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Poison Pills with Lower Ownership Thresholds for Activist Investors Come Under Attack

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On March 25, 2014, Daniel Loeb's Third Point LLC filed suit against Sotheby's and its directors in Delaware's Court of Chancery to invalidate Sotheby's poison pill. The board of Sotheby's adopted the poison pill this past October two days after Mr. Loeb sent a letter stating that Third Point had increased its ownership of Sotheby's to 9.3% and offering to join Sotheby's board, among other things.¹

In its complaint, Third Point asks the court to decide on what is described as a novel question for Delaware courts – whether a board of directors can adopt a poison pill with a 10% ownership trigger directly in response to a stockholder who does not threaten a takeover of the company, but simply seeks minority representation on the board, where the poison pill has a 20% threshold for other investors.² Third Point alleges that Sotheby's poison pill improperly attempts to entrench the incumbent directors and impede a proxy contest by Third Point.

Unlike a traditional poison pill triggered at a single threshold of stock ownership (historically, 15% or 20%), the Sotheby's poison pill has two different thresholds depending on the type of investor. It effectively prevents any shareholder from acquiring 10% or more of Sotheby's stock, except that passive stockholders – or "13G Investors," as defined in Sotheby's preferred shares rights agreement – may acquire up to 20%.³

In its complaint, Third Point argues that the Delaware Court should not consider vocal stockholders seeking representation on a corporation's board of directors as a cognizable threat to the corporation under *Unocal*, and suggests that the adoption of a poison pill with a 10% trigger – and an exemption for passive investors who may purchase up to 20% – is neither a reasonable nor a proportionate response.⁴ According to Third Point, bifurcation of the poison pill's ownership threshold between passive stockholders and other stockholders serves as evidence of the poison pill's purpose, which would be to favor those stockholders who are more likely to be friendly to management and make it more difficult for activist stockholders to win a proxy contest.

Sotheby's is not the first company to adopt a poison pill with a bifurcated or two-tiered triggering threshold. In late 2012, Netflix adopted a poison pill after Carl Icahn reported a 9.98% stake and expressed the belief that Netflix held significant strategic value for several larger companies. Netflix, like Sotheby's, set a general threshold of

¹ For additional details, please refer to the [Sotheby's/Third Point chronology](#).

² See Verified Complaint, *Third Point LLC v. William F. Ruprecht, et al.*, Case No. 9469-VCP, filed March 24, 2014 (Del. Ct. of Chancery).

³ See <http://www.sec.gov/Archives/edgar/data/823094/000089882213000385/exhibit4-1.htm>.

⁴ See *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 955 (Del. 1985). Under *Unocal*, defensive actions are analyzed under a two-pronged test aimed at establishing (i) whether directors had "reasonable grounds for believing that a danger to corporate policy and effectiveness existed" and (ii) whether the defensive measure decided upon was "reasonable in relation to the threat posed."

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10% and a 20% threshold for “13G institutional investors.”⁵ Around the same time, SandRidge Energy adopted a poison pill with a trigger of 10% for activist investors and 15% for passive investors in response to a letter from TPG-Axon Capital seeking to replace SandRidge Energy’s CEO and to nominate directors to the board.⁶

In July 2013, Air Products & Chemicals implemented a poison pill following what it referred to as “unusual and substantial activity in the Company’s shares” – one week later, Bill Ackman’s Pershing Square Capital disclosed a 9.8% ownership stake in the company. Also, in this case, the rights received as part of the rights plan are exercisable if an investor acquires 10% of the company’s shares (or 20% in the case of institutional investors filing on Schedule 13G) without approval of the Air Products board.

More recently, Riverbed Technology, Inc. adopted a poison pill with an ownership threshold of 10% generally and 20% in the case of institutional investors filing on Schedule 13G. Riverbed’s board adopted this poison pill just a few days after Elliott Associates disclosed ownership of approximately 9% of the company’s outstanding shares.⁷ Similarly, after observing what it described as “unusual and substantial activity in the company’s shares,”⁸ Hertz Global Holdings Inc. recently adopted a poison pill with a general threshold of 10% and a higher 15% threshold for passive investors.

Some commentators have criticized the use of poison pills with a bifurcated triggering threshold, arguing that their intended purpose is not to prevent a creeping takeover by a large stockholder without payment of a control premium, but rather to prevent an activist from increasing its influence in the context of a proxy fight.⁹ However, others have argued, particularly in the case of Third Point and Sotheby’s, that an activist stockholder seeking merely to gain seats on a company’s board of directors still has the ability to engage and ultimately succeed in a proxy fight even in the face of a poison pill capping its ownership of the company at 10%.¹⁰

As this new type of poison pill becomes increasingly popular, it will be interesting to see how the Delaware Court responds to Third Point’s claims and whether the use of separate triggering thresholds for activists and passive investors will continue to be permitted going forward.

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⁵ See <http://www.sec.gov/Archives/edgar/data/1065280/000119312512452184/d435273dex41.htm>.

⁶ For additional details, please refer to the archived [SandRidge/TPG-Axon chronology](#).

⁷ For additional details, please refer to the [Riverbed Technology/Elliott Associates chronology](#).

⁸ See <http://www.sec.gov/Archives/edgar/data/47129/000095015713000484/ex99-1.htm>.

⁹ See, e.g., <http://www.corporatesecretary.com/articles/proxy-voting-shareholder-actions/12697/poison-pill-draws-renewed-scrutiny/>.

¹⁰ See, e.g., <http://blogs.wsj.com/moneybeat/2014/03/26/dealpolitik-will-third-point-lawsuit-invalidate-sothebys-poison-pill/>.

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