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Sotheby's Annual Meeting Rights Preserved as Poison Pill Usage Upheld by Delaware Chancery Court

BY ROB R. CARLSON & MICHAEL J. NIETO

Introduction

In Third Point LLC v. Ruprecht, the Delaware Court of Chancery (the "Court") held that the Board of Directors of Sotheby's had not breached its fiduciary duties by adopting and refusing to waive the application of a two-tiered stockholder rights plan (also known colloquially as a "poison pill") during a preliminary injunction hearing in an attempt to enjoin Sotheby's from holding its annual meeting. Third Point LLC ("Third Point"), Sotheby's largest stockholder at the time the suit was brought, claimed that the Sotheby's Board of Directors had violated its fiduciary duties by adopting the rights plan and refusing to provide a waiver to Third Point, in an attempt to obtain an unfair advantage in an upcoming proxy contest.

Utilizing the standard two-prong Unocal test, the Court held that plaintiff Third Point failed to persuade the Court that there was a reasonable probability of success on the merits of its claim. The Court identified that the concept of negative control—essentially, a controlling influence without paying a premium to stockholders—by a stockholder without an express veto right or 20% control could reasonably be seen as a threat to corporate policy, and thus justified defensive action by the Board, including the adoption of a rights plan.

Brief History

During 2013, three hedge funds began acquiring significant portions of Sotheby's stock. These funds included plaintiff Third Point, known for its activist investing and penchant for pushing toward event-driven situations including mergers, acquisitions and tender offers. On May 15, 2013, Third Point filed a Form 13F which disclosed that it held 500,000 shares of Sotheby's stock. By May 2014, Third Point held just under 10% of Sotheby's outstanding stock, with the three activist funds combined holding a collective 19% ownership interest in Sotheby's.

On July 19, 2013, William F. Ruprecht, the Chairman of the Sotheby's Board of Directors and the President and CEO of the Company, informed the Board that "there is an increasing probability that we are going to be subject to an imminent activist effort to shift our management agenda." Identifying the upcoming challenge to the Company, Ruprecht reached out to the Company's outside counsel and financial advisors to anticipate potential activist approaches and the potential responses the Company would need to take.

By October 2, 2013, Third Point's ownership stake in Sotheby's had increased to approximately 9.4% of the Company's outstanding stock. On that date, Daniel Loeb, the CEO of Third Point, sent a letter to Mr. Ruprecht. The letter raised several concerns, including Sotheby's weak operating margins and deteriorating market position relative to Christie's, and calling for a change in management backed by a short slate of directors selected by Third Point, including Loeb. Two days after receiving the letter from Third Point, the Sotheby's Board adopted the stockholder rights plan in question.

This poison pill adopted by Sotheby's contained several notable provisions: a two-tiered triggering mechanism, a one-year term and a qualifying offer exception. Under the two-tiered structure, "passive investors" could acquire up to a 20% ownership interest in the Company, while an "activist stockholder" could only acquire up to 10% before triggering the poison plan.[1] Additionally, under the qualifying offer exception, the poison pill would not be triggered as the result of "an 'any-and-all' share offer for the Company that cashes out all Sotheby's stockholders and gives them at least 100 days to consider the offer." Finally, the poison pill would expire after a one-year term unless approved by a shareholder vote. However, there were no restrictions that would prevent the Sotheby's Board from approving a new plan after the one-year term expired.

Discussion

In its analysis regarding the probability that Third Point's claims could succeed on their merits, the Court determined that the rights plan would have to be assessed under the standard set forth in Unocal[2], which has long been considered the seminal case for determining the validity of a contested rights plan. In order for a poison pill to be valid under the Unocal analysis, the poison pill must be (i) reasonable, which is "satisfied by a demonstration that the board had reasonable grounds for believing that a danger to corporate policy and effectiveness existed," and (ii) proportional, satisfied by a demonstration that the board of directors' defensive response was appropriate in relation to the proposed threat.

With respect to the adoption of the poison pill, the Court focused on the concept of "creeping control." When the Company's Board initially adopted the poison pill, the three activist hedge funds spearheaded by Third Point were actively buying large portions of Company stock, with the openly stated goal of replacing management and forcing a short slate of directors onto the Board. In consultation with its legal and financial advisors, the Board was informed that activist funds will commonly attempt to buy large allotments of stock in an effort to exert control without paying any sort of premium to shareholders. This type of de-facto control coupled with the track record of these three particular activist funds attempting to exert control over their investments strengthened the Company's claims that the activities of Third Point and its allied funds could exert creeping control over the Company, and the Court found that such control poses an objectively reasonable threat to the Company.

Further, the Court found that the main purpose behind the Sotheby's Board adopting the poison pill was not to undermine a stockholder vote in a coming proxy contest. The Company's Board was primarily independent from management, and the Court felt that the Board's actions were not meant solely to frustrate a stockholder challenge and preserve its members' incumbency. In fact, the Court found that the Company's Board had a shorter average term for its members than many other S&P 500 companies. The Court went on to find that the proxy contest was "eminently winnable by either side" and did not contain coercive features that would unduly compromise such a contest.[3]

Conclusion

The Third Point lawsuit is the first to challenge a two-tier ownership structure included in a poison pill. Despite Third Point's arguments that such a structure unfairly gives an advantage to incumbent management in a potential proxy contest and "open[s] the door to future efforts to squash outspoken stockholders," the Court confirmed that under Delaware law, there is no regulation which prevents a company's board from taking defensive measures to influence a potential stockholder vote, provided that the actions taken by the board are proportionate to the recognized threat, and do not compromise the effectiveness of the stockholders' voting power.

It appears that with this decision the Delaware Court of Chancery is prepared to allow for the use of a two-tier poison pill, provided that the circumstances surrounding its adoption are appropriate and satisfy the long-held Unocal standard.

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If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:

Atlanta

Reinaldo Pascual
1.404.815.2227
reypascual@paulhastings.com

Chicago

Thaddeus (Thad) J. Malik
1.312.499.6020
thaddeusmalik@paulhastings.com

Los Angeles

Claudia Simon
1.213.683.6199
claudiasimon@paulhastings.com

New York

Luke P. Iovine
1.212.318.6448
lukeiovine@paulhastings.com

Orange County

Brandon Howald
1.714.668.6239
brandonhowald@paulhastings.com

Palo Alto

Rob Carlson
1.650.320.1830
robcarlson@paulhastings.com

San Diego

Carl R. Sanchez
1.858.458.3030
carlsanchez@paulhastings.com

Elizabeth A. Razzano
1.858.458.3035
elizabethrazzano@paulhastings.com

Washington, D.C.

Eric D. Greenberg
1.202.551.1343
ericgreenberg@paulhastings.com

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[1] Stockholders who report their ownership in the Company on Schedule 13G (indicating that, among other requirements, they have "not acquired the securities with [the] purpose…of, changing or influencing the control of the issuer") may acquire up to a 20% ownership interest in Sotheby's; however, all other stockholders, including those who report their ownership pursuant to Schedule 13D (such as the plaintiff Third Point), are limited to a 10% ownership interest before triggering the terms of the poison plan.

[2] *See* Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 949 (Del. 1985).

[3] It is worth noting that, while the Court refused to enjoin Sotheby's annual meeting, the Company provided many of the items that Loeb sought in his discussions with Company management, including board seats for Loeb and two of his associates, and provided Loeb with a key role in Sotheby's strategic review of its core business and practices.