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Third Point LLC v. Ruprecht — Activism Confronts the Rights Plan

The Delaware Court of Chancery refuses to enjoin Sotheby's annual meeting and allows Sotheby's "poison pill" to protect against an activist's proxy contest.

Implications for our Clients

In a thirty year-long series of decisions beginning with *Moran v. Household International, Inc.*, 500 A.2d 1346 (Del. 1985), the Delaware courts have affirmed the value of shareholder rights plans to boards seeking to protect and maximize shareholder value. While the ruling in Third Point is on a preliminary basis, the decision 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 to corporations posed by activist hedge funds.

- Building a strong, contemporaneous record is crucial in supporting a board's decision to adopt and maintain defensive measures, including shareholder rights plans.
  - A board should identify and discuss the specific threats the corporation faces both when adopting a rights plan and again when taking any action under a rights plan, including in considering a shareholder waiver request.
  - A board's actions should be memorialized in contemporaneously written minutes that are finalized before initiation of litigation.
  - The board discussion should be led by independent directors and the board should seek and rely on the advice of outside financial, legal and other appropriate expert advisors.
- A board adopting a rights plan may focus its justifications on the threat to long-term shareholder value posed by activist hedge funds. These threats can include:
  - Multiple activist hedge funds building a concurrent stake in a corporation. While activists may not report as a group under US securities laws, a board may identify the threat of the activists forming a "wolf pack" or acting through "conscious parallelism" to gain effective control of a corporation without paying a control premium.

Summary

In mid-2013, three activist hedge funds, Third Point LLC, Trian Fund Management and Marcato Capital Management LLC, accumulated significant stakes in Sotheby's. Both Third Point and Marcato disclosed their ownership on Schedule 13Ds and engaged in discussions with Sotheby's management and board regarding potential changes in strategy and leadership as well as 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. The letter raised concerns regarding the Company's leadership, shareholder misalignment, strategic direction and board governance. Loeb indicated his willingness to join Sotheby's board and recruit other new directors, including from another large shareholder (presumably Marcato). Loeb emphasized the need to replace Ruprecht and to separate the roles of CEO and Chairman. Loeb also indicated he had already identified and spoken with potential CEO candidates.

In response to the activists' threats, Sotheby's adopted a shareholder rights plan, or "poison pill," with a two-tier structure. The two-tier structure provided for a 10 percent trigger threshold for shareholders filing a Schedule 13D and a 20 percent trigger for shareholders filing a Schedule 13G (available to "passive" investors). The rights plan also contained a "qualifying offer" exception, which provided that the plan would not apply to an offer for all of Sotheby's shares and expires in one year unless it is approved by a shareholder vote.

In February 2014, after negotiations failed to avoid a proxy contest, 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.

- Activists accumulating synthetic equity positions not reported on a Schedule 13G or 13D, but that could quickly be converted into beneficial ownership.
- An activist — limited by a rights plan to a 10 percent ownership stake — acting in an "aggressive and domineering" manner to exercise disproportionate control and influence over major corporate decisions.

- Delaware courts review specific elements of defensive measures, including specific rights plans technologies, under a "range of reasonableness" standard. No feature is *per se* valid absent a board's identification of the related threat, and other "soft" considerations may affect a court's assessment of a rights plan.
  - The record of a board's deliberations should demonstrate that defensive measures are not designed to improperly interfere with the effectiveness of the shareholder voting process or otherwise be "coercive" or "preclusive."
  - Rights plan technologies, such as a two-tier structure providing for a 10 percent trigger threshold for shareholders filing a Schedule 13D and a 20 percent trigger for shareholders filing a Schedule 13G (available to passive shareholders), should be responsive to a specific threat a board has identified.
  - A corporation's overall governance structure may be analyzed in determining the entrenchment effects of defensive measures. Indicia of good governance, such as an above-average board turnover rate, coupled with anti-entrenchment provisions in the defensive measures, such as the inclusion of a "qualified offer" provision in a rights plan permitting an offer to acquire the entire corporation, may demonstrate a board's independence and reduce a court's entrenchment concerns.

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.

The Delaware Court of Chancery denied Third Point's preliminary injunction, applying the *Unocal* standard of review to the board's decision to adopt the rights plan and refusal to waive the 10 percent trigger for Third Point. 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 in a "wolfpack." 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. 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; preventing activists from gaining control without paying a control premium and not unduly restricting passive investors' share purchases. Ultimately, the court found the two-tier structure was a "complete non-issue" based upon the composition of Sotheby's shareholders and the court's holding on a preliminary basis that a 10 percent trigger for activist shareholders is reasonable and proportionate.

With respect to the board's refusal to waive the rights plan so as 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, or disproportionate control and influence over major decisions. The court held on a preliminary basis that the board's refusal to grant the waiver request was reasonable in response to that threat.

Third Point also contended that the board was required under the more stringent *Blasius* standard to provide a "compelling justification" for its refusal to waive the rights plan because, according to Third Point, the board acted for the primary purpose of infringing on the shareholder voting process. 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.

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