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GOVERNANCE PERSPECTIVES

Sotheby's Board Wins the Battle But Loses the War

- Sotheby's largest shareholder launched a proxy contest, challenged Sotheby's recently adopted rights plan and sought to enjoin Sotheby's annual meeting.
- While the court denied injunctive relief, the activist shareholder and Sotheby's settled on the eve of the annual meeting, giving the activist the three board seats it originally sought.
- Shareholder's litigation strategy was successful—even without winning.
- Directors' emails—produced in the litigation—gave the activist the leverage it needed to win board representation.

Last week, the Delaware Chancery Court refused to grant an activist investor's motion to enjoin Sotheby's annual meeting pending the resolution of the investor's lawsuit relating to Sotheby's shareholder rights plan, or so-called "poison pill." The litigation was part of a months-long activist campaign by a 9.3 percent shareholder to secure board representation and changes at Sotheby's.

After the investor built its ownership stake, Sotheby's board adopted a rights plan. The rights issued under the plan would be triggered if a person or group acquired 10 percent of Sotheby's shares, except that passive investors (Schedule 13G filers) were permitted to acquire up to a 20 percent stake. The activist then launched a proxy contest for the election of three directors to Sotheby's 12-member board at its 2014 annual meeting.

When Sotheby's refused to waive the rights plan's 10 percent trigger, the activist sued, asking that the court declare the rights plan unenforceable or require Sotheby's to permit it to acquire a 20 percent stake. The complaint noted that it was not seeking control of Sotheby's, but merely seeking to elect a "short slate" of directors to its board. In addition, the investor contended that, under the *Unocal* standard, the adoption of a rights plan with a lower triggering threshold for non-passive investors was not a reasonable or proportionate response to a shareholder who merely wished to purchase additional shares, conduct a proxy contest, and communicate with other shareholders.

The court ruled in Sotheby's favor and denied injunctive relief. While the court ruled only on the issue as to whether a preliminary injunction was warranted—and not on the issues of whether Sotheby's directors had breached their fiduciary duties or whether the rights plan was invalid—the ruling suggests that directors who adopt a rights plan in the face of activism can reasonably determine that there is an objectively reasonable and legally cognizable threat to the company, and that a rights plan is a reasonable response to that threat.

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But this good news on the apparent viability of rights plans in the presence of activism belies the larger question: Are rights plans an effective tool in these circumstances?

The decision to adopt a rights plan in the face of activism for a short slate is a complex and highly nuanced decision. As we know, rights plans continue to face consistent opposition by proxy advisory firms and others, who readily control at least 20 percent to 30 percent of the vote. Further, in our experience, many activists are loathe to exceed the 10 percent ownership threshold in the first place because the Section 16(b) short-swing profit rules place a serious limitation on their ability to exit their positions within a six-month window. There are numerous additional considerations as well, but the Sotheby's situation teaches us that even a rights plan that survives enhanced scrutiny may still not be an effective remedy for every activism situation.

Although the denial of injunctive relief was a loss, the activist was ultimately successful in achieving its goals. As part of a settlement reached on the eve of the annual meeting, Sotheby's agreed to adjourn its annual meeting until later in May, to expand its board to 15 members, and to appoint three of the investor's nominees as directors. In addition, Sotheby's agreed to terminate the rights plan as of the date of the adjourned meeting and to permit the investor to acquire up to a 15 percent stake in Sotheby's while the plan remained in effect. Sotheby's won victories of its own, as its CEO retained his position, and the investor withdrew its litigation relating to the rights plan.

Ultimately, the Sotheby's campaign may best serve to demonstrate how many activist disputes are not won in the courtroom, but rather solved and settled in the boardroom. Although this contest settled, it presents some interesting lessons in dealing with activism. First, the court's opinion cited numerous emails from both sides that surely weren't drafted with a view to public disclosure—a reminder that private communications can be aired publicly, particularly when lawsuits are filed. Second, it shows that lawsuits can be used effectively as ammunition in the activism context, especially in the context of an impending shareholder meeting—whether or not the lawsuit is a technical success. Third, although the court did not rule on the validity of the rights plan, some would suggest that the court's opinion can be read as an endorsement of rights plans to defend against activist tactics. But perhaps most importantly, this matter shows once again the remarkable tenacity of activists in today's market—the investor ultimately won the three board seats it originally sought, despite Sotheby's apparent victory in the litigation.

Further Information

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