was "the baseline case forecast for iGov for FY07" and that iGov was "currently updating a version that shows EBITDA of over $4 million, which we think is possibly achievable this year."[16] On January 12, 2007, Tyrrell made a presentation at a business development strategy meeting that projected FY07 EBITDA at over $4 million.1[17] And on February 10, 2007, Tyrrell sent an email to a strategic consultant representing that "our working internal forecast shows EBITDA of $3MM."[18]

---

[12]The Tyrrell Baseline Forecast is important to our story because, as will be discussed, this forecast was relied upon by the SLC's independent valuation firm, Stout Risius Ross, in conducting its valuation of iGov.

[13]SLC Report Ex. L-20.

[14]Pls.' Answer Ex. 33.

[15]Marksberry was brought over from the same consulting firm as Tyrrell, Tatum LLC.

[16]SLC Report Ex. L-23. It is worth noting here that Tyrrell's characterization of the Third Textron Forecast (sent to Textron and Marksberry) as the "baseline case" contradicts defendants' characterization of the Tyrrell Baseline Forecast (sent to SRR) as the "baseline forecast."

[17]SLC Report Ex. L-26.

[18]SLC Report Ex. L-29.

K. Plaintiffs Object to the Final Valuation

On December 22, 2006, Tyrrell became concerned that nearly half a year had passed since the July 31, 2006 valuation date on Chessiecap's Final Valuation. The 2007 Plan was taking longer to implement than defendants had anticipated. Tyrrell contacted Chessiecap and asked them if the Final Valuation needed to be updated "since our 2006 valuation is dated July 31, 2006 and the stock options will not be given until the end of next month . . .?"[19] Chessiecap replied that the Final Valuation was good for one year, unless significant events had occurred that would materially change the financial prospects of the Company.[20]

On December 29, 2006, plaintiffs were provided a copy of Chessiecap's Final Valuation placing iGov's equity value at $4.7 million. After reviewing the Final Valuation plaintiffs requested copies of the information Chessiecap had relied on. Among other things, they were given the Revised Chessiecap Forecast. In the meantime, on January 7, 2007, Tyrrell sent an email to iGov management regarding a proposal to purchase London's shares for $4 per share, plus a "kicker" down the road if iGov was sold. In the email, Tyrrell expressed the view that "since [iGov's] valuation is a few months old, [iGov] will probably have to have it updated and the valuation will likely be higher than $4.7 million . . . ."[21] Tyrrell concluded that the $4 per share figure would still be fair to London because the number of iGov's issued shares was soon to be increased by the 2007 Plan. On January 16, 2007, however, after reviewing the Revised Chessiecap Forecast, London objected to iGov relying on Chessiecap's Final Valuation for purposes of the 2007 Plan because he felt the information upon which the Final Valuation was based was stale and inaccurate. The next day, Hunt, who also believed the Final Valuation was unreliable, made an offer to buy all of Neven's stock at $28 per share. Hunt later made the same offer to other shareholders, apparently with the design of purchasing enough shares to gain voting control of iGov.

L. Plaintiffs are Removed from the Board

At this point, in a narrative much belabored with disorienting descriptions of multiple financial forecasts, the human controversy begins. Plaintiffs London and Hunt comprised half of the iGov board on January 16

---

[19]SLC Report Ex. L-21.
[20]*Id.*
[21]SLC Report Ex. L-22.

and 17, when it became clear that they disagreed with using Chessiecap's Final Valuation in its then-current form. The other half of the iGov board consisted of defendants Neven and Hupalo. Collectively, Neven and Hupalo owned 42.5% of iGov's voting stock. On January 19, 2007, Neven and Hupalo teamed up with iGov officer and shareholder Jack Pooley, the three of them collectively owning 50.1% of iGov's voting stock, and executed written stockholder consents removing plaintiffs from the board. At the same time, they elected Tyrrell to the board. Thus, after January 19, 2007, defendants made up the entire iGov board.

M. The 2007 Plan is Adopted

On January 30, 2007, the core series of events occurred that gave rise to this litigation. To address Hunt's $28 per share offer, defendants engaged Chessiecap to prepare an addendum to its Final Valuation. In the addendum, dated January 30, 2007, Chessiecap opined that Hunt's offer did not affect or change Chessiecap's opinion that iGov's equity value was $4.7 million. The addendum stated that Hunt's offer was conditioned on his receiving enough shares to own a majority of iGov's voting stock and that this excluded Hunt's offer "from any consideration in Chessiecap's valuation of the Company, which was premised upon privately-held, minority discounted stock."[22] The addendum then determined for the first time the share price of iGov stock, concluding that the fair market value per share as of July 31, 2006 was $4.92. In calculating this per-share price, the addendum incorrectly included 65,000 shares and 300,000 options that were not outstanding as of the July 31, 2006 valuation date. These shares and options were not approved until January 30, 2007 (the day the addendum was issued) as part of the 2007 Plan, which I will describe in detail momentarily. Plaintiffs assert that defendants knew these shares and options were inappropriately included in Chessiecap's per share calculation, but ignored the purported error as it resulted in a lower value that benefitted defendants.

Defendants also held a special meeting of the iGov board on January 30, 2007. As Hunt, the former chairman, had just been removed as a director, the first order of business was appointing a new chairman. Neven was appointed by unanimous consent and he then called the meeting to order. During the meeting Tyrrell was named President, Chief Operating Officer, and Treasurer of iGov and Marksberry was named CFO.

The primary purpose of the meeting was to consider the 2007 Plan. Under the 2007 Plan, 300,000 stock options were to be issued to various

[22]SLC Report Ex. M.

directors and senior executives. Of the 300,000 options, Tyrrell was to receive 80,000, Neven 50,000, and Hupalo 50,000. Thus, collectively, defendants were to be given 60% of the options granted under the 2007 Plan. In addition, the 2007 Plan contemplated the sale of 65,000 shares of stock to Tyrrell. In contrast, plaintiffs were not to be given any options or shares under the 2007 Plan, presumably because they had been removed from their director and management positions.

The 2007 Plan provided that the exercise price of the options could not be less than 100% of the fair market value of iGov common stock *on the date the options were granted* and that the sale of shares to Tyrrell would be at their fair market value *on the date of sale*. Defendants unanimously voted as directors to approve the 2007 Plan. Defendants simultaneously adopted $4.92 per share as the fair market value of iGov shares on January 30, 2007 based on Chessiecap's Final Valuation, dated July 31, 2006, and the associated addendum. Before approving the 2007 Plan, Tyrrell represented to Chessiecap that no material change had occurred and so it was still appropriate, in his view, to rely on the Final Valuation.[23] All defendants then implicitly accepted that no material change had occurred by approving $4.92 per share as the fair market value. Tyrrell purchased his 65,000 shares the next day.

Plaintiffs allege that the 2007 Plan was designed to substantially reduce their ownership interests in iGov and increase defendants' interests to a level that would permit defendants to entrench themselves as iGov directors and managers. In support of this theory, plaintiffs assert that implementation of the 2007 Plan immediately reduced their collective ownership interests from 44% to 40%. On a fully diluted basis, the 2007 Plan allegedly reduced plaintiffs' collective ownership interests from 42.3% to 28.7%. At the same time, the 2007 Plan allegedly increased defendants' collective ownership interests from 50.1% to 54.1% and, on a fully diluted basis, defendants' collective ownership interests allegedly increased from 48.2% to 54.2%.[24]

As we have discussed, plaintiffs contend that defendants manipulated the Final Valuation by excluding positive developments which occurred after July 31, 2006 from the Revised Chessiecap Forecast.

---

[23]SLC Report 63.

[24]In calculating defendants' collective ownership interests, plaintiffs include shares owned by Pooley, who is not a defendant in this suit. According to plaintiffs, Pooley was controlled by Neven during all relevant periods and should be considered part of defendants' voting block. If Pooley's shares are not included in the calculation, the 2007 Plan increased defendants' collective ownership interests from 42.5% to 47.1%. On a fully diluted basis defendants' collective ownership interests increased from 40.9% to 49.3%.

Plaintiffs also contend that defendants wrongfully declined to update either the Revised Chessiecap Forecast or the Final Valuation before approving the 2007 Plan, falsely representing that no material change had occurred between July 31, 2006 and January 30, 2007. Plaintiffs point to three specific developments which were purportedly ignored. First, the $7 million PTO contract had been awarded on September 29, 2006, but was not reflected in the Revised Chessiecap Forecast or the Final Valuation. Second, on December 20, 2006, iGov received a pre-award notice that it had been selected as one of the vendors under the DHS contract, putting the Company one step further towards realizing DHS revenue in 2007, but no such revenues were included in the Revised Chessiecap Forecast or the Final Valuation. And third, by January 30, 2007, iGov was aware that the TACLAN contract was performing better than expected but did not have Chessiecap update its Final Valuation to reflect the increased profitability of the TACLAN contract.[25]

Other features of the 2007 Plan should be noted to tell the full story. For starters, the 2007 Plan replaced an existing equity incentive plan at iGov. In February 2001, the iGov board had approved the 2000 Stock Option and Incentive Plan (the "2000 Plan"). The 2000 Plan gave iGov the power to grant stock options to various officers, directors, consultants, and other employees at an exercise price of $5.00 per share. No formal valuation appears to have supported the $5.00 strike price, though options were granted to employees and exercised at this price. A few years later, on February 26, 2003, London proposed that Neven, Hupalo, and London should each be awarded 50,000 options under the 2000 Plan at an exercise price of $1.25 per share as compensation for their services to iGov. The board approved London's proposal, but these options were never exercised. In fact, there is a dispute over whether they were ever actually granted. Evidently, in 2005 iGov's auditors noted that the marked difference between

[25]In support of this last point about the TACLAN contract plaintiffs proffer an email from Tyrrell to Textron on October 12, 2006 reporting that iGov "now has $39 million in delivery orders for TACLAN. This is huge because it's the first time that our backlog has been so large and predictable." *See* SLC Report Ex. L-9. Plaintiffs also proffer an email from Tyrrell to iGov management on January 17, 2007 reporting on December 2006 income and explaining that "TACLAN led the way with $6.1 million in Revenues and over $655K in Net Income, which covered nearly 90% of our Operating Expenses for the month . . . Overall, TACLAN did much better than expected . . . ." *See* SLC Report Ex. L-27. In addition, the Revised Chessiecap Forecast showed TACLAN's projected gross profit for FY07 at approximately $4.5 million while the Third Textron Forecast showed TACLAN's projected gross profit for FY07 at approximately $6.5 million. Thus, the financials Tyrrell gave Textron on December 8, 2006 projected TACLAN's gross profit to be $2 million higher for FY07 than the financials Tyrrell provided to Chessiecap on October 18, 2006.

the $5.00 and $1.25 strike prices under the 2000 Plan had not been properly accounted for, and would give rise to a substantial charge on the financial statements if iGov was determined to leave the $1.25 options in place.

Defendants contend that the 2007 Plan was an effort to revamp the 2000 Plan, which was imperfectly structured, and to replace the $1.25 options granted to Neven, Hupalo, and London. Accordingly, defendants assert that in adopting the 2007 Plan Neven and Hupalo gave up options with a strike price of $1.25 for options with a strike price of $4.92, sacrificing personally for the good of the Company. Plaintiffs, on the other hand, contend that the $1.25 options were never actually granted and so Neven and Hupalo gave up nothing. I will explore this dispute later. For now, I simply note that the 2007 Plan as adopted explicitly superseded the 2000 Plan (at least to the extent it was legitimate).

The 2007 Plan also gave Neven and Tyrrell the collective authority to grant up to 25,000 options to the new CFO, Marksberry, at an exercise price equal to the fair market value of the shares *on the date of the grant.* If Neven and Tyrrell both wished to grant Marksberry these options, the 2007 Plan required them to do it by April 15, 2007. Marksberry did not receive a grant of options by that date and the delegated authority to Neven and Tyrrell expired.

Finally, the 2007 Plan provided that stockholder approval would be obtained within twelve months. Plaintiffs, who remained stockholders in iGov after their removal from the board, allege that they never voted on the 2007 Plan.[26]

N. The DHS Contract is Awarded

A few months later, in March 2007, iGov announced that it had formally been awarded the DHS contract. This placed the Company firmly in

---

[26]This is significant in part because 8 *Del. C.* § 144 provides that transactions approved by interested directors are not void or voidable if the transaction (1) is also approved by a majority of disinterested directors after disclosure of all the material facts, (2) is approved in good faith by the *disinterested* shareholders after disclosure of all the material facts, or (3) is fair to the corporation at the time it is approved by the board. Defendants were interested in the 2007 Plan and comprised the entire board at the time they approved it, so the 2007 Plan cannot be sustained under the first prong of § 144. After the 2007 Plan was enacted plaintiffs collectively owned a majority of the disinterested shares, so their vote would be necessary to validate the 2007 Plan under the second prong of § 144, but that did not happen. Accordingly, the 2007 Plan can only be upheld if it was fair to iGov when it was enacted. *See Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 366 n.34 (Del. 1993) ("Under this statute, approval of an interested transaction by either a fully-informed disinterested board of directors . . . or the disinterested shareholders . . . provides business judgment protection.").

the position of being able to realize DHS revenues in 2007. The amount of DHS revenues to be realized, of course, would depend on how well iGov performed under the DHS contract relative to the other approved vendors. As we have seen, Tyrrell had excluded DHS revenues from the Revised Chessiecap Forecast because the DHS contract had not been formally awarded.

O. Marksberry is Granted 25,000 Shares

Despite having formally secured the DHS contract, on May 30, 2007, defendants approved the grant of 25,000 options to Marksberry at a strike price of $4.92 per share.[27] Apparently cognizant that ten months had passed since the date of Chessiecap's Final Valuation, defendants explicitly stated in the board resolution approving the grants that "there ha[d] been no material changes affecting the Company's financial operations or prospects which would affect [the Final] Valuation since the date of its last determination of Fair Market Value."[28] Thus, in approving the option grants to Marksberry, defendants relied on Chessiecap's advice that the Final Valuation was good for one year absent any material changes and on its own determination that no material changes had occurred between July 31, 2006 and May 30, 2007. Defendants made this determination even though the DHS contract had been formally awarded in the interim.

P. Plaintiffs' Suit

After the 2007 Plan was approved, plaintiffs made a books and records request under 8 *Del. C.* § 220. The ground for the request was plaintiffs' objection to iGov using Chessiecap's Final Valuation as the basis for the $4.92 per share strike price. Plaintiffs also engaged the McLean Group, a valuation firm, to conduct separate valuations of iGov's equity as of October 31, 2006 and December 31, 2006 (the "McLean Valuations"). In performing the McLean Valuations, McLean used the Second Textron Forecast[29] rather than the Revised Chessiecap Forecast. McLean noted that Chessiecap's Final Valuation incorrectly included in its option-pricing model

[27]Defendants, acting as the entire board, had to approve this grant because the delegated authority to Neven and Tyrrell had expired.

[28]SLC Report Ex. L-30.

[29]The Second Textron Forecast was identical to the Original Chessiecap Forecast.

the 300,000 options and the 65,000 shares approved by the 2007 Plan, rather than the outstanding 745,000 shares that actually existed as of July 31, 2006. The McLean Valuations placed the per share value of iGov equity at $13.32 on October 31, 2006 and $15.45 on December 31, 2006. The McLean Valuations were sent to iGov on September 18, 2007, along with McLean's separate critique of Chessiecap's Final Valuation.

While the McLean Valuations were being conducted, iGov expanded the size of its board from three members to five. In August 2007, Vincent Salvatori and John Vinter became iGov directors. Both men were first approached by Tyrrell and both had connections to him, which I will discuss at some length later. Both men also had extensive experience in government contracting that understandably made them attractive candidates for iGov's board.

On October 31, 2007, after attempts to resolve the dispute failed, plaintiffs filed their complaint. The counts in the complaint are characterized as derivative and individual, alleging harm to iGov as a company and to plaintiffs in their personal capacity. In February 2008, the complaint was amended in response to defendants' motion to dismiss.

The amended complaint contains three counts. Count I is a derivative claim for breach of fiduciary duty alleging defendants failed to honor their duties of care and loyalty. With regards to the duty of loyalty, Count I alleges that defendants materially misrepresented iGov's business prospects to Chessiecap in order to ensure a low valuation so that they could personally obtain iGov stock at an artificially low price. Count I also alleges that defendants breached their duty of loyalty by approving the 2007 Plan with the intent that it would firmly entrench them in their positions as directors and managers of iGov. Regarding the duty of care, Count I alleges that defendants failed to consider all material information available to them in determining the value of iGov stock for purposes of the 2007 Plan. In that vein, Count I alleges that defendants knew when they approved the 2007 Plan that Chessiecap's Final Valuation was based on stale and inaccurate information and was therefore an inappropriate tool for determining the fair value of iGov shares as of January 30, 2007. Count I also alleges that defendants had even more reason to believe the Final Valuation was outdated by May 30, 2007 because the DHS contract had been definitively awarded by that date, but defendants still declined to have the Final Valuation updated. Count II is a request for relief rather than a cause of action. It seeks rescission of the option grants to defendants and the stock sale to Tyrrell based on the breaches of fiduciary duty described in Count I. Count III is characterized by plaintiffs as an individual claim, the personal harm being that defendants improperly diluted plaintiffs' ownership interests by implementing the 2007 Plan, thereby expropriating economic value and voting power from them. For their part, defendants contend that Count III is

a derivative claim.

Q. iGov Forms a Special Litigation Committee after its Motion to Dismiss is Denied

After plaintiffs' complaint was amended, defendants again filed a motion to dismiss on several grounds, including plaintiffs' failure to make a demand on the board before filing suit. In my June 24, 2008 Opinion, I found that plaintiffs' complaint "easily survived" defendants' motion to dismiss; demand being excused because a majority of the board was interested in the transaction.[30] Thereafter, on November 21, 2008, the iGov board voted to form a two-member SLC comprised of Salvatori and Vinter to consider whether it was in iGov's best interest to pursue the derivative claims in plaintiffs' complaint.

After its formation, the SLC obtained advisors. In February 2009 the SLC engaged Blank Rome LLC as independent counsel and in March 2009 the SLC engaged Stout Risius Ross ("SRR") as its independent financial advisor.

From April 2009 to July 2009 the SLC conducted its investigation. Discovery was stayed during this time. In conducting the investigation the SLC interviewed twelve witnesses and reviewed relevant documentation produced by the parties, iGov, Textron, Chessiecap, McLean, and others, including the documents provided to plaintiffs in response to their § 220 action. To inform their investigation, the SLC sought counsel's advice as to the legal principles that determine whether defendants complied with their fiduciary duties.

During the investigation, the SLC charged SRR with two tasks. First, SRR was instructed to perform independent valuations of iGov as of October 31, 2006 and as of January 30, 2007 (the "SRR Valuations"). The SLC required SRR to complete the SRR Valuations without reviewing the work done by Chessiecap and McLean, presumably to ensure that SRR would not be influenced by any previous valuation work performed. The SLC determined that October 31, 2006 was an appropriate valuation date because it believed that Chessiecap's Final Valuation was essentially current as of October 31, 2006, despite being dated July 31, 2006.[31] The SLC determined that January 30, 2007 was an appropriate date for more obvious reasons; it was the date the challenged 2007 Plan was adopted. I will discuss

---

[30] *London v. Tyrrell*, 2008 WL 2505435 (Del. Ch. June 24, 2008).

[31] SLC Report 63 ("The [Final] [V]aluation . . . relied upon iGov financial data for the fiscal year ending October 31, 2006. In the opinion of the [SLC] and SRR, Chessiecap's valuation is more properly viewed as a valuation as of October 31, 2006.").

the SRR Valuations at greater length later but for now I note that the FY07 EBITDA forecast SRR used was the Tyrrell Baseline Forecast. The SRR Valuations concluded that iGov was worth $3.90 - $4.15 per share as of October 31, 2006 and $5.24 - $5.39 per share as of January 30, 2007. The SLC concluded that the $4.92 per share price was "within the range of fair market value" based on the SRR Valuations as well as Salvatori and Vinter's own professional experience in government contracting.[32] Notably, despite the SRR Valuations, the SLC reasoned that $4.92 per share "was likely too high, from a practical, real world perspective, to express the Company's value."[33]

The second task SRR was charged with was to review the Chessiecap Final Valuation and the McLean Valuations and opine on them. SRR did this and helped the SLC prepare a summary comparison between the Chessiecap Valuation and McLean Valuations that was included in the SLC Report. The SLC concluded that both sets of valuations were "tainted" and reasoned that it was not necessary to determine which set of valuations was better.[34] The SLC concluded that it could make a recommendation respecting this suit and iGov's best interests without declaring a winner in the battle between plaintiffs' and defendants' experts.

On August 5, 2009, the SLC Report was filed. The SLC Report concludes that the suit is not in the best interests of the Company and recommends that it be dismissed. The SLC believes that the discovery that will resume if the suit is allowed to continue will be extremely disruptive to iGov's operations. The SLC also believes that negative publicity associated with the suit will immediately damage the Company's goodwill and reputation in the government contracting community.

As to the actual claims asserted in plaintiffs' complaint, the SLC Report concludes as follows. First, as to Count I, the SLC concluded that defendants acted properly in adopting the 2007 Plan and did not breach their duties of care or loyalty. With regards to the duty of care, the SLC found that the 8 *Del. C.* § 102(b)(7) provision in iGov's certificate of incorporation exculpates directors from personal liability not involving intentional misconduct or knowing violations of the law. The SLC concluded that a duty of care claim should not be pursued because defendants breach of care conduct, if it occurred, would be covered by the § 102(b)(7) provision. As to the duty of loyalty, the SLC concluded that defendants' approval of the 2007 Plan and actions leading to that approval would satisfy the entire fairness

---

[32]SLC Report 50.
[33]*Id.*
[34]SLC Report 47.

standard because the process employed was fair and the $4.92 strike price was fair. As to Count II the SLC determined that no rescission of the options granted and shares sold to defendants under the 2007 Plan should occur because $4.92 was in the range of fair market value. Finally, the SLC determined that Count III should be dismissed based on its belief that any dilution plaintiffs suffered was experienced equally by other shareholders and thus, no individual claim exists. Count III, according to the SLC, is a derivative claim arising out of the conduct alleged in Count I and should be dismissed for the same reasons that Count I should be dismissed.

After reviewing the SLC Report plaintiffs filed an opposition brief arguing that the SLC has not met the standard required by *Zapata Corporation v. Maldonado*[35] and its progeny for dismissal of a claim based on an SLC's recommendation in a demand-excused case. I now consider whether the SLC has met the *Zapata* standard and, consequently, whether the suit should be dismissed or permitted to proceed.

II. STANDARD

The Supreme Court's decision in *Zapata* governs demand-excused derivative cases in which the board sets up an SLC that investigates whether a derivative suit should proceed and recommends dismissal after its investigation.[36] In *Zapata*, the Supreme Court rejected the notion that the SLC's recommendation, made in the form of a motion to dismiss, should be subject to business judgment review.[37] Rather, the Supreme Court established a two-step analysis that must be applied to the SLC's motion to dismiss. The first step of the analysis is mandatory. The Court reviews the independence of SLC members and considers whether the SLC conducted a good faith investigation of reasonable scope that yielded reasonable bases supporting its conclusions.[38] The second step of the analysis is discretionary.[39] The Court applies its own business judgment to the facts to determine whether the corporation's best interests would be served by dismissing the suit. The second step is designed for situations in which the technical requirements of step one are met but the result does not appear to satisfy the spirit of the requirements.[40]

---

[35]430 A.2d 779 (Del. 1981).

[36]*Zapata Corp. v. Maldonado*, 430 A.2d 779, 784 (Del. 1981).

[37]*Id.* at 787.

[38]*Id.* at 789.

[39]*Id.*; *Kaplan v. Wyatt*, 499 A.2d 1184, 1192 (Del. 1985) (holding that the second step of the *Zapata* analysis is discretionary).

[40]*Zapata*, 430 A.2d at 789.

An SLC's motion to dismiss is a bit of a curiosity, procedurally speaking. It does not arise directly out of one of our rules of civil procedure. Rather, it is derived by analogy to a motion to dismiss a derivative suit based upon a voluntary settlement between parties and by analogy to a Rule 41(a)(2) motion whereby a plaintiff unilaterally seeks voluntary dismissal of a complaint after the defendant files an answer.[41] The Court treats the SLC's motion in a manner akin to a Rule 56 motion for summary judgment; the SLC bears the burden of demonstrating that there are no genuine issues of material fact as to its independence, the reasonableness and good faith of its investigation, and that there are reasonable bases for its conclusions.[42] If the Court determines that a material fact is in dispute on any of these issues it must deny the SLC's motion.[43] When an SLC's motion to dismiss is denied, control of the litigation is returned to the plaintiff shareholder.[44] With the relevant standard broadly articulated, I now proceed to step one of *Zapata*.

III. ANALYSIS

A. Were the SLC Members Independent?

Whether an SLC member is independent "is a fact-specific determination made in the context of a particular case."[45] When an SLC member has no personal interest in the disputed transactions, the Court scrutinizes the members' relationship with the interested directors, as that would be the source of any independence impairment that might exist.[46] The Court considers the relationship between each SLC member and the interested directors.

An SLC member does not have to be unacquainted or uninvolved with fellow directors to be regarded as independent.[47] But an SLC member is not independent if he or she is incapable, for any substantial reason, of making a decision with only the best interests of the corporation in mind.[48] Essentially, this means that the independence inquiry goes beyond determining whether SLC members are under the "domination and control"

---

[41] *Kaplan v. Wyatt*, 484 A.2d 501, 506-07 (Del. Ch. 1984).
[42] *Id.* at 507.
[43] *Id.* at 508.
[44] *Id.* at 509.
[45] *Beam v. Stewart*, 845 A.2d 1040, 1050 (Del. 2004).
[46] *Katell v. Morgan Stanley Group, Inc.*, 1995 WL 376952, at *8 (Del. Ch. June 15, 1995).
[47] *Sutherland v. Sutherland*, 958 A.2d 235, 241 (Del. Ch. 2008).
[48] *In re Oracle Derivative Litig.*, 824 A.2d 917, 920 (Del. Ch. 2003).

of an interested director.[49] Independence can be impaired by lesser affiliations, so long as those affiliations are substantial enough to present a material question of fact as to whether the SLC member can make a totally unbiased decision. For example, independence could be impaired if the SLC member senses that he owes something to the interested director based on prior events.[50] This sense of obligation need not be of a financial nature.[51]

The independence inquiry under the *Zapata* standard has often been informed by case law addressing independence in the pre-suit demand context and vice-versa.[52] This is a useful exercise but not one without limits. As the Supreme Court noted in *Beam v. Stewart*:

> Unlike the demand-excusal context, where the board is presumed to be independent, the SLC has the burden of establishing its own independence by a yardstick that must be "like Caesar's wife"-"above reproach." Moreover, unlike the presuit demand context, the SLC analysis contemplates not only a shift in the burden of persuasion but also the availability of discovery into various issues, including independence.[53]

Unlike a board in the pre-suit demand context, SLC members are not given the benefit of the doubt as to their impartiality and objectivity. They, rather than plaintiffs, bear the burden of proving that there is no material question of fact about their independence. The composition of an SLC must be such that it fully convinces the Court that the SLC can act with integrity and objectivity, because the situation is typically one in which the board as a whole is incapable of impartially considering the merits of the suit.[54] Thus, it is conceivable that a court might find a director to be independent in the pre-suit demand context but not independent in the *Zapata* context based on the same set of factual allegations made by the two parties. This is not because the substantive contours of the independence

---

[49] *Id.* at 937.

[50] *Id.* at 939 n.52.

[51] *Id* at 938-39.

[52] For example, in *Oracle*, a case governed by *Zapata*, after articulating what it means for an SLC member to be independent, the Court noted that "[t]his formulation is wholly consistent with the teaching of *Aronson* [a pre-suit demand case], which defines independence as meaning that 'a director's decision is based on the corporate merits of the subject before the board rather than extraneous considerations or influences." *Oracle*, 824 A.2d at 938 (citing *Aronson v. Lewis*, 473 A.2d 805, 816 (Del. 1984). Also, in the pre-suit demand case of *Beam v. Stewart*, 833 A.2d 961 (Del. Ch. 2003), the Court's independence analysis was informed by *Oracle*. *Id.* at 979.

[53] 845 A.2d 1040, 1055 (Del. 2004) (internal citations omitted).

[54] *Oracle*, 824 A.2d at 940.

doctrine are different in these two contexts. Rather, it is primarily a function of the shift in the burden of proof from the plaintiff to the corporation when the suit moves from the pre-suit demand zone to the *Zapata* zone.

It is undisputed that neither SLC member had a personal stake in the challenged transactions. Neither Salvatori nor Vinter received shares of stock or options under the 2007 Plan and neither faces any risk of personal liability in this suit. Moreover, Salvatori and Vinter were not appointed to the board until after the 2007 Plan was adopted. In addition, plaintiffs do not allege that any of the defendants dominate or control Salvatori or Vinter. Thus, the focus must be on whether the relationships Salvatori and Vinter have with defendants are of such a nature that they might have caused Salvatori and Vinter to consider factors other than the best interests of the corporation in making their decision to move for dismissal. Such a relationship would raise a material question as to the SLC's independence. After carefully reviewing the evidence produced by the limited discovery thus far permitted, I conclude that there is a material question of fact as to the independence of both SLC members based on their relationships to Tyrrell.

I begin by discussing Vinter. Plaintiffs argue that Vinter's independence is impaired by one simple fact; Vinter's wife is Tyrrell's cousin. According to plaintiffs, it was that association that caused Tyrrell to approach Vinter about joining the iGov board.[55] Defendants counter that this familial relationship does not impair Vinter's independence because Tyrrell and Vinter's wife are not close cousins; they only occasionally cross paths at large family functions once or twice each year. Plaintiffs respond that, even though Tyrrell and Vinter's wife may not be particularly close, it would have been impossible for Vinter not to think of Tyrrell as "my wife's cousin" when grappling with the difficult decision of recommending whether civil litigation against him should proceed. According to plaintiffs, this is a sufficient connection to create an unacceptable risk of bias in Vinter's mind.[56]

Defendants cite *Beam v. Stewart*, a case in which the Supreme Court stated that "allegations of mere personal friendship or a mere outside business relationship, standing alone, are insufficient to raise a reasonable

---

[55]The SLC Report did not reveal that Tyrrell extended the invitation to Vinter to join the iGov board. When Vinter was asked in his deposition how Tyrrell knew to call him, he initially stated "[y]ou'll have to ask [Tyrrell] that. I don't know." Vinter Dep. 20:14-15, Oct. 7, 2009. Plaintiffs' counsel then asked if Vinter knew who Tyrrell was when he called, to which Vinter responded "[w]ell, I mean, he's my wife's cousin" *Id.* at 20:20.

[56]*Id.* at 947 (holding that independence under *Zapata* is not established where "the connections identified [between the SLC and the interested directors] would be on the mind of the SLC members in a way that generates an unacceptable risk of bias.")

doubt about a director's independence."[57] Defendants argue that, under *Beam*, the familial connection between Tyrrell and Vinter is simply not enough to raise a material question of fact as to Vinter's independence. I disagree. *Beam* was a pre-suit demand case, and the burden in that case was on the plaintiffs to allege facts sufficient to create a reasonable doubt that the board could not objectively consider a suit against its Chairman, Martha Stewart. In their complaint, the plaintiffs broadly alleged that Stewart had personal friendships or outside business dealings with certain of the directors. This was not enough, standing alone, to create a reasonable doubt about the ability of the directors to objectively consider the merits of a suit against Stewart. In this case, however, the burden is on iGov to show that it has appointed SLC members whose independence cannot seriously be doubted. The Company, not plaintiffs, must do the explaining in the first instance if there are associations that cast a shadow on independence. Frankly, appointing an interested director's family member to an SLC will always position a corporation on the low ground. From there, the corporation must fight an uphill battle to demonstrate that, notwithstanding kinship, there is no material question as to the SLC member's objectivity. Put simply, explaining away a familial association in *Zapata* territory is a more difficult challenge for a corporation than confronting a broad allegation of personal or business relationships in pre-suit demand territory.

I admit that it is not possible, at this stage of the proceedings, to say unequivocally that Vinter's independence is impaired. On the one hand, the relationship between Vinter's wife and Tyrrell does not seem to be particularly close. They do not frequently associate with one another as some cousins are wont to do. On the other hand, they do see each other regularly, albeit infrequently, at family functions. For example, each year Vinter and his wife attend a large family party at Tyrrell's in honor of Tyrrell's mother, who has passed away.[58] Vinter also testified in his deposition that, while he did not see Tyrrell on a regular basis or personally discuss Tyrrell's work with him before joining the iGov board, he "sort of knew where he was at any given time . . . ."[59] Thus, the familial relationship appears to be close enough that Vinter has been kept apprised of Tyrrell's comings and goings through the family grapevine. To my mind, there is a material question of fact as to how much Vinter's family association with Tyrrell may have influenced his objectivity. I cannot say with certainty that Vinter would not have considered the potentially awkward situation of showing up to Tyrrell's

---

[57]845 A.2d 1040, 1050 (Del. 2004).
[58]Vinter Aff. ¶¶ 2-3.
[59]Vinter Dep. 21:3-4, Oct. 7, 2009.

annual party after the family rumor mill had spread the word that Vinter had recommended that a lawsuit should proceed against the host.[60] Therefore, I am not convinced, as I must be under *Zapata*, that Vinter's recommendation would have been solely influenced by considerations of iGov's best interests.

Now to Salvatori. Like Vinter, Salvatori's contact with iGov was based on an association with Tyrrell. In 1993, Tyrrell was hired by Salvatori to work as an internal auditor for a company called QuesTech. Salvatori was a QuesTech co-founder and served as its President, CEO, and Chairman while Tyrrell was employed there for six years. During that time, Salvatori promoted Tyrrell to CFO, in which role he reported directly to Salvatori. Tyrrell worked as QuesTech's CFO until it was sold in 1998. Tyrrell appears to have made a significant and valued contribution to the efforts to sell QuesTech. In his deposition, Salvatori testified that he has "a great respect for [Tyrrell]. And he was very helpful in helping me get a good price for my company. Very helpful."[61] Tyrrell's employment with QuesTech ended when it was sold. After the sale, Tyrrell and Salvatori maintained minimal connections. Their professional association was reinstated when Tyrrell approached Salvatori about joining the iGov board.

As noted, the independence of an SLC member may be impaired if that member feels he owes something to an interested director.[62] That sense of obligation does not have to be financial in nature.[63] In this case, I believe there is a material question of fact as to Salvatori's independence because his earlier associations with Tyrrell may have given rise to a sense of obligation or loyalty to him. Salvatori appears to have been satisfied with the price he received for QuesTech, and he continues to feel that Tyrrell was an important factor in securing that price. In saying this, I do not find that Salvatori in fact does feel a sense of obligation to Tyrrell, but there is

---

[60]Vice Chancellor Strine has made an important holding about the bearing of familial relationships on the independence inquiry. In a pre-suit demand case, plaintiff sought to carry its burden by alleging that a particular director was not independent, and could not impartially consider a demand, because he was the brother-in-law of an interested director. The Vice Chancellor held that "familial relationships between directors can create a reasonable doubt as to impartiality. The plaintiff bears no burden to plead facts demonstrating that directors who are closely related have no history of discord or enmity that renders the natural inference of mutual loyalty and affection unreasonable." *Harbor Fin. Partners v. Huizenga*, 751 A.2d 879, 889 (Del. Ch. 1999) (internal citations omitted). Thus, in the pre-suit demand context, plaintiffs can often meet their burden of establishing a lack of independence with a simple allegation of a familial relationship. Surely then, in the *Zapata* context, it will be nigh unto impossible for a corporation bearing the burden of proof to demonstrate that an SLC member is independent in the face of plaintiffs' allegation that the SLC member and a director defendant have a family relationship.

[61]Salvatori Dep. 29:3-5, Oct. 6, 2009.

[62]*Oracle*, 824 A.2d at 938-39.

[63]*Id.*

certainly a strong possibility that he does, and that is enough under *Zapata* to preclude dismissal.

Before moving on I note a few pieces of evidence that buttress my conclusion that there is a material question of fact regarding the SLC's independence. First, the SLC members appear to have reviewed the merits of plaintiffs' claims before the SLC was ever formed. In September 2007, plaintiffs' counsel sent a letter to iGov outlining many of the allegations that ultimately appeared in plaintiffs' complaint and requesting a meeting to begin resolving the dispute. The McLean Valuations were attached to the letter. In response, iGov's counsel sent a letter explaining that iGov disagreed with plaintiffs' allegations and would not meet until defendants and "iGov's new board members, John Vinter and Vincent Salvatori, had time to review the McLean Valuations."[64] Vinter and Salvatori both testified that they could not remember reviewing the McLean Valuations, but it is clear that the iGov audit committee, on which both men sit, reviewed the McLean Valuations on October 29, 2007.[65] When SLC members are simply exposed to or become familiar with a derivative suit before the SLC is formed this may not be enough to create a material question of fact as to the SLC's independence. But if evidence suggests that the SLC members prejudged the merits of the suit based on that prior exposure or familiarity, and then conducted the investigation with the object of putting together a report that demonstrates the suit has no merit, this will create a material question of fact as to the SLC's independence. In this case, that is what has occurred.

Two similar pieces of evidence suggest that Vinter and Salvatori may not have conducted their investigation objectively after having considered plaintiffs' claims. First, Salvatori was asked in his deposition about the SLC's efforts to investigate the allegations in plaintiffs' complaint. Salvatori responded "I know we read it all over and I know we *attacked* it all."[66] Plaintiffs' counsel followed up with "[y]ou did what it all?" to which Salvatori answered "*[a]ttacked* it all."[67] Salvatori's counsel then repeated "*[a]ttacked* it all" after which Salvatori changed his answer to "[w]e considered it."[68] To my mind, the word "attack" in this context suggests something other than objectivity. But I readily admit that expressions can be misinterpreted and words can be inadvertently misused. In fact, if this were the only piece of evidence suggesting that the SLC might have engaged in a

---

[64]Pls.' Answer Ex. 40.
[65]Pls.' Answer Ex. 41 (audit committee minutes from October 29, 2007 meeting).
[66]Salvatori Dep. 248:8-9, Oct. 6, 2009.
[67]*Id.* at 248:10-11.
[68]*Id.* at 248:12-13.

combative assault rather than an investigation I would be inclined to consider Salvatori's use of the verb "attack" as ambiguous. But the second piece of evidence has Vinter using the same verb—"attack"—in relation to the McLean Valuations.

Vinter's notes from a June 26, 2009 meeting, at which SRR gave an update of its views of the $4.92 strike price, state as follows:

> McLean *attack*
> -forecast
> -low margin 1.3 → 1.5
> -marketability discount
> -fully diluted approach[69]

As one can see, this appears to be a bullet-point summary of what is purportedly wrong with the McLean Valuations. Some of these criticisms of the McLean Valuations ended up in the SLC Report. In his deposition, Vinter stated his belief that he thought the word "attack" in the notes really said "attach."[70] But "attach" does not make any sense in the context of the note.

Plaintiffs characterize Salvatori and Vinter's uses of the word "attack" as an indication that from the outset of the investigation the SLC was gathering information with the object of putting together a report that cast doubt on the merits of plaintiffs' claims, rather than objectively considering plaintiffs' claims. Given the SLC members' relationships to Tyrrell, their exposure to the merits of plaintiffs' suit well before the SLC was formed,[71] and the unsatisfactory scope of the investigation conducted (of which more will be said below), Salvatori and Vinter's use of the word "attack" does not help to fully convince me that the SLC was independent.

In sum, the independence inquiry under *Zapata* is critically important if the SLC process is to remain a legitimate mechanism in our corporate law.[72] SLC members should be selected with the utmost care to ensure that they can, in both fact and appearance, carry out the extraordinary responsibility placed on them to determine the merits of the suit and the best interests of the corporation, acting as proxy for a disabled board. In this case,

---

[69]Pls.' Answer Ex. 5 at 127.

[70]Vinter Dep. 217:6-17, Oct. 7, 2009.

[71]Salvatori and Vinter had more than an entire year to mull over the merits of plaintiffs' suit before the SLC was formed and they began their investigation.

[72]*In re Oracle Corp. Derivative Litig.*, 824 A.2d 917, 940 (Del. Ch. 2003).

I am not satisfied that the independence prong of the *Zapata* standard has been met.

B. Did the SLC Conduct an Investigation of Reasonable Scope in Good Faith and Did the SLC Have Reasonable Bases for its Conclusions?

Because the manner in which the SLC investigated plaintiffs' complaint bears directly on whether it had reasonable bases for its conclusions, I will address both of these aspects of the *Zapata* test together. I begin with an overview of the legal standards for these two components of the test.

To conduct a good faith investigation of reasonable scope, the SLC must investigate all theories of recovery asserted in the plaintiffs' complaint.[73] In doing this, the SLC should explore all relevant facts and sources of information that bear on the central allegations in the complaint.[74] If the SLC fails to investigate facts or sources of information that cut at the heart of plaintiffs' complaint this will usually give rise to a material question about the reasonableness and good faith of the SLC's investigation.[75] In addition, before an SLC decides not to explore specific acts of alleged misconduct because the costs of a full investigation outweigh any harm that may have been caused by those specific acts, the SLC should carefully analyze whether a summary investigation of those specific acts could shed light on the more serious allegations in the plaintiffs' complaint.[76] A total failure to explore the less serious allegations in plaintiffs' complaint may cast doubt on the reasonableness and good faith of an SLC's investigation when exploring those less serious allegations, at least in summary fashion, would have helped the SLC gain a full understanding of the more serious allegations in plaintiffs' complaint.[77] Finally, an SLC fails to conduct a

---

[73] *Lewis v. Fuqua*, 502 A.2d 962, 967 (Del. Ch. 1985) ("I find that the [SLC] addressed all the issues presented in the complaint and researched an additional issue of whether the Company's directors had a personal interest in the challenged transaction. The investigation spanned four and a half months and was thorough and exhaustive as to all possible claims for recovery. I therefore find that the investigation conducted by the [SLC] was reasonable.").

[74] *See Kaplan v. Wyatt*, 499 A.2d 1184, 1190-91 (Del. 1985).

[75] *Sutherland v. Sutherland*, 958 A.2d 235, 242 (holding that there was a material doubt as to the reasonableness and good faith of an SLC's investigation where the SLC's report did not include an analysis of two large payments the corporation had made on the defendants' behalf, even though the complaint alleged that defendants had used corporate funds for personal benefit).

[76] *Electra Inv. Trust PLC v. Crews*, 1999 WL 135239, at *4 (Del. Ch. Feb. 24, 1999).

[77] *Id.* (holding that an SLC's failure to explore a $2,600 secondary dispute on cost-benefit grounds cast doubt on the SLC's investigation because a minimal investigation might have provided the SLC with facts that would have helped it better evaluate the merits of the larger primary dispute).