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EXPERT ANALYSIS

Delaware Court Upholds Poison Pill in Response to Activist Accumulations

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The Delaware Court of Chancery on May 2 rejected a request by Third Point to enjoin Sotheby's annual stockholder meeting, scheduled for May 6, because of a "poison pill" stockholder rights plan adopted by Sotheby's board. *Third Point LLC v. Ruprecht, et al.* No. 9469, 2014 WL 1922029 (Del. Ch. May 2, 2014).

Sotheby's plan provided a 20% ownership trigger for stockholders who disclaimed intent to control the company, but a 10% ownership trigger for other stockholders (including activist investors like Third Point).¹ Third Point asked for a waiver that would give it a 20% limit, but the Sotheby's board refused. Third Point then asked the court to postpone the stockholder meeting, claiming that the board had breached its fiduciary duties in adopting the plan and refusing the waiver. In this opinion the court denied Third Point's request.

Following the decision, the parties quickly negotiated a settlement that gave Third Point three seats on an expanded Sotheby's board, allowed Third Point to increase its ownership position to 15%, and provided for termination of the rights plan upon completion of the stockholder meeting. The stockholder meeting was opened as scheduled but then adjourned until May 29 to give stockholders time to review the settlement and related information.

The opinion provides support for boards that are trying to protect their companies from perceived risks from activist investors, including risks arising from actions other than a direct challenge for control. However, it does not provide unfettered discretion – boards taking defensive actions must first identify a legitimate threat to the company and must limit their responses to those proportionate to the threat they have identified, and moreover must be prepared to adjust in light of new information or circumstances.

BACKGROUND

Sotheby's adopted the plan in October 2013, shortly after receiving a letter from Third Point critical of Sotheby's management and strategy and after being advised that activist funds had accumulated a 19% position in Sotheby's stock, including just under 10% held by Third Point.

The plan provided:

- 1-year term;
- qualifying offer provision, exempting acquisitions pursuant to an offer for "any and all" shares that gave stockholders at least 100 days to respond; and

- 2-tier trigger for the beneficial ownership level that would trigger the plan, allowing a person that reported its ownership on a federal Form 13G, thus indicating a lack of intent to seek to control the company (sometimes referred to as a “passive” investor), to acquire up to 20%, while other stockholders could acquire up to only 10%.

The court noted that the plan did not prohibit Sotheby’s from seeking stockholder approval to extend the term or from otherwise extending the term at the board’s discretion.

COURT ANALYSIS

Adoption of the Plan as a Reasonable Response to a Perceived Threat

The court reviewed the board’s adoption of the plan under the enhanced scrutiny established by the Delaware Supreme Court’s 1985 *Unocal* decision, which requires that a board, in taking defensive measures, (1) identify reasonable grounds for believing a threat to the company existed and (2) take reasonable and proportionate steps in response.

Threat. The court focused on the board’s concern with “creeping control” and the possibility that activists could form a control block without paying a control premium to Sotheby’s other stockholders. The court noted that the board faced several hedge funds accumulating stock at a rapid pace, and had been “informed by its advisors that it was not uncommon for activist hedge funds to form a group or ‘wolfpack’” to acquire, in the aggregate, large blocks of stock. The court also noted the profiles of Third Point and another activist provided to the board by its advisors.

The court also took into account that the board was comprised of a majority of independent directors, and had retained outside advisors in connection with its investigation into the activists’ activity, which reflected a good faith and reasonable investigation that supported the board’s findings of threat.

Proportionality. The court found that there was a reasonable probability that the board could show that the plan was a proportionate response to the threat it had identified, since even the 10% limit allowed activists to obtain substantial ownership positions, particularly when compared to the less than 1% ownership represented by the board. The court further noted that when the board adopted the plan there had been a possibility that Third Point was working in connection with other funds and that, through “conscious parallelism,” a limit above 10% could “make it easier” for a few activists to obtain control. The court also found that Third Point had not shown that the plan was either coercive or preclusive, since the plan did not impose “any consequences” on stockholders for voting as they pleased, and Third Point still could win the proxy contest.

Notwithstanding its findings, the court noted that it did “not mean to endorse” the two-tier trigger structure. The court confirmed that it found the 10% limit on activists to be reasonable, and that the discriminatory impact of this feature “most likely” would be to allow Form 13G filers, who “may be more inclined to vote with management,” to acquire more stock, but that here the largest stockholder in any event was Third Point. On the other hand, the court also found that the two-tier structure might provide a “closer fit” to a company’s need to prevent activists from gaining control while allowing others to acquire more stock. Ultimately, though, the court stated that it was “inclined to agree” that the distinction between active and passive stockholders raises “some valid concerns.”

The Board’s Refusal to Grant the Waiver to Third Point

The court also reviewed under *Unocal* enhanced scrutiny the board’s refusal to grant the waiver requested by Third Point. The court found that the board’s refusal presented “a much closer question,” since Third Point had asked only to be allowed to acquire up to 20% and not to be relieved from other proscribed actions in concert with others, and thus did not present the kinds of concerns that it had potentially presented when the board adopted the plan.

Nonetheless, the court found that the board had shown a threat from “negative control,” that is, that allowing Third Point to acquire 20% of the stock “could effectively allow [it] to exercise

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disproportionate control and influence,” despite a lack of actual control or an explicit veto power, particularly given that Third Point would be the company’s largest stockholder and further given the “aggressive and domineering manner” in which Third Point’s CEO had conducted himself.

The court cited executive recruitment as an “important corporate action” that the board could be concerned that Third Point could control. The court also noted, though, that Third Point’s claims with respect to infringement on its stockholder franchise appeared “at least colorable” and “raise[d] important policy concerns.”

Board’s Motivation for Adopting the Plan and Refusing the Waiver

The court rejected Third Point’s argument that the board, in adopting the plan, had the “primary purpose” of interfering with stockholder votes, which would have required that the board meet the very high “compelling justification” standard established by the court’s 1988 *Blasius* decision. The court noted that the board was facing the apparent threats discussed above, and that there were no signs that the board was motivated by entrenchment, pointing out that the board is not staggered, is “dominated” by independent directors, and has an above-average turnover rate. The court also noted that, pursuant to the qualifying offer provision of the plan, a bidder could make an offer for the entire company and replace the entire board.

Likewise, the court found that the board’s refusal to grant Third Point’s waiver request was not primarily for the purpose of interfering with Third Point’s franchise, though the court found the question “uncomfortably close.” The court noted that the board’s refusal came shortly after it was advised that allowing Third Point to acquire the requested additional shares probably would lead to a Third Point victory in the pending proxy contest.

IMPLICATIONS

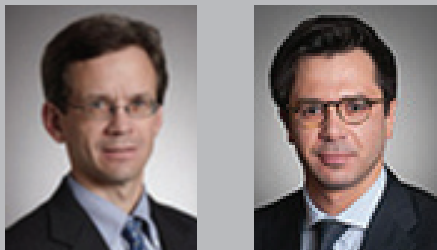
The opinion addresses Third Point’s request for a preliminary injunction of Sotheby’s stockholder meeting; a full trial on the merits of the board’s actions, including with respect to the rights plan, might lead to different results. However, the opinion provides a number of practical pointers for boards.

- A board can use a poison pill to help defend the company in certain activist situations. However, the board must be prepared to undergo a court’s *Unocal* enhanced scrutiny, and show both that it had reasonable grounds for believing there was a threat to corporate policy and effectiveness and that the terms of the pill provided a proportionate and reasonable response to that threat. As shown by the court’s detailed analysis, the company’s actual circumstances must be considered carefully.
- Boards may be able to use two-tiered pill trigger structures in some circumstances, and such triggers may allow for greater proportionality to the perceived threat. However, courts have concerns with such structures and are likely to look closely at the actual discriminatory impact in the context of the company.
- The court acknowledged potential threats beyond the open pursuit of control, including the threats of “creeping control” and “conscious parallelism” and of “effective ... negative control.” However, the court also noted that activists may take steps that may at least reduce some of these concerns (such as the limited waiver sought by Third Point), emphasizing the need to take all relevant circumstances into account.
- A request for a waiver under a pill can present a “closer” question for the board than the initial adoption of the pill, since in the context of the request the threat may have become, or may become, more specific or narrow and the steps needed to contain it correspondingly more limited. The board’s response to a waiver request also must be able to survive a court’s enhanced scrutiny.

- A pill is not a panacea; the pill imposed some constraints on the activists, and the court upheld Sotheby's use of the pill (at least for purposes of a preliminary injunction with respect to its annual stockholder meeting), but Sotheby's still settled with Third Point and gave Third Point the board seats and some of the potential additional ownership it had sought.

NOTES

¹ A general description of this relatively new two-tier trigger, including examples of its use in plans adopted by other companies, is included in our article *Poison Pills with Lower Ownership Thresholds for Activist Investors Come Under Attack*, Apr. 22, 2014.



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