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# *Court of Chancery Enjoins COVID-19 Poison Pill Targeting Activist Stockholders*

By Rick S. Horvath

In the early days of the market turmoil caused by the COVID-19 pandemic, 21 public companies adopted shareholder rights plans, or so-called "poison pills." On February 26, 2021, Vice Chancellor McCormick enjoined one such plan adopted by the board of directors of the Williams Companies (the "Company"). The Company's board adopted the plan as a precaution against stockholder activism.[1] The Vice Chancellor's decision indicates that the circumstances when a board could adopt a rights plan due to concerns about shareholder activism are narrow.

### What is a poison pill?

Poison pills are "the nuclear weapon of corporate governance."[2] While pills come in a variety of forms, they share some common features. At the most basic level, a pill sets an ownership threshold which, if triggered, causes the corporation to issue a massive number of new shares, often at a discount, to existing stockholders. The stockholder who triggers the ownership threshold, however, is not permitted to participate in this distribution. If the triggering stockholder was seeking to acquire the company through a tender offer, the new shares would make that attempt economically ruinous at the expense of severely diluting the corporation's shares.

Because of the potentially ruinous impact of a poison pill, and its entrenchment of corporate management, Delaware law treats pills carefully. Thus, Delaware courts impose on companies and their boards the obligation to justify the adoption of a pill.

### The Williams Board of Directors Adopts a New Pill to Counter Stockholder Activism

At the start of the COVID-19 pandemic in early 2020, the trading volume in the stock of the Company was high and the stock price was falling. Following a cut in prices in crude oil by Saudi Arabia, the Company's stock price fell even lower. By March 19, the Company's stock price had fallen approximately 55% from January 2020.

In March 2020, an outside director on the Company's board (who also happened to be a retired corporate lawyer), proposed that the board adopt a new poison pill (the "Plan") to prevent stockholder activism directed at the Company. With that goal in mind, the Plan had a number of unique, and extreme, features.

First, the Plan would trigger upon a 5% ownership threshold. Synthetic instruments, such as warrants and options, counted toward this threshold.

The Plan also included an acting-in-concert provision ("AIC Provision") that effectively prohibited stockholders owning a combined 5% of shares of Company stock from: (1) "'knowingly act[ing] in concert or in parallel or towards a common goal, (2) if the goal 'relates to changing or influencing the control of the Company . . . ', (3) where each Person is 'conscious of the other Person's conduct' and 'this awareness is an element in their respective decision-making process,' and (4) there is at least one additional factor to be determined by the Board, 'which additional factors may include exchanging information, attending meetings, conducting discussions, or making or soliciting invitations to act in concert or in parallel.'"[3] The AIC Provision also included, among other things, a "daisy chain," meaning that if A acted in concert with B, and B acted in concert with C, then A would be deemed to act in concert with C.

So-called "passive" investors were excluded from triggering the Plan. However, the Plan's definition of "active" investors was expansive, and included "any investor that seeks to 'direct or cause the direction of the management and policies of the Company."[4] Even under the most generous reading of the Plan, only three stockholders could have qualified as "passive" investors.[5]

Over the course of two meetings on March 18 and 19, the Board considered and adopted the Plan. On March 20, the Company issued a press release publicly disclosing the Plan. On March 30, the Company supplemented its annual proxy statement to disclose the Plan's adoption.

The reaction of the market and stockholders to the Plan was negative. The Chair of the Company's board of directors had to campaign to keep his position. One significant stockholder told the board to put the Plan up to a stockholder vote in the following year if the Plan was extended, or else the stockholder would hold the entire board accountable.[6] And, of course, some stockholders sued.

## The Court's Findings and Analysis

In its post-trial opinion, the Court offered a number of findings that should guide corporations, their directors, and their stockholders going forward. Some of those findings are summarized below.

To assess the Plan, the Court applied enhanced scrutiny pursuant to *Unocal Corp. v. Mesa Petroleum Co.*[7] Under *Unocal*, it was the job of the Company's directors to show (1) they had reasonable grounds for concluding that a threat to the Company existed and (2) the Plan was a reasonable and proportional response to that threat.[8]

### ***The Directors Identified Hypothetical Threats Insufficient to Justify a Pill***

While the Court found the directors made a good faith, reasonable investigation before adopting the Plan, the Court concluded that two of the three threats the directors identified did not exist. These threats were:

- Stockholder activism during a time of market uncertainty and a low stock price;
- Activists might pursue "short-term" agendas or distract management; and
- Activists might rapidly accumulate over 5% of the stock during the time-period before any public disclosure was required by the federal securities laws.[9]

In rejecting the first "threat," the Court noted that "[v]iewing all stockholder activism as a threat is an extreme manifestation of the proscribed we-know-better justification for interfering with the [stockholder] franchise."[10] Indeed, the Court indicated that giving credence to such a threat would run

counter to the fundamental rights of stockholders recognized by modern corporate law: to vote, to sell, and to sue.[11] Thus, concrete action by an activist stockholder, and not a general concern about activism, is needed to justify a rights plan.[12]

The Court likewise rejected the notion that hypothetical concerns about short-termism gave rise to a cognizable threat justifying the Plan.[13] While recognizing the policy debates about long-term versus short-term goals, the Court likened a generic concern about short-termism to the same "we-know-better justification that Delaware law eschews in the voting context."[14]

As for whether the Plan could be justified out of so-called "gap-filling" concerns that an activist stockholder would acquire a position before having to disclose that position under the federal securities laws, the Court did not need to resolve this issue for the reasons stated below. And yet, the Court noted its skepticism. Specifically, the Court observed that "gap-filling" concerns would provide ever-present grounds for the adoption of a poison pill, at least for companies subject to the federal securities regime. Such a result would be inconsistent with the Court's enhanced scrutiny of rights plans under Delaware law.[15]

### *The Pill Was Not a Proportionate Response*

Accepting without deciding the threat posed by "gap-filling" concerns without deciding the issue, the Court nonetheless found the Company's response was disproportionate.[16]

First, the Court was critical of the Plan's 5% ownership trigger. For example, only 2% of rights plans identified by the Company's financial adviser had a trigger below 10% ownership.[17] Among Delaware corporations, the Company was one of only two to use a 5% trigger outside of the context of preserving Net Operating Losses.[18] In addition, the Plan's inclusion of synthetic positions in that trigger and its broad definition of "acting-in-concert" went beyond both the defaults of the federal securities laws and recommendations offered by academics for so-called gap-filling pills.[19]

Second, the Court found that, because of the AIC Provision and the Plan's distinction between "active" and "passive" investors, the Plan would chill a broad range of routine stockholder communications.[20] For example, the Court noted that the Plan would likely prohibit two 3% stockholders from discussing an ESG proposal, even if that communication was to determine the level of support for the proposal among the stockholder base.[21]

Ultimately, the Court found that these "extreme, unprecedented collection of features bears no reasonable relationship to" the directors' stated purpose for the Plan. Having found the directors failed to prove the Plan was a reasonable response to the possible threat, the Court invalidated the Plan and permanently enjoined its continued operation.

## Conclusion

While the Court carefully notes that it is not speaking to every possible scenario involving activist stockholders, the *Williams* decision suggests that Delaware courts will view with a jaundiced eye attempts by boards to adopt a poison pill in response to generic concerns about shareholders activism. The *Williams* decision once again shows that directors interested in adopting a rights plan should proceed with caution, and do so in response to an identifiable threat.

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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:*

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[1] The Williams Cos. S'holder Litig., C.A. No. 2020, 0707-KSJM, Slip Op. (Del. Ch. Feb. 26, 2021).
[2] *Id.* at 76.
[3] *Williams*, Slip Op. at 23-24 (cleaned up).
[4] *Id.* at 29.
[5] *Id.*
[6] *Id.* at 29-33.
[7] 493 A.2d 946 (Del. 1095).
[8] *Williams*, Slip Op. at 48-51.
[9] *Id.* at 63-64.
[10] *Id.* at 65.
[11] *Id.* at 44-45, 65.
[12] *Id.* at 65-71.
[13] *Id.* at 71-73.
[14] *Id.* at 72-73.
[15] *Id.* at 76.
[16] *Id.* at 77-89.
[17] *Id.* at 77.
[18] *Id.* at 78.
[19] *Id.* at 78-82.
[20] *Id.* at 82-88.
[21] *Id.* at 85-88.

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