Potter Anderson Corroon LLP

Delaware Law Updates

THIRD POINT LLC V. RUPRECHT, C.A. NO. 9469-VCP (MAY 2, 2014) (PARSONS, V. C.)

May 2, 2014

In this memorandum opinion, the Court of Chancery denied plaintiff's motion to preliminarily enjoin the 2014 annual meeting of nominal defendant Sotheby's (or the "Company") pending a trial on plaintiff's challenge to a two-tier rights plan adopted by the Company. Plaintiff Third Point LLC ("Third Point") claimed the rights plan impermissibly advantaged the board in an ongoing proxy contest between Third Point and the Company for three seats on Sotheby's board of directors. Analyzing Third Point's claim under *UnocalCorp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985), the Court determined that Third Point had not demonstrated a reasonable likelihood of success on its claim that the Sotheby's directors breached their fiduciary duties by adopting the rights plan and then by later refusing to waive a 10% trigger in the plan as to Third Point. The Court therefore denied Third Point's application.

Sotheby's operates the oldest auction house in the world. The Company's board has 12 directors—one inside director, who is also Chairman, President, and CEO, and 11 independent, outside directors. The board is not staggered, and its 12 members collectively own 0.87% of the Company's stock. Third Point is an activist hedge fund run by billionaire Dan Loeb.

In spring 2013, Third Point and other hedge funds began acquiring Sotheby's stock and disclosing their acquisitions on Schedules 13D and 13F. The Company's CEO informed the board of these developments in July 2013. The board's advisors thereafter provided the board with information on shareholder activism, including at the board's regularly scheduled August 6 meeting. Also in early August, Sotheby's management met with Third Point and one other hedge fund that had been acquiring Sotheby's stock. On August 26, 2013, Third Point filed its first Schedule 13D, disclosing it had acquired a 5.7% stake in the Company. Another hedge fund held a 6% stake in the Company, while a third fund held a 3% stake. The Company continued to monitor the hedge funds, and the board and management received background information on Third Point and the other hedge funds.

On October 2, 2013, Third Point filed an amended Schedule 13D revealing that it had increased its stake to 9.4% and attaching a letter to the Company's CEO. The October 2 letter raised several concerns about Sotheby's and was highly critical of Sotheby's board and management. On October 3, 2013, the board held a special meeting with its advisors and discussed Third Point's Schedule 13D filing and the October 2 letter. At the meeting, the board discussed whether the recent accumulations of stock and other, related items posed a threat to the Company to which adoption of a rights plan was an appropriate response. The board decided it would continue discussing a potential rights plan the next day at a regularly scheduled board meeting.

On October 4, the board met again. After continued discussion of a potential rights plan, the board unanimously adopted a rights plan that provided protection against creeping acquisitions through open market purchases. The rights plan expired within one year, did not apply to offers to acquire the whole Company, and had a two-tier structure with a 10% ownership trigger and a 20% ownership trigger. Those persons who reported their ownership in the Company pursuant to Schedule 13G (i.e., "passive" investors) were permitted to acquire up to a 20% interest in Sotheby's. Those persons who reported their ownership in the Company pursuant to Schedule 13D (i.e., "activist" investors) were permitted to acquire up to a 10% stake in Sotheby's. Third Point reported its ownership on Schedule 13D and was therefore limited to acquiring 10% of the Company's stock under the rights plan.

Throughout late 2013 and into early 2014, Dan Loeb conducted himself as though he already had significant influence over the Company's decision making. He identified himself to third parties as someone "in charge" of Sotheby's and as the person who would be making the Company's future real estate decisions. Also, he approached at least three prominent members of the art community about whether they would be interested in being CEO of Sotheby's. By January 2014, Loeb's conduct was raising questions from the Company's possible consignors and clients.

In February 2014, Sotheby's and Third Point began negotiating in an attempt to avoid a proxy contest. Those efforts were unsuccessful, and on February 27, 2014, Third Point filed another Schedule 13D that revealed it had increased its stake in the Company to 9.53%. Third Point also announced that it was going to run a slate of three directors at the upcoming annual meeting. On March 13, 2014, Third Point again amended its Schedule 13D and revealed that it owned 9.62% of Sotheby's stock. In addition, Third Point sent a letter to Sotheby's requesting that the Company grant Third Point a waiver from the rights plan's 10% trigger and allow it to purchase up to a 20% stake in the Company.

The board met on March 19 to receive an update from its advisors about possible voting outcomes in the ongoing proxy contest with Third Point and to consider Third Point's waiver request. The board was advised that the proxy contest could be a dead heat. As to the waiver request, the board denied it and informed Third Point of its decision on March 21. On March 25, Third Point commenced litigation challenging the rights plan and the board's decision not to waive the 10% trigger. The Court scheduled a preliminary injunction hearing to determine whether the Company's annual meeting should be enjoined until after a trial on the merits to address Third Point's challenge to the rights plan.

In its memorandum opinion following the preliminary injunction hearing, the Court analyzed the three showings Third Point was required to make to secure injunctive relief: (i) a reasonable probability of success on the merits of its claims, (ii) that absent injunctive relief, Third Point would suffer irreparable harm, and (iii) that the balance of the harms weighs in favor of injunctive relief.

As to the reasonable probability of success showing, the Court first considered whether *Unocal* or *Blasius Industries, Inc. v. Atlas Corp.*, 564 A.2d 651 (Del. Ch. 1988)provided the proper legal framework for the dispute. The Court recognized that both the Chancery Court and the Delaware Supreme Court have used *Unocal* exclusively as the lens through which the validity of a contested rights plan is analyzed. Although examining whether *Blasius* could be applied within the *Unocal* framework, the Court ultimately determined that it was settled law that the board's compliance with its fiduciary duties in adopting and refusing to amend or redeem the rights plan should be assessed under *Unocal*, and that it was unlikely that *Blasius* would be implicated within the *Unocal* framework in this case.

The Court then analyzed two decisions of the board under the *Unocal* framework: the decision to adopt the rights plan in October 2013 and the decision not to waive the 10% trigger as to Third Point in March 2014. For the adoption of the rights plan in October 2013, the Court found that the board made an objectively reasonable determination that creeping control by the various hedge funds without paying a control premium was a legally cognizable threat to Sotheby's. The Court determined next that the rights plan was neither coercive (i.e., it did not impose any consequences on stockholders for voting their shares as they wish) nor preclusive (i.e., it did not make Third Point's success in the proxy contest "realistically unattainable"). The Court then turned its review to whether the rights plan was a reasonable and proportionate response to the threat of creeping control. The Court noted that the board collectively owned less than 1% of Sotheby's stock and that the 10% trigger therefore permitted activist investors to achieve a substantial ownership interest in the Company vis-à-vis the board. The Court also noted that the 10% trigger prevented a small group of activist investors from achieving control through "conscious parallelism" but without paying a premium. As to the two-tier nature of the rights plan, the Court found that structure should not serve as a basis in the circumstances before it to enjoin the annual meeting. Arguably, the 20% trigger for passive investors could allow a stockholder friendly to the board to acquire a large stake in the company and vote in favor of the board at the annual meeting. However, for purposes of this case, no such stockholder existed, and Third Point was the Company's largest stockholder. Accordingly, the Court found that the two-tier structure was a "complete non-issue in terms of the current composition of Sotheby's stockholders." The Court thus concluded that Third Point failed to demonstrate a likelihood of success on the merits of its claim that the board breached its fiduciary duties by adopting the rights plan in October 2013.

As to the refusal to waive the 10% trigger in March 2014, the Court found that the board made an objectively reasonable determination that negative control by Third Point was a legally cognizable threat to Sotheby's. At 20%, Third Point would have been by far the Company's largest stockholder. That level of ownership, coupled with the "aggressive and domineering manner in which the evidence suggests Loeb has conducted himself in relation to Sotheby's," provided an adequate basis for concern about Third Point. The Court thus concluded that evidence indicated that Sotheby's may have had "legitimate real-world concerns that enabling [Third Point] to obtain 20% as opposed to 10% ownership interests in the Company could effectively allow [Third Point] to exercise disproportionate control and influence over major corporate decisions, even if [it did] not have an explicit veto power." The Court next considered whether the board's refusal to grant Third Point the waiver from the 10% trigger was a reasonable and proportionate response to the threat of negative control. The Court found that the response was consistent with the board's stated purposes, that the operation of the 10% trigger in the rights plan would help the board achieve its end of preventing negative control, and that the response was reasonable and proportionate to the negative control threat. The Court concluded that Third Point failed to demonstrate a likelihood of success on the merits of its claim that the board breached its fiduciary duties by refusing to grant Third Point the waiver in March 2014.

Although the Court had determined that *Unocal* provided the proper framework for analyzing the rights plan, it also considered whether the adoption of the rights plan and the refusal to waive the 10% trigger was for the primary purpose of interfering with the stockholder franchise. Although it was a "close call" as to the waiver, overall the Court determined that it was reasonably likely that the board would be able to show that it was motivated primarily by the control threat and that any effect on electoral rights "was an incident to that end." The Court also found that there were no facts in the record that would support an entrenchment motive on the part of the board – the board was not staggered, it was dominated by outside, independent directors, and there was no showing that serving on the board was material to any director.

The Court then considered the irreparable harm and balance of the equities showings that Third Point would have to make to secure injunctive relief. As to irreparable harm, the Court found that, although another "close call," 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. Despite Third Point's substantial 10-to-1 stock ownership advantage over the board and the substantial possibility that Third Point would win the proxy contest—making any preliminary intervention by the Court unnecessary, the Court found that the proxy contest was in a "dead heat" and would likely be decided by a thin margin, such that Third Point's reduced odds of winning due to the rights plan would support a finding of imminent harm. Because the harm to a dissident slate from a flawed stockholder vote typically cannot be remedied after the fact by holding a second meeting, the Court found that the harm Third Point would suffer, were it to lose the proxy contest, would likely be irreparable. As to the balance of the equities, the Court found that the potential harm to Third Point if the meeting were not enjoined outweighed the potential harm to the Company of postponing the annual meeting. The Court stated that the "[p]rotection of the stockholder franchise is important in every instance, but it is of particular importance here, where Third Point is engaged in a hotly contested proxy fight with the Company and certain of the Company's directorships are at stake."

Although the irreparable harm and balance of the equities analyses favored Third Point, the Court denied the preliminary injunction application because Third Point failed to make the requisite showing that it was reasonably likely to succeed on its breach of fiduciary duty claims.