

Delaware Court Declines to Enjoin Sotheby's Annual Meeting

Rejects Activist Stockholder's Requests to Enjoin the Meeting Pending an Expedited Trial Concerning the Company's Two-Tiered Poison Pill

May 5, 2014

On May 2, 2014, the Delaware Court of Chancery denied a preliminary injunction motion by activist stockholder Third Point LLC to enjoin Sotheby's annual meeting based on claims that the board breached its fiduciary duties by adopting a stockholder rights plan that has a 20% trigger for passive investors who file on Schedule 13G and a 10% trigger for all other stockholders. Third Point claimed that the board's adoption of—and subsequent refusal to waive the lower trigger in—the rights plan violated the board's fiduciary duties under *Unocal* because Third Point was not trying to obtain corporate control, but rather to run a proxy contest for a minority slate, and the two-tiered rights plan was designed to thwart its efforts. Vice Chancellor Parsons held that Third Point was not reasonably likely to succeed on the merits on such claims, holding that, under *Unocal*'s heightened review standard, the board had identified legitimate and legally cognizable threats to the company's corporate policy and effectiveness and that the board's actions were not preclusive of a proxy contest and were proportionate responses to the threats posed.

The decision builds on recent Delaware rulings upholding the use of poison pills outside of the classic hostile takeover context—and extends their use to more contemporary “hostile” situations involving campaigns by activists for minority seats. However, the Court expressed concern regarding the pill's two-tiered structure, noting that, while the record did not warrant an injunction at this stage, the claims “appear to be at least colorable and raise important policy concerns that deserve careful consideration in the examination of poison pills under *Unocal*.” Indeed, while the decision reaffirms a board's broad discretion in adopting and refusing to redeem or waive portions of a pill (including one with a relatively low, 10% trigger for certain stockholders), whether a two-tiered pill will be permissible will remain highly dependent on the particular facts and circumstances of a given case.

In early October 2013, the Sotheby's board adopted a stockholder rights plan in response to multiple purchases of the company's stock beginning in May 2013 by several hedge funds with records of activism. Third Point had disclosed in a Schedule 13D that it had accumulated just under 10% of the company's stock and urged potential changes of company strategy and leadership, including the replacement of the company's CEO. During those months, the board met and received advice from financial and legal advisers on stockholder activism and potential company-specific vulnerabilities, including information regarding the specific profiles of the relevant hedge funds. Following failed negotiations with the company, Third Point amended its Schedule 13D, disclosing an increased position in the company and its intention to run a proxy contest with a slate of three directors. On March 13, 2014, Third Point filed another amended Schedule 13D disclosing a further-increased position and requesting a formal waiver from the poison pill to allow it to purchase up to a 20% stake in Sotheby's. About a week later, the board denied Third Point's request, and Third Point commenced litigation in the Delaware Court of Chancery.

Vice Chancellor Parsons began the Court's analysis by explaining that, in order to survive review under *Unocal*, (a) the board must articulate a legally cognizable threat (in order to demonstrate that the board had reasonable grounds for believing that a danger to corporate policy and effectiveness existed) and (b) the defensive response must be reasonable in relation to the threat posed (i.e., it must not be preclusive or coercive and must fall within a range of reasonable responses). The Court reviewed both the board's initial adoption of the rights plan in October 2013 and the board's refusal to waive the 10% trigger for Third Point in March 2014.

The Board's Adoption of the Rights Plan in October 2013

With respect to the adoption of the rights plan, the Court held that the threat of “creeping control” was an objectively reasonable threat given the simultaneous and rapid accumulation of stock by multiple hedge funds and the specific profiles of those hedge funds. The Court further concluded that the rights plan was neither coercive (in that it did not impose any consequences on stockholders for voting their shares as they wish) nor preclusive (as both parties agreed that, even with the poison pill, the proxy contest would be a coin flip or dead heat) and fell within a range of reasonableness. The Court focused on the risk that Third Point could acquire a controlling interest without paying the other stockholders a control premium. The Court looked to the relative ownership of the board (less than 1%) and Third Point (nearly 10%), as well as the fact that Third Point was the company's largest stockholder, to conclude that the 10% threshold was reasonable. The Court observed that a “[a] trigger level much higher than 10% could make it easier for a relatively small group of activist investors to achieve control, without paying a premium, through conscious parallelism.”

Notably, with regard to the two-tiered nature of the poison pill, Vice Chancellor Parsons noted that he was not expressly endorsing two-tiered poison pills and seemed to allow that, had there been any large 13G filers holding more than 10% of the company's shares, there could be some evidence of favoritism by the board (given that 13G filers may be more inclined to vote with the company's management). However, he concluded that it was ultimately a non-issue in this case given that no other stockholder held more shares than Third Point. The Court's reasoning further illustrates the fact-driven analysis of pill cases: “[W]hile the question of whether Schedule 13G filers should be permitted under a rights plan to buy a larger interest in a company than activist stockholders is important in a general sense, I am not persuaded it can or should serve as a basis to enjoin the Sotheby's annual meeting when, as a practical matter, it is a complete non-issue in terms of the current composition of Sotheby's stockholders.”

The Board's Rejection of Third Point's Waiver Request in March 2014

With respect to the board's rejection of the waiver request, the Court noted that because Third Point had merely requested permission to buy up to a 20% interest in the company, and not a redemption of the pill or a waiver of the pill's proscription of concerted action by multiple stockholders, the board could not credibly claim that it perceived a “creeping takeover” risk, either individually or as part of a “wolf pack” when it made its decision. However, Vice Chancellor Parsons concluded that, taking into account the fact that at 20% Third Point would be by far the largest stockholder “combined with the aggressive and domineering manner in which the evidence suggests [Third Point CEO Daniel] Loeb has conducted himself in relation to Sotheby's,” the board's concern that Third Point could obtain “negative control” over corporate decisions, such as executive recruiting, represented an objectively reasonable and legally cognizable threat. The Court found that the record supported the conclusion that the board “may have had legitimate real-world concerns that enabling individuals or entities, such as Loeb and Third Point, to obtain 20% as opposed to 10% ownership interests in the Company could effectively allow those persons to exercise disproportionate control and influence over major corporate decisions, even if they do not have an explicit veto power.” The Court further concluded that the board's decision was consistent with the stated purpose of responding to the threat of negative control and thus fell within the range of reasonableness.

In a footnote, Vice Chancellor Parsons noted that the question of whether the Board refused to provide the waiver for the primary purpose of interfering with the franchise of Third Point was “uncomfortably close” given that the board elected not to grant the waiver soon after learning that, with a 20% stake, Third Point likely would prevail in the proxy contest. The Court suggested that a *Blasius*-type claim along these lines could survive a motion to dismiss and noted that “important policy concerns” regarding two-tiered poison pills should be considered more closely under *Unocal*.

Denial of Preliminary Injunction Motion

Because Vice Chancellor Parsons concluded that plaintiffs were not reasonably likely to prevail on the merits, the Court denied the preliminary injunction application.

It is noteworthy, however, that the Court concluded that, had Third Point established a likelihood of success, “Third Point’s reduced odds of winning the proxy contest due to the Rights Plan likely would have qualified as a threat of irreparable harm.” The Court also concluded that it would have found the balance of the equities tipped in favor of the issuance of the injunction.

The decision in Sotheby’s again underscores the importance of a board and its advisors building a clear (and contemporaneously documented) record when adopting and refusing to waive a poison pill. Although the decision was highly fact-specific, it is the latest in a line of cases ultimately giving substantial deference to a board’s use of the poison pill defense. It also confirms that the Delaware courts are sympathetic to the practical and legal threats posed by activist stockholders, particularly with respect to “creeping” and “negative” control and parallel activity by activist groups.

Notably, while Third Point lost its injunction request, on May 5, 2014, the day before Sotheby’s scheduled annual meeting date, Sotheby’s announced an agreement with Third Point pursuant to which Third Point will receive three seats on Sotheby’s board and Sotheby’s will terminate its rights plan. Under the agreement, Third Point’s ownership in Sotheby’s will be capped at 15%. The annual meeting is expected to be convened as scheduled and adjourned pending distribution of updated proxy materials.

See Third Point LLC v. Ruprecht, C.A. No. 9469-VCP.

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