Hunton & Williams
Mergers & Acquisitions Update
August 2010

DE Court Upholds Barnes & Noble's Poison Pill

On August 12, 2010, Vice Chancellor Leo E. Strine, Jr., issued a post-trial opinion in *Yucaipa American Alliance Fund II, L.P. v. Riggio* in which he upheld a rights plan adopted by Barnes & Noble's board of directors. The rights plan was implemented in response to a rapid accumulation of the company's shares by a well-known investor, Ronald Burkle. The court confirmed that rights plans are reviewable under the *Unocal* standard and concluded that the board's adoption of the plan was a reasonable response to the threat that Burkle, acting alone or with other stockholders, would acquire a large and influential bloc of the company's shares to the detriment of the company's other stockholders.

Background

In November 2008, investment funds affiliated with Ron Burkle (collectively, "Yucaipa") acquired an 8 percent stake in Barnes & Noble. Burkle thereafter met with Barnes & Noble's founder, chairman and largest stockholder, Leonard Riggio ("Riggio"), who together with family members controlled almost 29 percent of Barnes & Noble's stock. Riggio unsuccessfully tried to dissuade Burkle from his interest in Barnes & Noble, and Burkle continued to consider various strategies that Barnes & Noble might pursue.

In November 2009, Yucaipa increased its stake in Barnes & Noble to 17.8 percent. In its Schedule 13D, Yucaipa stated that it might influence or engage in an "extraordinary transaction" involving Barnes & Noble. As a result, Barnes & Noble's management retained outside legal counsel and financial advisors to consider the company's response, including adoption of a rights plan. At a special meeting to consider the issue, the company's board (including Riggio and his brother) approved a rights plan with a 20 percent trigger applicable to all shareholders except Riggio, who was "grandfathered" at his then-ownership level but prohibited from making additional share purchases.

Yucaipa sued Barnes & Noble in the Delaware Court of Chancery, arguing, among other things, that the rights plan was impermissibly vague and that Yucaipa did not present a threat that warranted the rights plan. Yucaipa argued generally that the rights plan was invalid because it prevented Yucaipa from waging a successful proxy contest for one-third of the available seats on Barnes & Noble's classified board at its next annual meeting of stockholders.

Court of Chancery's Opinion

The court first reaffirmed settled law that the use of a rights plan is judged under the standard set forth in the Delaware Supreme Court's 1985 decision in *Unocal*, which requires that (i) the board have "reasonable grounds for believing that a danger to corporate policy and effectiveness existed" and (ii) the board's response was "reasonable in relation to the threat posed" and neither "preclusive" nor "coercive." The court rejected Yucaipa's argument that the stringent "entire fairness" test applied, reasoning that the grandfathering of Riggio did not constitute a "self-dealing transaction," particularly where it was approved by an independent board majority.

The court also rejected Yucaipa's argument that the rights plan must be reviewed under the *Blasius* test, which requires that a board have a "compelling justification" whenever it acts for the sole or primary purpose of thwarting a stockholder vote. Among other things, the court found that, rather than seeking to interfere with a vote, "the board's motivation was to protect Barnes & Noble from the threat of being subject to inordinate influence or even control by a bloc that emerged without paying a fair price for that control." It also held that *Blasius* was not triggered simply because the rights plan prevented Yucaipa from forming "a coalition to jointly propose a sale and run a proxy contest." Nothing prevented a 20 percent holder such as Yucaipa from soliciting and receiving revocable proxies.

The court then turned to Yucaipa's argument that the rights plan was impermissibly vague such that it prevented Yucaipa from holding discussions about a proxy contest

with other stockholders, including Aletheia Research and Management, Inc. ("Aletheia"), which held 17.44 percent of Barnes & Noble's shares. The court ruled against Yucaipa, finding that the rights plan expressly excluded the receipt of a revocable proxy from its definition of "beneficial ownership." At the same time, the court upheld the provisions of the rights plan providing that any agreement between stockholders who collectively owned in excess of 20 percent of the company's shares to propose a joint slate of director-nominees or share proxy expenses would trigger the rights plan.

Next, the court upheld the Barnes & Noble board's actions under the two-pronged *Unocal* test. First, the court held that the board identified a valid threat — namely, that Yucaipa might obtain an "effective control bloc … in which it wielded great leverage to seek advantage for itself at the expense of other investors." Based on Yucaipa's stock ownership, public disclosures, and investment history at other companies, "the board had a reasonable basis to conclude that Burkle was potentially planning to acquire a controlling stake in Barnes & Noble, or form a governing bloc with another large stockholder like Aletheia, in order to put his own policies in place."

Finally, the court held that under *Unocal* the board's response was both reasonable and proportionate to the threat posed by Yucaipa. In support of its determination, the court explained that Yucaipa not only could wage a successful proxy contest despite the rights plan but that, with the support of proxy advisory firms, it was likely to win at Barnes & Noble's next annual meeting. The court also refused to accept that Barnes & Noble's classified board, which limited the number of available seats to one-third of the total board, rendered the rights plan preclusive.

Implications

Validation of Rights Plans and Threats. *Yucaipa* upheld an established purpose of rights plans — preventing a large stockholder or group of stockholders from accumulating a significant or control bloc of shares in order to influence the company's actions, possibly to the detriment of its other stockholders. Perhaps of greater importance, the court confirmed that a rights plan can prevent two large stockholders — in this case, Yucaipa with 17.8 percent and Aletheia with 17.4 percent — from banding together to wage a proxy contest or forming a control bloc without paying a control premium. In addition, the court recognized the threat posed by a dissident that proposes to run a short slate of directors while disclaiming any specific intent in acquiring the company itself.

Proxy Contests. Rights plans were first upheld in Delaware in the Delaware Supreme Court's 1985 decision in *Moran v. Household Int'l, Inc.* Since then, Delaware courts have made clear that rights plans cannot unduly impede proxy contests on the theory that the ballot box serves as a safety valve on the potential for board entrenchment. For that reason, rights plans exclude shares subject to revocable proxies from the definition of "beneficial ownership." Consistent with that approach, *Yucaipa* recognized that "pills … do not disenfranchise any stockholder in the sense of preventing them from freely voting." It also emphasized that the evidence showed that Barnes & Noble's board understood when it adopted the rights plan that it was not thwarting a proxy context. This was important since, according to Vice Chancellor Strine, the Delaware Supreme Court's "pill jurisprudence channels takeover battles into the electoral forum."

In a footnote, the court did question the proper standard for determining whether a defense measure is "preclusive." It suggested that a defensive measure such as a rights plan might be invalidated if it "does not leave a proxy insurgent with a *fair chance for victory*" or "both prevents a tender offer and *unfairly tilts the electoral playing field against an insurgent*" (emphasis added). This standard differs from the Court of Chancery's recent decision in *Selectica, Inc. v. Versata Enterprises, Inc.* (also discussed below), where it looked to whether there was a "mathematical or theoretical possibility of winning a proxy contest." In examining whether a rights plan is preclusive, future boards should examine the corporation's existing stockholder base. Where shares are widely held, a standard rights plan trigger of 15 percent or 20 percent would seem unlikely to pose any significant obstacle. Barnes & Noble was distinguishable because an insider (Riggio) already controlled almost 30 percent of the company's shares.

Board Process and Corporate Governance. The court was somewhat critical of the manner in which Barnes & Noble's board considered the rights plan and its relation to Riggio, who may have viewed Yucaipa as a personal threat to his influence at the company. Barnes & Noble's financial advisor and one of the two law firms involved in the board's decision making had done personal work for Riggio. Referencing the popular *Saturday Night Live* skit, Vice Chancellor Strine stated that "there appears to have been no Jack Handey deep thinking done as to whether the outside counsel and investment bank hired to advise the board should have been selected by

the independent directors themselves, in a process not involving Riggio."

The court also characterized as "weird" the board's discussion of what dangers and conflicts of interest were posed by Riggio while he was present in the boardroom. The court stated bluntly that this was "a less than adroit way to have an important discussion — a discussion that should have occurred in an executive session" of independent directors.

Finally, the court refused to give any additional deference to the board's decision making even though a majority of disinterested and independent directors adopted the rights plan. The court indicated that where a "bare" majority makes a decision, it is preferable that they also confer among themselves outside the presence of interested directors and advisors. Thus, rather than merely counting heads in determining how many independent directors voted, the court wanted to see actual deliberation. Ultimately, however, these perceived process flaws did not affect the court's decision, which is reminiscent of the *Disney* litigation where the Delaware courts found that director conduct fell short of best practices but did not constitute a breach of fiduciary duty.

Precatory Proposals on Rights Plan. In order to appease certain proxy advisory firms and corporate governance activists, some companies, including Barnes & Noble, have agreed to submit their rights plans to stockholder votes within a year of adoption. It is not clear whether this factor influenced the court's ruling, but Vice Chancellor Strine noted the practical difficulties that directors face if stockholders vote against the pill: "the incumbent board, while having the legal authority to adopt a new pill if the shareholders vote not to renew the Rights Plan, would by doing so be walking with open eyes right into a whirling helicopter blade."

NOL Rights Plans. The Court of Chancery's recent decision in *Selectica* upheld the use of so-called NOL rights plans that have low trigger levels (e.g., 4.9 percent) in order to safeguard a company's net operating losses. In *Yucaipa*, Vice Chancellor Strine expressed concern about these pills and suggested that they could be more narrowly tailored, for example, to prevent shareholders from owning 4.9 percent of a company's shares for purposes under the Internal Revenue Code but not from entering into voting agreements or other arrangements. The *Selectica* decision currently is on appeal, so this issue may be addressed by the Delaware Supreme Court in the near future.

If you have questions about this decision or other matters of corporate law, please consult your Hunton & Williams LLP contact or Gary Thompson at (804) 788-8787 or Steven Haas at (804) 788-7217.

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