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Corporate Governance Group

Client Alert

DELAWARE COURT OF CHANCERY UPHOLDS RIGHTS PLAN ADOPTED IN RESPONSE TO OPEN MARKET STOCK ACCUMULATION PROGRAM

In *Yucaipa American Alliance Fund II, L.P. v. Riggio,*[1] the Delaware Court of Chancery recently was asked to rule on a claimed breach of fiduciary duties by a board of directors that adopted a shareholder rights plan in response to a perceived takeover threat. Notably, this rights plan established a higher triggering threshold for the company's largest shareholder (who is also its founder and chairman of its board of directors) than it did for any other current or future investor. While Vice Chancellor Strine's 89-page opinion does not provide blanket approval of shareholder rights plans and appears to rely heavily on the specific (and detailed) facts of the case, the Vice Chancellor does make it clear that the existing standard of review applicable to the adoption and implementation of rights plans – the "*Unocal* standard" – remains the appropriate one, and that rights plans continue to be acceptable takeover defenses for Delaware corporations, at least under certain circumstances.[2]

Background

Leonard Riggio founded Barnes & Noble, Inc. in 1971. The company remained private until 1993, when its shares began trading on the New York Stock Exchange. Even after Barnes & Noble became public, Riggio retained a large stake in the company's stock. Riggio continues to serve as Chairman of the Board and, together with his brother (who served for many years as the company's chief executive officer and remains a director), holds approximately 29% of the outstanding stock.

In addition to Riggio's brother, "two other directors have close ties to Riggio" – Lawrence Zilavy serves as Riggio's personal financial advisor and Michael Del Giudice not only advises Riggio on political candidates to whose campaigns he should contribute,

[1] C.A. No. 5465-VCS (Del. Ch. Aug. 11, 2010).

[2] A notice of appeal of the Vice Chancellor's decision has been filed with the Delaware Supreme Court.

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but also co-manages a venture in which Riggio invested $4.8 million. Due to these ties, Vice Chancellor Strine determined that "the Barnes & Noble [nine-member] board is comprised of a bare majority of independent directors."

In November 2008, the well-known investor Ronald Burkle advised Riggio that his Yucaipa funds were going to take a stake in Barnes & Noble. Riggio and Burkle had crossed paths nearly ten years beforehand in a joint investment that "did not go well" by Riggio's account, due to what Riggio considered "Burkle's poor treatment of his other partners."

Following Yucaipa's acquisition of approximately an 8% stake in Barnes & Noble, Burkle contacted Riggio again to request a meeting to discuss Yucaipa's ideas for the company. Although, Riggio discouraged Burkle from making further investments, Burkle proposed several strategies for Barnes & Noble, including a purchase of Borders or a "Best of Borders" strategy to acquire only Borders' most valuable retail stores. Riggio dismissed the "Best of Borders" idea, "insisting that, due to the financial crisis and the bursting of the real estate bubble, he did not want the additional exposure that acquiring any of Borders' stores" would entail. Riggio also opined that "'merging with Borders would be a disaster' because of what he perceived to be a 'coming crisis in American retail.'"

Following this meeting, Yucaipa remained on the sidelines until August 2009, when Barnes & Noble announced its acquisition – *from Riggio and his wife* – of Barnes & Noble College Booksellers, an independent college bookstore company, for $596 million in cash. In response, Burkle wrote Riggio a "stinging" letter objecting that the deal "appeared to deepen Barnes & Noble's retail and real estate exposure just like a Borders deal would." The transaction ultimately closed at the end of September 2009, but remains in litigation regarding its fairness.

Shortly thereafter, Yucaipa "dramatically" increased its stake in Barnes & Noble – first to 16.8% and then 17.8% – and made a Schedule 13D filing that "criticized Barnes & Noble's management and corporate governance policies [and] reserved Yucaipa's right to pursue a wide range of options, [including] the right to pursue a variety of M&A transactions." Yucaipa also made two antitrust notifications disclosing the possibility of potential transactions which "would have given Yucaipa control over a majority of Barnes & Noble stock."

In light of Burkle's aggressive approach, Barnes & Noble sought the advice of outside legal counsel, which recommended implementation of a shareholder rights plan. The key provisions of the proposed rights plan included a 20% beneficial ownership trigger and a definition of beneficial ownership that included "not only the shares held by a stockholder but also the shares of any person with whom a stockholder has certain 'agreements, arrangements or understandings.'" Riggio's 30% stake would be grandfathered, but he would not be permitted to make additional purchases without triggering the rights plan.

Barnes & Noble's board of directors considered the rights plan at a meeting held on November 17, 2009. Present at the meeting were representatives of two law firms, one of which had advised Riggio personally on estate planning and other matters, and Morgan Stanley, which had previously advised Riggio personally as well as Barnes & Noble. Outside counsel noted that Burkle had a reputation of "get[ting] on a board through friendly means, and then . . . 'quietly influenc[ing] from the wings' once he was on." Morgan Stanley advised that the adoption of a rights plan "looked better in the 'public eye' than an 'arms race' of open market stock purchases between Riggio and Yucaipa." The directors were instructed, and understood, "that the board could not adopt a Rights Plan that would foreclose an effective proxy challenge from Yucaipa because to do so would be preclusive."

The board adopted the rights plan as discussed and issued a public announcement. In response, Burkle wrote Riggio a letter critical of the rights plan and Yucaipa increased its stake to 18.7%. At about the same time, Aletheia Research and Management, Inc., a California-based investment advisor that was previously a Schedule 13G "passive investor" in Barnes & Noble, increased its stake from 6.37% to 17.44% and filed a Schedule 13D reserving Aletheia's right to enter into "an 'extraordinary corporate transaction' involving Barnes & Noble." The Barnes & Noble board was advised by counsel that "Aletheia's founder had followed Burkle's lead in at least three other investments," giving the board what Vice Chancellor Strine found to be "good reason to be concerned that these two large investors were capable of and interested in cooperating in a joint effort to take effective voting control of the company."

Next, Burkle complained in a letter to the board dated January 26, 2010 that the rights plan, as drafted, made it "'mathematically impossible or realistically unattainable'" for him to win a proxy contest, and requested an exception to allow Yucaipa to buy up to a 37% stake (which was equal to the aggregate number of shares owned by the Riggios, the other directors and Barnes & Noble's employees). The board met to consider Burkle's letter. First, the board considered, and then dismissed, the potential threat posed by the large stake owned by Riggio himself. Outside counsel then advised the board that "Yucaipa and Aletheia posed a threat to the company, and that the 20% threshold was a reasonable, non-preclusive response to that threat." On this basis, the board rejected Burkle's request to raise the trigger to 37%.

Burkle filed suit in early May, alleging that the board breached its fiduciary duties by adopting the rights plan and not ceding to his request that the triggering threshold be raised to 37%. After this suit was filed, the board amended the rights plan to revise the definition of beneficial ownership to more closely conform to rights plans previously upheld by the Court of Chancery (but *not* to raise Yucaipa's threshold).[3]

The Court's Analysis

In addressing Yucaipa's lawsuit, Vice Chancellor Strine addressed the appropriate standard of review for Yucaipa's breach of fiduciary duty claims and make number of noteworthy observations that proponents of rights plans will need to be aware of and consider going forward:

- The standard of review developed in *Unocal Corporation v. Mesa Petroleum Company*[4] is the appropriate one for analyzing the propriety of a rights plan, rather than (as proposed by Yucaipa) an entire fairness review or the "compelling justification" standard of review articulated in *Blasius Industries, Inc. v. Atlas Corporation,*[5] either of which in Vice Chancellor Strine's eyes would have "reverse[d] decades of settled law."
    - Entire fairness review is inapplicable because adoption of the Barnes & Noble rights plan was "not the type of self-dealing transaction that invokes entire fairness." Not only did the grandfathering of Riggio's holdings under the rights plan "not confer any special benefit on Riggio, or allow Riggio to obtain a majority stake in Barnes & Noble," but it actually subjected Riggio to "a new limitation." Further, an "independent board majority" adopted the rights plan, "thus invoking the business judgment rule standard anyway."

[3] At the annual meeting to be held on September 28, Barnes & Noble shareholders will consider a slate of three nominees proposal by Yucaipa and a proposal to amend the rights plan.

[4] 493 A.2d 946 (Del. 1985).

[5] 564 A.2d 651 (Del. Ch. 1988).

- o Likewise, the *Blasius* "compelling justification" standard of review, which would require the Barnes & Noble board to "provide a 'compelling justification' for its actions where the board acted 'for the primary purpose of interfering with the effectiveness of a stockholder vote,'" does not apply to the implementation of a rights plan. Vice Chancellor Strine could "not conclude that the board acted with the primary purpose of disenfranchising Barnes & Noble's stockholders . . . . Rather, 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. The effect on electoral rights was an incident to that end."

- o Under the "familiar *Unocal* standard," "adoption of a defensive measure will be protected by the business judgment rule so long as: (1) the board that adopts the measure in question had 'reasonable grounds for believing that a danger to corporate policy and effectiveness existed'; and (2) the 'defensive response was reasonable to the threat posed.'" In relation to the actions of the Barnes & Noble board in implementing its rights plan in response to Yucaipa's actions, this translates into an obligation of the board to prove that "it, in good faith, reasonably determine[d] that Yucaipa posed a threat and adopted a pill that reasonably addresses that threat and that does not preclude Yucaipa from waging an effective proxy contest."

- o In a footnote, Vice Chancellor Strine urged that "*Unocal* review of the effect of a pill on election contests be robust," and observed that "if a defensive measure does not leave a proxy insurgent with a fair chance for victory, the mere fact that the insurgent might have some slight possibility of victory does not render the measure immune from judicial proscription as preclusive. . . . When a pill both prevents a tender offer and unfairly tilts the electoral playing field against an insurgent, this court . . . should not hesitate to enjoin its operation."

- Yucaipa's argument that the rights plan's definition of beneficial ownership is ambiguous, thereby rendering the rights plan "unreasonable," is "based on unrealistic and absurd premises." Rather, the definition "is based on a well-recognized standard, which sophisticated investors like Yucaipa must address as a regular course of doing business due to provisions like § 13(d) of the Securities Exchange Act of 1934 . . . and . . . has been the subject of many judicial rulings." One of the keys to this judgment appears to be that the rights plan's definition of beneficial ownership "expressly carves out seeking revocable proxies," thereby allowing Yucaipa (and others) to solicit proxies in support of its candidates.

- Even though the process of including the full board in deliberations – rather than excluding Riggio and those with ties to him "when Riggio's own motivations and interests were under consideration" – "was not ideal," the board "acted loyally, in the sense of trying to advance the best interests of the company and its public stockholders, and not those of Riggio." Moreover, the board "was also appropriately informed . . . [and] took action that constrained Riggio in an important way from addressing the threat of a proxy contest by making market purchases to secure voting control." As such, the Vice Chancellor was "convinced by the defendants of the good faith of the board majority."

- Barnes & Noble's board was justified in considering Yucaipa as a legitimate threat, despite "its portrayal of itself as an 'aw shucks, purely friendly' investor."
  - o The Vice Chancellor found this portrayal to be "at odds with its own behavior and public disclosures," giving the board "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

Altheia, in order to put its own policies in place." In fact, "Yucaipa's prior investing history is replete with the sorts of investments that often lead to transactions in which public stockholders are treated differently." On this basis, the Vice Chancellor concluded that "the board could reasonably assume that Yucaipa, like other profit-seeking investors, might pose a danger to other company investors if it, in concert with a party like Altheia, obtained strong unilateral control over a major portion of the company's voting securities."

  - The legitimacy of the threat posed by Yucaipa was not diminished by the fact that "all it seeks to do is to elect three directors this year, not a controlling slate." To the contrary, "the election of three directors to a classified board is not a trifling event, which gives the prevailing party no influence. . . . Once an insurgent has won one election, the incumbent board majority's ability to be intransigent in the face of stockholder sentiment is greatly limited."

- The "key issue" in determining whether adoption of the rights plan was proportional to the threat posed is whether the plan "unreasonably inhibits" the ability of Yucaipa to run an effective proxy contest. Vice Chancellor Strine observed that it was "obviously a lift . . . [b]ut not a herculean lift" for Yucaipa "to garner a strong super-majority of the remaining vote to get a majority" in light of the large bloc held by Riggio and the rest of the board. In fact, given the likelihood that the influential proxy advisory firm RiskMetrics would likely support an insurgent slate for less than a majority of the board (a "short slate"), the Vice Chancellor noted that "it is plain that Yucaipa can win and is indeed perhaps a favorite in a proxy fight for three members of Barnes & Noble's board."

  - In assessing whether Yucaipa would be foreclosed from running a successful proxy contest, in light of the Riggios' significant ownership stake, "it is critical that the board used a 20% trigger rather than a 15% cap." On the other hand, the 20% trigger "was reasonable because setting the threshold any higher would have only made Yucaipa's creeping acquisition of control more likely."

  - While it is not clear how significant a factor this was to the Vice Chancellor, he did make reference to the importance of the fact that "Yucaipa and other Barnes & Noble stockholders will also have a chance to vote on the Rights Plan before the end of the year, another feature that minimizes its preclusive effect."

Conclusion

Vice Chancellor Strine's opinion makes it clear that while Delaware courts remain willing to uphold the validity of a shareholder rights plan adopted by a board of directors in response to a threat to "corporate policy and effectiveness," the court will likely reach such a finding only after conducting a close parsing of the particular facts of the case. Moreover, it is important to note that the Vice Chancellor re-affirmed that *Unocal* is the applicable standard of review, rather than a more rigorous entire fairness or *Blasius* approach. It should also be noted, however, that Vice Chancellor Strine pointed to several factors mitigating the preclusiveness of the Barnes & Nobles rights plan – such as the 20% triggering threshold and the upcoming shareholder vote on the plan – which also might be viewed as limiting the effectiveness of a rights plan. Time will only tell whether these become necessary features of rights plans generally, or only when an influential corporate insider – such as Mr. Riggio – already holds a significant block of stock.

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