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Delaware Court of Chancery Finds Sotheby's Poison Pill Reasonable; Declines to Enjoin Sotheby's Annual Meeting

In *Third Point LLC* v. *Ruprecht*, the Delaware Court of Chancery held, in the context of a suit for preliminary injunction, that plaintiffs would be unlikely to demonstrate that the Sotheby's board breached its fiduciary duties by adopting a two-tiered stockholder rights plan (a so-called "poison pill") which provided that passive institutional investors could acquire a greater percentage of the company than other investors, and then later refusing to waive the application of the lower threshold as to Third Point. In so holding, the Court found that the possibility of "creeping control" and "negative control" by stockholders posed objectively reasonable and legally cognizable threats to Sotheby's at various times (as described in more detail below), and, therefore, declined to enjoin Sotheby's from holding its annual meeting. Sotheby's and Third Point have since announced a settlement of this litigation, thus, it appears unlikely that this decision will be appealed.

BACKGROUND

Throughout 2013, hedge funds began to acquire positions in Sotheby's. Then, in the fall of 2013, Third Point amended its Schedule 13D, revealing that it held approximately 9.4% of Sotheby's outstanding stock and calling for management change and the election of new directors recruited by Third Point. Two days later, the Sotheby's board responded by adopting a poison pill that included the following terms:

- *A two-tiered share-ownership threshold* – Stockholders who reported their ownership in the company pursuant to Schedule 13G (i.e., passive institutional investors) could acquire up to a 20% interest in Sotheby's before triggering the poison pill, but all other stockholders, including those who reported their ownership pursuant to Schedule 13D, could only acquire up to a 10% stake.

- *A one-year term and "qualifying offer" exception* – The poison pill expired in one year unless approved by a stockholder vote. Also, the poison pill does not apply to cash offers for any and all shares of Sotheby's that gives stockholders at least 100 days to consider the offer.

In early 2014, after announcing that it intended to run a slate of three directors at Sotheby's annual meeting, Third Point requested a waiver of the poison pill's 10% trigger to allow it to purchase up to a 20% stake. After deliberation and based on information from its advisors, the Sotheby's board denied Third Point's request because, among other reasons, the waiver would increase Third Point's chances of winning the proxy contest and allow them to exercise disproportionate control over major corporate decisions (even without explicit veto rights). Third Point sued to enjoin Sotheby's annual meeting, arguing that the

Sotheby's board breached its fiduciary duties by adopting the poison pill and refusing to waive the 10% trigger.

ANALYSIS

The Court held that Delaware's well established *Unocal* standard would apply to its review of the board's adoption of the poison pill as well as to its refusal to waive the lower pill threshold. For a poison pill to be valid under *Unocal*, (i) a board of directors must articulate a reasonable and legally cognizable threat, and (ii) the poison pill must be reasonable in relation to the threat posed (and not be preclusive or coercive). On a motion for a preliminary injunction, the Court declined to enjoin Sotheby's annual meeting, finding that Third Point and the other stockholder plaintiffs did not have a reasonable probability of success on the merits of their claims. The Court specifically held that:

- *"Creeping control" was an objectively reasonable and legally cognizable threat to Sotheby's at the adoption of the poison pill* – When the Sotheby's board initially adopted the poison pill, several hedge funds were accumulating Sotheby's stock, and Third Point, in particular, was accumulating Sotheby's stock on a rapid basis. Further, Sotheby's board's advisors informed the board that hedge funds could and often would form a group or "wolf pack" to acquire a control block without paying a premium. The Court concluded that these facts supported the Sotheby's board's assertion that possible creeping control by Third Point and others posed a legally cognizable threat and that this threat was objectively reasonable.

- *The poison pill was reasonable in relation to the threat of "creeping control"* – The poison pill's 10% trigger allowed investors to achieve a substantial ownership in Sotheby's while simultaneously preventing one or more hedge funds from forming a control block, and therefore was reasonable in relation to the perceived threat to Sotheby's. Further, although the poison pill was discriminatory because 13G filers could acquire up to 20% of Sotheby's shares as opposed to only 10% for other stockholders, the Court held that this feature was arguably a "closer fit" to addressing Sotheby's needs of preventing an investor from gaining control than a typical poison pill that restricts all stockholders to the same ownership level.

- *"Negative control" posed an objectively reasonable and legally cognizable threat when Sotheby's board refused to waive the 10% trigger* – When Third Point asked for a waiver of the 10% trigger so that it could purchase up to a 20% interest in Sotheby's, the evidence indicated that Sotheby's had legitimate concerns that Third Point could effectively exercise disproportionate control and influence over Sotheby's with a 20% ownership interest, although Third Point would lack an explicit veto power. The Sotheby's board's refusal to waive the poison pill's 10% trigger was, therefore, consistent with the board's stated purpose of avoiding negative control by Third Point and fell within the range of reasonable responses and was neither preclusive nor coercive.

- *The "primary purpose" of the initial adoption of the poison pill was not to interfere with stockholder's voting rights* – Based on the Sotheby's board's articulated concerns regarding creeping control, the Court found that it was reasonably likely that the board would be able to demonstrate that it adopted the poison pill in response to that perceived threat rather than in an attempt to thwart stockholders' voting rights. As a result, it was unlikely that the heightened *Blasius* standard, which requires that boards have a "compelling justification" for any action taken with the primary purpose of interfering with the stockholder franchise, would apply in this context.

The Court also held that (i) Third Point had made a marginal showing of imminent irreparable harm because its odds of winning the proxy contest were reduced by its inability to acquire more than 10% of Sotheby's shares, and (ii) the balancing of the equities weighed slightly in favor of Third Point and the other stockholder plaintiffs because of possible harms to the stockholder franchise. The Court, however, declined to enjoin Sotheby's annual meeting, because plaintiffs failed to demonstrate a probability of success on the merits.

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