LEGAL UPDATES

PUBLISHED: MAY 19, 2014

Delaware Chancery Court Upholds Sotheby's Stockholder Rights Plan Against Activist Challenge

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The Delaware Court of Chancery's recent decision in *Third Point LLC v. Ruprecht*, C.A. No. 9469-VCP (Del. Ch. May 2, 2014), denied a motion by stockholders, including activist hedge fund Third Point, to preliminarily enjoin the annual meeting of publicly held auction house Sotheby's. The stockholders alleged that the Sotheby's board violated its fiduciary duties by (1) adopting a stockholder rights plan with a two-tiered trigger, capping stockholders who file Schedule 13Ds at 10 percent of the outstanding stock, but permitting passive investors who file Schedule 13Gs to acquire up to 20 percent of the outstanding stock (the "Rights Plan"); and (2) refusing to grant a waiver enabling Third Point, Sotheby's largest stockholder, to acquire up to 20 percent of its outstanding stock. In a decision with important implications concerning Delaware courts' evaluation of "legally cognizable" threats to corporate policy and effectiveness that can support the implementation of a stockholder rights plan (or "poison pill"), Vice Chancellor Donald F. Parsons held that the shareholder plaintiffs were not likely to succeed on the merits of their allegations.

What This Means to You

Stockholder rights plans, or "poison pills," historically have been deployed in the context of hostile takeover attempts. This case is significant because it supports the application, in an appropriate case, of traditional takeover defenses against the evolving threat of corporate policy being hijacked by "negative control" exerted through shareholder activists' exercise of "disproportionate control and influence over major corporate decisions, even if they do not have an explicit veto power." The decision also supports the deployment of a poison pill in response to rapid stock accumulations by activists that threaten a “creeping” change in control without investors receiving an appropriate premium.

The decision further serves a reminder of the role of electronic discovery in these cases. The record cited numerous emails from both sides that included derogatory comments about the other parties, some of which the court focused on as evidence of motive and intent. For the Sotheby’s parties in particular, sensitive business information may have been released when these materials were made public. It is important for corporate directors and management teams to bear in mind the discovery risks attached to conducting sensitive deliberations through written and electronic communications when evaluating potential threats or facing potential litigation.

The Sotheby’s Rights Plan

The Sotheby’s board began consulting with its legal and financial advisors during the summer of 2013, following SEC filings and receipt of information from their proxy solicitor showing a rapid accumulation of shares was underway by Third Point and two other hedge funds, Marcato Capital Management LLC and Trian Fund Management, L.P. At a meeting on August 6, 2013, Sotheby’s board received presentations from its financial advisor, Goldman Sachs, and outside counsel concerning current stockholder activism, and specific information on these three funds. This presentation included a focus on “wolf pack” tactics, where multiple hedge funds or other activists – while not forming a “group” under SEC rules – may engage in consciously parallel actions that effectively transfer control of a corporation without shareholders having the opportunity to receive a control premium.

On August 9, 2013, Sotheby’s management met separately with both Marcato and Third Point. The record indicated Marcato urged management to return to stockholders much of the cash-on-hand Sotheby’s held as a hedge to limit borrowing required to support the natural volatility of its business, and Third Point questioned management on several strategic topics, including what they would “do differently if Sotheby’s was a private company.” The funds increased their holdings over the next two months as Sotheby’s board began considering a returning of capital in response to investor concerns, announcing on September 11 that the company was “conducting a capital allocation review.”

Third Point filed an amended Schedule 13D on October 2, 2013, revealing its stake had increased to 9.4 percent of Sotheby’s outstanding shares. The amendment included a letter from Third Point’s Loeb to William Ruprecht, Sotheby’s Chairman, President and CEO, leveling several unsupported accusations against the management and board and publicly stating that Third Point planned to replace Ruprecht as CEO and had initiated discussions with potential candidates. Over the following two days, the board learned the funds had increased their collective stake to approximately 19 percent of Sotheby’s shares. After again reviewing activists’ tactics to acquire “creeping control” and potential responses with its advisors, the board adopted the two-tiered Rights Plan described above. The Rights

Plan was to expire in one year unless approved by subsequent vote of Sotheby's stockholders and included a "qualifying offer" exception, exempting a cash tender offer for "any-and-all" outstanding shares provided it remained open for at least 100 days.

Throughout late 2013 and early 2014, as negotiations failed to resolve the controversy, the Sotheby's board became increasingly concerned over the extent to which aggressive tactics by Loeb and Third Point were raising doubts over the stability of the company and driving business to its chief competitor, Christie's. Third Point amended its 13D while the Sotheby's board was meeting on February 27 to announce an increase in its stake to 9.53 percent and a short-slate proxy contest to elect 3 directors at Sotheby's May 6 annual meeting. Following failed further negotiations, Sotheby's denied Third Point's request for a waiver to allow it to purchase up to 20 percent of the company. Third Point filed suit and sought to enjoin the annual meeting, alleging that the board adopted and enforced the Rights Plan for the primary purpose of inhibiting its ability to wage a successful proxy contest without compelling justification for doing so, that the refusal to waive the 10 percent trigger was disproportionate to any threat posed by Third Point and constituted an impermissible effort to entrench the board, and that they would be irreparably harmed if the meeting went forward while the inhibition on their voting rights existed.

The Decision

Vice Chancellor Parsons confirmed that the legal standard for assessing the validity of *any* contested rights plan in Delaware, whether it is adopted in response to a hostile takeover or otherwise, is the "reasonableness" standard originally articulated in *Unocal Corp. v. Mesa Petroleum Co.* A board must satisfy two criteria to justify the adoption of a rights plan under Unocal: (1) a reasonableness test, which is satisfied by demonstrating the board had reasonable grounds for believing that a legal cognizable threat to corporate policy and effectiveness existed; and (2) a proportionality test, which is satisfied by demonstrating that the board's defensive response was appropriate in relation to the threat posed.

The decision notes a board satisfies the first prong of the *Unocal* test by demonstrating a good faith and reasonable investigation that leads to the finding of an objectively reasonable threat. The proportionality test under *Unocal* is satisfied if a court can conclude that (1) the board's defensive actions are neither preclusive (i.e., imposing a predetermined outcome on shareholders) nor coercive (i.e., penalizing neutral shareholders who do not act as the board wishes); and (2) they fall within a range of reasonable responses to the threat posed. The court rejected plaintiffs' attempt to require the Sotheby's board to demonstrate a "compelling justification" for its actions under the more stringent test articulated in *Blasius Industries, Inc. v. Atlas Corp.*, noting the *Blasius* test could be applied within the Unocal framework only where "the primary purpose of the board's action is to interfere with or impede exercise of the shareholder franchise and the shareholders are not given a full and fair opportunity to vote." The court found that such was not the case here, and pointed out that plaintiffs cited no Delaware case in which *Blasius* was invoked in testing a rights plan under *Unocal*.

Applying *Unocal* to the actions of the Sotheby's board, the court denied plaintiffs' motion for a preliminary injunction. Vice Chancellor Parsons found plaintiffs had failed to demonstrate a reasonable probability of success on their claims since the board could likely demonstrate, based on evidence presented, that its adoption of the poison pill was both rational and proportional to the threat posed by the activist funds.

Specifically, the court found that Sotheby's board, composed almost entirely of independent directors with no discernable entrenchment motive, made a *prima facie* showing of having conducted a good faith and reasonable investigation. The board held extensive consultations with competent outside financial and legal advisors, who informed the board that it was not uncommon for activist hedge funds to informally coordinate their acquisition of large blocks of a target company's stock. Evidence of such a "creeping control" threat was provided by the funds' multiple 13D filings, coupled with aggressive public statements by Third Point's Loeb about changing management.

Focusing on these factors, the Vice Chancellor found that the Rights Plan's two-tiered trigger could be reasonable under the circumstances, and that the board could demonstrate that it made "an objectively reasonable determination that Third Point posed a threat of forming a control block for Sotheby's with other hedge funds without paying a control premium." The court also found plaintiffs failed to demonstrate a reasonable ability to prove the Rights Plan was either "coercive" or "preclusive," since it did not force a stockholder to vote in favor of the board or penalize a stockholder for not doing so. Both sides presented evidence that, even with the Rights Plan in place, the election contest was "too close to call." Accordingly, the court found the board probably could demonstrate that its adoption of the Rights Plan was a reasonable and proportionate response to the "creeping control" threat posed by the activist funds.

The court found the board's refusal to waive the Rights Plan's 10 percent trigger during the proxy fight to be a "much closer question," since Third Point asked only to raise its stake to the same 20 percent level permitted for passive investors and did not request a waiver of the entire Rights Plan, thus limiting the potential for a "creeping takeover." However, the record coupled the fact that a 20 percent stake would make Third Point "by far" Sotheby's largest stockholder with evidence of over-the-top "aggressive and domineering" conduct by Third Point's CEO – such as contacting a real estate developer the company was working with and informing him that Loeb was "in charge" and would be making Sotheby's future real estate decisions. This persuaded the Vice Chancellor that Third Point potentially could exercise influence sufficient to control important corporate actions "despite a lack of actual control or an explicit veto power." He found the board could demonstrate that this risk of "negative control" constituted an objectively reasonable, legally cognizable threat to Sotheby's corporate policy and effectiveness, and that its refusal to grant Third Point a waiver from the 10 percent trigger fell within the range of reasonable responses to that threat.

The Settlement

The day before Sotheby's May 6 annual meeting, the parties announced that they had settled the proxy contest and Third Point was withdrawing its suit with respect to the Rights Plan. Sotheby's agreed to add Mr. Loeb and two other directors nominated by Third Point to its board. The parties further agreed that Third Point would cap its ownership at 15 percent and Sotheby's would terminate the Rights Plan concurrent with its annual meeting.

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