

Delaware Court of Chancery Recognizes Potential Benefits of Shareholder Rights Plans in Addressing Shareholder Activism

If you have any questions regarding the matters discussed in this memorandum, please contact the following attorneys or call your regular Skadden contact.

Stephen F. Arcano

New York
212.735.3542
stephen.arcano@skadden.com

David J. Friedman

New York
212.735.2218
david.friedman@skadden.com

Richard J. Grossman

New York
212.735.2116
richard.grossman@skadden.com

Thomas H. Kennedy

New York
212.735.2526
thomas.kennedy@skadden.com

Edward B. Micheletti

Wilmington
302.651.3220
edward.micheletti@skadden.com

* * *

This memorandum is provided by Skadden, Arps, Slate, Meagher & Flom LLP and its affiliates for educational and informational purposes only and is not intended and should not be construed as legal advice. This memorandum is considered advertising under applicable state laws.

One Rodney Square, 920 N. King Street
Wilmington, Delaware 19801
Telephone: 302.651.3000

Four Times Square, New York, NY 10036
Telephone: 212.735.3000

WWW.SKADDEN.COM

On May 2, 2014, the Delaware Court of Chancery entered a decision in *Third Point LLC v. William F. Ruprecht, et al., and Sotheby's*,¹ which, in essence, recognized that a board of directors could adopt a shareholder rights plan as a reasonable response to a threat posed by an activist shareholder.

Following the accumulation of Sotheby's shares by Third Point LLC and other "activist" shareholders, Sotheby's board adopted a shareholder rights plan that would be triggered at a 10 percent share ownership threshold generally, but provided a higher 20 percent threshold for passive institutional holders filing on Schedule 13G. Such an exception is not new and reflects an assessment that the risks posed by passive 13G filers are different from the risks posed by share accumulation by non-passive institutions or individuals. Third Point argued that Sotheby's board breached its fiduciary duties when it adopted the two-tiered shareholder rights plan and refused to grant Third Point a waiver from the 10 percent threshold trigger, and sought a preliminary injunction to postpone Sotheby's May 6, 2014, annual meeting until a full trial could be conducted on the validity of Sotheby's shareholder rights plan.

The court denied Third Point's request for a preliminary injunction, noting that under the standard of review established in *Unocal Corp. v. Mesa Petroleum Co.*,² Third Point failed to demonstrate a reasonable probability of success on the merits, a required element for injunctive relief. Following the court's decision, on May 5, 2014, (one day before Sotheby's annual meeting), the parties reached a settlement in the litigation. Under the terms of the settlement, Sotheby's agreed to add the three nominees proposed by Third Point to Sotheby's board and terminate its shareholder rights plan concurrent with the 2014 annual meeting. In return, Third Point agreed to limit its ownership of Sotheby's stock to 15 percent.

Background

Beginning in mid-2013, activist shareholders, including Third Point, Trian Fund Management, L.P. and Marcato Capital Management LLC, filed reports with the SEC disclosing their purchases of Sotheby's stock. On October 2, 2013, Third Point filed an amendment to its previously filed Schedule 13D, disclosing that it had acquired 9.4 percent of Sotheby's stock and intended to effect corporate change. The filing included a letter from Daniel Loeb of Third Point that attacked Sotheby's on several grounds and recommended the removal of Sotheby's CEO. The letter also stated that Loeb had started discussions with potential candidates for Sotheby's CEO position.

On October 4, 2013, Sotheby's board, after receiving advice from legal and financial advisors, including with respect to the typical *modus operandi* of activist shareholders, adopted the aforementioned shareholder rights plan, with a term of one year. The plan contained a

1 C.A. No. 9469-VCP, memo. op. (Del. Ch. May 2, 2014).

2 Under *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985), a board's defensive actions will be upheld if the board had reasonable grounds for believing that a danger to corporate policy and effectiveness existed and the board's actions were reasonable in response to the threat posed.

“qualifying offer” exception, providing that the plan would not be triggered if shares are acquired pursuant to an offer to purchase “any-and-all” shares of Sotheby’s stock that gave its shareholders at least 100 days to consider the offer. This provision was noted favorably by the court when it considered the coerciveness or preclusiveness of the plan. Following the adoption of the plan, Third Point announced that it would nominate three new directors for Sotheby’s board at the May 6, 2014, annual meeting.

In March 2014, Third Point requested that Sotheby’s board act to waive the plan’s 10 percent threshold trigger in order for Third Point to acquire up to 20 percent of Sotheby’s stock. Sotheby’s board considered the request, but refused to grant the waiver. The board determined that there was no change in circumstances that warranted a different application of the plan’s terms.

On March 25, 2014, Third Point filed a complaint in the Delaware Court of Chancery, asserting that Sotheby’s board breached its fiduciary duties, both when it adopted the plan and when it refused to grant the waiver, arguing that Sotheby’s board used the two-tiered plan to help incumbent directors retain their board seats, rather than in response to a legitimate, perceived threat. Sotheby’s board maintained that adopting the plan was an appropriate and proportionate response to the threat that activist hedge funds, acting either alone or in concert, could form a control block of Sotheby’s stock (“creeping” control) or obtain “negative” control, noting that a lower-level of share ownership also could be sufficient to block certain corporate actions. Third Point sought a preliminary injunction to postpone Sotheby’s May 6, 2014, annual meeting until a trial could be conducted to determine the validity of Sotheby’s shareholder rights plan.

Legal Discussion

The court denied Third Point’s request for a preliminary injunction, finding that it failed to demonstrate a reasonable probability of success on the merits, a required element for obtaining injunctive relief.³ The court determined that *Unocal*, rather than the more onerous standard of review established in *Blasius Industries, Inc. v. Atlas Corp.*,⁴ was the appropriate standard of review in assessing the actions of Sotheby’s board. The court applied *Unocal* to both the board’s adoption of the two-tiered shareholder rights plan and its refusal to grant Third Point a waiver from the plan’s 10 percent threshold trigger.

The court held that Third Point did not demonstrate a reasonable probability of success on the merits with respect to the board’s decision to adopt the shareholder rights plan. First, the court found that Third Point presented an objectively reasonable and legally cognizable threat of creeping control. Third Point and other hedge funds had accumulated Sotheby’s stock on a rapid basis. Also, Sotheby’s advisers informed the board that it was not uncommon for a hedge fund, or a “wolfpack” of hedge funds, to act together to acquire large, controlling blocks of stock without paying a control premium.

Second, the court found that the primary purpose behind the board’s adoption of the plan was not to interfere with the shareholder franchise. In the court’s view, Third Point did not establish that interference with shareholder voting rights was a major, let alone primary, purpose behind the board’s decision. Sotheby’s board, which was not staggered, did not appear motivated to entrench incumbent directors or act on an impermissible animus toward Loeb. The court also noted that the proxy contest was “eminently winnable by either side” and that the plan did not contain features that suggested it was coercive or preclusive.

3 Because Third Point sought a preliminary injunction, the court explained that “[t]he substantive issue on the plaintiffs’ motion is not whether the defendants have breached their fiduciary duties or whether the corporation’s rights plan is invalid. Rather, the question is whether the plaintiffs have made a sufficient showing to warrant [the court] granting a preliminary injunction.” The court explained that a decision on the merits could follow.

4 Under *Blasius Industries, Inc. v. Atlas Corp.*, 564 A.2d 651, 659 (Del. Ch. 1988), a board must have a “compelling justification” for its actions when taken “for the primary purpose of interfering with the effectiveness of a stockholder vote.”

Third, the court determined that the shareholder rights plan was a reasonable and proportionate response to Third Point's threat of creeping control. Even though the plan discriminated among shareholders because it contained different threshold triggers for passive and activist investors, the court explained that the plan was a "closer fit" to addressing Sotheby's needs than the usual "garden variety" shareholder rights plan. While the court acknowledged that a plan with a discriminatory feature potentially could raise concerns to the extent that this feature may be viewed as favoring incumbent directors, this did not present an issue in this case, since there were no passive investors who owned more than 10 percent of Sotheby's stock (the limit for activist investors under the plan).

The court also found that Third Point did not show a reasonable probability of success on the merits with respect to the board's refusal to grant Third Point a waiver from the plan's 10 percent threshold trigger. First, the court found that the board recognized an objectively reasonable and legally cognizable threat of negative control. The court acknowledged the concern that certain companies may use the threat of negative control as a license to enact shareholder rights plans or other defensive measures in an unreasonable manner. However, in this case, the court concluded that Third Point posed an objectively reasonable threat of negative control. The court reasoned that, if Sotheby's board had waived the trigger and permitted Third Point to acquire up to 20 percent of Sotheby's stock, Third Point would have become Sotheby's largest single shareholder. Even though this would not have amounted to majority control, it could have been sufficient to block certain corporate actions, such as actions that require a supermajority vote.

Second, the court concluded that the board's refusal to waive the 10 percent threshold trigger was within the "range of reasonable" responses to Third Point's negative control threat. The court conceded that it is possible the board could have addressed the negative control threat without precluding Third Point from acquiring more than 10 percent of Sotheby's stock. However, the court explained that in order to pass muster under *Unocal*, the 10 percent cap only had to be reasonable, not perfect.

Conclusion

The Delaware Court of Chancery's decision in *Third Point* recognizes the appropriateness of the use of a shareholder rights plan as a defensive measure by a board that reasonably believes, after receiving and considering the advice of legal and financial advisors, that a threat to corporate policy and effectiveness exists based on a rapid accumulation of stock by an activist investor that could result in control or negative control over the company. This is consistent with earlier Delaware cases that have denied challenges from a hostile bidder in a takeover context, such as in *Versata Enterprises, Inc. v. Selectica*⁵ (2010), which had focused on a rights plan designed to protect an NOL, and *Air Products & Chemicals, Inc. v. Airgas, Inc.*⁶ (2011), or from a shareholder seeking to acquire additional shares and engage in a proxy contest, such as in *Yucaipa American Alliance Fund II v. Riggio*⁷ (2010).

A board's decision to adopt a shareholder rights plan is by necessity based on the specific situation before the directors, and multiple considerations, including the views of the proxy advisory firms and institutional shareholders, invariably will come into play. However, the *Sotheby's* case should help provide directors with comfort that, when the circumstances warrant adoption of a rights plan or another reasonable defensive device, the courts should support their decision.

5 5 A.3d 586, 601 (Del. 2010).

6 16 A.3d 48, 92 (Del. Ch. 2011).

7 1 A.3d 310, 330 (Del. Ch. 2010).