DS. ALERT MEMORANDUM

Delaware Court Enjoins Poison Pill Adopted in Response to COVID-19-Related Market Disruption

March 2, 2021

On February 26, 2021, the Delaware Court of Chancery (McCormick, V.C.) issued a memorandum opinion in *The Williams Companies Stockholder Litigation*[1] enjoining a "poison pill" stockholder rights plan adopted by The Williams Companies, Inc. ("Williams") in the wake of extreme stock price volatility driven by the double whammy of COVID-19 and the Russia-Saudi Arabia oil price war.[2] While the pill adopted by the board in this case had unusual features (such as a 5% trigger and a broad "acting in concert" provision), the Court's decision provides important reminders for boards in considering whether (and when) to adopt a poison pill in the face of a threat to the corporation. This includes the types of "threats" that will justify the adoption of a pill, and the scope of protections that will be considered a "proportionate" response to those legitimate threats. Although the Court struck down the pill in this case, that

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[1] *The Williams Companies Stockholder Litigation*, C.A. No. 2020-0707-KSJM at *3 (Del. Ch. Feb. 26, 2021).
[2] *Id.* at *3.

should not prevent boards from considering adoption of a pill in a situation where they are facing an identifiable threat, whether from a potential takeover or activist shareholder, and tailoring the terms of such a pill to the threat posed.

Background

Williams is a publicly traded energy company that owns and operates natural gas assets, handling around 30% of U.S. natural gas volumes.[3] In the months preceding COVID-19, Williams enjoyed a relatively stable stock price, reaching a high of $24.04.[4] After the U.S. declared a public health emergency due to COVID-19, however, its stock price fell to $18.90 by the end of February 2020.[5] By March 19, after a public spat between OPEC members caused oil prices to swoon, Williams's stock had dropped to $11 a share, a more than 50% decline.[6] This stock price decline was in sharp contrast to the company's performance, which remained relatively steady.

Concerned that the stock price decline made the company a target for activists, a Williams director proposed adopting a poison pill geared toward creating a one-year "moratorium" on shareholder activism of any type, designed to protect management from activists who might be able to take advantage of uncertainty in the market.[7] After receiving input from outside advisors, the board adopted the plan on March 19, 2020.[8]

The Williams pill, which had a one-year duration, had four key features:

— The plan would be triggered and rights distributed when one person acquires "beneficial ownership" of 5% or more of Williams stock or commences a tender or exchange offer resulting in that threshold of ownership.[9]

— The plan broadly defined "beneficial ownership" to include synthetic equity interests like shares underlying derivatives.[10]

— The plan also had a broad "Acting in Concert" ("AIC") provision (sometimes referred to as a "wolfpack" provision), which included persons "knowingly" acting "in concert or in parallel" toward a goal related to "changing or influencing the control of" Williams, where each person is aware of the others' conduct, and the board determines there is another factor present, such as exchanging information or attending meetings.[11] The AIC provision also included a "daisy chain" concept that would aggregate stockholders acting in concert.[12]

— While the plan purported to exclude passive investors, the carve-out for passive investors was narrowly drafted. The carve-out would not apply to any investor who, among other things, sought to "direct or cause the direction of the management and policies" of Williams—a scope of activity that is broader than the "changing or influencing control" standard for Schedule 13G, and would arguably capture a variety of engagement efforts frequently conducted by Schedule 13G filers.[13]

As the Williams board predicted, market and shareholder reaction to the plan was negative.[14] Management was forced to engage in a stockholder outreach campaign to preserve the seat of the company's chairman who had voted in favor of the plan, but even with that campaign, approximately one-

[3] *Id.* at *4.
[4] *Id.* at *6.
[5] *Id.* at *7.
[6] *Id.* at *7-8.
[7] *Id.* at *10.
[8] *Id.* at *20.
[9] *Id.* at *22. 5% of Williams's market capitalization constituted an investment of roughly $650 million in March 2020. *Id.* at *22-23.
[10] *Id.* at *23.
[11] *Id.* at *23-24.
[12] For example, if Stockholder A is "acting in concert" with Stockholder B, who in turn is acting in concert with Stockholder C, then Stockholder A is deemed to be acting in concert with both Stockholders B and C, even if Stockholder A had no knowledge of Stockholder C or its activities. *See id.* at *25.
[13] *Id.* at *28-29.
[14] *Id.* at *29-30.

third of the shares were voted against his reelection at the company's annual meeting.[15]

Beginning in August 2020, class actions were filed seeking to enjoin the pill.[16] Plaintiffs alleged that the Williams directors breached their fiduciary duties in adopting the pill, and sought a permanent injunction requiring the board to withdraw it.[17] The Court conducted a three-day trial in January 2021.[18]

The Decision

The Court evaluated the board's decision to adopt the pill under the two-part *Unocal* standard: *first*, the board must show that "it had reasonable grounds for concluding that a threat to the corporate enterprise existed."[19] *Second*, the board must show that its defensive measures were "reasonable in relation to the threat posed."[20]

In this case, the Court found the Williams board had not adopted the plan in response to any specific threat.[21] After a thorough examination of the record,[22] the Court found the board had identified three reasons for adopting the plan: 1) the plan "was intended to deter shareholder activism;" 2) the plan was intended to "insulate the board" from the "short-term" agendas of shareholder activists specifically; and 3) the board was concerned that a shareholder might take advantage of the market disruption to quietly accumulate large amounts of stock, given "gaps" in the federal disclosure regime (*i.e.*, Section 13(d) of the Exchange Act and the pre-merger notification provisions of the Hart-Scott-Rodino Act).[23]

The Court determined that neither of the first two justifications were legitimate in the context of this case. Acknowledging that a board "has authority to respond to a specific takeover attempt, even when that attempt does not involve a traditional tender offer," the Court rejected "the notion that a generalized concern about stockholder activism constitutes a cognizable threat under *Unocal*."[24] Although the Court acknowledged that a specific shareholder activist campaign—even one that did not involve a takeover attempt (the threat poison pills traditionally have been aimed at neutralizing)—could in some circumstances justify the adoption of a pill, there was no activist campaign when the board adopted the pill in this case. Likewise, the Court found "hypothetical" concerns of short-termism or disruption caused by hypothetical activists not to constitute legitimate threats under *Unocal*.[25]

The Court assumed, without deciding, that the third justification—using the Plan to detect threats before they would be noticed via the federal disclosure system—was legitimate.[26] The Court acknowledged that various commentators had recommended that boards consider adopting pills to avoid "lightning strike attacks," where, for example, stockholders acquire large stakes in the 10-day period between the triggering of a Schedule 13D filing obligation and the date such report is due.[27] The Court, however, expressed concern that recognizing such an interest would provide "a ready-made basis for adopting a pill" to all, or at least many, Delaware corporations subject to the federal disclosure regime.[28]

Having concluded that the only (potentially) legitimate threat was the rapid accumulation by an activist of a large amount of stock without detection, the Court concluded that defendants "failed to show that th[e] extreme, unprecedented collection of features" in the pill at issue in this case "bears a reasonable relationship to [the board's] stated corporate

[15] *Id.* at *30-31.
[16] *Id.* at *35.
[17] *Id.* at *35-36.
[18] *Id.* at *36.
[19] *Id.* at *48-49.
[20] *Id.* at *49.
[21] *Id.* at *53.
[22] *Id.* at *51-61.
[23] *Id.* at *62.
[24] *Id.* at *70.
[25] *Id.* at *73.
[26] *Id.* at *74, *77.
[27] Such an "early warning" rights plan might, for example, be triggered by a 5% accumulation *unless* the acquiring stockholder disclosed its position within two days of crossing the 5% threshold (after which the acquiring person would be subject to a higher, more customary threshold).
[28] *Id.* at *76.

objective."[29] The Court began by noting that the 5% trigger was an outlier, as most pills (other than net operating loss ("NOL") pills) have triggers of 10% or higher. More concerning to the Court, however, was the breadth of the AIC provision, coupled with the definition of beneficial ownership and the narrow exclusion for passive investors.[30] Although recognizing, as commentators had suggested, the purpose a pill might serve in supplementing the federal disclosure regime, the Court concluded that the pill in this case was significantly more extreme than any proposed by such commentators.[31] Moreover, the Court concluded that the effect of the pill was likely to "chill a wide variety of anodyne stockholder communications."[32] Finding that the board's decision to adopt the pill did not withstand scrutiny under *Unocal*, the Court granted a "mandatory" injunction requiring that the pill be withdrawn. [33]

Takeaways

— This decision should not be construed as jeopardizing the ability of boards of directors to deploy more mainstream poison pills in response to legally cognizable threats. The Williams pill was overly strong medicine—a nearly unprecedented 5% trigger and expansive anti-wolf-pack protections with daisy-chain implications—and in that sense the prescription was worse than the disease. Pills with a trigger of $\geq$10% and other litigation-tested terms that are adopted in response to a specific threat and supported by a robust record should still stand on solid legal ground.

— As this decision reminds us, the record is paramount. In *Williams*, the court found the record was unclear as to what the board viewed as the actual or emerging threat at the time the rights plan was adopted. This led the Court to second-guess the board's true motivations, and may have fostered skepticism as to whether the Williams board adopted the rights plan in response to a cognizable threat or as a mere pretext. For these reasons, it is critical that a board considering adopting a pill ensure that there is an adequate record reflecting its deliberations, the threats it is trying to address, and the specific features of the pill.

— While the Court acknowledged that the emergence of a shareholder activist, even if not presenting an active takeover threat, may present a credible threat justifying adoption of a pill, the Court found the board's general or "hypothetical" concerns about shareholder activism lacking in this case. The Court's opinion suggests that, in order for activism to be a cognizable threat under *Unocal*, the board would need to identify a specific activist threat, such as suspicious trading activity, credible information of stake-building or other real-world evidence of heightened vulnerabilities that call for action.

— The Court also left open the possibility that a poison pill could be implemented to serve as an early warning system to fill the gaps in the federal disclosure regime, although the Court expressed concern that granting such a justification, which would apply to nearly all public companies at all times, would constitute a significant departure from the situationally specific review of poison pills traditionally conducted by Delaware courts. In many respects, this would turn back the clock to an earlier era when many public companies had pills in place, and not just on the shelf. We don't expect a return to that age anytime soon, as corporate governance norms have dramatically shifted and institutional investors and proxy advisory firms' views have hardened in the years since.

[29] *Id.* at *88-89.
[30] *Id.* at *78. Although the Court was concerned by the 5% trigger, it did acknowledge that it represented a larger investment than many smaller companies' typical triggers given Williams's large market capitalization. *See id.*
[31] *See id.* at *79-82.
[32] *Id.* at *82.
[33] *Id.* at *89.

— Even when responding to a legitimate threat, boards and their advisors should consider whether the terms of a poison pill are appropriately tailored to the threat at hand. The Court noted that the provisions of the Williams pill were unusual, including the low (outside of the NOL context) 5% triggering threshold. But what seemed to concern the Court the most was the broad "acting in concert" provision, especially when combined with the narrow "passive investor" definition. The Court noted that the effect of those provisions would deter ordinary shareholder activity, even if the board would be unlikely to deploy the pill in response to such activity.[34] Accordingly, when adopting a pill, boards should give careful consideration to any chilling effect the pill would have on anodyne stockholder activity.[35]

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[34] It is possible tailored acting-in-concert-like language could pass legal muster where the record suggests multiple shareholders are coordinating their activities in a manner that poses a threat to the corporation and is designed to evade classic beneficial ownership and group concepts. The Court left this question to be answered for another day.

[35] This Alert Memorandum was prepared with the assistance of Joseph Condon.