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Case No. 5465-VCS

IN THE COURT OF CHANCERY OF THE STATE OF DELAWARE

YUCAIPA AMERICAN ALLIANCE FUND II, L.P., a Delaware Limited Partnership, and YUCAIPA AMERICAN ALLIANCE (PARALLEL) FUND II, L.P., a Delaware Limited Partnership,	)	
Plaintiffs,	)	C.A. No. 5465-VCS
v.	)	
	)	**PUBLIC VERSION – Dated: July 30, 2010**
LEONARD RIGGIO, STEPHEN RIGGIO, GEORGE CAMPBELL JR., MICHAEL J. DEL GIUDICE, WILLIAM DILLARD, II, PATRICIA L. HIGGINS, IRENE R. MILLER, MARGARET T. MONACO, LAWRENCE S. ZILAVY, and BARNES & NOBLE, INC., a Delaware Corporation,	)	
Defendants.	)	

PLAINTIFFS' ANSWERING PRE-TRIAL BRIEF

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PRELIMINARY STATEMENT[1]

Defendants' Opening Pre-Trial Brief ("Defendants' Brief") largely ignores or subtly, but significantly, misstates the issues. The first issue relates to the reasonableness of the 20% trigger level in the Rights Plan. Specifically, assuming the purpose of the Rights Plan was to prevent a change of control without the Board negotiating the terms of the acquisition, was the 20% trigger a reasonable or proportionate response to accomplish that objective when (a) there was no acquisition proposal and (b) it had the undeniable effect of preserving the Riggios' controlling stock position? As Plaintiffs noted in their brief, no presentation was made to the Board on that subject by either Cravath or Morgan Stanley, and Defendants' Brief fails to even address the issue. Instead, Defendants address two nonissues. Defendants argue at length that the adoption of the Rights Plan was justified by the need to protect against an acquisition of the Company by Yucaipa. While Yucaipa neither has, nor ever had, any intention to acquire control of the Company, this litigation does not challenge the decision to adopt the Rights Plan. It challenges the trigger level used in the Rights Plan. Defendants also launch into a defense of rights plans with "grandfather" clauses, but Plaintiffs do not challenge the grandfathering of the Riggios. Of course, the Riggios needed to be "grandfathered" if the trigger level was to be set at or below their current level of stock ownership. The issue is what the trigger level should be.

The second issue is regarding the definition of "Beneficial Ownership" in the Rights Plan. The fundamental issue is Defendants' unprecedented argument that a rights plan may operate to prevent stockholders from collectively organizing to conduct a proxy contest for

[1] All definitions used in Plaintiffs' Opening Pre-Trial Brief ("Plaintiffs' Brief") are incorporated herein. Plaintiffs' Brief will be cited as "POB" and Defendants' Brief as "DOB."

the election of directors where (1) there is no acquisition proposal being made or contemplated, (2) the election is for a minority of the directors on a staggered Board, and (3) a controlling or dominant insider voting block already exists. Nothing was ever presented to the Board to justify using the definition of Beneficial Ownership to prevent stockholders from organizing a proxy contest in such circumstances, and all of the Board members testified that they did not intend the Rights Plan to have such effect. Defendants' Brief nowhere explains why the professed objectives of the Rights Plan require preventing agreements among stockholders pertaining to a proxy contest in this circumstance. Defendants' Brief is silent on this point because the Board never discussed the Beneficial Ownership provision, much less determined that the interpretation and application being presently advanced by the Company is necessary to serve the stated purpose of the Rights Plan. The terms of the Rights Plan are not an "act of God," such that the parties must live with the adverse effect this provision has on proxy contests as the inevitable consequence of the Rights Plan accomplishing its stated objectives. If the Company asked, Cravath could draft the necessary language to eliminate this effect.

Defendants spend a large part of their brief mischaracterizing Yucaipa's concerns about the Beneficial Ownership provision and then arguing that those concerns have been eliminated by the Second Amendment to the Rights Plan on June 23, 2010. That amendment deleted the largely unprecedented second clause of that definition covering "agreements, arrangements and understandings for the purpose of . . . cooperating . . . to influence control" of the Company.[2] Defendants contend that Plaintiffs and their experts misunderstood or

[2] 2009 Rights Plan § 1, Definition of Beneficial Ownership.

mischaracterized the Rights Plan as precluding "communications" with other stockholders, and that the adverse effect identified by Plaintiffs' experts was the inability to communicate with other stockholders. According to Defendants, the elimination of the "cooperation" clause cured the concerns of Plaintiffs' experts. But as the Cravath partner who counseled the Board testified at his deposition two days ago, the elimination of that clause did not change in any respect the answer the Company gave to Yucaipa at the commencement of this litigation concerning the impact of the Rights Plan on a proxy contest.[3] According to the Company, the Rights Plan still precludes any agreements, arrangements, or understandings among stockholders with more than 20% of the stock concerning the conduct of a proxy contest. In addition, according to the Company, the Rights Plan still will be triggered if Yucaipa reaches any "understanding" with another stockholder as to how that stockholder will vote. It is the very ambiguity of what communications might result in such "understandings" that will deter stockholders from talking with Yucaipa about the election of directors or a proxy contest.

Having eliminated the novel and expansive Beneficial Ownership provision, Defendants then argue that the remaining provision is almost "boilerplate" in rights plans and has been accepted by the Delaware courts. Defendants accuse Plaintiffs of trying to relitigate settled law.[4] Defendants also cite to Section 203 of the DGCL and SEC rules as precedent for this language. While language of this type has been used in rights plans for over a decade and appears in Section 203, Defendants ignore that it has never been given the interpretation currently advanced by the Company and has never been applied as it is being

[3] Barshay Tr. 265:5-166:8, 267:12-17.

[4] DOB at 4.

applied in the present circumstances. Indeed, what is most frightening with respect to Defendants' interpretation and application of this provision are the implications for Section 203, which has the same language. If Defendants' interpretation and application of this provision are correct, Section 203 would be triggered for every Delaware corporation whenever stockholders of that corporation collectively owning 15% or more of the stock reach an "understanding" with respect to organizing a proxy contest or an "understanding" as to how they will vote their stock in a proxy contest. Such an interpretation would transform Section 203 from a statute addressing tender offers and other acquisition proposals into a constraint on the stockholder franchise, and such an interpretation would significantly undercut the recent amendments of the DGCL that expressly allow bylaws for reimbursement of proxy expenses and proxy access.

Defendants also completely ignore Count V of the Verified Complaint, which alleges that the entire fairness doctrine applies to the Board's issuance of Rights. There may be a reason that Defendants decided to ignore this Count. It alleges—and Plaintiffs' Brief explains—that the Riggios are controlling stockholders by virtue of their dominant stock position (now protected by the Rights Plan), their status as founders of the Company, their executive roles, their participation in selecting all or substantially all of the directors of the Company, and their longstanding and extensive self-dealings with the Company. Defendants cannot deny that the Riggios are controlling stockholders and yet contend that a 20% trigger is necessary to protect against an acquisition of control by Yucaipa, especially when Defendants testified that they would not be concerned about control by Leonard Riggio at less than 35 or 40%. Rather than confront that conundrum, Defendants simply ignore the

issue and ignore that the Riggios have an obvious and substantial conflict of interest with respect to the Rights Plan.

Finally, Defendants largely ignore claims pertaining to the Board's motivations for adopting the Rights Plan. Yet, Defendants advance an entirely new purpose for the Rights Plan—nowhere set forth in Board resolutions, minutes, or disclosures about the Rights Plan—that virtually admits to an improper purpose. Defendants now assert that one purpose of the Rights Plan is to prevent an "arms race" between Yucaipa and the Riggios. The reason given for stopping this "arms race" is to prevent the Company from having two large stockholders, as opposed to the one large stockholder it has presently. Stripping away the intuitive reaction that "arms races" are bad things and it is good to prevent them, the reality of this asserted purpose is that the Board adopted the Rights Plan so that (1) Yucaipa could not acquire shares to challenge the Riggios' control and (2) Leonard Riggio would not need to purchase additional shares to maintain his dominant stock position, as he did when Pershing acquired a stake in the Company. And the ultimate end game for this exercise is to preserve the Riggios as the single largest stockholder and not allow two large stockholders. Such conduct is not consistent with proper Board motivation, and it certainly is not a cognizable justification for a rights plan.

STATEMENT OF FACTS

The Incumbent Board

In their brief, Defendants contend that their judgments are entitled to "material enhancement" under *Unocal* because a majority of the Board allegedly is disinterested and independent. This argument must fail for two reasons. First, Defendants cannot carry their burden of establishing that a majority of the Board is disinterested and independent. Second, Leonard Riggio, who clearly was conflicted, together with his personal investment banker (Morgan Stanley),[5] led the Board's consideration and adoption of the Rights Plan and the Board's response to Yucaipa's request to purchase additional shares. Even were the Board independent and disinterested, which it is not, a board's independence is undermined when its decision-making process is dominated by an interested director and his advisors.[6]

As to the composition of the Board, there is no question that the Riggios were interested in adopting and implementing the Rights Plan. There also is no dispute that Zilavy is not independent of the Riggios.[7] Zilavy evidences the type of director selected by the Riggios as recently as 2006, and has been a B&N Board member since then.[8] Previously, Zilavy was the Executive Vice-President and CFO of B&N.[9] Additionally, Zilavy served as

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[5] L. Riggio Tr. 105:16-106:8.

[6] MBCA § 8.62(a)(1) (approval of an interested director transaction by a majority of disinterested and independent directors is still subject to entire fairness scrutiny unless "the qualified directors have deliberated and voted outside the presence of and without participation by [the interested directors].").

[7] Defendants do not contest that Zilavy is interested and not independent. DOB at 6.

[8] Schedule 14A, Apr. 16, 2009, at 2.

[9] *Id.* at 4.

Senior Vice President of B&N College.[10] Zilavy was a director and officer of other companies in which the Riggios have an interest,[11] is a trustee and executor under various Riggio family trusts and wills,[12] and is currently the Manager of LR Enterprises Management LLC, which is the family office of Leonard Riggio, and has office space at the Company's headquarters.[13]

Given the clear interest and lack of independence of these three members of the Board, Defendants must prove that five of the remaining six members of the Board are independent of Leonard Riggio. However, four of those remaining six cannot be deemed independent.[14]

Del Giudice shares a personal relationship, as well as political alliances, with Leonard Riggio.[15] Del Giudice and Leonard Riggio have served together on the Board for the New York Racing Association since 2006.[16] Del Giudice and Leonard Riggio also have invested in two of the same enterprises.[17] In 2006, Leonard Riggio invested in Midland Cogeneration,

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[10] Schedule 14A, Apr. 16, 2009, at 4. Zilavy "is involved in strategic, operational and planning issues at Barnes & Noble College Bookstores, as well as in other family investments and interests of Leonard Riggio, the Chairman of Barnes & Noble." B&N Press Release, June 8, 2006.

[11] Schedule 14A, Apr. 16, 2009, at 4; B&N Press Release, June 8, 2006.

[12] Zilavy Tr. 154:3-154:6, 158:19-161:23, 165:2-6; Defs.' Resps. & Objections to Pls.' Third Set of Interrogs., June 14, 2010 ("Defs.' 3d Resps. to Interrogs."), Resp. No. 10.

[13] Zilavy Tr. 61:10-63:21; Defs.' 3d Resps. to Interrogs., Resp. No. 10.

[14] Indeed, all of the independent directors have an interest in the Rights Plan and its interpretation (particularly Del Giudice) because the Rights Plan materially increases the likelihood of their remaining in office.

[15] *See* Defs.' 3d Resps. to Interrogs., Resp. No. 8; Del Giudice Tr. 35:10-23; Devin Leonard, *Can Dollar Bill Bradley Dunk Al Gore?*, New York Observer, Sept. 26, 1999, *available at* http://www.observer.com/node/41996.

[16] Defs.' 3d Resps. to Interrogs., Resp. No. 7.

[17] Del Giudice Tr. 37:6-9.

an independent power venture that is managed by Rockland Capital, a company that Del Giudice is involved in, formed, and has invested money.[18] Leonard Riggio recouped his original investment in Rockland Capital and made a profit of more than $5 million.[19]

Monaco has served on B&N's Board alongside its Chairman, Leonard Riggio, for the past fifteen years.[20] As a former long-time member of the B&N Compensation Committee, she had a hand in approving compensation for the Company's executives.[21] Monaco was removed from the Compensation Committee in 2007 as a result of an internal investigation in 2006 which found that improperly backdated options had regularly been granted for nearly a decade, but she was not removed from the Board.[22] Throughout her tenure, Monaco has reaped significant financial benefits, including nearly $1.5 million in 2005 through the exercise of Company-issued stock options, and nearly $200,000 to serve as a director in 2009.[23] Moreover, Monaco had financial conflicts as a result of her professional relationship (as former COO of two wholly-owned subsidiaries) with Merrill Lynch,[24] which received substantial fees and large profits by acting as B&N's financial advisor with respect to the

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[18] *Id.* 37:13-17.

[19] *Id.* 40:18-41:2.

[20] Schedule 14A, Apr. 16, 2009, at 4; L. Riggio Tr. 20:16-21:10.

[21] Schedule 14A, Apr. 23, 2007, at 5.

[22] Del Giudice Tr. 69:22-70:4, 73:8-19, 74:5-11.

[23] Schedule 14A, Apr. 16, 2009, at 31; Am. Verified Consol. S'holder Deriv. Compl., *In re Barnes & Noble S'holder Deriv. Litig.*, C.A. No. 4813-VCS (Del. Ch. Mar. 25, 2010) ("Deriv. Compl."), ¶ 57.

[24] Schedule 14A, Apr. 16, 2009, at 4; Deriv. Compl. ¶ 58.

College Booksellers transaction.[25] Finally, Leonard Riggio and Monaco have a long-standing personal relationship.[26]

Since B&N went public in 1993, Dillard has continuously served on the B&N Board alongside Leonard Riggio.[27] As a result of Dillard's seventeen-year relationship with Leonard Riggio and his Company, Dillard has received $450,792 through the exercise of Company stock options in 2004, significant additional stock grants, and a $200,000 salary in 2008.[28] Dillard, as a long-time member of the Nominating Committee,[29] allowed Leonard Riggio to unilaterally appoint his younger brother to the position of CEO,[30] without raising any objections. Such conduct does not evidence independence. Dillard also had financial conflicts as a result of his affiliation with JPMorgan Chase Bank, which was one of the banks committed to providing the $1 billion, four-year, revolving credit facility that will replace the existing facilities and finance the College Booksellers transaction (along with Merrill Lynch).[31] Dillard is presently a member of the JPMorgan Chase & Co. National Advisory Board, and the JPMorgan Chase & Co. Dallas Region Advisory Board.[32] Additionally, Dillard has a close personal relationship with Leonard Riggio, playing golf and socializing with him.[33]

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[25] Deriv. Compl. ¶ 58.

[26] Defendants cannot assert the independence of Monaco because they improperly prevented Plaintiffs from taking her deposition after first agreeing to it.

[27] Schedule 14A, Apr. 16, 2009, at 2.

[28] *Id.* at 31; Deriv. Compl. ¶ 59.

[29] Schedule 14A, May 5, 1994, at 4.

[30] Schedule 14A, Apr. 27, 2005, at 2.

[31] *See* B&N Press Release, Aug. 10, 2009; Deriv. Compl. ¶ 59.

[32] Schedule 14A, Apr. 16, 2009, at 3.

[33] Deriv. Compl. ¶ 107.

Former Vice Chairman and CFO of the Company, Miller has a longstanding and close relationship with Leonard Riggio. Leonard Riggio hand-selected Miller to run the private company he founded and eventually sold to the public.[34] Miller served as B&N's CFO from 1993 through 1997 and was Vice Chairman of the Company from 1995 through 1997.[35] Miller also has been a director of B&N since 1995.[36] From 2004 to 2006, Miller earned approximately $7 million by exercising B&N stock options.[37]

ARGUMENT

I. COLLECTIVE STOCKHOLDER ACTION IN A PROXY CONTEST DOES NOT RESULT IN ATTRIBUTION UNDER THE TERMS OF THE RIGHTS PLAN

In their brief, Defendants accuse Plaintiffs of misconstruing the Rights Plan, necessitating two amendments to the Rights Plan by Defendants to "clarify" ambiguities. These amendments did not clarify ambiguities. Rather, they eliminated or modified provisions of the Rights Plan that were indefensible, but only after being pressed by Yucaipa. While accusing Plaintiffs of misconstruing the Rights Plan, Defendants never explain the basis for their interpretation of the Rights Plan to preclude "agreements, arrangements or understandings" respecting the conduct of a proxy contest. They treat the Rights Plan as if it were unambiguous in this regard. It is not. The fact that the Rights Plan is ambiguous is evidenced by the directors' confusion over what it means. For example, Zilavy testified that he did not know whether Yucaipa could reach an agreement with other stockholders to share

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[34] *See* Prospectus, Sept. 29, 1993, at 44.

[35] Schedule 14A, Apr. 16, 2009, at 3.

[36] *Id.* at 2.

[37] Deriv. Compl. ¶ 56.

proxy expenses without triggering the Rights Plan.[38] He also did not know whether Yucaipa could reach an agreement or understanding with other stockholders about who should be nominated as a director.[39] Higgins thought that stockholders could only nominate directors if the nominee was approved by the nominating committee,[40] and she thought that if Yucaipa "want[s] to introduce their slate of directors they need to in fact put forth an offer to purchase the company."[41] While Higgins believed that Yucaipa would trigger the Rights Plan if some other stockholder told Yucaipa that they "would be willing to support [Yucaipa's] candidates,"[42] she was not certain the same rules applied to the Riggios.[43] In short, the utter confusion of the directors as to the meaning and operation of the Beneficial Ownership provision demonstrates its inherent ambiguity, and the clause must be construed against the Company.

II. THE ADOPTION AND USE OF THE RIGHTS PLAN HAS NOT BEEN REASONABLE IN RESPONSE TO ANY COGNIZABLE THREAT

A. Defendants Have the Burden to Demonstrate the Reasonableness of the Rights Plan

Defendants have the burden to demonstrate the reasonableness of using a 20% trigger and interpreting and applying the Beneficial Ownership provision as they are doing. Defendants make no attempt to do either. Instead, they argue there was a need for a Rights Plan, but that has never been the issue in this litigation. Similarly, they argue that "grandfathering" pre-existing stockholders is typical, but that has never been the issue in this

[38] Zilavy Tr. 129:4-10.

[39] *Id.* 130:19-25.

[40] Higgins Tr. 149:18-150:3, 151:16-152:16, 154:6-155:5.

[41] *Id.* 154:6-155:5.

[42] *Id.* 241:21-242:10.

[43] *Id.* 245:25-246:9.

litigation. The issue is whether the undeniable, adverse impact the 20% trigger has on the stockholder franchise is justified by the need, if any, to protect against a theoretical hostile acquisition of the Company by Yucaipa. Defendants' brief does not offer any justification for using a 20% trigger in these circumstances other than saying it is typical.

Defendants also characterize the issue as whether the Rights Plan is preclusive of a proxy contest—meaning that "a Yucaipa victory in a proxy contest is 'mathematically impossible or realistically unattainable.'"[44] But the issue here is not whether the Rights Plan is preclusive. The issue here is whether the Rights Plan, as interpreted and applied by the Company, materially impairs or impedes the conduct of a proxy contest and whether under *Unocal* such impairment or impediment is reasonably related to some cognizable corporate purpose.

B. A 20% Trigger Is Unreasonable When There is a Pre-existing Insider Voting Group at 32-38%

1. Freezing Yucaipa at 20% Hinders Yucaipa and Advantages Leonard Riggio in a Proxy Contest

In their brief, Plaintiffs demonstrated the obvious fact that freezing Yucaipa at 20% while there is an Internal Voting Control Group at between 32 and 38% provides a material advantage to the Riggios and a material disadvantage to Yucaipa in a proxy contest. Successful proxy contests where an insider group owns in excess of 30% are almost nonexistent. Defendants' expert does not disagree.[45] Defendants' expert was asked to opine only on whether "the provisions of the shareholder rights plan . . . make the likelihood of a

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[44] DOB at 47.

[45] Harkins Tr. 164:8-15. Indeed, Barshay, the author of the Rights Plan, concedes this. Barshay Tr. 230:12-24.

successful proxy contest . . . 'a mathematical impossibility' or 'realistically unattainable.'"[46] He concluded only that "Yucaipa's election of directors in opposition to the Board is both mathematically possible and realistically attainable."[47] However, he also testified that it "would be difficult [for Yucaipa] to win a [proxy] contest."[48] The only reason Defendants' expert gives Yucaipa even a realistic possibility of winning the proxy contest is because of the existence of Aletheia. Yet, according to the Company, Yucaipa cannot reach an understanding with Aletheia regarding its vote without triggering the Rights Plan. And, as Aletheia testified, its policy and practice is that it does not vote and, instead, institutional investors in its fund decide how to vote their own shares, except in the rare circumstance that they request Aletheia do so in which case it simply contracts with ISS to do the voting.[49]

A document produced by Morgan Stanley only three days ago evidences its view about the advantages of maintaining the Riggios' current stock position and freezing other stockholders.[50] The document is entitled "Shareholder Rights Plan Discussion Materials, November 17, 2009," and it contains a discussion of "Barnes & Noble Defense Profile." One of the "Structural Defenses" identified by Morgan Stanley is a "Significant Insider Stake," which is described as follows: "Approximately 30% of shares outstanding held by insiders, enough to act as a strong deterrent."[51] In fact, the shares held by "insiders" represent a larger stake of 38% and an even larger percentage of the shares expected to vote.

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[46] Harkins Report at 4.

[47] *Id.* at 5.

[48] Harkins Tr. 164:14-15.

[49] Eichler Tr. 103:12-23, 141:6-7 & 14-23; Aletheia Manual (ARMI-BN 29 at 45).

[50] *See* Morgan Stanley Materials (MS 168-85).

[51] *Id.* (MS 182).

Thus, the insider stake is an even "stronger deterrent" than Morgan Stanley imagined. The preservation of that deterrent, by setting the trigger of the Rights Plan at 20%, is unquestionably a material advantage to the Riggios and a material disadvantage to Yucaipa in a proxy contest. No reasonable argument can be made to the contrary.

2. The 20% Trigger Is Not a Reasonable or Proportionate Means to Prevent Yucaipa From Acquiring Control

a. Yucaipa Cannot Acquire Control With Fewer Shares Than the Riggios

The record is bereft of any reasoning or analysis that was provided to the Board demonstrating that the trigger level of the Rights Plan needed to be set at 20% in order to prevent Yucaipa or any other stockholder from acquiring control in these circumstances.[52] Even if one considers the possibility of a group acting to acquire control, a 20% trigger is not reasonable or proportionate. A properly-operating Beneficial Ownership provision would prevent a group from acquiring a greater percentage than the Riggios.

Defendants cannot make any credible argument as to why a 20% trigger is a reasonable method to accomplish the objective of the Rights Plan set forth in their Board minutes and public statements, *i.e.*, to prevent a change of control at a disadvantageous price. Consequently, Defendants have developed a new purpose for the Rights Plan nowhere set forth in the Board's minutes, the Board resolutions, the Cravath materials, the Morgan Stanley materials, or the public disclosures about the Rights Plan.[53] This new rationale is

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[52] Barshay concedes that at 30% Yucaipa would not have control and further concedes that Yucaipa never made an unsolicited offer to acquire any other company and never previously threatened a proxy contest. Barshay Tr. 170:4-22, 234:19-21.

[53] *See generally* Nov. 17, 2009 Board Minutes & Resolutions (BKS 922-28); Feb. 16, 2010 Board Minutes & Resolutions (BKS 4285-94); Cravath Mem. for B&N Board, Nov. 17,

that the Rights Plan prevents an "arms race" between the Riggios and Yucaipa because it would be detrimental for the public stockholders to remain in a corporation with two large stockholders. The problem with this new purpose for the Rights Plan—besides the fact that it was never identified in the minutes or public disclosures about the Rights Plan—is: (a) there was no information presented to the Board to substantiate the conclusion that two large stockholders at B&N would be worse than one large stockholder who habitually self-deals with the Company; and (b) preventing an "arms race" between the Riggios and Yucaipa is simply an effort to protect the Riggios from being forced to purchase shares to maintain their percentage advantage over Yucaipa, as they did when Pershing increased its B&N stake.

By any other name, the "arms race" that Defendants now claim they are trying to prevent is what might otherwise be termed competitive bidding—two bidders competing in the public market for the shares of the public. Such a competition may not be attractive to the bidders—such as the Riggios—as it is not preferable to a controlling stockholder that has engaged consistently in pervasive self-dealing transactions. However, it ought to be very attractive to the Company's public stockholders. Defendants were not presented with any advice and have no basis to conclude otherwise. In addition, the prospect of another large stockholder to balance or neutralize the power of the Riggios—and who would have the ability to hold the Riggios accountable—ought to be an advantage to the public stockholders. Again, Defendants were not presented with any advice on this subject when they adopted the Rights Plan and have no basis to conclude otherwise.

2009 (BKS 781-84); Cravath PPT Slides, Nov. 17, 2009 (BKS 790-91); Morgan Stanley Materials, Nov. 17, 2009 (MS 168-72); Form 8-K, Nov. 18, 2009; Form 8-K, Feb. 17, 2010.

The short story of this "arms race" is that Daniels made notes of a comment Del Giudice made at a board meeting about preventing an "arms race."[54] That comment never made it into the minutes and never became the basis for the Board's purpose in adopting the Rights Plan because it obviously reflects a desire to protect the Riggios—as was done when Pershing threatened their percentage ownership. When her notes were produced in discovery and she was questioned about the reference to an "arms race," Defendants creatively decided to attempt to make a silk purse from a sow's ear. The newly-minted "arms race" rationale shows an improper purpose, not a reasonable purpose, for the Rights Plan or its trigger.

b. Yucaipa Is Not a Threat to Acquire Control.

In their brief, Plaintiffs demonstrated that Yucaipa has no intent to acquire control of the Company, has offered to enter into a "standstill agreement," and has no history of making hostile acquisitions. In their brief, Defendants spend four pages citing articles never produced in discovery and never provided to the Board in a belated effort to concoct a story that Yucaipa is a threat. Those articles are unsubstantiated hearsay and often are double hearsay, as one article quotes another. In fact, most of those articles relate to Yucaipa's investment in Wild Oats—where Yucaipa acquired 17% of the stock. Defendants also cite an article quoting yet another article for the unsubstantiated proposition that "Burkle is calling the shots [at Wild Oats] now."[55]

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[54] While Del Giudice coined the term "arms race," he repeatedly reaffirms that the "only" reason for adopting the Rights Plan was to prevent a shareholder from "taking majority control of the company without paying a premium." *See* Del Giudice Tr. 222:8-12. *See also id.* 176:10-19; 188:10-18; 214:12-21; 217:11-17; 219:20-25; 232:6-10.

[55] DOB Ex. 2 at 1.

Finally, in the ultimate contradiction, Defendants cite to reported complaints by a stockholder in Source Interlink Companies. Defendants assert that "Yucaipa had a 34% stake and a majority of the board at the time" in Source Interlink and that a stockholder was complaining that Yucaipa had elected a majority of the board without paying a control premium.[56] The implication of this criticism is that Defendants were attempting to protect against Yucaipa doing the same thing at B&N. What Defendants ignore is that the same situation already exists at B&N by virtue of the Riggios' interest and the relationship between the Riggios and the incumbent Board. In the case of B&N, a public stockholder concerned about a 34% stockholder exercising control without paying a control premium would be concerned about the Riggios, not Yucaipa.[57] The stockholders would support allowing Yucaipa to acquire additional shares to neutralize the control already exercised by the Riggios, not put a Rights Plan in place to protect the Riggios from that competition.

The simple facts are that Yucaipa has never attempted or made a hostile acquisition of a public company.[58] The most that can be said about Yucaipa is that it is an activist investor. Exhibits that Defendants seek to introduce at trial, but which were never produced by Defendants in this litigation, demonstrate as much.[59] For example, one article is titled "Ron

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[56] DOB at 8.

[57] Higgins and Barshay have conceded that when L. Riggio increased this ownership from 24% to in excess of 30%, he did it at market without a control premium. Higgins Tr. 256:20-257:12; Barshay Tr. 209:20-210:8.

[58] *See* Burkle Tr. 128:11-13 ("The more we looked at [the Rights Plan], the more we read it, surprised his Board approved it given that *we haven't done anything hostile ever.*") (emphasis added).

[59] At the beginning of this litigation, Plaintiffs propounded interrogatories to Defendants seeking answers to certain inquiries about the basis for the Board's conduct, including one which asked for Board materials that "set forth the corporate benefit to Barnes & Noble" of adopting the Rights Plan and that "set forth the Barnes & Noble corporate policy and the

Burkle Thinks Like An Activist," and discusses that Burkle's plan is to launch a corporate governance fund in 2007.[60] Another describes Burkle as an activist in connection with the Whole Foods investment.[61]

Finally, another document that was never produced in this litigation and that Defendants seek to mark Defendants' Trial Exhibit 320 actually demonstrates that Yucaipa has no history of making unsolicited or hostile acquisitions. That document is the Capital IQ profile for Yucaipa, which describes it as an "investment firm specializing in private equity and venture capital investments."[62] While this document is not entirely accurate, the profile lists transactions in which Yucaipa has been involved. In the category identified as "Buy-Side Merger/Acquisition," only one of the twenty-seven transactions listed involved a public company (Xinhua Sports & Entertainment Ltd.), and that involved the acquisition of a 6.21% stake [for $25.7 million] from investors no longer bound by a lockup agreement. All of the other acquisitions were of private companies on a negotiated and friendly basis. The other transactions involving public companies were purchases of equity in private placements from Morgans Hotel Group Co. ($75 million purchase of preferred securities), The Great Atlantic & Pacific Tea Company, Inc. ($115 purchase of cumulative, convertible preferred shares representing 27.6% on fully-diluted basis), Xinhua Sports & Entertainment Ltd. ($30 million purchase of convertible preferred shares representing 12.1% if fully converted), Pathmark

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danger to it and its effectiveness addressed by" adopting the Rights Plan. Defendants responded that any Board materials that set forth the basis for these matters would be produced. Defs.' Resps. To Pls.' First Interrogs. Nos. 4 & 5. None of these documents were ever produced; consequently, they cannot be used by Defendants to justify their conduct.

[60] DX 330.

[61] DX 343.

[62] DX 320 at 1.

Stores, Inc. (approximately $150 million purchase of common stock representing 40% stake), Fleming Companies, Inc. ($50 million purchase of common stock representing an 8.7% stake), Simon Wordwide Inc. ($25 million purchase of convertible preferred representing 23% of the common if fully converted), and LiveWorld Inc. (Yucaipa was one of eleven buyers of private placement of convertible preferred that in the *aggregate* was for $25 million). In short, the very exhibits Defendants seek to introduce at trial actually confirm that Yucaipa has no history of making hostile or unsolicited acquisitions of public companies. What it does have is a history of being an active investor in those companies in which it invests.

While Yucaipa does not represent any acquisition threat, Defendants acknowledge in their brief that Leonard Riggio has a personal hostility for Ron Burkle. Defendants state that "Mr. Riggio had known Mr. Burkle as a result of an investment that Mr. Riggio had made in a company that was formed to acquire the Source Interlink Companies . . . Along with many others, Mr. Riggio lost millions of dollars in that investment and was distressed about the lack of concern that Mr. Burkle had demonstrated for the interests of Mr. Riggio and other investors."[63]

3. The Board Treatment of the Riggios Shows that 20% Is Not Control.

During his deposition, Scott Barshay—the Cravath partner who counseled the Board—asserted that the Riggios do not have control despite their over 30% stake, history with the Company, executive positions, participation in selecting the Board members, and

[63] DOB at 8-9.

relationships with the Board members.[64] He was forced by logic to concede that Yucaipa also could not have control with a comparable percentage of stock, much less 20% of the stock.[65]

4. The Other Provisions of the Rights Plan Exacerbate Its Unreasonableness

As noted in Plaintiffs' Brief, the Rights Plan contains other provisions that exacerbate its unreasonableness. One such provision authorizes the Board to approve purchases of stock by an Excluded Person so that additional purchases by the Excluded Person will not trigger the Rights, but does not give the Board the same power to approve purchases by other stockholders. In their brief, Defendants contend that the Board has that same power to approve purchases by other stockholders, such that the Board could approve stock purchases by Yucaipa in excess of 20% without triggering the Rights.[66] The Rights Plan does not expressly give the Board that authority.[67] However, if Defendants are correct, the Board's refusal to have any discussions with Yucaipa with respect to its request to acquire additional

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[64] *See* Barshay Tr. 232:2-6.

[65] *See id.* 234:19-21.

[66] DOB at 20.

[67] A comparison of the relevant provisions reveals the difference. Acquiring Person is defined as "any Person who or which . . . shall be the Beneficial Owner of more than 20% of the Common Shares then outstanding, but not including [certain specified situations]." Rights Plan, § 1, Definition of Acquiring Person. Neither the definition of Acquiring Person nor the exclusions to that provision allow for acquisitions by a Person in excess of 20% if approved by the Board. The provisions that are triggered by a Person becoming an Acquiring Person do not have any exception for Persons who become an Acquiring Person with the approval of the Board. *Id.* at § 3 (Issue of Rights), § 7 (Exercise of Rights), and § 11 (Flip-In allowing dilutive purchases). By contrast, the exclusion for Excluded Persons expressly states that Excluded Person is not an Acquiring Person "unless and until such Excluded Person shall acquire after the date hereof, *without the prior approval of the Board*, Beneficial Ownership of any additional Common Shares[.]" § 1, Definition of Acquiring Person, subpart (c).

shares is even more unreasonable, because the Board had the power to negotiate the amount of additional purchases it might permit Yucaipa to make and under what conditions.

C. The Use of a Rights Plan to Prevent Collective Stockholder Action in a Proxy Contest Is Not Reasonably Related to a Proper Corporate Objective

1. Frustrating a Proxy Contest Is Not a Cognizable Objective

Defendants do not contest that adopting, interpreting, or using a Rights Plan for the purpose of impairing or impeding a proxy contest for the election of directors is an improper objective for a Rights Plan. Indeed, Defendants state that "the Board's primary objective in this case was a traditional and well-recognized one—to prevent the risk of a corporate takeover at an inappropriately low price through an acquisition strategy that denied the Board a meaningful opportunity to bargain on its shareholders' behalf."[68]

2. The Company's Interpretation of the Beneficial Ownership Provision Materially Impairs the Conduct of a Proxy Contest

In their brief, Plaintiffs explained their experts' opinions that the Beneficial Ownership provision impairs or impedes a proxy contest in two general ways. *First*, the definition of Beneficial Ownership is so ambiguous that stockholders cannot be certain when a conversation becomes an "agreement, arrangement or understanding . . . for the purpose of . . . voting" stock. As noted above, Defendants were similarly uncertain about whether certain types of conversations would trigger the Rights Plan, and even the Cravath partner who counseled the Board was unsure.[69] The risk that a conversation might result in triggering the Rights has an *in terrorem* effect on the willingness of institutional stockholders

[68] DOB at 43.

[69] *See* Barshay Tr. 261:18-262:21.

to have such conversations. The deletion of the second clause respecting "understandings" to "cooperate" for the purpose of "influencing control" does not cure this problem, although that clause certainly was the most expansive and ambiguous. *Second*, the experts explained that the inability to enter into outright agreements for the conduct of a proxy contest, particularly with respect to selecting nominees, setting an agenda for change, and sharing expenses also impairs or impedes the proxy contestant. Defendants' expert does not disagree; he simply opines that notwithstanding those impairments there is a mathematical possibility that Yucaipa may win a proxy contest, provided it can garner Aletheia's support.

In their brief, Defendants mischaracterize the positions of Plaintiffs' experts. Defendants first assert that Plaintiffs contend that the Rights Plan is "preclusive" because the Rights Plan "diminishes the ability of the dissident to know, in advance and with certainty, that it will prevail."[70] However, the simple and obvious truth is that any reasonable stockholder—before beginning a proxy contest—would survey what support it might have from other large stockholders by reaching some "agreement" or "understanding" as to how such stockholders will vote. Yet such understandings or agreements, Defendants say, will trigger the Rights Plan. In that way, the Rights Plan forces a stockholder to commit in a vacuum to the substantial investment of resources required to mount a proxy contest. But that is not the only way the Rights Plan impairs or impedes the proxy process.

Defendants next contend that Yucaipa has changed position on whether it will conduct a proxy contest.[71] Defendants are wrong. Plaintiffs have consistently conveyed that they are prepared to conduct a proxy contest, given a resolution of this litigation that would

[70] DOB at 47.

[71] *Id.* at 51.

level the playing field by removing the impairments created by the Board.[72] Plaintiffs also stated that one of the first steps they would take would be to communicate with other major stockholders about whether those stockholders would support a joint slate or the slate proposed by Yucaipa. Plaintiffs sought relief sufficiently in advance of the date for notice of nominations under the Company's bylaws precisely so that those discussions could occur.[73] If those discussions are precluded by the Rights Plan on the basis that they may result in an "understanding" about "voting," Yucaipa may be unable to rationalize the risk and expense of a proxy contest without knowing its prospects, especially if it is precluded from acquiring additional shares to close the gap with the Riggios. Conversely, even if those discussions are allowed to occur, Yucaipa might learn facts—such as what has been discovered in this litigation about Aletheia's policy of not voting shares or passing that vote to its institutional investors—that would dissuade it from conducting a proxy contest, especially if Yucaipa is precluded from acquiring more shares itself to close the gap with the Riggios. Burkle's testimony was consistent with the representations made to the Court and with common sense.[74]

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[72] *See* Mot. for Expedited Proceedings ¶ 13 ("In order for Yucaipa to be able to wage a meaningful proxy contest . . . Yucaipa needs relief from this Court to level the playing field . . . ."). *See also* Ltr. from D. McBride to Court, May 13, 2010 (". . . Plaintiffs . . . may not be willing to incur the substantial expense of a proxy contest where the playing field is so biased against them and, perhaps even more importantly, 'rules' of the election are unresolved."), at 4.

[73] *See* Mot. for Expedited Proceedings ¶ 13.

[74] Burkle Tr. 8:14-9:23, 283:8-19.

3. Attribution Rules Addressing a Proxy Contest for the Election of Directors Are Not Needed to Protect Against Changes of Control.

In their brief, Plaintiffs demonstrated that the Beneficial Ownership provision of the Rights Plan need not be interpreted or drafted so broadly as to cover a proxy contest to elect three directors to a nine member Board in order to serve its presumed purpose. Defendants argue that the reasonableness of the Beneficial Ownership language already has been resolved in *Stahl v. Apple Bancorp, Inc.*[75] However, *Stahl* involved a proxy contest in connection with an acquisition proposal and did not involve an insider voting group being advantaged in the proxy contest by the use of the Beneficial Ownership. Under the interpretation of the Beneficial Ownership provision being advanced by Plaintiffs, a group conducting a proxy contest—as was the case in *Stahl*—would be covered by attribution rules applicable to "agreements" for the purpose of "acquiring, disposing or holding" shares. In addition, under Plaintiffs' interpretation, attribution also would result from agreements that provide to one person "control" of the vote of shares owned by another, even in a proxy contest only for the election of directors. In short, Defendants' interpretation and application of the Beneficial Ownership unnecessarily impairs proxy contests and is not sanctioned by *Stahl.*

In their brief, Defendants cite to Section 203 and SEC Rule 13d-5 as precedent for the existing language in the Rights Plan.[76] Section 203 contains the same language as the Rights Plan, but that language has never been interpreted to have the meaning urged by Defendants here. Section 203 concerns "takeovers" and is not intended to impair or impede proxy

[75] 1990 Del. Ch. LEXIS 121 (Aug. 9, 1990).
[76] DOB at 54.

contests for the election of directors unrelated to any acquisition proposal. In addition, the consequences of becoming an Interested Stockholder under Section 203 are distinct from the consequences of triggering the Rights Plan. Under 203, the consequence is foreclosure from entering into a "Business Combination" with the Company for three years unless the Business Combination comes within a specified exception, which includes a business combination approved by a 2/3rds vote of stock other than shares of the Interested Stockholder. Thus, a stockholder would only be concerned about becoming an Interested Stockholder under Section 203 if it intended or anticipated proposing a Business Combination. Stockholders seeking only to elect directors would not be concerned with such a prohibition. In short, the consequences of triggering Section 203 are tailored to the objective of the statute, *viz.* to force an acquirer to negotiate with the Board before pursuing a Business Combination.

The SEC Rules are also different from the Rights Plan. As explained in Plaintiffs' Brief, Rule 13d-3(a) defines beneficial ownership as existing when a person has or shares "voting power which includes the power to vote, or to direct the voting of such security."[77] Defendants do not cite this Rule, and it supports Plaintiffs' position. The Rule Defendants cite provides that "[w]hen two or more persons *agree to act together* for the purpose of acquiring, holding, voting or disposing of equity securities" the securities of each member of the "group" are treated as beneficially owned by every other member.[78] This Rule is broader than the definition of Beneficial Ownership in the Rights Plan because it covers "agree[ments] to act together," language not included in the Rights Plan definition. More

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[77] 17 C.F.R. § 240.13d-3(a).

[78] 17 C.F.R. § 240.13d-5(b)(1).

importantly, this broader language is reasonable in the context of Section 13(d) because it is simply a reporting requirement. The SEC does not impose sanctions on stockholders who organize to conduct a proxy contest, and the SEC presumably would not be in favor of such sanctions in light of its current efforts to facilitate stockholders' ability to nominate directors through "proxy access."[79]

D. The Board's Refusal to Negotiate or Communicate with Yucaipa Concerning Its Request to Increase Its Position to Match the Riggios Was Not Reasonable.

Whatever concerns the Board had with respect to Yucaipa's intentions when the Rights Plan was originally adopted, Yucaipa's request for leave to exceed the 20% limit was the perfect opportunity for the Board to have discussions about that subject with Yucaipa and to propose alternatives—such as the standstill agreement Burkle suggested in a subsequent meeting—that would allow Yucaipa to compete with the Riggios without threatening a "creeping acquisition." Yucaipa's proposal made evident that Yucaipa was agreeable to keeping the Rights Plan in place with either a higher trigger level or with the Board retaining discretion to allow share purchases in excess of 20% on a case-by-case basis. But the Board's response to this proposal was led by the conflicted Leonard Riggio and his personal investment bankers. There were no discussions, and the response was an absolute and unconditional "no." Such conduct is even more inexplicable if the Board *did* have discretion under the Rights Plan to approve such an acquisition, as the Company now contends is the case.

[79] Facilitating Shareholder Director Nominations, SEC Release Nos. 33-9046, 34-60089.

E. The Board Has Used the Rights Plan in a Discriminatory Manner.

The Board's avowed purpose of preventing an "arms race" is a virtual admission of its discriminatory intent. The Board's apparent objective was to prevent any other stockholder from acquiring shares sufficient to compete with the Riggios and to allow the Riggios to maintain their dominant stock position without purchasing additional shares.

III. THE RIGHTS PLAN IS INVALID BECAUSE ITS ADOPTION WAS NOT ENTIRELY FAIR

Count V of Plaintiffs' Verified Complaint expressly alleges that the adoption of the Rights Plan is a self-dealing transaction subject to "entire fairness" scrutiny. Defendants have presented no response to this Argument, but will undoubtedly address it in their Answering Brief, to which Plaintiffs will have no opportunity to respond before trial.

IV. THE RIGHTS PLAN WAS ADOPTED AND IMPOSED IN BAD FAITH, IS INVALID UNDER *BLASIUS* AND SHOULD THEREFORE BE ENJOINED

A. The Board Acted in Bad Faith to Advantage the Riggios

Plaintiffs' Brief evidences the fact that the Board adopted the Rights Plan to advantage the Riggios. Such a motivation constitutes bad faith because it is conduct undertaken for an impermissible purpose—advantaging the Riggios. The avowed "arms race" rationale for the Rights Plan is a virtual admission that the Rights Plan was intended to protect the Riggios' dominant stock position from competition from Yucaipa and to allow the Riggios to remain the largest stockholders in the Company. Defendants expressly state that they did not want two large stockholders,[80] which necessarily means that the Defendants' objective was to leave the Company with one large stockholder—the Riggios.

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[80] DOB at 17.

B. The Board Acted to Suppress Stockholder Activism Without a Compelling Justification.

Plaintiffs' Brief also evidences the fact that the Board was acting to suppress "stockholder activism" by making a proxy contest more difficult. Such a motivation falls squarely within the *Blasius* test for conduct undertaken for the principal purpose of "inter[ing] with or imped[ing] the effective exercise of the shareholder franchise in a contested election for directors."[81] Defendants contend that their conduct does not come within *Blasius*, even if it was intended to impair or impede the franchise, so long as there is still a mathematical possibility that Yucaipa could prevail in the proxy contest.[82] However, the *Blasius* doctrine, as articulated by the Delaware Supreme Court in *MM Cos.*, requires a compelling justification for conduct undertaken for the principal purpose of "inter[ing] with or imped[ing] the effective exercise of the shareholder franchise in a contested election for directors."[83] Neither *MM Cos.* nor *Blasius* is so indifferent to the protection of the stockholder franchise as to permit directors to purposefully impair or impede the franchise without justification, so long as the stockholders retain the mathematical possibility of prevailing in a proxy contest. Rather, Board action for the purpose of interfering or impeding the franchise cannot be undertaken absent a "compelling justification."

After misstating the test, Defendants go on to declare that they have a "compelling justification" because they contend they are acting in good faith for what they believe to be "in the best interests of the corporation." This defense conflates "good faith" with "compelling justification." It is always necessary for directors to act in "good faith." That is

[81] *MM Cos. v. Liquid Audio, Inc.*, 813 A.2d 1118, 1132 (Del. 2003).

[82] DOB at 67-68.

[83] *MM Cos.*, 813 A.2d at 1132.

necessary but not sufficient to survive scrutiny under *Blasius*. When acting to purposely impair or impede the franchise, the directors also must have a "compelling justification." As Chancellor Allen made clear in *Blasius,* the Board's good faith belief that the exercise of the franchise would not be in the best interest of the corporation is not sufficient to justify conduct that purposefully impairs or impedes the franchise.[84]

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[84] *See Blasius Indus., Inc. v. Atlas Corp.*, 564 A.2d 651 (Del. Ch. 1988).

CONCLUSION

In short, Defendants have failed to explain what legitimate corporate policy or purpose justifies a rights plan that preserves the effective internal voting power of the Riggios and the Board at 38% or more and freezes all other stockholders acting as a "group" at half that amount, especially when the limited purpose of that "group" is to elect three (out of nine) directors at an annual meeting. The Company's interpretation of the Rights Plan's attribution rules and the words "agreement, arrangement, or understanding" to include even "non-binding agreements or understandings"—coupled with devastating economic consequences of having a conversation that results in such an "understanding"—substantially hinders the ability to conduct a proxy contest.[85]

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[85] Barshay Tr. 277:22-279:15.

CERTIFICATE OF SERVICE

I, Kristen Salvatore DePalma, Esquire, hereby certify that on July 30, 2010, a copy of the foregoing document was served on the following counsel in the manner indicated below:

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