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Poison Pills—How Effective Is Too Effective?

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Although its prevalence has been in decline in recent years,[1] the traditional stockholder rights plan (the so-called "poison pill") remains one of the most effective anti-takeover devices in a board of directors' arsenal. The pill's validity has long been established in Delaware.[2] Recent opinions have even suggested affirmatively that, in certain circumstances, a board of directors should adopt a pill,[3] underscoring the effectiveness of these devices. But the pill's best quality is also its greatest flaw—that is, the more effectively that a particular pill operates to deter acquisitions and other concerted stockholder action, the less likely it is to survive a court's scrutiny. In the years following the Delaware Supreme Court's landmark *Moran* decision, the Delaware courts cut back on certain features that took the basic structure too far.[4]

Because the pill is such a potent defense, and because pill challenges invariably implicate fundamental issues of corporate governance and control, cases addressing a pill's validity have historically had an outsized influence in corporate law. The most recent addition to Delaware's line of pill cases, *Yucaipa American Alliance Fund II, L.P. v. Riggio*,[5] is no exception. *Yucaipa* involved a challenge to a poison pill that grandfathered an existing 30% insider stockholder and capped all other stockholders at 20%. While this fact pattern is not applicable to most companies facing a hostile takeover threat—the presence of a significant stockholder itself would generally be expected to dissuade acquirers—the Chancery Court's decision to uphold the pill, and its observations regarding the adoption process, may still provide helpful guidance to boards considering a pill.

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Background

In four days in November 2009, two of Ron Burkle's Yucaipa funds (together, "Yucaipa") doubled their stake in Barnes & Noble, Inc. to nearly 18% through open-market purchases. In announcing these acquisitions on a Schedule 13D filed with the SEC, Yucaipa criticized Barnes & Noble's management and indicated that it might pursue various M&A transactions.[6] Shortly thereafter, Barnes & Noble's board adopted a poison pill with a 20% triggering threshold. The pill included a "grandfather" clause for Leonard Riggio—the company's founder and chairman, and the holder of approximately 30% of its stock—but limited his further stock acquisitions. Following the adoption of the rights plan, Yucaipa wrote a letter to the board criticizing the decision and signaling that it was likely to commence a proxy contest.[7]

After the pill's adoption, another major Barnes & Noble stockholder, Aletheia Research and Management, Inc., increased its stake from approximately 6.5% to 17.5%. Although it had previously reported its Barnes & Noble holdings on Schedule 13G as a "passive investor," Aletheia reported its new purchases on Schedule 13D. Unlike Yucaipa, Aletheia reported that it had no current plans or proposals regarding M&A transactions, but it "'reserve[d] the right, at a later date, to effect one or more of such changes or transactions.'"[8] This increase was of particular concern to Barnes & Noble's directors, who had been advised that Aletheia tended to follow Yucaipa in investments. After Aletheia's acquisition had been announced, Yucaipa sent a second letter to Barnes & Noble's board, requesting that the board consider increasing the pill threshold to 37%. The full board—including Mr. Riggio and the directors affiliated with him—met to consider this request, which they ultimately rejected.[9] Yucaipa then brought suit, alleging, among other claims, that the board breached its fiduciary duties by adopting the pill with a 20% trigger and by failing to increase the pill's triggering threshold per Yucaipa's requests.

Standard of Review: *Unocal*, *Blasius*, or Entire Fairness

The first stage of arguments that the Court addressed involved the proper standard of review. Yucaipa argued that the board's decision to adopt the rights plan was subject to entire fairness review since Mr. Riggio, as the largest stockholder and as a beneficiary of the "grandfather" provision, stood on both sides of the transaction.[10] The Court rejected this argument, noting that the rights plan neither conferred a special benefit on Mr. Riggio nor permitted him to obtain a majority stake in Barnes & Noble.[11] The Court also held that the pill's adoption was not subject to entire fairness since it had been approved by an independent board majority.[12]

Yucaipa's second line of attack was that the board had failed to demonstrate a "compelling justification" under *Blasius* for adopting the rights plan. The *Blasius* standard applies where the board acts for the primary purpose of impeding a stockholder vote.[13] Noting that the "trigger under *Blasius* is as extreme as the standard it invokes," the Court rejected Yucaipa's argument.[14] The Court found that the board's motivation was to protect Barnes & Noble from the threat of a stockholder group acquiring control without paying a control premium. "The effect on electoral rights," according to the Court, "was an incident to that end."[15] The Court therefore reiterated prior case law and held that the *Unocal* standard applied.[16]

In concluding its *Blasius* discussion, the Court stated: "As a trial judge, I am also aware that a standard of review only has utility if it is actually the means by which a judge decides a case."[17] As a practical matter, "if a board can meet its burden under *Unocal* to show that a rights plan is not unreasonable" because the rights plan does not prevent an insurgent from running an effective proxy contest, then the rights plan would not give rise to the type of "disenfranchisement that both invokes *Blasius* review and almost invariably signals a ruling for the plaintiff."[18] Thus, the Court revealed what it believed to be the "key feature" of pill litigation—"whether the pill unreasonably restricts the ability of stockholders to run a proxy contest."[19]

Application of the *Unocal* Standard

Analysis of the Barnes & Noble board's actions followed the familiar *Unocal* standard applicable to defensive measures: the board must have reasonably perceived a threat to corporate policy and effectiveness, and the steps taken must have been reasonable in relation to that threat.[20] In any event, a pill may not be preclusive or coercive; but a pill that passes the preclusion and coercion tests may still be outside the range of reasonableness.[21] In this context, the Court held that it must examine the company's entire defensive profile (including the pill) to determine whether it is "preclusive in the precise sense of making it unrealistic for an insurgent to win a proxy contest."[22]

In the present case, the Court seemed to have little trouble addressing the "threat" component of the *Unocal* analysis. Yucaipa's claim that it was merely trying to have a voice on the board—since Yucaipa could not gain control of Barnes & Noble's staggered board in a single election—was inconsistent with the reality of the impending proxy contest. The particular directors that Yucaipa would replace in the proxy contest included Mr. Riggio and the lead director, so the proxy contest would essentially become "a referendum about whether the future of the company should follow Riggio's vision or the vision Yucaipa articulates."[23] Moreover, the Court noted that the "reality . . . that even the combination of a classified board and a rights plan are hardly showstoppers in a vibrant American M & A market" and that the election of three directors would be no "trifling event."[24] The Court seemed to agree with Barnes & Noble's board that Yucaipa's actions—its rapid acquisition of stock, followed by its public communications and correspondence with the company—posed a legitimate threat that Yucaipa would attempt to gain control without a control premium or otherwise use its control position to its advantage and to the detriment of other investors.[25]

Although not specifically mentioned in the opinion, the threat posed by Yucaipa was made all the more real by the fact that Barnes & Noble had opted out of Section 203 of the Delaware General Corporation Law.[26] Were that statute applicable, Yucaipa (and virtually any other stockholder) would not have been able to acquire more than 15% of Barnes & Noble's voting stock without subjecting itself to restrictions on a broad array of business combinations.[27] Additionally, although the Court acknowledged that Yucaipa's ability to obtain control without paying a control premium was "complicated by the pre-existing presence of the Riggios' substantial bloc," that fact did not "undermine the reasonableness" of the board's concern that such a bloc could do so.[28]

In this regard, the Court pointed out that Yucaipa and Aletheia, viewed together, had already acquired nearly 40% in the open market. "[T]he most logical economic rationale" for Aletheia's increase, the Court stated, was that Aletheia "hoped to reap gains from some fundamental strategy change that would produce a materially higher stock price and, having accumulated a large bloc of shares that could be the swing vote in an election, Aletheia will act to ensure that those shares are used in the way that Aletheia believes will maximize its return."[29] Thus, far from responding with overwhelming force to one stockholder's desire to be heard, Barnes & Noble's board was responding to a legitimate threat. In the end, Yucaipa could not avoid the fact that it posed a threat—the Schedule 13D, on which the Court relied heavily, betrayed its intentions, as did the Schedule 13D of Aletheia (which was also found to have a history of following Yucaipa's lead in investments).

After determining that the Barnes & Noble board reasonably perceived a legitimate threat, the Court turned to whether the poison pill was within the range of reasonableness.[30] As noted above, the Court's analysis focused on "whether the Rights Plan unreasonably inhibits the ability of Yucaipa to run an effective proxy contest."[31] The Court grappled first with the basic fact that Mr. Riggio controlled approximately 30% of Barnes & Noble's outstanding stock and that the remaining board members controlled an additional 3.26%.[32]

Despite Mr. Riggio's significant holdings, the Court found that Yucaipa could pull off a victory in a potential proxy contest. First, Yucaipa could gain the support of Aletheia, which would effectively cancel out the incumbents' mathematical advantage. Second, nothing in the pill prevented Yucaipa from seeking to gain what the experts seemed to agree would be critical in any proxy contest: the backing of the proxy advisory firms.[33]

Although the Court upheld the 20% trigger in Barnes & Noble's pill, it suggested that other options might be available that have a less stringent effect on the establishment of voting blocs in proxy contests. Twice, the Court mentioned the concept of a "double trigger" pill, one that limits direct ownership of more than the triggering threshold, but permits agreements, arrangements, and understandings up to a higher threshold for the purpose of running a proxy contest.[34] While not central to the Court's holding, this observation again demonstrates that there is no magic formula for adopting defensive measures. Further, boards and their advisors, when considering changes or additions to their defensive profiles, must review all the individual components (and the interaction of those components) to ensure that they are effective in protecting the stockholders generally—but not so effective that they prevent the stockholders from exercising their rights at the ballot box.

Points for Practitioners

Although it ultimately found that the pill was adopted by an independent board majority, the Court made several observations regarding the board's process that may serve as helpful reminders to practitioners advising boards in similar situations. At the most basic level, the Court suggested that the defendants should have given more consideration to whether it was appropriate for the independent directors—rather than Barnes & Noble's full board—to consider the adoption of the pill or to consider raising the pill's trigger level.[35] While the Court ultimately agreed that the board's decision to freeze Mr. Riggio at his then-current stake was reasonable, it found the board's process of discussing whether Mr. Riggio constituted a threat, in Mr. Riggio's presence, "less than adroit."[36] Thus, the Court seemed to focus not only on which directors should have the final power and authority to adopt or amend the pill, but also on whether it was appropriate for the independent directors to consider such matters in the presence of a director whose interests arguably could have been found to differ from those of the stockholders generally.

The Court also expressed concern over the selection of advisors. By the time the board had been called to the meeting at which the pill was to be considered, an investment bank had already been selected to advise on the pill. The Court found this selection troublesome because the investment bank had served as Mr. Riggio's personal investment advisor and had recently advised him personally on the sale of one of his entities to Barnes & Noble. The Court suggested that the independent directors, rather than management who worked for Mr. Riggio, should have driven the process of selecting advisors.[37] Nevertheless, the Court appeared sympathetic to the intense pressures that directors and officers face in a hostile situation—and seemed to recognize the need to act without delay during these times. "Yucaipa's rapid purchases and indication of a willingness to buy up to half of Barnes & Noble's shares undoubtedly put extreme time pressure on the response. Thus, the board had to assemble its advisors quickly."[38]

The Court's comments, while not outcome-determinative,[39] are pertinent reminders that the Court of Chancery will scrutinize carefully all procedural aspects of a transaction that merits *Unocal* review. Advisors should take note of these (and other) points in the opinion for future use; hostile takeovers often arise unexpectedly, and decisions must be made in short timeframes. A best-practices plan that is set out in advance may avoid some of the risks inherent in these high-pressure situations.

NOTES

1. *See* John Laide, *A New Era in Poison Pills*, SharkRepellent.net (Apr. 1, 2010), https://www.sharkrepellent.net/request?an=dt.getPage&st=1&pg=/pub/rs_20100401.

html&Specific_Purpose_Poison_Pills&rnd=29249.

2. *Moran v. Household Int'l, Inc.*, 500 A.2d 1346 (Del. 1985).

3. In *Fertitta*, the Court of Chancery suggested that, depending on the circumstances, the board's failure to adopt a pill could contribute to a finding of breach of fiduciary duty: "To say that there is *no per se* duty to employ a poison pill to block a 46% stockholder from engaging in a creeping takeover does not refute the conclusion that the board's failure to employ a pill, together with other suspect conduct, supports a reasonable inference at the motion to dismiss stage that the board breached its duty of loyalty in permitting the creeping takeover." *La. Mun. Police Employees' Ret. Sys. v. Fertitta*, 2009 WL 2263406, at *8 n.34 (Del. Ch. July 28, 2009). And in *CNX*, the Court emphasized the importance of providing to a special committee charged with responding to a controlling stockholder's tender offer the full power of the board, including the authority to adopt a rights plan, and stated: "The shadow of pill adoption alone may be sufficient to prompt a controller to give a special committee more time to negotiate or to evaluate how to proceed." *In re CNX Gas Corp. S'holders Litig.*, 2010 WL 2291842, at *16 (Del. Ch. May 25, 2010).

4. *See, e.g.*, *Quickturn Design Sys., Inc. v. Shapiro*, 721 A.2d 1281, 1292 (Del. 1998) (invalidating the provision of a rights agreement that delayed redemption of the rights for a six-month period); *Carmody v. Toll Bros., Inc.*, 723 A.2d 1180, 1191 (Del. Ch. 1998) (declining to dismiss a challenge to the "dead hand" feature of a pill (*i.e.*, the provision limiting the redemption of the pill to the "continuing directors")). These challenged provisions, of course, amplify a pill's deterrence by ensuring that, even if an insurgent stockholder obtains board control, that stockholder will be unable to redeem the pill and proceed with its tender offer.

5. — A.2d —, 2010 WL 3170806 (Del. Ch. Aug. 12, 2010). At press time, this deision was on appeal to the Delaware Supreme Court.

6. Ronald W. Burkle, Schedule 13D/A (Nov. 13, 2009).

7. A proxy contest had commenced as of the time this article went to press. *See* Jeffrey A. Trachtenberg, *Barnes & Noble Slams Burkle Bid*, Wall St. J., Aug. 26, 2010, at B3.

8. *Yucaipa*, 2010 WL 3170806, at *10.

9. *Id.* at *11-12.

10. *Id.* at *14.

11. *Id.* That is, capping an equity holder at his existing percentage ownership while limiting the ownership of other stockholders to a lower percentage did not constitute the type of "self-dealing" that gives rise to entire fairness review. *Id.*

12. *Id.* The Court noted that its decision did not foreclose a finding of breach of fiduciary duty: "[if] it turns out that the board acted to entrench the grandfathered holder, then of course a fiduciary duty breach will be found." *Id.* Thus, the Court suggested that the outcome might have been different if the board, instead of freezing Mr. Riggio at his current level, granted him the unfettered right to obtain a majority or granted him other exemptions from the pill's operation that would have unfairly advantaged him in a proxy contest.

13. *See, e.g., Blasius Indus., Inc. v. Atlas Corp.*, 564 A.2d 651, 652 (Del. Ch. 1988).

14. *Yucaipa*, 2010 WL 3170806, at *14.

15. *Id.* at *15. Yucaipa argued that the pill was impermissibly restrictive on the ability of separate groups of stockholders to combine to wage a more effective proxy contest, but the Court disagreed, holding that Yucaipa's arguments had already been resolved by the Supreme Court's *Moran* decision. *See id.* Although the *Moran* Court noted that a pill's effect on the formation of groups was "troublesome," it nevertheless found "that the application of the 20% trigger to joint action to propose a proxy contest was reasonable," a finding that was "buttressed by the evidence that a single stockholder or group of stockholders owning up to the 20% limit could still wage a winnable proxy contest." *Id.*

16. *Id.* at *17.

17. *Id.* at *18.

18. *Id*.

19. *Id*.

20. *Id*.

21. *Id*.

22. *Id*.

23. *Id.* at *26.

24. *Id.* The Court also alluded to the effect of the pill's one-year stockholder ratification requirement, noting that, if the incumbent board renewed the pill following a negative stockholder vote, it would "be walking with open eyes right into a whirling helicopter blade." *Id.*

25. *Id.* at *28.

26. Amended and Restated Certificate of Incorporation of Barnes & Noble, Inc., Art. Twelfth (Nov. 12, 1992).

27. *See* 8 *Del. C.* § 203.

28. *Yucaipa*, 2010 WL 3170806, at *29.

29. *Id*.

30. *Id.* at *30.

31. *Id.* The Court expressed skepticism over the view that a rights plan is "not preclusive if it merely leaves open a mathematical or theoretical possibility of winning a proxy contest," suggesting instead that the rights plan must not prevent the insurgent from having a "fair chance for victory." *Id.* at *18 n.182. The Court further stated that where a pill "unfairly tilts the electoral playing field" against the insurgent, its operation may be enjoined. *Id.*
32. *Id.* at *30. While the Court was dubious that non-director employees would invariably vote with management, it nonetheless counted in the incumbents' column the 6% owned by such employees. *Id.*
33. *Id.* at *32.
34. *Id.* at *31 n.244, *33 n.254.
35. *Id.* at *7, *11.
36. *Id.* at *11.
37. *Id.* at *7; *see also id.* at *25 n.214.
38. *Id.* at *8.
39. *But cf. id.* at *25 n.214 (declining to grant the "material enhancement" typically given when a pill is adopted by a majority of independent directors).