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IN THE COURTS

Delaware Court of Chancery Issues Important Poison Pill Opinion

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On August 11, 2010, the Delaware Court of Chancery issued an important opinion in the area of stockholder rights plans, or poison pills. Vice Chancellor Leo E. Strine's opinion in *Yucaipa American Alliance Fund II, L.P. v. Riggio, et al.,*[1] reaffirms Delaware's traditional deference to a board's well-informed and well-reasoned implementation of antitakeover measures. It gives meaningful guidance to boards and their advisors in the implementation of poison pills and other defensive measures in the face of a potential unsolicited change in control situation.

Barnes & Noble's Rights Plan

The case arose out of Barnes & Noble's implementation of a poison pill as a response to the rapid stock accumulation on the part of funds associated with Ronald Burkle (Yucaipa), which had approximately doubled their stake in Barnes & Noble to nearly 18 percent over a four day period in November 2009. Barnes & Noble's pill would be triggered when a shareholder acquired over 20 percent of Barnes & Noble's outstanding stock. The pill also would be triggered when two or more stockholders, who combined own over 20 percent, enter into an "agreement, arrangement or understanding … for the purpose of acquiring, holding, voting … or disposing of any voting securities of the Company." The poison pill's 20 percent threshold did not apply to Barnes & Noble's chairman and founder Leonard Riggio, whose approximately 30 percent stake was grandfathered under the terms of the implemented pill. However, the pill did limit Riggio from further increasing his stake in the company. Yucaipa challenged the implementation of the poison pill by Barnes & Noble's board of directors, claiming that such action, and the board's subsequent refusal to amend the pill, was a breach of the board's fiduciary duties.

The Chancery Court's Opinion

In rejecting Yucaipa's arguments, the Court first concluded that, consistent with long-standing precedent, the adoption of the poison pill in connection with the facts of this case would be reviewed under the *Unocal* standard of review. The Court expressly rejected application of the more stringent entire fairness review, which generally applies to the review of transactions between a corporation and its controlling stockholder, or the "compelling justification" standard articulated in the 1988 Chancery Court decision in *Blasius Indust., Inc. v. Atlas Corp.*,[2] which generally

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applies where a board is found to have acted "for the primary purpose of interfering with the effectiveness of a stockholder vote."

Under the well-recognized *Unocal* standard applied by the Court, adoption of a defensive measure such as a poison pill will be protected by the deferential business judgment rule as long as: (1) the board that adopts the measure at issue had "reasonable grounds for believing that a danger to corporate policy and effectiveness existed;" and (2) the "defensive response was reasonable in relation to the threat posed."[3] The Court noted that the Delaware Supreme Court's *Unitrin* decision helpfully highlighted the utility of the concepts of preclusion and coercion in addressing the question of whether a pill was an unreasonable response.

In reaching the conclusion that Barnes & Noble's implementation of a poison pill passed the *Unocal* standard of review, the Court made several important points:

Customary Pill "Group" Language Not Ambiguous

The Court rejected Yucaipa's argument that the poison pill was ambiguous with respect to the provision that would trigger the pill when two or more stockholders, who combined own over 20 percent, enter into an "agreement, arrangement or understanding … for the purpose of acquiring, holding, voting … or disposing of any voting securities of the Company." Yucaipa argued that such language was ambiguous and would leave Yucaipa and other stockholders without guidance as to what activities could trigger the pill. However, as noted by the Court, such language is not only customary for rights plans, but is based on a known standard which sophisticated investors must navigate as a regular course of doing business due to provisions like Section 13(d) of the Securities Exchange Act of 1934, and the rules thereunder, which contain similar language. The Court also emphasized the fact that the Barnes & Noble poison pill, as customary in other rights plans, had a carve out for the solicitation of revocable proxies, even though it otherwise circumscribed the stockholders' ability to reach agreement regarding the joint conduct of a proxy contest.

Reasonable Determination of a Threat

The Court found that the Barnes & Noble board made a reasonable determination that Yucaipa posed a threat. Among other things, the Court noted that Yucaipa was in contact with, and operating within a network of, other large investor activists. The Court also considered Yucaipa's rapid stock accumulation, the broad reservation of rights it had included in its Schedule 13D, the fact that its HSR filing indicated that Yucaipa might buy up to 50 percent of Barnes & Noble shares, and that Yucaipa's leader had contemplated various fundamental strategy changes for Barnes & Noble, including a going private transaction. According to the Court, this gave the board reasonable basis to conclude that Yucaipa was potentially planning to acquire a controlling interest in Barnes & Noble, or to form a governing bloc with another stockholder in order to put its own policies in place.

Dissident Could Run Successful Proxy Fight

Finally, the Court found that the poison pill was a proportionate response to the ongoing threat the company faced, thereby satisfying the second prong of *Unocal*. In that regard, the key issue explored by the Court was whether the poison pill unreasonably inhibited the ability of Yucaipa to run an effective proxy contest. It is noteworthy that V.C. Strine did not adopt the view that a rights plan or other defensive measure is not preclusive if it merely leaves open a mathematical or theoretical possibility of winning a proxy contest. In V.C. Strine's view, "[w]hen 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." However, applying the facts of the case, the Court ultimately concluded that the Barnes & Noble rights plan did not unreasonably restrict Yucaipa's ability to run a proxy contest. The Court reached this conclusion on the basis that with the rights plan in place, Yucaipa still had a fair chance to prevail, and would be the likely favorite in a proxy contest in light of the substantial stake owned by Barnes & Noble's second largest institutional holder, as well as the power of proxy advisory firm ISS—with whom Yucaipa was free to communicate—to sway the vote of other institutional holders.

Implications

Vice Chancellor Strine's decision reaffirms the traditional deference extended by Delaware courts to a board's well-informed and well-reasoned implementation of antitakeover measures. Also noteworthy is the fact that the Court found the Barnes & Noble board to have made a reasonable determination that Yucaipa posed a threat in light of the facts and circumstances surrounding Yucaipa's rapid stock accumulation. This is of consequence at a time when boards face mounting pressure from various forms of stockholder activists, some of whom may be inclined to accumulate a substantial stake in a company and form governing blocs with other stockholders. The Court validates a board's well-informed decision that such actions may pose a threat, thereby justifying implementation of a poison pill. In implementing a poison pill, however, a board must be mindful of the pill's effect on the ability of stockholders to run a successful proxy contest.

NOTES

1. 2010 WL 3170806 (Del. Ch. Aug. 11, 2010).
2. 564 A.2d 651 (Del. Ch. 1988).
3. *Unitrin, Inc. v. Am. Gen. Corp.*, 651 A.2d 1361 (Del. 1995).