

## Testing Poison Pill Tolerance In Del.

Law360, New York (October 06, 2010) -- Delaware courts have recently ruled on the validity of a shareholder rights plan, or "poison pill," in two situations that presented issues of first impression under Delaware law.

On Aug. 12, 2010, Vice Chancellor Leo E. Strine, in *Yucaipa American Alliance Fund II LP v. Riggio*, C.A. No. 5465-VCS (Del. Ch. Aug. 12, 2010), upheld the use of a poison pill with a 20 percent threshold to delay a possible takeover of Barnes & Noble Inc. by funds controlled by Ronald Burkle, even though the founder and chairman of Barnes & Noble, Leonard Riggio, controlled more than 30 percent of the company's outstanding common stock.

Less than a month later, on Sept. 9, 2010, Chancellor William Chandler, in *eBay Domestic Holdings Inc. v. Newmark, et al.*, C.A. No. 3705-CC (Del. Ch. Sept. 9, 2010), rescinded a poison pill adopted by the directors of Craigslist Inc. because the court found that the purpose of the pill was to punish eBay, the holder of about 28 percent of Craigslist's outstanding common stock, rather than to protect the company or its shareholders from economic harm.

These cases demonstrate the willingness of the Delaware courts to uphold the use of poison pills when directors can make a reasonable argument that they are being used to protect the economic interest of shareholders and the unwillingness of those courts to permit the use of poison pills in other circumstances.

In both cases, the courts applied the familiar test formulated in *Unocal Corp. v. Mesa Petroleum Corp.*, 493 A.2d 946, 955 (Del. 1985): that adoption of defensive measures are protected by the business judgment rule so long as: (i) the board had reasonable grounds for believing that a danger to corporate policy and effectiveness existed and (ii) the defensive response was reasonable in relation to the threat posed.

In determining whether a poison pill is a reasonable response to the threat posed, Delaware courts will examine, among other things, whether the pill, in connection with the company's defensive arsenal as a whole, unreasonably restricts the ability of stockholders to run a proxy contest, precludes stockholders from exercising their right to vote or coerces them into voting a particular way.

### **Yucaipa**

In Yucaipa, a Delaware court considered for the first time a poison pill with an asymmetrical trigger. The pill had been adopted by the board of directors of Barnes & Noble in order to prevent Burkle from amassing a larger stake in the company after he had quickly increased his ownership from approximately 8 percent to more than 18 percent and had been agitating for certain strategic transactions and governance changes.

The board generally set the trigger at which rights would be issued to the nonacquiring shareholders at an ownership level of 20 percent, but also "grandfathered in" an approximately 32 percent block of shares of the company held by Riggio by providing that the pill would not be triggered by Riggio unless he acquired additional shares.

Burkle's Yucaipa funds, through which he held his interest in Barnes & Noble, brought an action challenging the validity of the pill.

Vice Chancellor Strine first discussed the appropriate test for "preclusiveness" and determined that a poison pill is not preclusive if a proxy insurgent has a "fair chance of victory." The court found that this pill would not preclude Burkle from winning a proxy contest.

The facts that the court cited in making this determination included: (i) Burkle's sizeable stake and the relatively high 20 percent trigger, (ii) the existence of another large stake held by a fund that was known to often support Burkle's position and (iii) the reasonable likelihood that proxy advisory firms would be sympathetic to Burkle's position.

Turning to an analysis of whether the poison pill, even though nonpreclusive, was nonetheless unreasonable in light of the threat faced by the company, the court determined that the 20 percent trigger was within the range of reasonable responses to the threat posed by Yucaipa.

While noting that the board of directors' process was not ideal, as it had not excluded Riggio and other nonindependent directors from the process, the court found that the board had still acted independently of Riggio and was appropriately informed.

The court also found that the board had reasonable grounds to believe that the possibility that Burkle would acquire control without paying a premium posed a legitimate threat to the company and its shareholders.

In light of the plaintiff's arguments regarding the fairness of the asymmetrical trigger, the court considered the presence of the Riggio family's pre-existing 32 percent block in examining the reasonableness of the 20 percent trigger.

Vice Chancellor Strine suggested that, while the court's analysis of reasonableness was "complicated" by this fact, it did not "undermine the reasonableness of the board's concern that without a limit on open market purchases by Yucaipa and others at a level below the level of the Riggios' range, a control block could emerge that did not pay a control premium."

Further, the court pointed out that the poison pill in fact "cabined" the situation, and froze the blocks held by all large holders approximately where they were at the time of adoption of the pill. The court found that the board could have reasonably determined that this would be a better result for the remaining smaller investors than an open market free-for-all between Riggio and Burkle.

## **EBay**

In eBay, a Delaware court considered for the first time the validity of a poison pill adopted by the board of directors of a closely held corporation. In 2004, eBay Inc. became a minority investor in Craigslist Inc. by acquiring approximately 28 percent of the company's shares from a previous shareholder.

Pursuant to the relevant stock purchase agreement and a contemporaneous shareholders agreement entered into between eBay, Jim Buckmaster and Craig Newmark, the other two shareholders of Craigslist (referred to by the court on a first name basis), eBay was granted certain rights, including the right to consent to charter amendments and certain transactions that might adversely affect eBay.

The shareholders agreement also contained transfer restrictions on the Craigslist shares held by the three shareholders, limited eBay's use of confidential information and included provisions that would be triggered if eBay started to compete with Craigslist.

Almost from the beginning of the relationship, however, it was apparent that eBay did not agree with Buckmaster and Newmark on a business model for the company. eBay was a profit-seeking investor with the aspiration of someday acquiring control of Craigslist, while Buckmaster and Newmark believed that the company was providing a valuable public service and, in turn, did not focus on maximizing its profits.

In addition, eBay hoped to acquire the remainder of the company's stock, which Buckmaster and Newmark had no intention of selling.

In mid-2007, eBay began competing with Craigslist through the launch of eBay's own online classified site, Kijiji. Craigslist sent eBay a notice pursuant to the shareholders agreement, informing eBay that its rights under the shareholders agreement would cease in the event that the competitive activity did not cease.

In January 2008, Buckmaster and Newmark, as the sole directors of Craigslist, adopted various governance measures, including a poison pill. The poison pill effectively prevented eBay from acquiring additional shares of Craigslist and limited eBay's ability to transfer its shares in a single block to a third party.

eBay subsequently challenged the governance measures taken by Buckmaster and Newmark.

Chancellor Chandler found that eBay posed no immediate threat to take over Craigslist or even increase its stake in the company, since eBay remained a minority shareholder that could not acquire additional shares unless Buckmaster or Newmark decided to either sell their own shares to eBay or to cause the company to issue additional shares to eBay.

Because the shareholders agreement contained share transfer restrictions and provided the shareholders with preemptive rights, eBay could not have increased its ownership stake unless both Buckmaster and Newmark agreed to allow it.

The court found that the "takeover" threat that Buckmaster and Newmark were concerned about would not arise until one or both of them died.

In applying Unocal to these facts, the court held that, in taking defensive actions, the directors must "1) identify the proper corporate objectives served by their actions; and 2) justify their actions as reasonable in relationship to those objectives."

Focusing on the first prong of this test, Chancellor Chandler found that the directors did not adopt the poison pill in response to a reasonably perceived threat or for a proper purpose.

Buckmaster and Newmark claimed that they were trying to protect the corporate culture of Craigslist, a culture that apparently eschews profit maximization in favor of serving the community as a whole.

The court stated that it "cannot accept as valid for purposes of implementing the rights plan a corporate policy that specifically, clearly and admittedly seeks not to maximize the economic value of a for-profit Delaware corporation for the benefit of its stockholders" and found "that the defendants failed to prove, as a factual matter, the existence of a distinctly protectable Craigslist culture and failed to prove, both factually and legally, that they actually decided to deploy the rights plan because of Craigslist culture."

The court further found that the defendants instead "acted to punish eBay for competing with Craigslist."

Finally, the court assumed for the sake of argument that the Craigslist culture had been a legitimately protectable interest and considered whether the plan was within the range of reasonableness.

The court found that the poison pill would fail this prong of the Unocal test as well, because (i) the stated purpose of the poison pill was to protect the "culture" of Craigslist at a future point and (ii) Buckmaster and Newmark, as the majority of the board of directors and the controlling shareholders, could sufficiently protect the culture of Craigslist without the pill.

The court found that the pill did not have a reasonable connection to Buckmaster and Newmark's goal, because the pill would affect neither when eBay could sell its shares nor when the Craigslist culture could change.

### **Takeaways from Yucaipa and EBay**

- The Delaware courts appear willing to uphold poison pills in novel situations as long as the board has reasonably concluded that the pill will prevent an economic threat to the corporation or its shareholders.

This is evident from Yucaipa, where the founder was exempted from the pill's 20 percent threshold, and from the recent case of *Selectica Inc. v. Versata Enterprises Inc., et al.*, C.A. No. 4241-VCN (Del. Ch. Feb. 26, 2010), in which the court upheld the use of a poison pill to protect a company's ability to deduct its net operating losses against hoped-for future earnings.

- EBay indicates that the Delaware courts may not sustain the use of a poison pill to protect noneconomic values, such as the company's culture as it is perceived by its founders.

Poison pills that are seen as punitive measures against an insurgent or minority shareholder, rather than legitimate measures designed to further corporate objectives, are likely to be struck down by a Delaware court.

- A poison pill is not likely to be found to be preclusive if a proxy insurgent has a reasonable chance of winning a proxy contest.

A merely theoretical possibility of winning a proxy contest, however, would not meet the test put forward in Yucaipa. A fair chance of winning must in fact exist.

- When considering whether to adopt a poison pill to protect the company against an insurgent, a board of directors should consider whether it would be beneficial to form a special committee of independent directors in order to create the factual record of a fully independent process in the event that the action is subsequently reviewed by a court.

It may also be prudent for the special committee or the independent directors of the board to retain legal and financial advisers who are independent of any interested director.

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