April 6, 2021

Delaware Chancery Court Strikes Down "Unprecedented" Poison Pill

Poison Pill Provision Insufficient to Survive *Unocal* Scrutiny if Perceived Threat Is Only Hypothetical and the Provision is so Broad as to Abrogate Potentially Innocuous Exercise of Shareholder Rights

SUMMARY

In a February 26, 2021 post-trial decision by Vice Chancellor McCormick, the Delaware Court of Chancery enjoined The Williams Companies, Inc. ("Williams" or the "Company") from continued operation of a stockholder rights plan, or so-called "poison pill" (the "Plan"), that Williams implemented in response to plummeting stock prices brought about, in part, by COVID-19 and an international feud over oil prices. The Court held that a poison pill challenge need not be brought through a derivative action, and the appropriate standard of review is the intermediate enhanced scrutiny established in *Unocal* v. *Mesa* rather than the more deferential business judgment standard. Applying that standard, the Court held that the Board conducted a good faith, reasonable investigation in adopting the Plan, but cast doubt on some of the threats underpinning the Plan and found that, while the motivations behind the Plan may have been proper, the Company's response was not proportional to the stated threat. Although the Court balked at the Plan's 5% threshold, the Court was most critical of the Plan's abrogation of stockholders' rights through an overly broad "Acting In Concert" provision and its limited passive-ownership exception.

BACKGROUND

Williams is a publicly traded corporation that owns and operates natural gas infrastructure assets and handles approximately 30% of U.S. natural gas volumes.[1] From March 2020 through the time of trial in January 2021 Williams' market capitalization ranged from $11 to $28 billion.[2] In the first quarter of 2020, Williams experienced a precipitous decline in stock price due, in part, to the onset of COVID-19 and ensuing emergency health declarations, and a pricing war between major oil producing countries. By March 19, 2020, Williams' stock price had fallen to $11 from a high of $24.04 in late 2019.

In early March, in response to this decline in Williams' market value, the Board began discussing the potential implementation of a poison pill. After two urgent meetings where the Board considered advice of outside legal counsel and the Company's financial advisor, the Board adopted the Plan. "The Plan was set to expire at the end of one year and had "four key features: (i) a 5% ownership trigger; (ii) a definition of 'acquiring person' that captures beneficial ownership as well as ownership of certain derivative interests, such as warrants and options;" (iii) an "acting in concert" provision that includes a "daisy chain" provision wherein a person "Acting in Concert" with another person is also deemed to be "Acting in Concert" with any third party "Acting in Concert" with such other person seeking to acquire Williams (the "AIC Provision"); and (iv) a limited "passive investor" exemption that purports to exempt only "truly passive investors" like Schedule 13G filers.[3]

On August 27, 2020, Plaintiff Steven Wolosky filed this litigation asserting a direct claim for breach of fiduciary duty against the Director Defendants and seeking declaratory and injunctive relief regarding the validity and enforceability of the Plan. The matter was consolidated with a subsequently filed action and the Court ultimately certified a class of shareholders. A three-day trial was held from January 12 to 14, 2021 and post-trial briefing concluded on February 5, 2021.

THE DELAWARE CHANCERY COURT DECISION

The Director Defendants argued that (i) poison pill challenges must be brought derivatively; (ii) poison pill challenges should be scrutinized under the business judgment standard rather than the heightened *Unocal* standard; and (iii) even if poison pills are subject to heightened scrutiny, the Plan should nevertheless be upheld because it was enacted after good faith and reasonable investigation and was reasonable in relation to legitimate threats to the corporate enterprise. The Court rejected each of the Director Defendants' arguments. As to the first two propositions, the Court held that poison pill challenges may be brought directly and must be scrutinized under the *Unocal* standard. With respect to the legitimacy of the Plan, the Court held that notwithstanding the sufficiency of the Board's due diligence, the Plan was nevertheless disproportionate to the stated threat.

First, Defendants referenced *Moran* v. *Household Int'l*, *Inc.*, ("*Moran I*")[4] for the proposition that all poison pill challenges must be brought derivatively unless there is an active proxy contest.[5] The Court rejected that argument, finding that "[t]he derivative presumption of *Moran I*" was "a direct application of the [now-defunct] special-injury test, and this aspect of *Moran I* was thus impliedly abrogated by [*Tooley* v. *Donaldson, Lufkin & Jenrette, Inc*, 845 A.2d 1031, 1033 (Del. 2004)]."[6] *Tooley*—the controlling standard in Delaware—"expressly rejected the special-injury test in favor of a new, two-part standard, asking: '(1) who suffered the alleged harm (the corporation or the suing stockholders, individually); and (2) who would receive the benefit of any recovery or other remedy (the corporation or the stockholders, individually)?'"[7]

Applying *Tooley*, the Court held that "[a]ll rights plans interfere to [ ] some degree with the right to sell and the right to vote."[8] Here, the extreme combination of features, including a 5% trigger, the AIC provision and limited passive ownership exception restricted "the act of communicating itself, whether with other stockholders or management . . . [and] restrict[ed] the stockholder's ability to nominate directors."[9] Specifically, the AIC Provision provided that in determining whether individuals intended to act in concert with one another, the Board may consider factors like whether those individuals exchanged information, attended the same meetings, conducted discussions, or made or solicited invitations to act in concert or in parallel.[10] As such, the Court concluded that Plaintiff's claim is direct because the AIC provision "infring[ed] on the stockholders' ability to communicate freely in connection with the stockholder franchise" and such harm "flows to stockholders and not the company,"[11] even if the named stockholder plaintiff had no desire or intent to engage in the restricted activities.

Second, even though Delaware courts post-*Moran* have "used *Unocal* exclusively as the lens through which the validity of a contested rights plan is analyzed[,]" Defendants argued that the more deferential business judgment standard should apply.[12] Defendants reasoned that the specter of a board acting in self-interest "is not present where a poison pill is designed to address stockholder activism as opposed to hostile takeover attempts."[13] The Court rejected that contention, holding that it is "settled law that the Board's compliance with their fiduciary duties in adopting and then failing to redeem the Plan must be assessed under *Unocal*."[14] Under *Unocal*, a poison pill may be valid if (1) the board had reasonable grounds for identifying a legitimate threat to the corporate enterprise and (2) the board's response was reasonable in relation to the threat posed.[15]

Before beginning its substantive *Unocal* analysis, the Court noted three threats identified by Defendants: "first, the desire to prevent stockholder activism during a time of market uncertainty and a low stock price, although the Williams board was not aware of any specific activist plays afoot; second, the apprehension that activists might pursue 'short-term' agendas or distract management from guiding Williams through uncertain times; and third, the concern that activists might stealthily and rapidly accumulate over 5% of Williams stock."[16] In assessing the threats, the Court began by determining whether the Board had conducted a good faith and reasonable investigation when adopting the Plan and found that it had. The Court gave weight to the fact that nearly all of the directors were independent, the Plan was considered over the course of two meetings, and the Board was advised by outside legal and financial advisors.[17] Notably, the Court rejected Defendants' assertion that the Plan was adopted in light of the company's prior experience with activism. That is, although one director cited prior activism as his motivation for supporting the Plan, there was "no evidence that it was a motivating factor of the Board as a whole" because the "Board simply did not discuss the Company's prior experience with activism during the [emergency meetings]."[18]

Nevertheless, the Court reasoned that "[t]he real problem [was] not the process that Defendants followed, but the threats they identified."[19] The Court found that the first two threats—deterring stockholder activism and protecting against short-term agendas and distraction—were not sufficient to satisfy the *Unocal* standard. The Court held that "categorically concluding that all stockholder efforts to change or influence corporate direction constitute a threat to the corporation runs directly contrary to the ideological underpinnings of Delaware law" and that such a "broad category of conduct . . . cannot constitute a cognizable threat under the first prong of *Unocal*."[20] The Court also held that even if short-termism and distraction "could rise to the level of a cognizable threat, hypothetical versions of these justifications cannot," and that "[w]hen used in the hypothetical sense untethered to any concrete event, the phrases 'short-termism' and 'disruption' amount to mere euphemisms for stereotypes of stockholder activism generally and thus are not cognizable threats."[21]

As to the third threat—the potential for rapid accumulation of Williams stock by stockholder activists—the Court declined to decide whether that justification was sufficient and instead assumed for the purposes of analysis that it served a legitimate corporate purpose.[22] As such, the Court went on to the second prong of the *Unocal* analysis and considered whether the Plan was reasonable in relation to that threat. First, the Court found that "the 5% trigger alone distinguished the Plan; only 2% of all plans identified by [the Company's financial advisor] had a trigger lower than 10%" and "[e]ven among pills with 5% triggers, the Plan ranked as one of only nine pills to ever utilize a 5% trigger outside the NOL context [and] among Delaware corporations, it was one of only two."[23] The Court added that the Plan's other key features were also "extreme" in that the "beneficial ownership" definition went beyond the default federal definitions to capture synthetic equity, such as options; (2) the "definition of 'acting in concert' [went] beyond the express-agreement default of federal law to capture 'parallel conduct' and add the daisy-chain concept[;]" and (3) the "'passive investor" definition went beyond the influence-control default of federal law to exclude persons who seek to direct corporate policies."[24]

Furthermore, the Court reasoned that "[a]lthough the 5% trigger is a marked departure from market norms, it [was] not the most problematic aspect of the Plan."[25] Rather, "[t]he primary offender [was] the AIC Provision, whose broad language sweeps up potentially benign stockholder communications 'relating to changing or influencing the control of the Company.'"[26] Ultimately, the Court found that the AIC provision considered in the broader context of the entire plan gave the Board too much "discretion to determine whether 'plus' factors as innocuous as 'exchanging information, attending meetings, [or] conducting discussions' can trigger the Plan."[27] Because this language encompassed routine activities such as attending investor conferences and advocating for the same corporate action, the Court found it was an inappropriate and excessive abrogation of stockholder rights.

IMPLICATIONS

Williams clarifies that poison pill challenges may be brought directly regardless of whether a corporation is engaged in a proxy fight. While the *Tooley* standard mandates a case-specific evaluation of the harm(s) alleged, the Court expressly opined that all poison pills interfere to some extent with stockholder rights and relevant harm (and any recovery) therefore flows directly to stockholders rather than to the company.

Additionally, the Court's decision reaffirms that poison pills must be scrutinized under the heightened *Unocal* standard rather than the business judgment standard. In applying *Unocal*, the Court clarified that it is not enough that a board demonstrate due diligence in investigating potential threats, it must show that its investigation ultimately gave the board grounds for concluding that a valid threat to the corporate enterprise existed. It appears from the Court's decision that although hypothetical threats are not per se invalid, broad or generalized hypothetical threats like "stockholder activism" will be insufficient to satisfy *Unocal* scrutiny. *Williams* is also the first decision to consider whether "short-termism" and "disruption" constitute cognizable threats under *Unocal*, and clarifies that such threats cannot be "hypothetical."[28]

Most significantly, *Williams* discusses the proper scope of a poison pill. In addition to expressing discomfort with respect to a 5% trigger, the decision casts doubt on the validity of daisy-chain mechanisms and otherwise cautions against the adoption of overly broad "Acting In Concert" provisions that abrogate or deter the potentially benign exercise of stockholder rights like communicating with other stockholders or the management, attending meetings, or otherwise engaging in corporate governance. It appears that without a recognizable threat on the horizon, such sweeping provisions are vulnerable to challenge. As such, it is incumbent upon a board seeking to promulgate a poison pill to define specific and viable threats, narrowly tailor the provisions of the pill to those threats, and to memorialize the foregoing through the establishment of a clear and thorough record. The Court also specifically noted the lack of non-privileged evidence that the board considered redeeming the Plan, highlighting the need for boards to memorialize contemporaneously their consideration of important topics in non-privileged board records. Notwithstanding the foregoing, in the absence of "extreme" elements like those presented here, the *Williams* decision does not present significant challenges to standard practices.

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ENDNOTES

[1] *The Williams Companies Stockholder Litigation,* No. CV 2020-0707-KSJM, 2021 WL 754593, at *2 (Del Ch. Feb. 26, 2021).

[2] *Id.*

[3] *Id.* at *9, 10-11.

[4] 490 A.2d 1059, 1070 (Del. Ch. 1985) ("*Moran I*"), *aff'd*, 500 A.2d 1346 (Del. 1985).

[5] *Williams*, 2021 WL 754593, at *16, 18.

[6] *Id.* at *18.

[7] *Id.* at *17.

[8] *Id.* at *20.

[9] *Id.*

[10] *Id.* at *10.

[11] *Id.* at *20.

[12] *Id.* at *21.

[13] *Id.*

[14] *Id.*

[15] *Id.* at *2.

[16] *Id.*

[17] *Id.* at *29.

[18] *Id.* at *25.

[19] *Id.* at *29.

[20] *Id.* at *30.

[21] *Id.* at *33.

[22] *Id.* at *34.

[23] *Id.* at *35.

[24] Id.

[25] *Id.* at *37.

[26] *Id.*

[27] *Id.* (alteration in original).

[28] *Id.* at *32-33.

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