

August 24, 2010

Yucaipa American Alliance Fund II, L.P. v. Riggio et al.

Delaware Chancery Court Finds Barnes & Noble, Inc.'s Rights Plan Was a Good Faith, Reasonable Response to a Threat Posed to the Company and Its Stockholders

SUMMARY

In a decision issued on August 11, 2010, Vice Chancellor Strine, in *Yucaipa American Alliance Fund II, L.P. v. Riggio et al.*, confirmed the applicability of the *Unocal* standard to the Barnes & Noble Board of Directors' decision to adopt a stockholder rights plan following the rapid accumulation of shares by Yucaipa. The plan grandfathered the 30% position of the founding stockholder of Barnes & Noble but established a 20% threshold for all other acquirers. The Court also found that maintenance of the plan in the face of a pending proxy contest by Yucaipa, and the refusal to amend the plan to permit Yucaipa to acquire sufficient additional shares (including by acting in concert with other stockholders in running the proxy contest), to eliminate the founding shareholder's advantage in the contest, did not fundamentally restrict Yucaipa from winning a proxy contest and was thus a good faith, reasonable response to the threat posed to Barnes & Noble and its stockholders. *Yucaipa* provides significant guidance as to the use, and limitations, of a rights plan in connection with a proxy contest.

BACKGROUND

In November 2009, shortly after having privately expressed strong dissatisfaction with the acquisition by Barnes & Nobles, Inc. ("B&N") of a business from its founding stockholder, Leonard Riggio, Ronald Burkle's Yucaipa funds increased their 8% position in B&N to 17.8%, mostly over a four-day period. The Schedule 13D under the Securities Exchange Act of 1934 ("13D") filed by Yucaipa reflected a broad range of potential actions Yucaipa might pursue, including acquisition of B&N, and Yucaipa made a Hart-Scott-Rodino filing that would have permitted it to acquire up to a majority of B&N's stock. In response,

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following the advice of its outside counsel, the Board of Directors (the “Board”) adopted a stockholder rights plan (the “Rights Plan”). Counsel advised the Board about their fiduciary duties, focusing on the balance between protecting shareholders from a person acquiring control without paying a premium and their duty to adopt defensive measures that are reasonable in relation to the threat posed, and advised that the Rights Plan would not be preclusive of a proxy fight.¹

The Rights Plan’s key provisions were as follows:

- Dilution would occur to the acquiring person when such person acquired beneficial ownership of more than 20% of Barnes & Noble’s common stock;
- The definition of “beneficial ownership” includes 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,” including for the “purpose of acquiring, holding, voting . . . or disposing of any voting securities of the Company”; and
- B&N founder’s approximately 30% stake was grandfathered in under the Rights Plan, but he was precluded from purchasing additional shares subject to a few narrow exceptions.

In its discussion of the process by which the Rights Plan was considered and adopted, the Court expressed some concern that the independent directors never met separately, despite the presence of Riggio, his brother, his personal financial advisor and the chairman of a small investment fund in which Riggio had made sizable investments on the nine-person Board, and the fact that two of the three advisors had strong prior ties to Riggio.

Following adoption of the Rights Plan, Burkle criticized the adoption of the plan, and continued to buy shares. During this same time, Aletheia Research and Management, Inc. (“Aletheia”), a California-based investment advisor, with a history of following Yucaipa’s investments in at least three other instances and whose founder had discussed B&N with Burkle at two meetings, increased its stake in B&N from approximately 6.5% to 17.5%, reserving the right, at a later date, to effect one or more extraordinary corporate transactions in its 13D filing.²

Burkle then asked the Board to grant an exception to the Rights Plan to allow Yucaipa to acquire up to 37% of B&N outstanding stock. The Court was again critical of the Board process in resolving this request, describing a discussion of whether Riggio posed a threat to B&N while he was in the room as “weird.”³ The Court went on to explain that the Board “[i]nstead of holding an executive session of the independent directors to ponder these issues, the board instead discussed whether Leonard Riggio was a threat in his presence, eventually determining, no doubt to his great relief, that he was not.”⁴

¹ Notably, B&N waived attorney-client privilege to permit counsel to testify about its advice to the board.

² *Yucaipa American Alliance Fund II, L.P. v. Riggio*, C.A. No. 5465-VCS, slip op. at 23 (Del. Ch. Aug. 11, 2010).

³ *Id.* at 26.

⁴ *Id.* at 27.

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Nevertheless, the Board went on to thoroughly discuss the Yucaipa threat with counsel to the Board pointing out that because of the continued acquisition by Yucaipa of shares, the parallel acquisitions by Aletheia and the fact that Aletheia elsewhere followed Yucaipa's lead, Yucaipa and Aletheia posed a threat.⁵ The Board was further advised that the plan would not stop someone from successfully running a proxy contest. Based on this discussion, the Board unanimously voted to reject Yucaipa's request.

On May 5, 2010, Yucaipa filed a complaint in Delaware alleging that the Board breached its fiduciary duties by adopting the Rights Plan and declining to amend it to Yucaipa's satisfaction. After Yucaipa filed suit, the Board again amended the Rights Plan, deleting the language which previously attributed to a person beneficial ownership of stock held by any other party with which such person has "any agreement, arrangement or understanding, written or oral, to cooperate in obtaining, changing or influencing the control of the Company," thereby, as the Court noted, changing the definition of beneficial ownership to more strictly conform it to prior rights plans that have been upheld by Delaware Courts, and to Section 203 of the Delaware General Corporation Law.⁶

THE CHANCERY COURT DECISION

First, Yucaipa argued that the Board decision adopting the Rights Plan should be subject to an entire fairness review because B&N's largest stockholder and current chairman of the Board stood on both sides of the transaction.⁷ Second, Yucaipa argued that the Board was required to supply a "compelling justification" under the decision in *Blasius*⁸ for adopting the Rights Plan because it was adopted for the improper purpose of disenfranchising stockholders.⁹ Third, Yucaipa argued that the Board breached its fiduciary duty to B&N and its stockholders by adopting the Rights Plan because the Rights Plan is so ambiguous about the activities it proscribes that, for that reason alone, its maintenance must be deemed unreasonable, or it must be interpreted to allow groups owning in the aggregate over 20% of the shares to jointly run proxy contests without triggering the Rights Plan. Finally, Yucaipa argued that the Rights Plan was beyond the range of reasonable responses to any threat posed by Yucaipa as Yucaipa only wanted to elect one-third of the board, had not announced any acquisition proposal, and has never before made a hostile proposal.¹⁰

⁵ *Id.* at 28.

⁶ *Id.* at 31.

⁷ *Id.* at 33.

⁸ *Blasius Indus., Inc. v. Atlas Corp.*, 564 A.2d 651, 659 (Del. Ch. 1988).

⁹ *Id.* at 34.

¹⁰ *Id.* at 47.

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A. ENTIRE FAIRNESS REVIEW

Based on the fact that the Rights Plan did not grant any special benefits to the Riggio family and capped their stakes at the existing level, the Court determined that the decision of the Board to adopt a Rights Plan that restricts an existing holder to his current level of ownership and restricts others to a lower level is not the type of self-dealing transaction that invokes the entire fairness review.¹¹ The Court emphasized that mere “grandfathering” an existing holder, as opposed to acting to entrench the grandfathered holder, does not trigger the entire fairness standard.¹²

B. COMPELLING JUSTIFICATION

The Court also rejected the *Blasius* “compelling justification” standard of review of the Rights Plan. The Court stated that *Blasius* only applies when a board acts with the primary purpose of disenfranchising stockholders and held the Board was primarily motivated by a desire to protect B&N from the potential threat of being inordinately influenced or even controlled by a bloc that emerged without paying a fair price for that control, and any effect on electoral rights was incidental to that end.¹³ Yucaipa argued that the Rights Plan here was being employed for a novel purpose different from earlier contested rights plans—preventing a stockholder such as Yucaipa from forming a coalition to jointly propose a slate and run a proxy contest, while earlier plans, including *Moran*, simply prevented parties from acquiring additional shares to enhance their position in the contest. The Court stated that this argument was inaccurate because it ignores that the Supreme Court in *Moran* expressly stated that “Appellants contend that the ‘20% trigger . . . prevents stockholders from banding together into a group to solicit proxies if, collectively, they own 20% or more of the stock . . .,’” and found the effect on proxy contests to be minimal.¹⁴ Similarly, the Court noted that in the *Stahl* decision, Chancellor Allen, the author of *Blasius*, in considering a rights plan that attributed beneficial ownership among parties who formed a committee for the purpose of nominating or electing directors or who agreed to share expenses with respect to a proxy contest, expressly held that the question was subject to review under the *Unocal* standard, rather than the *Blasius* standard.¹⁵

C. BREACH OF FIDUCIARY DUTY

The Court then applied *Unocal* to the Rights Plan. *Unocal* requires boards to establish that, in adopting a defensive measure: (1) it had reasonable grounds to believe that a danger to corporate policy and

¹¹ *Id.* at 33.

¹² *Id.* at 34.

¹³ *Id.* at 35.

¹⁴ *Id.* at 39 (quoting *Moran v. Household Int’l Inc.*, 490 A.2d 1059, 1070 (Del. Ch. 1985)).

¹⁵ An interesting side issue discussed in *Yucaipa* was whether *Blasius* has in the 20 plus years since it was decided been instrumental as to *Unocal* or still exists as a separate standard of review.

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effectiveness existed, and (2) the response it took was reasonable in relation to the threat posed.¹⁶ The Court rejected Yucaipa's ambiguity argument—pointing out that the terms “agreement, arrangement or understanding” which Yucaipa argued were ambiguous are based on the well-recognized requirements of Rule 13(d) of the Securities Exchange Act of 1934.¹⁷ The Court further noted that, as amended, “the definition of beneficial ownership . . . is no different than the language that has been incorporated into countless rights plans since *Moran*.”¹⁸ The Court rejected a tortured argument by Yucaipa that it should be permitted to reach an agreement with Aletheia about all aspects of a proxy contest, including a slate and platform, as long as they reserved the right to vote against the slate, saying that nobody but the most gullible would believe such a right would ever be exercised.

The Court next addressed Yucaipa's contention that the Rights Plan was not a reasonable response to the Yucaipa threat. Yucaipa's argument essentially was that even if the 20% threshold was initially reasonable given the rapid accumulation of shares, once the threat “somehow receded or became clearer over time” because the danger of further purchases by Yucaipa was addressed, failing to amend the plan as requested was unreasonable.¹⁹

The Court first noted that, while the process was not ideal, the independent directors and the lead director acted in good faith and for reasons unrelated to the perpetuation of Riggio as the largest stockholder. The Court also stated that the Board was appropriately informed and outside legal advisors consistently kept the Board focused on their duty to avoid precluding an effective proxy contest. The Court then found that the Board had a legitimate concern that Yucaipa, along with Aletheia, could essentially form a control bloc without paying a control premium or Yucaipa could, under conditions in which it wielded great leverage, take actions in the future that treat it differently from the remaining shareholders, notwithstanding Yucaipa's words to the contrary. The Court also noted that it was critical that the board used a 20% trigger in this instance, rather than the usual 15%, and the plan was to be put to shareholder vote within a year. Although Yucaipa was denied the chance to form a bloc with Aletheia or through its own purchases to improve its chances to win the proxy contest, the Court noted that Yucaipa could still win the election by convincing other stockholders on the merits to vote for its slate. The Court finally found that the Rights Plan did not preclude Yucaipa from winning the contest and election of three directors to a classified board “is not a trifling event,” especially in 2010 when Riggio, Riggio's personal financial advisor and the board's lead director are the three directors up for election.²⁰

¹⁶ *Id.* at 45 (quoting *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 955 (Del. 1985)).

¹⁷ *Id.* at 48.

¹⁸ *Id.* at 52.

¹⁹ *Id.* at 60.

²⁰ *Id.* at 63.

COMMENT

This decision reflects a thoughtful re-affirmation by the Delaware Chancery Court, in an environment in which activist shareholders increasingly engage in proxy contests and collective action which skirts the definition of group, that rights plans can be an appropriate response to certain threatened proxy contests, that it is appropriate for rights plans to prohibit the formation of groups with respect to a proxy contest which hold shares in excess of the triggering threshold, and that Delaware courts will be appropriately skeptical of implausible arrangements intended to avoid the prohibition on group formation. At the same time, the decision reiterates the need to fully address all procedural issues, including, where appropriate, the need for independent board consideration, and highlights the advisability of staying within the wording that has long been included in rights plans and previously considered by Delaware courts.

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