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Delaware Court of Chancery Reaffirms Validity of Shareholder Rights Plans

Citing “decades of settled law,” the Delaware Court of Chancery this week upheld the validity of a standard shareholder rights plan and affirmed the continuing relevance of rights plans to address not only threatened takeovers but also acquisitions of substantial, but not controlling, positions. [*Yucaipa Am. Alliance Fund II, L.P. v. Riggio, C.A. No. 5465-VCS \(Del. Ch. Aug. 11, 2010\)*](#).

The case involved a dispute between funds controlled by activist investor Ronald Burkle and the bookseller Barnes & Noble, Inc. In late 2008, Burkle acquired an 8% stake in Barnes & Noble and met with its founder and largest shareholder in March 2009 to promote his ideas for strategic changes in the company’s policies. When Barnes & Noble declined to accept the suggestions and later completed an acquisition over Burkle’s objections, Burkle dramatically increased his stake in the company, amassing a 17% position in a matter of days in November 2009 and noting in the corresponding 13D filing the possibility of acquiring more shares or even effecting a change of control.

In response, Barnes & Noble adopted a rights plan that triggered when any stockholder acquired beneficial ownership of more than 20% of the company’s shares. As is customary, a stockholder’s beneficial ownership was defined to include the shares of any person with whom the stockholder had agreements or understandings respecting acquiring, holding, voting, or disposing of Barnes & Noble shares. The plan grandfathered the company’s founder, who held a 29% stake, but would trigger if he acquired additional shares. Barnes & Noble stated that it intended to submit the rights plan for shareholder ratification within 12 months of adoption. The board later rejected Burkle’s request to increase the trigger threshold to 37% to equal the aggregate ownership of Barnes & Noble’s founder, management, and employees.

Vice Chancellor Strine rejected Burkle’s challenge to the board’s adoption of the rights plan, including the 20% triggering threshold, holding that the defensive action was a reasonable and proportionate response to the threat Burkle posed. Finding that “the board had 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,” the Court held that “the board could reasonably conclude that [Burkle] should deal with the board in the first instance” to protect the interests of the company’s public shareholders. The Court further held that the rights plan did not “unreasonably inhibit[] the ability of [Burkle] to run an effective proxy contest.” To the contrary, given the “influence over the vote” of proxy advisory firms such as RiskMetrics, the Court found that the plan left Burkle a realistic opportunity to wage a successful proxy contest by nominating a qualified slate and articulating the reasons why his vision for the company is meritorious. Vice Chancellor Strine rejected Burkle’s argument that a traditional rights plan was an unreasonable response in view of the protections already provided by Barnes & Noble’s classified board, given the influence that electing even one-third of the board would provide to the activist shareholder, as well as “the reality . . . that even the combination of a classified board and a rights plan are hardly show-stoppers in a vibrant American M&A market.” Nor, the Court held, could the plan be attacked for improperly interfering with corporate voting rights, as it neither “disenfranchise[d] any stockholder in the sense of

preventing them from freely voting [nor] prevent[ed] a stockholder from soliciting revocable proxies.”

The Court also rejected Burkle’s argument that the plan’s definition of “beneficial ownership” was unworkably ambiguous because it might hypothetically be triggered by discussions among large investors. Ruling that “[a] corporate board is not required to conjure up every hypothetical situation imaginable and reduce it to writing in order to create a plainly drafted rights plan,” Vice Chancellor Strine reaffirmed that a rights plan could properly prevent dissident shareholders, who collectively own shares in excess of the triggering threshold, from working together to run a proxy contest. Another large investment firm, which the Court said frequently followed Burkle in his investments, had contemporaneously acquired a 17% stake in Barnes & Noble. In light of this, the Court concluded that the Barnes & Noble board was entitled to take:

reasonable, non-preclusive action to ensure that an activist investor like [Burkle] did not amass, either singularly or in concert with another large stockholder, an effective control bloc that would allow it to make proposals under conditions in which it wielded great leverage to seek advantage for itself at the expense of other investors. Precisely by cabining [Burkle] at a substantial, but not overwhelming, level of voting influence, the board preserved for itself greater authority to protect the company’s public stockholders.

Like the Court of Chancery’s recent decision in *Selectica* (which is now pending before the Delaware Supreme Court on appeal), the *Yucaipa* decision demonstrates once again that the Delaware courts are willing to uphold the use of a rights plan to deter open market accumulations of stock above the threshold set by the plan. While it is too early to know whether the *Yucaipa* decision will also be appealed to the Delaware Supreme Court, the press release that Burkle issued following the decision indicates that, at least for now, Burkle plans to focus on his proxy contest to replace the three Barnes & Noble directors up for election at this year’s annual meeting and to approve a shareholder proposal asking the board to increase the rights plan threshold from 20% to 30%.

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