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Rights Plans and Proxy Contests: Chancery Court Denies Activist's Motion to Enjoin Sotheby's Shareholder Meeting

On May 2, 2014, the Delaware Chancery Court denied a motion to preliminarily enjoin Sotheby's annual stockholder meeting based on allegations by an activist stockholder, Third Point LLC, that the Sotheby's board of directors violated its fiduciary duties by adopting a rights plan (or "poison pill") and refusing to provide a waiver from its terms in order to obtain an advantage in an ongoing proxy contest. Applying the two-prong *Unocal* test, Vice Chancellor Parsons held that the plaintiffs failed to demonstrate a reasonable probability of success on the merits of their claims. Notably, the Chancery Court accepted that the threat of "negative control" (i.e., disproportionate influence over major corporate decisions) by a stockholder with less than 20% ownership and without any express veto rights may constitute a threat to corporate policy justifying responsive action by a board, including the adoption and retention of a right plan.

Background

Beginning in early 2013, Third Point and two other activist hedge funds established a position in Sotheby's stock, with Third Point ownership eventually reaching approximately 9.6% and the collective ownership of the three funds reaching approximately 19%. In August 2013, Sotheby's management met separately with Third Point and one of the other funds, Marcato, with the funds suggesting potential changes to Sotheby's strategy and leadership.

In October 2013, Third Point filed an amended Schedule 13D attaching a letter from Daniel Loeb, Third Point's CEO, to William Ruprecht, Sotheby's Chairman, President and CEO, raising concerns about Sotheby's and suggesting, among other things, that several new directors recruited by Mr. Loeb be added to Sotheby's board. Inferring the letter to be part of an "all out assault" intended to destabilize Sotheby's, the board adopted a two-tiered rights plan, triggered at a 10% ownership level, but allowing any "passive" stockholder to acquire up to 20%. By its terms, the rights plan would expire in one year unless approved by a vote of Sotheby's stockholders and would not apply to a tender offer for all outstanding Sotheby's shares that remained open for at least 100 days.

In February 2014, Third Point and Sotheby's engaged in negotiations in an attempt to avoid a proxy contest in the lead up to Sotheby's annual meeting scheduled for May 6. Third Point sought, among other things, two seats on Sotheby's board and for the rights plan's trigger to be raised to 15%. Sotheby's offered Third Point a single board seat, subject to certain conditions including a standstill agreement capping Third Point's ownership at approximately 10%. The parties failed to reach agreement and, in March 2014, Third Point requested a waiver from the rights plan to allow it to purchase up to a 20% stake in Sotheby's. Sotheby's board was aware that the proxy contest was a "dead heat" and that an increase in Third Point's stake may have improved its likelihood of success. The board denied the request and Third Point filed suit, alleging that the board adopted and enforced the rights plan against Third Point for the

primary purpose of inhibiting its ability to wage a successful proxy contest, without any compelling justification for doing so.

Applicable Legal Framework: *Unocal* and/or *Blasius*?

In evaluating the probability that Third Point's claims would succeed on their merits, the Chancery Court held that the board's compliance with its fiduciary duties as they relate to the rights plan must be assessed under the *Unocal* standard. The *Blasius* stringent "compelling justification" standard, though not mutually exclusive of the *Unocal* standard, could be applied 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 effectively". Vice Chancellor Parsons noted that the plaintiffs had not cited any case in which *Blasius* was invoked to examine a rights plan, and suggested that the "reasonableness" prong of *Unocal* may adequately deal with any rights plan that adversely affects the shareholder franchise, making the application of *Blasius* unnecessary.

In any event, the Chancery Court concluded that the plaintiffs did not have a reasonable probability of demonstrating that the board adopted the rights plan for the *primary purpose* of interfering with any stockholder's franchise. In so concluding, the Chancery Court focused on the absence of any inference of entrenchment on the part of the board and the fact that the rights plan is neither coercive (since it does not impose any consequences on stockholders for voting their shares as they wish) nor preclusive (as the parties conceded that the proxy contest could be won by either side).

With respect to the board's refusal to grant Third Point's request to waive the 10% trigger, however, the Chancery Court described the question of the applicability of *Blasius* as "uncomfortably close", noting that the board's refusal came soon after it learned that Third Point's acquisition of an additional 10% stake likely would ensure Third Point's victory in the proxy contest. Vice Chancellor Parsons was "not unsympathetic" to the plaintiffs' position, but noted that in *Moran* the Delaware Supreme Court held that some incidental reduction of the stockholder franchise as a result of the adoption of a rights plan was acceptable so long as a proxy contest remained a viable option, and that subsequent case law had expanded the scope of threats justifying an incidental reduction of the franchise beyond the hostile takeover context. Nevertheless, the Vice Chancellor indicated that the plaintiffs' claims in this respect raised important policy concerns that deserved careful consideration under *Unocal*.

Application of the *Unocal* Standard

The Chancery Court applied the two-prong *Unocal* standard separately to its review of Sotheby's adoption of the rights plan and the board's subsequent denial of Third Point's request for a waiver from its 10% trigger, in each case concluding that Third Point had failed to demonstrate a reasonable probability that the board would not be able to demonstrate that it had satisfied the relevant test.

The "reasonableness" prong of the *Unocal* test requires the board to have had reasonable grounds for believing that a legally cognizable threat to Sotheby's corporate policy and effectiveness existed, both when Sotheby's adopted the rights plan and when it refused

Third Point's waiver request. With respect to the initial adoption of the rights plan, the Chancery Court focused on the threat of "creeping control" by the activist hedge funds, who may form a "wolfpack" to jointly acquire large blocks of a target company's stock. As to the board's refusal to waive the rights plan's 10% trigger and allow Third Point to buy up to 20% of Sotheby's, the Chancery Court relied on the threat of "negative control": the possibility that Third Point, as a 20% stockholder, could exercise disproportionate influence over major corporate decisions, even without any explicit veto power. Earlier Delaware case law relating to negative control had involved *explicit* veto power obtained via contractual rights or by ownership of a stake sufficient to block actions requiring a supermajority vote. Nevertheless, on the basis of the aggressive and domineering manner in which Mr. Loeb conducted himself in relation to Sotheby's and that, at 20% ownership, Third Point would be Sotheby's largest single stockholder by far, the Chancery Court found that the board could have an objectively reasonable basis to believe Third Point could control important corporate actions, presenting a threat legally cognizable under *Unocal*.

The "proportionality" prong of the *Unocal* test requires the board to demonstrate that its defensive response was reasonable and proportional in relation to the threat posed. The Chancery Court considered that a 10% threshold would allow any activist stockholder to hold a substantial ownership position relative to that of Sotheby's board (which collectively held less than 1%), that Third Point at just under 10% ownership was Sotheby's largest single stockholder, and that a trigger level much higher than 10% would make it easier for a small group of activist investors to achieve control without paying a premium.

Lessons Learned

The Chancery Court's opinion provides various important reminders for Delaware corporations, including:

- When considering whether to adopt, redeem, amend or waive any stockholder rights plan, directors should focus at all stages on the types of legally cognizable threats that will pass muster under the "reasonableness" prong of the *Unocal* test—the focus remains on threats to control of the company, including "creeping control" and "negative control".
- An independent board, advised by competent outside financial and legal advisors, will be granted additional deference in its determination of the threats posed by an activist investor. The Vice Chancellor highlighted that the Sotheby's board included only one member of management and ten of the eleven other directors were independent under NYSE standards, and that the average board tenure of 7.1 years was three years less than the average for the S&P 500.
- Another reminder that all written and electronic communications may be subject to discovery and subsequently revealed in litigation. The parties introduced numerous and candid emails among members of the board; among members of Sotheby's financial advisors; and among the Third Point investment team—and the Chancery Court's opinion even refers to personal emails exchanged between Sotheby's CEO and his sister. The candid sharing of ideas among independent directors is critical to a healthy

board debate, but is best reserved for a meeting or conversation. The likelihood of potentially embarrassing communications can be reduced by providing sufficient and regular opportunities for directors to engage in in-person discussions.

- More generally, a rights plan is of limited utility in connection with shareholder activism and therefore boards ought to continue to take into account the considerations and advice conveyed in our recent memorandum, [Selected Issues for Boards in 2014](#).

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In connection with these topics, please do not hesitate to reach out to your regular contacts at Cleary Gottlieb or any of the U.S. M&A partners listed below.

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