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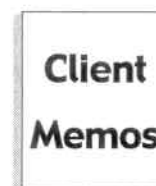

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IN THE COURTS

Delaware Court Upholds Poison Pill Defense Against Activist

By Jason M. Halper, William P. Mills, Martin L. Seidel, and Gregory A. Markel

In a May 2, 2014 ruling relating to activist hedge fund Third Point LLC's proxy battle with auction house Sotheby's, the Delaware Chancery Court found that Third Point was not likely to succeed in its argument that the Sotheby's board violated its fiduciary duties when it adopted a two-tiered stockholder rights plan in response to a rapid accumulation of shares by activist funds and later refused Third Point's request for a waiver of the rights plan.[1] While the Court did not address the claims on the merits, the preliminary injunction opinion offers important guidance for boards in deploying a rights plan, particularly one that treats active and passive stockholders differently.

Background

The Sotheby's rights plan contains an increasingly common two-tier structure. The plan is triggered if "active" stockholders who disclose ownership on a Schedule 13D acquire 10 percent of Sotheby's stock or if "passive" stockholders who disclose ownership on a Schedule 13G acquire 20 percent of Sotheby's stock. The plan has a term of one year unless approved by stockholders and also contains a "qualifying offer" clause, which exempts from the rights plan certain offers for all of the company's shares, a feature favored by proxy advisory firms.

When it adopted the rights plan in October 2013, the Sotheby's board had observed significant share accumulations by several hedge funds, including Marcato Capital, Trian, and Third Point. These accumulations were accompanied by Schedule 13D filings by Third, Point and Marcato disclosing intentions to consider seeking fundamental changes at Sotheby's, including an extraordinary corporate transaction. Third Point later announced that it would run a slate of director candidates at Sotheby's annual meeting and requested that the board waive the 10 percent trigger so that Third Point could acquire up to 20 percent of Sotheby's shares. Sotheby's rejected the waiver request citing, among other things, "the risk that Third Point could obtain 'negative control' or effectively a controlling influence without paying a premium with respect to certain matters if it achieved a 20% stake."

On May 5, 2014, following the decision, Sotheby's and Third Point announced that they had settled the proxy contest and Third Point agreed to withdraw its lawsuit with respect to the rights plan. Under the agreement, Sotheby's will add Mr. Loeb and two other directors nominated by Third Point to the board. Sotheby's will terminate the rights plan concurrent with its annual meeting and Third Point has agreed to cap its ownership at 15 percent.

Takeaways

As is typically the case when Delaware courts evaluate a board's use of defensive measures, the particular facts of the case weighed heavily in the Court's ruling. Nonetheless, the decision is the first by a Delaware court to address the use of a two-tier stockholder rights plan in response to activist activity. It therefore provides important guidance to directors and their advisors in

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deploying rights plans in response to stockholder activism.

Effective Negative Control Can Be a Threat Against Which a Board May Deploy a Rights Plan

To pass muster under the *Unocal*[2] standard of review, a board must show that it adopted a stockholder rights plan in response to a reasonably perceived threat to corporate policy and effectiveness, and the plan must be a reasonable and proportional response to that threat. The Court said that whether there was a legally cognizable threat at the time Third Point requested a waiver of the rights plan's 10 percent trigger was "a much closer question" than whether a threat existed at the time of the board's adoption of the plan. Nonetheless, Vice Chancellor Parsons was persuaded that the potential for Third Point to obtain "negative control" posed an "objectively reasonable and legally cognizable threat." The Court found there was evidence that Sotheby's directors had "legitimate real-world concerns" that permitting Third Point to obtain 20 percent as opposed to 10 percent ownership could effectively permit Third Point to "exercise disproportionate control and influence over major corporate decisions."

The Court acknowledged it was breaking new ground because prior Delaware decisions addressing negative control dealt with situations where a person obtains an explicit veto right through contract or otherwise, whereas in this case the Court was addressing "effective" negative control. The Court observed that, at 20 percent, Third Point would "by far" be the largest stockholder and that fact, "combined with the aggressive and domineering manner in which the evidence suggests [Third Point founder Dan] Loeb has conducted himself in relation to Sotheby's," meant that the board could have legitimate concern that Third Point would be able to "exercise influence sufficient to control certain important corporate actions, such as executive recruitment, despite a lack of actual control or an explicit veto power."

The opinion provides a reminder to boards that a decision to maintain a rights plan must take into account the state of play as it exists at the time of the relevant decision.

Rapid Stock Accumulations by Activists Can Be a Threat Against Which a Board May Deploy a Rights Plan

Vice Chancellor Parsons' decision makes clear that rapid stock accumulation by activists, leading to so-called "creeping control," can constitute a reasonably perceived threat to corporate policy and effectiveness under *Unocal*.

When the board enacted the rights plan, several hedge funds were accumulating Sotheby's stock, with Third Point accumulating stock rapidly. The board's advisors informed it that activists commonly formed a "wolf pack" for the purpose of acquiring a large block of shares and, in that circumstance, there is a risk that activists acquire control without paying stockholders a control premium. Taking into account the funds' rapid accumulation of stock and the actions of these funds in other situations, the Court found sufficient evidence that the board made an objectively reasonable determination that Third Point and other funds posed a threat of acquiring creeping control.

A Two-Tiered Rights Plan Might Be a Reasonable Response by a Board

While the Court did not endorse the two-tier structure of the rights plan and noted some concern regarding discriminating against "active" versus "passive" stockholders, the Court also noted that the two-tiered structure

> arguably is a 'closer fit' to addressing Sotheby's needs to prevent an activist or activists from gaining control than a 'garden variety' rights plan that would restrict

the ownership levels for every stockholder, even those with no interest in obtaining control or asserting influence.

The Court highlighted the fact that a 10 percent threshold still allowed an investor to establish a significant stake in the company. Third Point was the company's largest stockholder with just under a 10 percent stake. In contrast, the board collectively owned less than 1 percent of the company. As the Court noted, a trigger level much higher than 10 percent could "make it easier" for Third Point and the other funds to acquire creeping control without paying a premium. The Court also noted that no Schedule 13G filers (which in theory could be more inclined to vote for incumbent directors than would an activist) owned more than 10 percent, which in this case made the question of whether a Schedule 13G filer should be permitted to buy more stock than an activist stockholder "a complete non-issue." It is important, however, to view the ruling in the light of the relevant facts, including a board with a low ownership stake and no passive investor—which would be subject to a higher ownership threshold under the rights plan—in actuality owning more stock than Third Point. It is an open question whether the outcome would have changed had these or other relevant facts been different.

The *BLASIUS* "Compelling Justification" Standard Could Potentially Be Implicated in Judicial Review of a Rights Plan

While *Unocal* is the appropriate standard of review for contested rights plans, the Court explained that it was possible (although not entirely clear) that the *Blasius*[3] standard of review also could be implicated within the *Unocal* framework in the stockholder rights plan context. Under *Blasius*, a board must show a compelling justification for actions it takes with the primary purpose of interfering with the effectiveness of a stockholder vote. In practice, this is a much higher standard to meet than *Unocal*, and courts rarely find that there is a compelling justification for actions that interfere with a stockholder vote.

The Court found that Third Point did not establish a reasonable probability that, by adopting the rights plan and not agreeing to Third Point's waiver request, the Sotheby's board was acting for the primary purpose of interfering with the stockholder franchise. The evidence showed that the board was responding to what it believed to be a threat to the corporation and "any effect of [sic] electoral rights was an incident to that end." Further, as the board was unstaggered and comprised of a majority of independent directors with no material financial interests in continuing to serve on the board, there was no evidence the directors were trying to entrench themselves or acting out of animus towards Third Point.

A Board Must Conduct a Good Faith and Reasonable Investigation into the Threat Posed By Activists

A board attempting to satisfy *Unocal* must demonstrate that its conclusion that there exists a threat to corporate policy or effectiveness is predicated on a reasonable and thorough investigation. If a board is comprised of a majority of independent directors and retains competent outside financial and legal advisors on which it relies, the board will establish a *prima facie* case of good faith and reasonable investigation. Boards should meet frequently with their advisors and request information on the activist landscape, the backgrounds of the activists who are known to be invested in the company's stock, the likely plan of attack by the activists and the company's alternatives and defensive posture. The board's investigation, analysis and conclusions with respect to the threat posed by the activists should be properly documented in the minutes of board meetings.

Boards Should Remember That Private Communications Among Directors May Become Public in Discovery

In the course of discovery for the case, several emails sent among directors became public and the source of media scrutiny. At the preliminary

injunction hearing, Third Point's attorneys highlighted emails from directors claiming that the compensation of the Sotheby's CEO was "red meat for the dogs" and that "[the directors] have handed Loeb a killer set of issues on a platter." While these emails do not appear to have adversely impacted the Court's decision, they did become the subject of several prominent articles in the media and serve as a reminder to boards to exercise discretion in communications, especially when a company is in the midst of a contested proxy solicitation.

A Properly Adopted Rights Plan Remains an Effective Tool for Boards in Combating Stockholder Activists

While the Court found that Third Point was not likely to succeed on its claims, the Court's analysis of the harm likely to be suffered by Third Point if it were successful underscores the effectiveness of rights plans. The Court found that the rights plan would reduce the likelihood of Third Point winning the proxy contest because, in a close contest, Third Point's inability to purchase more shares "substantially reduces its odds of winning." The Court cited an expert's report, which analyzed 34 proxy contests occurring in 2012 and 2013 and concluded that the 10 percent rights plan trigger reduces the probability that Third Point would prevail in the proxy contest by 21-25 percent. According to the Court, Third Point's reduced odds of winning "likely would have qualified as a threat of irreparable harm." However, because Third Point was unable to show a likelihood of success that the board breached its fiduciary duties, it still refused to grant a preliminary injunction notwithstanding the threat of irreparable injury.

Notes

1. *Third Point, LLC v. Ruprecht*, C.A. No. 9469-VCP (Del. Ch. 2014).
2. *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985).
3. *Blasius Indus., Inc. v. Atlas Corp.*, 564 A.2d 651 (Del. Ch. 1988).