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Of Wolf Packs, Plans and Pills: Making Puppies Out of Predators

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Remember corporate raiders, green-mailers and sharks? They have all moved up town and been embraced by ISS and its institutional investor clients as shareholder activists committed to corporate "reform." Cheap capital and the expanded use of derivatives to accumulate enormous equity positions both quickly and quietly have fueled a binge that has more than tripled activist campaigns over the past four years. Poor governance "scores" are used to threaten board tenure, executive compensation schemes, corporate strategic plans and well-conceived programs for creating shareholder value. The recent successes of high profile activist campaigns have lured hedge funds, mutual funds, pension funds, sovereign wealth funds and collective media of every stripe into high profile campaigns where ISS overwhelmingly favors dissidents in contested proxy votes. Vulnerable targets of these assaults must become their own "activists." Sotheby's recently learned that lesson:

In May of this year, the Delaware Chancery Court denied a motion to preliminarily enjoin the annual shareholder meeting of Sotheby's auction house.[1] This motion, which had been filed by several of Sotheby's activist investors, argued that the company's adoption and subsequent refusal to waive a rights plan amounted to a breach of the directors' fiduciary duties to their shareholders, and that failure to enjoin the shareholder meeting would result in the company having an impermissible advantage in an ongoing proxy contest with the plaintiffs. Sotheby's board of directors objected, on the grounds the funds presented numerous legally cognizable threats to the company that the rights plan addressed without making victory in the proxy contest unobtainable. The Court denied the funds' motion, and in doing so, it not only extended the second prong of the *Unocal* test to allow rights plans adopted in response to threats of creeping and negative control, but also continued its trend of allowing boards of directors to act in ways that protect their companies and their shareholders from external threats to corporate resources or vision.

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Factual Background

The facts leading up to the Chancery Court's opinion began in May 2013, when an investment manager for a series of funds totaling over $14.5 billion in assets, disclosed in an SEC filing that it had acquired 500,000 shares of Sotheby's stock. When two other hedge funds announced their acquisition of additional shares (col-

[1] *Third Point LLC v. Ruprecht*, 2014 BL 124025 (Del. Ch. May 2, 2014).

lectively, the ''Activist Investors''), Sotheby's board became concerned about ''an increasing probability that'' the company was ''going to be subject to an imminent activist effort to shift [its] management agenda.''[2] Based on these intimations, the board began working with financial and legal advisors on how to respond to future activist shareholder activity. In particular, Sotheby's CEO expressed his concern that the Activist Investors would suggest changes to the company's financial philosophy and strategy, ''which would have dramatic consequences on [the company's] P&L.''[3] The board also received information from its legal and financial advisors of the typical behavior exhibited by activist investors, including ''form[ing] a 'wolf pack,' applying pressure on the entity, including threatening to agitate against a board's preferred strategic objectives, and finally taking action against the board by threatening 'withhold the vote' campaigns, demanding board seats, launching a short-slate proxy contest, or making aggressive use of derivatives.''[4] The board was also informed of the Activist Investors' previous successes in shareholder activism, including past transactions with corporations in which the fund received benefits that were not available to the entity's other shareholders.

The board's early fears appeared to be warranted; at an August 2013 meeting between the company's management and two of the three funds, the Activist Investors raised multiple questions regarding company's strategic direction, financial planning, and board membership. Moreover, following the meeting, the Activist Investors continued to increase their stakes in Sotheby's, and with one of them disclosing that it intended to ''engage in a dialogue with members of the Board or management'' while also pursuing discussions with other shareholders or ''knowledgeable industry or market observers (including art market participants).''[5] Sotheby's management viewed these moves as a signal that the company was ''going to be the target of a proxy fight with activist shareholders,'' an opinion confirmed by its financial advisor.[6]

A key aspect of Sotheby's concerns regarding the funds' overtures was the effect they would have on the company's corporate vision and financial well-being. The board believed that ''every suggestion [the Activist Investors] had made was terrible – and not good for business.''[7] Meanwhile, the Activist Investors' goals in taking over Sotheby's appeared to be limited to ''stir[ring] up dissent among the company's staff and experts'' in order to ''replac[e] management/board composition or simply to be so disruptive that [the board] accommodate.''[8] Perhaps for this reason, Sotheby's CEO expressed his belief that the company should plan, enact, and publicly announce its own strategic plan before informing the other shareholders of the impending proxy contest, which could risk the other shareholders' acceptance of the Activist Investors' plan.[9]

[2] *Id.* at *4.
[3] *Id.* at *5.
[4] *Id.* at *6.
[5] *Id.* at *8.
[6] *Id.* at *9.
[7] *Id.* at *10.
[8] *Id.* at *9.
[9] *Id.* at *8.

By October 2013, the situation between Sotheby's and the Activist Investors had intensified. One of the Activist Investor funds disclosed that it had increased its stake in Sotheby's to 6.35 million shares, equating to approximately 9.4% of the Company. As part of this disclosure, this fund's CEO raised various concerns about Sotheby's management and suggested how to ''repair'' the Company by, among other things, appointing him and several of his recruits onto the board. Documents produced during discovery in fact revealed that this CEO viewed this disclosure as an ''all out assault meant to destabilize the company'' and ''part of a holy jihad intended to make sure all the Sotheby's infidels are made aware that there is only one true God.''[10]

In order to preserve Sotheby's corporate vision and protect the company's own strategic plan from the looming threat posed by the funds, the board adopted a two-tiered shareholder rights plan. This plan, which distinguished between passive and active investors, was aimed at preventing the Activist Investors from accumulating a position of power within Sotheby's without paying a control premium.[11] Under its terms, passive investors could acquire up to a 20% interest in Sotheby's before triggering the poison pill, while active investors were limited to a 10% stake. This plan was set to expire one year after its enactment, although there did not appear to be any limitation to the board's ability to re-adopt it following its expiration.[12]

In February 2014, after several months of the Activist Investors' continued representations to Sotheby's employees and third parties that they already had substantial control over the company, they began negotiating with Sotheby's management in order to avoid a proxy contest at its upcoming shareholders meeting. To that end, the Activist Investors submitted a settlement proposal, the core points of which were that the company modify the rights plan to allow 15% ownership, that the roles of the CEO and Chairman of the company be separated, and that the CEO of one of the Activist Investors and one of his designees join the Board.[13] Sotheby's provided a counter offer, including allowing the Activist Investors one board nominee (who could not be its CEO), but it was rejected. Over the next several weeks, the Activist Investors made additional filings with the SEC, each reflecting that the threat posed by the funds continued to increase along with the size of their stakes in Sotheby's.

In March 2014, the Activist Investors requested that Sotheby's grant it a waiver from the rights plan's 10% trigger. At the board's next meeting, it was informed by its advisors that the proxy contest between Sotheby's and the Activist Investors was basically a dead heat, and that if the 10% trigger was waived, the Activist Investors would probably win the contest. The board also discussed how the Activist Investors ''continued to pose a threat to corporate policy and effectiveness and a risk of creeping control.''[14] Based on these considerations, the board denied the waiver request. The Activist Investors filed suit four days later, claiming that Sotheby's breached their fiduciary duties by adopting and enforcing the rights plan.

[10] *Id.* at *12.
[11] *Id.*
[12] *Id.* at *13.
[13] *Id.* at *15.
[14] *Id.* at *17.

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The Unocal Standard

The Court's first step in evaluating whether the Activist Investors' motion for a preliminary injunction had a reasonable probability of success on the merits was to determine the proper legal standard upon which to judge Sotheby's board's behavior. Typically, Delaware courts apply the two-pronged test set forth in *Unocal Corp. v. Mesa Petroleum Co.*[15] to analyze the validity of a contested rights plan. Under *Unocal*, a court must first consider the reasonableness of the board's action, as evidenced by the board (*i*) conducting a good faith and reasonable investigation into whether the company was facing a danger to its corporate policy, and thereby (*ii*) articulating a legally cognizable and objectively reasonable threat posed to the corporation. The second prong of *Unocal* evaluates the proportionality of the board's action to the threat, which is satisfied by a showing that the board's defensive actions (*i*) were neither preclusive nor coercive, and (*ii*) fell within a range of reasonable responses to the threat posed.

Determining the Relevant Standard

As an initial matter, the Court rejected the Activist Investors' argument that *Unocal* was not the appropriate standard by which to evaluate Sotheby's board's behavior. Instead, the Activist Investors proposed in their preliminary injunction motion that the Court's standard of review should be governed by *Blasius Industries, Inc. v. Atlas Corp.*, which held that a board of directors must provide a compelling justification for its conduct when it acts ''for the primary purpose of interfering with the effectiveness of a stockholder vote.''[16] Activist Investors applied within the *Unocal* framework if the ''primary purpose of the board's action [wa]s to interfere with or impede exercise of the shareholder franchise.''[17]

The Court here declined to apply *Blasius* to Sotheby's board's conduct, as the Activist Investors were unable to cite to a single Delaware Chancery Court case in which *Blasius* had in fact been used to examine a rights plan. Nevertheless, because the Court did not feel that *Blasius*'s role in challenges to rights plans was entirely clear, it evaluated whether the Activist Investors had a reasonable probability of successfully showing that Sotheby's board acted with the primary purpose of interfering with the shareholder vote. In all material respects, the Court found that although the Company was clearly concerned with the impending proxy fight, it neither adopted the rights plan nor refused the Activist Investors' waiver request for the *primary* purpose of interfering with their (or any other shareholders') franchise.[18]

The Court's Application of Unocal

After arriving at the appropriate standard by which to evaluate the board's action, the Court evaluated whether Sotheby's board had met its burden under *Unocal* in defending itself. In so doing, the Court applied *Unocal*'s two-prong test to the board's two actions: (*i*) the adoption of the rights plan in October 2013, and (*ii*) the March 2014 refusal to grant a waiver from the plan.

[15] 493 A.2d 946, 949 (Del. 1985).
[16] 564 A.2d 651, 659 (Del. Ch. 1988).
[17] 813 A.2d 1118, 1130 (Del. 2003).
[18] 2014 WL 1922029, at *18, 22 n.39.

The Adoption of the Rights Plan. With respect to the board's October 2013 adoption of the rights plan, the Court found that no serious argument could be made that the board's investigation into the threat posed by the Activist Investors was insufficient under *Unocal*. Its investigation was conducted by a majority of independent directors who retained competent outside financial and legal advisors, all of which supported a ''*prima facie* showing of good faith and reasonable investigation.''[19]

Moving on, the Court then turned to the question of whether the Activist Investors posed a legally cognizable and objectively reasonable threat to Sotheby's. In coming to its conclusion that the funds did, in fact, pose such a threat, the Court focused on signs of their ''creeping control'' over the company.[20] In particular, the Court viewed the funds' simultaneous and rapid accumulation of stock, coupled with the board's advice from its advisors regarding the formation of activist hedge fund ''wolf packs,'' led to the board's ''objectively reasonable determination that [the Activist Investors] posed a threat of forming a control block for Sotheby's with other hedge funds without paying a control premium.''[21]

Next, the Court addressed whether the board's adoption of the rights plan satisfied *Unocal*'s proportionality prong. Critical to this examination was the Court's finding that the rights plan was neither preclusive nor coercive – it was not preclusive because the proxy contest between the board and the Activist Investors was ''eminently winnable by either side,'' even with the rights plan in place, and it was not coercive because it did not impose any consequences on stockholders who voted their shares in the proxy contest as they wished.[22] The Court also determined, under *Unocal*'s proportionality test, that the rights plan was a reasonable reaction to the funds' threat of creeping control, due to the reasonable probability that the Activist Investors, ''alone or with others, could acquire a controlling interest in the company without paying Sotheby's other stockholders a premium.''[23]

The Court noted that the plan's discrimination between ''active'' and ''passive'' shareholders raised some concerns, and the Court did not go so far as to say that all two-tiered rights plans would satisfy *Unocal*.[24] However, given the specific threat facing Sotheby's, the Court held that the plan's two-tiered structure made it a ''closer fit to addressing the Company's needs to prevent an activist or activists from gaining control than a garden variety rights plan that would restrict the ownership levels for every stockholder.''[25]

The Refusal to Waive the Rights Plan's 10% Trigger. The Court's review of Sotheby's March 2014 refusal to waive the rights plan's 10% trigger was a somewhat closer call than the adoption of the rights plan itself. The Court did not doubt Sotheby's ability to show that it undertook a good faith and reasonable investigation in response to the waiver request, yet it was less sure

[19] 2014 BL 124025, at *21.
[20] *Id.*
[21] *Id.*
[22] *Id.* at *24.
[23] *Id.* at *25.
[24] *Id.* at *25 n.37.
[25] *Id.* at *25.

about whether the threat posed by the waiver request was legally cognizable or objectively reasonable. The Court's reticence was based in part on the fact that the Activist Investors did not request to be excused from the rights plan in its entirety, but rather only a waiver of the 10% trigger. In the Court's view, it was ''not clear, therefore, that the Board did or should have had the exact same concerns in March 2014 that it did in October 2013 when it adopted the Rights Plan.''[26]

Despite this change in circumstances, the Court found that Sotheby's board made a sufficient showing as to the objectively reasonable and legally cognizable threat of *negative* control. The Court defined negative control as the threat that exists in ''situations in which a person or entity obtains an explicit veto right through contract or through a level of share ownership or board representation at a level that does not amount to majority control, but nevertheless is sufficient to block certain actions.''[27] With respect to the situation facing the board, the Court held that Sotheby's ''may have had legitimate real-world concerns'' that waiving the 10% trigger for the Activist Investors would ''effectively allow [them] to exercise disproportionate control and influence over major corporate decisions.''[28]

The Court admitted that allowing ''effective negative control'' to satisfy *Unocal*'s proportionality prong could result in ''a license for corporations to deploy defensive measures unreasonably.''[29] Yet, given the particular facts before it, the Court believed that Sotheby's had an objectively reasonable basis to believe that the Activist Investors were positioning themselves to exercise negative control in their request to waive the 10% provision of the rights plan.

Finally, the Court held that Sotheby's refusal to waive the rights plan met *Unocal*'s reasonableness prong. Limiting the Activist Investors to a 10% cap on its ownership interest appeared to the Court to be to be a tailored response to the negative control threat. Furthermore, the waiver refusal was not preclusive or coercive, since ''some incidental reduction of the shareholder franchise as a result of adopting a rights plan was acceptable so long as a proxy contest remained a viable option.''[30]

Despite its determination that the Activist Investors had not demonstrated a likelihood of success on the merits of its preliminary injunction, the Court considered the other elements of a preliminary injunction and found both of them to be in favor of the plaintiffs. First, the Court found that, although it was a close question, the Activist Investors would suffer irreparable harm through a reduction of their odds of winning the proxy contest. Moreover, the Court also determined found that the last requirement for a preliminary injunction — balancing of the equities – weighed slightly in the Activist Investors' favor, as none of the potential harms that delaying the shareholder vote would have on Sotheby's outweighed the irreparable harm that the funds faced. Yet neither of these factors changed the Court's initial determination that the Activist Investors would not be successful in proving a reasonable probability of success on the merits and therefore was not entitled to enjoin the shareholder meeting.

Implications

The *Sotheby's* case appears to be the latest Delaware Chancery Court opinion to validate corporate boards' ability to act in ways that protect their corporation's interests from threats or other external forces that could change the company's vision and strategic plan. For example, last year, the Court upheld a board of directors' ability to create exclusive forum selection bylaws without a shareholder vote in order to avoid costly multiforum lawsuits, on the grounds that the unilateral enactment of such bylaws fell within statutory and contractual limits.[31] The Court also recently approved of another board's entry into a controlling shareholder buyout when the board agreed at the outset of the transaction to appoint an independent special committee to evaluate the buyout and to obtain approval of the deal from a majority of non-controlling shareholders. By meeting both of these requirements, the Court held that the board was sufficiently protecting its shareholders' interests while still allowing for the exploration of other strategic transactions.[32] The Chancery Court's approval of Sotheby's two-tiered rights plan similarly reinforces the notion that directors may take action to protect their corporation from outside threats, in particular in the form of a poison pill.

More importantly, however, the Court's decision makes it clear that before a corporation can take defensive measures, it must have something to defend. Without a well-defined company strategy, there is no reason to allow a board to take defensive action against a competing strategy launched by an outside entity. Underlying the Court's opinion here is the notion that Sotheby's had a corporate vision and plan for securing that vision that needed to be protected. Moreover, the contours of that strategic plan informed the board's response to the threats posed by the activist funds. Accordingly, a company that finds itself facing a looming threat of negative and/or creeping control from an activist shareholder should primarily focus not on how to attack the threat, but rather on how to solidify its corporate vision and demonstrate that the company has something worth protecting.

When the wolf pack roams, keep the lambs close to the fold.

[26] *Id.* at *26.
[27] *Id.* at *27.
[28] *Id.*
[29] *Id.*
[30] *Id.* at *27 n.39.

[31] *Boilermakers Local 154 Ret. Fund v. Chevron Corp.*, 73 A.3d 934 (Del. Ch. 2013).
[32] *In re MFW S'holders' Litig.*, 67 A.3d 496 (Del. Ch. 2013).

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