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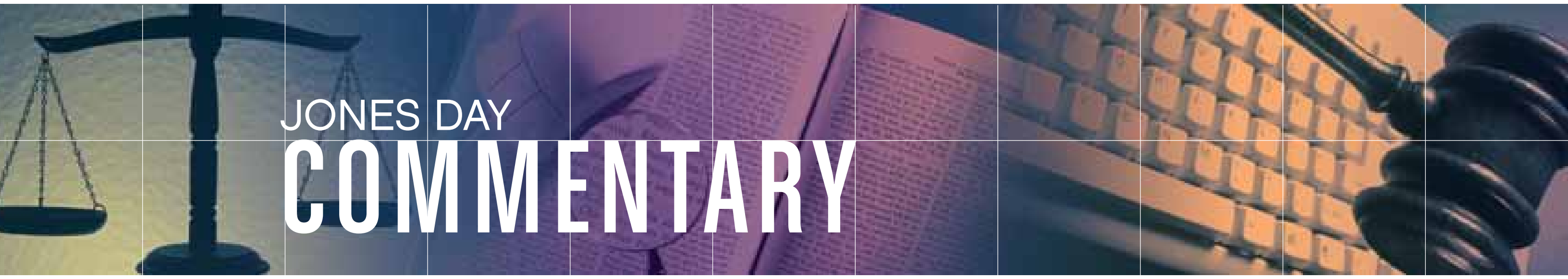

BARNES & NOBLE DEFENDS POISON PILL ADOPTED IN CONTEXT OF PROXY CONTEST IN *YUCAIPA*

The Delaware Chancery Court decision:

- validates the use of a rights plan in the context of a potential proxy contest;
- highlights the influence of ISS and other proxy advisors in proxy contests; and
- reaffirms importance of appropriate processes regarding interested directors.

On August 11, 2010, the Delaware Chancery Court upheld the adoption of a rights plan in the context of a potential proxy contest by a large and disgruntled shareholder. The decision, *Yucaipa American Alliance Fund II v. Riggio*, C.A. No. 5465-VCS (Del. Ch. Aug. 11, 2010), arose out of a struggle for control of Barnes & Noble that began in 2009.

Leonard Riggio, the founder and chairman of Barnes & Noble, remains its largest shareholder, holding approximately 29 percent of the outstanding shares (37 percent when taken together with other insiders). In 2009, Ronald Burkle's Yucaipa funds acquired approximately 8 percent of Barnes & Noble's shares over Riggio's objection. Riggio did not welcome Burkle's investment due to past dealings between the two; Riggio had participated in a joint investment led by Burkle, and Riggio felt that Burkle had mistreated the other partners in the enterprise. After Yucaipa became a Barnes & Noble shareholder, Burkle lobbied unsuccessfully for changes to Barnes & Noble's strategic plans—changes that Riggio refused to adopt.

In August 2009, Barnes & Noble announced its plans to acquire Barnes & Noble College Booksellers, a then-independent college bookstore company owned by Riggio and his wife. Burkle objected strongly to that related-party transaction and rapidly accumulated additional Barnes & Noble shares, doubling Yucaipa's stake within a matter of days. Yucaipa also filed a Schedule 13D that criticized Barnes & Noble's management and the adequacy and enforcement of its governance policies, and reserved Yucaipa's right to pursue a variety of M&A transactions relating to the company. Further, Yucaipa filed

Hart-Scott-Rodino Act notifications indicating its intention to acquire additional Barnes & Noble shares—possibly up to a majority of the outstanding shares. Yucaipa also met with two investment banks regarding a possible leveraged buyout of the company.

In response, the Barnes & Noble board convened a meeting with its advisors, many of whom had past ties to Riggio, to consider the adoption of a rights plan. The board included Riggio in all of its discussions and deliberations, notwithstanding his unique position as the company's largest shareholder and the chairman of its board. At that meeting, Riggio indicated that he believed that if left unchecked, Yucaipa would increase its holding to more than 20 percent and launch a proxy contest for board seats at the next election of Barnes & Noble's directors, either by itself or with others. The board ultimately decided to adopt a rights plan with a 20 percent triggering threshold. Riggio's holdings were grandfathered from the operation of the plan, but the plan prohibited him from further increasing his stake.

Yucaipa sharply criticized the board's adoption of the rights plan, increased its total ownership to more than 18 percent of the outstanding shares, and asked the Barnes & Noble board to amend the rights plan to permit Yucaipa to buy up to a 37 percent stake in Barnes & Noble to enable it to match the stake held by Barnes & Noble insiders. The full board—including Riggio—considered the request and refused it. (Notably, around the same time, Aletheia, another fund that was known to follow Burkle's lead in other investments, had increased its stake in Barnes & Noble shares from 6 percent to 17 percent.)

Thereafter, Yucaipa sued, claiming that the board's adoption of the rights plan, and its failure to amend it per Yucaipa's request, breached the directors' fiduciary duties. The Delaware Chancery Court, applying the *Unocal* standard, disagreed and dismissed the lawsuit, noting that the rights plan also constrained Riggio by precluding him from defending against the threat posed by Yucaipa by acquiring more shares to secure voting control. This is an interesting take, as the rights plan clearly helped Barnes & Noble successfully defend against Yucaipa's proxy contest—it prevented Yucaipa from increasing its ownership and prohibited Yucaipa from launching a joint proxy contest with other holders, but it did not limit in any way Riggio's ability to vote his significant stake for the board's nominees. The case is now on appeal.

While *Yucaipa* can be seen as yet another installment of Delaware case law permitting rights plans, the court's decision, authored by Vice Chancellor Strine, raises several interesting points about the use of poison pills to block a proxy contest, the influence of ISS and other proxy advisory firms, and the need for a deliberate and thoughtful board process when dealing with interested directors.

USE OF A RIGHTS PLAN IN THE CONTEXT OF A PROXY CONTEST

Yucaipa is not the first time that the Delaware courts have examined the impact of rights plans on proxy contest activity; that issue was central to the court's 1985 decision *Moran v. Household Int'l Inc*. In *Moran,* the court acknowledged that Household's rights plan would be triggered if a group that owned 20 percent or more of its stock was formed for the purpose of conducting a proxy contest. In validating the Household plan, the court found that a holder of less than 20 percent of the outstanding shares could solicit and receive revocable proxies without triggering the plan, and that the evidence indicated that a single holder or group of holders with less than the 20 percent limit could wage a winnable proxy contest.

The *Yucaipa* court similarly noted that in the context of a proxy contest, the rights plan did prevent Yucaipa from pursuing what may have been a preferable strategy—*i.e.,* teaming up with Aletheia or other like-minded investors to conduct a joint proxy contest. The record indicated, however, that "even with the pill in place, Yucaipa not only has a reasonable chance to, but is in fact likely to, prevail in a proxy contest if it runs a credible slate of candidates and articulates a sound business platform justifying the slate's election," particularly if the platform and candidates were attractive to Aletheia and ISS, the leading proxy advisory firm. Accordingly, the court decided that the adoption of the rights plan was not unreasonable. Interestingly, the court seems to make much of the fact that an insurgent owning less than 20 percent of a company's shares can win a proxy contest by convincing other shareholders to support its slate but seems to discount the fact that, in the case of Barnes & Noble, Yucaipa confronted the task of gaining the support of almost all of the outstanding shares not held by Riggio and other board members. Burkle ultimately failed to convince his fellow holders to support his slate, as the Barnes & Noble board's nominees were elected by a modest margin. In any event, the court's affirmation of the use of a rights plan in the context of a threatened proxy contest is timely, as many more companies may be facing contested director elections, assuming that the federal proxy access rules will be put into effect.

INFLUENCE OF PROXY ADVISORY FIRMS

Yucaipa also includes colorful commentary about the influence of ISS and other proxy advisory firms. Each of the experts in the case testified that one of the key factors affecting a proxy contest's outcome is the recommendation of ISS and other proxy advisory firms. The proxy solicitors who testified for each side agreed that ISS exercised "a great deal of influence over the vote of many of its clients" and that those clients are often an integral segment of the vote. Further, the experts agreed that based on the facts, ISS was likely to support Yucaipa's slate over management's, and that the two most important factors affecting the outcome of a proxy contest would be the vote of Aletheia and the recommendation of ISS. (ISS did in fact support Yucaipa's slate, but ISS's support was not enough to outweigh the power of Riggio's stake.)

In an interesting aside, the court noted that the rights plan posed no barrier to Yucaipa talking to these "potent players" during its proxy contest, and noted that Burkle had already met with ISS to discuss Barnes & Noble. The discussion thus recognized that Yucaipa could use its ability to lobby ISS and other proxy advisory firms as a way to overcome the limitation on its ability to act as a group with other shareholders.

IMPORTANCE OF PROCESS

Yucaipa also provides a lesson in appropriate board process for matters in which directors may have interests divergent from or in addition to those held as a board member. In the opinion, the court seemed somewhat perplexed by what it termed the "less than fully adroit process" employed by the Barnes & Noble board. The court noted that Riggio, as Barnes & Noble's founder and largest shareholder, "may have unique reasons to find the emergence of other large blocholders as a threat" to him personally, separate from the threat posed to Barnes & Noble. Further, the opinion that states there was no doubt that "the board, and its advisors, could have done a better job in excluding Riggio" and related individuals "at key points when Riggio's own motivations and interests were under consideration. The process was not ideal." The opinion suggests that the board and its advisors should consider whether the process should be driven primarily, if not exclusively, by the independent directors, in a process that excluded Riggio, or at the least included a role for separate deliberations by the independent directors.

Despite its somewhat chiding tone, the court ultimately concluded that the Barnes & Noble board acted loyally. That said, the *Yucaipa* case should encourage boards with interested directors—in the rights plan context and otherwise—to develop a thoughtful and deliberative board process, and to consider carefully which decisions should be considered and made solely by disinterested directors.

Yucaipa is not the first important rights plan case decided by the Delaware Chancery Court this year. Last February, the court upheld the adoption and use of a so-called "NOL rights plan," which is a shareholder rights plan designed to protect against the loss of certain tax assets. As discussed in a prior *Jones Day Commentary*, the decision, *Selectica, Inc. v. Versata Enters., Inc.*, arose out of the intentional triggering of Selectica's rights plan by a shareholder with which Selectica had a business dispute. That case was affirmed by the Delaware Supreme Court in October 2010.

Yucaipa and *Selectica* not only illustrate the Delaware courts' willingness to expand and modernize Delaware case law to address modern and novel uses of rights plans, but also demonstrate the continued strength and efficacy of the poison pill defense, particularly in cases where the plan is adopted by a thoughtful and deliberative board process and evidenced by a proper record.

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