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PERSPECTIVE

Ruling offers 'poison pill' guidance

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Edvard Munch's "The Scream" is auctioned at Sotheby's, May 2, 2012, in New York.

In *Third Point LLC v. Ruprecht,* C.A0. No. 9469-VCP (Del. Ch. May 2, 2014), the Delaware Court of Chancery ruled on a preliminary injunction motion seeking to enjoin Sotheby's annual shareholders meeting. Third Point LLC, an activist investor, and other shareholders, claimed that Sotheby's board of directors adopted and refused to waive a two-tier shareholder rights plan, or "poison pill," for the primary purpose of inhibiting Third Point's ability to wage a successful proxy contest. The court denied the preliminary injunction motion. Ruling on a preliminary basis, the court held that that the board had acted reasonably in identifying threats that Third Point and others might pose to Sotheby's and that the board's adoption of the rights plan and refusal to waive the two-tier ownership threshold were reasonable responses in relation to those threats. The court's opinion provides directors with important guidance on how their actions in adopting and maintaining defensive measures will be evaluated under Delaware law.

Background

In mid-2013, activist hedge funds accumulated significant stakes in Sotheby's and engaged in discussions with Sotheby's regarding potential changes in strategy and leadership and consideration of strategic alternatives.

In October 2013, Third Point, then holding a 9.4 percent stake of the company, filed a public "poison-pen" letter from its CEO, Daniel Loeb, to Sotheby's CEO, William Ruprecht, raising concerns regarding the company's leadership, shareholder mis-alignment, strategic direction, and board governance. Loeb indicated his willingness to join Sotheby's board and recruit other new directors, including from another large shareholder. Loeb emphasized the need to replace Ruprecht and to separate the roles of CEO and chairman, and indicated he had already identified and spoken with potential CEO candidates.

In response to the activists' threats, Sotheby's adopted a shareholder rights plan. The rights plan included a 10 percent trigger threshold for shareholders filing a Schedule 13D and a 20 percent trigger for passive shareholders (i.e., shareholders filing a Schedule 13G because they have not acquired shares with a purpose or effect of changing or influencing the control of the company). The rights plan provided that the plan will not apply to a "qualifying offer" for all of Sotheby's shares and expires in one year.

Ultimately Third Point nominated three individuals for election to Sotheby's board and requested a waiver from the rights plan restrictions to allow Third Point to purchase up to a 20 percent stake in the company. Sotheby's board denied the waiver request. In response, Third Point sought to enjoin Sotheby's annual meeting, alleging that Sotheby's directors violated their fiduciary duties by adopting the rights plan and refusing to grant Third Point a waiver to acquire more than a 10 percent stake.

Chancery Court Ruling

In reviewing the board's decision to adopt the rights plan and refusal to waive the 10 percent trigger for Third Point, the court applied the standard of review set forth in *Unocal Corp. v. Mesa Petroleum Co.,* 493 A.2d 946, 949 (Del. 1985), which consists of two prongs: The first is that the board must perceive a legally cognizable threat to corporate policy and effectiveness. To satisfy this prong, directors must demonstrate that they acted reasonably and in good faith. The second prong requires that the defensive actions not be "coercive" or "preclusive," and that the board's response be reasonable in relation to the threat posed.

With respect to the plan adoption, the court noted that an independent and disinterested board considered the potential for "creeping control" by several hedge funds simultaneously accumulating shares. The court held on a preliminary basis that the board acted reasonably in concluding that the activists posed a legally cognizable threat of obtaining a controlling stake without paying a control premium.

The court also held on a preliminary basis that the rights plan was neither coercive (the "Rights Plan does not impose any consequences on stockholders for voting their shares as they wish") nor preclusive (it was "undisputed" that either side could win the proxy contest). Further, the court held on a preliminary basis that the board's adoption of the rights plan was reasonable in response to that threat, including the 10 percent trigger for Schedule 13D filers. Although the court viewed the two-tier trigger structure as "discriminatory" — differentiating between activist and passive investors — the plan was arguably better tailored to the circumstances by preventing activists from gaining control without paying a control premium and not unduly restricting share

purchases by passive investors. The court found that given that no holder owned more than 10 percent the two-tier structure was a "complete non-issue" in its ruling.

With respect to the board's refusal to allow Third Point to buy up to 20 percent of the company, the court indicated this was "a much closer question" since the threat of "creeping control" had disappeared when the waiver request was made. Nevertheless, the court found that Sotheby's had a reasonable basis to believe that Third Point posed a legally cognizable threat of exercising effective "negative control" from the accumulation of a 20 percent stake. Although Third Point did not have an explicit right to block corporate action through contract, share ownership or board representation, Third Point's ownership of 20 percent could effectively allow it to exercise disproportionate control and influence over major corporate decisions. The court expressed concern that boards not unreasonably rely on the broad threat of effective negative control to justify defensive measures. However, given that Third Point would be the largest stockholder by far and given the "aggressive and domineering" manner in which Loeb acted, the court upheld on a preliminary basis the board's refusal to grant the waiver request.

Third Point also contended that the board's actions also should be evaluated under the stringent standard articulated in *Blasius Industries Inc. v. Atlas Corp.*, 564 A.2d 651, 659 (Del. Ch. 1988). Under Blasius, a board must provide a "compelling justification" for its actions if it acts with the "primary purpose of interfering with the effectiveness of a stockholder vote." While noting that these arguments were at least colorable and raise policy concerns that deserve careful consideration, the court rejected the arguments on the record before it.

Implications for Boards of Directors

It is not unusual for a board of directors to consider the adoption of a rights plan when faced with a rapid accumulation of shares by activist investors. The preliminary ruling in Third Point demonstrates that independent directors acting in good faith and on an informed basis with the advice of outside advisors should be afforded substantial latitude to adopt and maintain rights plans with features responsive to the threats that may be posed by activist hedge funds.

In adopting or maintaining a rights plan, a board should build a strong, contemporaneous record supporting its decision. A board should identify and discuss the specific threats faced by the corporation and should demonstrate leadership of independent directors. Directors should rely on the advice of outside financial, legal and other appropriate expert advisors.

A board may base its decision to adopt a rights plan on the perceived threat to long-term shareholder value posed by activist hedge funds that form a "wolf pack" or act through "conscious parallelism." Directors may conclude that rapid stock acquisitions, including through synthetic equity positions, and aggressive actions pose such a threat. The defensive measures should not improperly interfere with the effectiveness of the shareholder voting process

A board's independence, overall governance structure and anti-entrenchment provisions in the defensive measures may reduce a court's entrenchment concerns. In Third Point, the court noted favorably the board's above-average turnover rate and the rights plan's "qualified offer" provision.

No defensive feature is per se valid absent identification of a related threat. The two-tier structure has grown significantly in recent years as boards perceive that the threats posed by activist investors are best met with a rights plan with a lower ownership threshold. Given the caution that the court expressed about the two-tier feature, a board should be mindful that if its actions are challenged it will need to demonstrate that this feature is a reasonable response to the activities that the board believes in good faith constitute a cognizable threat.

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