

May 19, 2014

## *Third Point LLC v. Ruprecht*

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### **Delaware Court of Chancery Finds Board's Use of Rights Plan Reasonable Based on Creeping Takeover and Effective Negative Control Threats Created by Activist Shareholders**

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#### **SUMMARY**

In a recent [opinion](#),<sup>1</sup> the Delaware Court of Chancery (Parsons, V.C.) refused to preliminarily enjoin the Sotheby's annual meeting based on claims from activist hedge fund Third Point LLC and other shareholders that the Sotheby's board breached its fiduciary duties by adopting a two-trigger shareholder rights plan and later, in connection with Third Point's proxy contest, denying Third Point's request to waive the lower 10% ownership cap that applied to it and allow it to acquire up to the higher 20% cap in the company. The decision is notable for recognizing that activist share accumulations and the potential for negative control at low ownership thresholds can pose a cognizable threat under *Unocal Corp. v. Mesa Petroleum Co.*<sup>2</sup> and for making clear that it is not easy to defeat a rights plan on the basis of shareholder disenfranchisement claims where a plausible purpose other than disenfranchisement exists.

#### **BACKGROUND**

The Sotheby's board, comprised of a majority of independent directors, adopted its rights plan in the face of an increasing activist threat. Starting in May 2013, Third Point, Trian Fund Management, L.P. and Marcato Capital Management LLC announced purchases of Sotheby's stock in filings with the SEC. Third Point later amended its Schedule 13D, indicating that it had increased its stake to 9.4% and that it intended to seek certain management and board changes. Two days later, the Sotheby's board adopted a rights plan with a one-year term (unless approved by shareholders or readopted by the Sotheby's board) and a 10% ownership trigger threshold for "active" shareholders (i.e. Schedule 13D filers) and 20% ownership trigger for all other shareholders. The rights plan defines ownership broadly to include derivatives and excepts acquisitions made pursuant to any-and-all, all cash offers open for at least 100

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days. Following the adoption of the rights plan and after failed settlement negotiations, Third Point again amended its Schedule 13D to announce that it had further increased its stake closer to the 10% cap and intended to nominate a short slate of three directors. After commencing a proxy fight, Third Point requested that Sotheby's waive the 10% cap so that it could acquire up to 20% of the company's common stock. The Sotheby's board rejected the request shortly after receiving an update from its proxy advisors that Third Point was almost certain to prevail in the proxy contest if it acquired an additional 10%. Third Point and certain other shareholders subsequently filed suit. Following the Court's decision and before Sotheby's annual meeting, Sotheby's and Third Point agreed to a settlement that provides Third Point with three out of fifteen board seats and the ability to increase its ownership interest to 15%, and that requires Sotheby's to terminate its rights plan.

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### THE COURT OF CHANCERY'S DECISION

#### A. BOARD'S ADOPTION OF RIGHTS PLAN WAS REASONABLE RESPONSE TO ACTIVISTS AND THE PRIMARY PURPOSE OF THE ADOPTION OF THE PILL WAS NOT TO DISENFRANCHISE STOCKHOLDERS

The Court first determined that the intermediate standard of review set forth in *Unocal* applied to the Sotheby's board's actions, finding that both the Court of Chancery and the Delaware Supreme Court have applied *Unocal* exclusively in determining whether a board has complied with its fiduciary duties in adopting and refusing to amend or redeem a rights plan, even when those actions have been taken outside of the hostile takeover context.

Applying *Unocal* first to the adoption of the rights plan, the Court determined that the plaintiffs did not have a reasonable probability of success of showing that the Sotheby's board breached its fiduciary duties. The Court found that the Sotheby's board's actions met *Unocal's* first prong – on the basis of good faith and reasonable investigation, the Sotheby's board determined that Third Point and other shareholders posed an objectively reasonable and legally cognizable threat to corporate policy. The Court stated that at the time it adopted the rights plan, the Sotheby's board reasonably concluded that several hedge funds which were simultaneously accumulating Sotheby's stock (while Third Point rapidly increased its stake) could form a “wolfpack” and create a control block without paying a control premium.

While acknowledging that the more burdensome *Blasius Industries, Inc. v. Atlas Corp.*<sup>3</sup> standard could be implicated at the same time as *Unocal* in the rights plan context, requiring the Sotheby's board to provide a “compelling justification” for its actions, the Court found that Third Point likely could not show that the Sotheby's board acted for the primary purpose of interfering with the franchise of any shareholder, a requisite showing for *Blasius* to apply.<sup>4</sup> In the Court's view, the Sotheby's board could likely demonstrate that it was motivated by creeping takeover and negative control threats and that any adverse impact to electoral rights was incidental. The Court noted that because the record was “devoid of facts that would support an inference of entrenchment” of the Sotheby's board, citing to the above-average turnover rate of directors and the lack of evidence that the Sotheby's directorship was material to the directors, the

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Court stated it would be hard to meet *Blasius's* “primary purpose” test in the instant case.<sup>5</sup> Moreover, the Court could not find evidence of any impermissible animus toward Third Point’s CEO that might have driven the Sotheby’s board’s decision to adopt the rights plan. Finally, the Court found that the terms of the rights plan – it does not force shareholders to vote in favor of the incumbent board or induce votes in its favor and the possibility existed that either Sotheby’s or Third Point could have prevailed in the proxy contest – make clear that it is neither coercive nor preclusive, and therefore weighed against a conclusion that it was adopted for the primary purpose of interfering with the stockholder franchise.

While noting that the validity of the rights plan’s 10% trigger was not challenged, the Court further determined that the Sotheby’s board’s response to the creeping control threat was reasonable and proportionate to the threat of Third Point and other stockholders acquiring control without paying a premium, satisfying *Unocal's* second prong. Having concluded that the adoption of the rights plan was neither preclusive nor coercive, the Court found two factors persuasive in finding that the Sotheby’s board’s response in adopting a rights plan with a low trigger was proportionate: (i) a 10% threshold permitted activists to buy a substantial stake given that the Sotheby’s board collectively owned less than 1% and (ii) a trigger higher than 10% could allow a small group of activists to gain control without paying a premium through “conscious parallelism”.<sup>6</sup> Moreover, the Court determined that, while it was not endorsing the discriminatory nature of the rights plan’s two-trigger structure because it “raises some valid concerns”, the adoption of such a rights plan was not disproportionate.<sup>7</sup> In particular, the Court found that (i) the differing treatment of passive and active investors arguably better addresses Sotheby’s need to prevent activists from achieving control when compared with a more standard rights plan that universally restricts ownership levels regardless of the holder’s interest in asserting influence and (ii) although in theory a court could find a rights plan unreasonable or disproportionate because it allowed Schedule 13G filers who were more likely to vote with management to acquire 20% of the company’s shares than because it capped activists at 10%, in this instance, because no 13G filer had a greater ownership interest than the 9.6% of common shares of Sotheby’s held by Third Point, the issue was not relevant.

### **B. BOARD’S REFUSAL TO WAIVE RIGHTS PLAN WAS REASONABLE RESPONSE TO EFFECTIVE NEGATIVE CONTROL THREAT**

Applying the *Unocal* standard to the Sotheby’s board’s denial of Third Point’s request to waive the 10% cap in the rights plan and allow it to increase its ownership to 20%, the Court found that the Sotheby’s board sufficiently showed that it determined after a good faith and reasonable investigation that allowing Third Point to acquire a 20% stake presented an objectively reasonable and legally cognizable threat – negative control. The Court further determined that the refusal to grant the waiver was likely within the range of reasonable responses. The Court stated that the waiver decision presented a much closer question than the original decision to adopt the rights plan. Noting that it was skeptical that at the time of the waiver request Third Point continued to pose a “creeping control” risk, the Court found that Sotheby’s could have legitimate concerns that waiving the 10% cap to allow Third Point to obtain a 20% ownership interest might permit it to exercise disproportionate “effective negative control” over corporate decision-

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making. The Court's view of the trigger differs from ISS's poison pill position that rights plans should not have a trigger lower than 20%. While stating that it did not want to allow negative control to easily become a license for the adoption of defensive measures, the Court noted that in the instant case, two factors supported an inference of a reasonable belief that Third Point would exert disproportionate negative control: Third Point's ownership interest in Sotheby's would be significantly higher than that of any other shareholder and the Third Point CEO's past aggressive conduct directed at Sotheby's. In so finding, the Court, however, indicated that the question of whether the Sotheby's board refused to grant Third Point a waiver for the purpose of interfering with its franchise rights in order to affect the outcome of the ongoing proxy contest was "uncomfortably close" in that the Sotheby's board rejected the waiver soon after being informed by its proxy advisors that Third Point was almost certain to prevail in the proxy contest if it acquired an additional 10%. "Plaintiffs' claims that the challenged actions ... improperly impinge on the shareholders franchise appear to be at least colorable and raise important policy concerns that deserve careful consideration in the examination of poison pills under *Unocal*",<sup>8</sup> the Court stated.

### C. IRREPARABLE HARM COULD HAVE BEEN ESTABLISHED

The Court went on to indicate that if Third Point had established a likelihood of success on the merits, its reduced odds of winning the closely contested proxy contest likely would have qualified as a threat of irreparable harm.<sup>9</sup> The Court stated that the harm Third Point would have suffered if it had lost the proxy fight because of the 10% trigger would likely be irreparable insofar as "the harm to a dissident slate from a flawed stockholder vote typically cannot be remedied after-the-fact by holding a second meeting" and that Third Point would be denied a presence on the Sotheby's board until next year's meeting, when it would have to bear the costs and uncertainty of running another proxy contest.<sup>10</sup> However, the Court rejected plaintiffs' attempt to show that the Sotheby's board's "self-interested use of the corporate machinery to interfere with the stockholder franchise and manipulate the proxy contest" was the basis for a finding of irreparable harm.<sup>11</sup> Contrasting *Kallick v. Sandridge Energy, Inc.*,<sup>12</sup> where the Court had held that a board improperly used a "proxy put" to coerce shareholders into voting for the incumbent directors or risk causing the company to suffer severe financial consequences, the Court found that the Sotheby's rights plan was not coercive because nothing about it forced shareholders to favor the incumbent slate.

### D. IMPLICATIONS

The *Third Point* opinion makes clear that the Delaware courts are prepared, at least in some circumstances, to respect an independent board's well-considered view that an activist poses a sufficient threat to corporate policy and effectiveness to justify the adoption and decision not to amend or waive a rights plan containing a 10% trigger. It also makes clear that it will be hard for an activist to invoke *Blasius* to defeat a rights plan so long as there is an identifiable basis for the plan other than shareholder disenfranchisement. While the decision upheld the two-trigger plan the Sotheby's board adopted, it does not, however, provide a blanket endorsement of a board's decision to impose a two-trigger rights plan that "discriminates" against activists or a board's decision not to redeem or waive a two-trigger pill as a result

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of the threat of negative control that may be exerted by an activist seeking to nominate a short slate to a board. It is fact-specific. In circumstances, for example, in which shareholders other than the activists hold a significant percentage of a company's stock or the holdings by insiders make the activist's cap particularly meaningful, the imposition of a lower cap on the activist shareholder may not be viewed by the Court as defensible.

Separately, *Third Point's* extensive quoting of Sotheby's Chairman and CEO's emails to other directors and his family highlights the possible risks associated with the use of email by decision-makers, as a court is likely, as it did in *Third Point*, to view such emails as an accurate contemporaneous record when they may be no more than ad hoc musings.

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ENDNOTES

- <sup>1</sup> *Third Point LLC v. Ruprecht*, C.A. No. 9469-VCP, slip op. (Del. Ch. May 2, 2014) [hereinafter *Slip Op.*].
- <sup>2</sup> 493 A.2d 946 (Del. 1985).
- <sup>3</sup> 564 A.2d 651 (Del. Ch. 1988).
- <sup>4</sup> The Court noted that the plaintiffs failed to cite any Delaware decision invoking *Blasius* to examine a rights plan, distinguishing *Carmody v. Toll Brothers, Inc.*, 723 A.2d 1180 (Del. Ch. 1998), on the basis that the *Carmody* Court invoked *Blasius* because of the preclusive and coercive effects of a so-called “dead hand” poison pill on a proxy contest, not because the trigger level of the rights plan at issue required a compelling justification.
- <sup>5</sup> *Slip Op.* at 42.
- <sup>6</sup> *Id.* at 47. The fact that the Sotheby’s board apparently did not consider the effect of the 15% threshold under Section 203 of the DGCL when adopting a rights plan with a 10% trigger and later when it denied Third Point’s waiver request was irrelevant in the Court’s view – while Third Point would face additional challenges in extracting non-pro rata benefits if its stake went above 15%, the Court said that the board is entitled to protect against a transfer of control without the payment of an appropriate premium.
- <sup>7</sup> *Id.* at 48 n.37.
- <sup>8</sup> *Id.* at 52 n.39.
- <sup>9</sup> The Court acknowledged that it was not clear that the relief requested would be necessary as Third Point had a 10-to-1 advantage in stock ownership over the incumbent Sotheby’s board, the chances of winning the proxy contest essentially amounted to a 50-50 coin flip, nothing prevented Third Point from making its case to shareholders and it was not certain that Third Point would acquire any additional shares and only purchase those shares from holders who were backing the incumbent Sotheby’s board.
- <sup>10</sup> *Slip Op.* at 58.
- <sup>11</sup> *Id.* at 59.
- <sup>12</sup> 68 A.3d 242 (Del. Ch. 2013).

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