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Delaware Court of Chancery Affirms Use of Stockholder Rights Plan

In *Yucaipa American Alliance Fund II, L.P. v. Riggio*, the Delaware Court of Chancery upheld the implementation of a stockholder rights plan by the board of directors of Barnes & Noble, Inc. The court specifically approved the plan's grandfather provision which allowed Barnes & Noble's largest stockholder to maintain its ownership level above the level that would otherwise trigger the rights plan.

This dispute began when the Yucaipa investment vehicles controlled by investor Ronald Burkle accumulated a substantial interest in Barnes & Noble, first buying approximately nine percent and then, over just four days, increasing to approximately eighteen percent.[1] In response, the Barnes & Noble board adopted a stockholder rights plan with a twenty percent trigger. The twenty percent trigger did not apply to the holdings of the founding Riggio family, which held approximately thirty percent. Instead, the Riggio family holdings were capped at their current levels. The Yucaipa funds filed suit claiming that the board of directors of Barnes & Noble breached its fiduciary duties by adopting the rights plan which Yucaipa claimed was "a disproportionate response to an illusory threat."

The court began by rejecting Yucaipa's argument that the appropriate standard of review was either entire fairness or the compelling justification standard of *Blasius*. Entire fairness did not apply because the court found that there was no party standing on both sides of the transaction. The Riggio holders were not treated exactly the same as other holders, but the court held that "the mere decision to grandfather an existing holder does not invoke the entire fairness standard." *Blasius* was also inapplicable because the court found that the primary purpose of implementing the stockholder rights plan was to protect the corporation from the threat posed by Yucaipa and not, as required to trigger *Blasius* review, for the "primary purpose of thwarting the exercise of a shareholder vote." Instead, the court held that the appropriate standard of review was the one articulated in *Unocal*.

In its application of *Unocal*, the court held that there was a threat that without action by the board of directors, "the corporation's stockholders would relinquish control through a creeping acquisition without the benefit of receiving a control premium." Mr. Burkle had, for example, in his Hart-Scott Rodino filings, publicly disclosed the possibility of acquiring a majority of Barnes & Noble stock. And, as the court observed, Yucaipa was working at least in parallel, if not in concert, with another fund that also purchased approximately eighteen percent of Barnes & Noble stock. Together, these funds could form a controlling block even if their individual holdings were less than the Riggios' holdings. Thus, the court found that a legitimate threat to the corporation existed, a finding that Yucaipa had not contested in post-trial argument.

[1] Barnes & Noble had opted out of the application of Section 203 of the DGCL (the Delaware Takeover Statute), which otherwise would have limited Yucaipa's ability to consummate a full takeover of Barnes & Noble.

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Yucaipa had also acknowledged that the rights plan was not preclusive. Yucaipa was, in fact, more likely than not to win the upcoming proxy fight and thus, the rights plan had clearly not precluded such a possibility. Having acknowledged these legal conclusions, Yucaipa argued that the maintenance of the rights plan was nevertheless beyond a range of reason. But while the board process was not ideal (the Riggios and a close ally participated in all discussions of the rights plan and the advisors had pre-existing relationships with the Riggios) the court found that the board had acted on an informed basis, in good faith and within a range of reasonableness.

The court relied heavily on the application of *Unocal* in *Moran v. Household International, Inc.* For example, the court examined the impact of the stockholder rights plan on Yucaipa's prospects for having a reasonable chance of success in a proxy fight. The court in *Moran* held that stockholder rights plans "do not disenfranchise any stockholder in the sense of preventing them from freely voting and do not prevent a stockholder from soliciting revocable proxies." The reiteration of this holding from *Moran* dispatched Yucaipa's argument that the rights plan had improperly inhibited Yucaipa from even presenting a slate of directors for which stockholders could grant revocable proxies.

The court, in *dicta*, also discussed its views as to the potential preclusiveness of stockholder rights plans with low thresholds, such as those with five percent triggers intended to protect net operating loss carryovers. The court indicated that it would take a more skeptical view of such rights plans. In the court's view, rights plans can be preclusive even if they are not so draconian as to make winning a proxy contest mathematically or theoretically impossible. As the court stated, "[i]f 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." The court also discussed how this approach relates to rights plans with low threshold triggers that are intended to protect a corporation's net operating losses. The court stated that "[i]n unique situations where a company faces some other threat from ownership purchases (e.g., the loss of tax benefits), it may well be required that a more nuanced version of a pill be adopted that distinguishes more finely between shares that are owned in the more common sense by a stockholder, and those 'beneficially owned' in the broader sense of being subject to 'agreements, arrangements or understandings … for the purpose of … voting." The court suggested that, in order to prevent low threshold rights plans from unduly inhibiting proxy contests, it may be necessary to have a double trigger. The first trigger would be at the low threshold and addressed to ownership. The second trigger would be at a more customary level of fifteen to twenty percent and would allow stockholders to form a group consisting of such a block for the limited purpose of organizing a proxy fight.

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