Delaware Court Enjoins an 'Extreme' Stockholder Rights Plan

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On February 26, 2021, Vice Chancellor Kathaleen S. McCormick of the Delaware Court of Chancery permanently enjoined a stockholder rights plan — or so-called "poison pill" — with a 5% trigger[1] that The Williams Companies, Inc. ("Williams" or the "Company") adopted at the beginning of the COVID-19 pandemic. In a lengthy post-trial opinion, Vice Chancellor McCormick reviewed the rights plan under the *Unocal* standard and determined that the members of the Williams board of directors breached their fiduciary duties by adopting it, rendering it unenforceable.

The decision is a reminder that although rights plans remain an important tool, boards of directors should carefully consider and evaluate them before adoption based on a company's particular facts and circumstances.

Background

On March 19, 2020, the Williams board of directors adopted a one-year stockholder rights plan in response to the severe decline of Williams' stock price resulting from plummeting oil prices and the unprecedented COVID-19 pandemic, and concerns about opportunistic activist stockholders acquiring a substantial position in the Company.[2] In the press release announcing the adoption of the rights plan, Williams noted that the rights plan "is intended to enable all Williams stockholders to realize the full potential value of their investment in the company and to protect the interests of the company and its stockholders by reducing the likelihood that any person or group gains control of Williams through open market accumulation or other tactics (especially in recent volatile markets) without paying an appropriate control premium."

The Williams rights plan included two key features on which the court focused: (i) a 5% trigger and (ii) an expansive "acting in concert"[3] provision. Although Institutional Shareholder Services had relaxed its rights plan policy in light of the pandemic, it recommended that stockholders vote against the reelection of the chairman of the board at Williams' 2020 annual meeting of stockholders, opining that the low 5% trigger threshold was "problematic" and that the rights plan "was not a reaction to an actual threat — real or perceived — of an activist investor or hostile bidder."

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Williams stockholders sued to permanently enjoin the rights plan and for the court to declare it unenforceable. In her ruling, after first deciding that such claims were properly brought directly by stockholders against the Company and its board (not derivatively, on behalf of the Company), Vice Chancellor McCormick wrote that it is "settled law" that adoption of a rights plan must be analyzed under the so-called enhanced scrutiny *Unocal* standard. In applying the two-part *Unocal* framework, the court examined first whether directors could demonstrate that they acted in good faith "to serve a legitimate corporate objective by responding to a legitimate threat," and second whether the response by the board of directors was "reasonable in relation to the threat posed."

[1] Practically speaking, the rights plan is triggered if a person or a group acquires beneficial ownership of at least 5% of the company's outstanding shares.

[2] It should be noted that a number of companies adopted rights plans in 2020 in light of the COVID-19 pandemic and associated stock price declines. According to the research firm Deal Point Data, at least 74 other companies adopted a non-NOL (net operating loss carryforwards) stockholder rights plan in 2020.

[3] These provisions intend to prevent a group of stockholders (often activist hedge funds) from sharing strategies and goals with respect to a campaign against the target company.

With respect to the first prong, the court reviewed three areas of focus the Williams board had identified: (i) deterring a general threat of stockholder activism at a time of uncertainty and a low stock price, (ii) insulating "the board from activists pursuing 'short-term' agendas and from distraction and disruption generally," and (iii) addressing a concern about a "lightning strike," where "a stockholder might stealthily and rapidly accumulate large amounts of stock" that would otherwise "go undetected under the federal disclosure regime." The court referred to each of these threats as "purely hypothetical," as the Williams board was not aware of any actual activist activity relating to the company. Following a lengthy analysis, Vice Chancellor McCormick concluded that abstract concerns about activism "untethered to any concrete event" were not cognizable threats under the first prong of the *Unocal* standard. However, without deciding the issue, the court assumed for purposes of analysis that detecting a lightning strike at a time when the stock price undervalues a corporation was a legitimate purpose.

Vice Chancellor McCormick then analyzed whether adopting this rights plan was within a range of reasonable responses to the threat posed and concluded that the plan's "combination of features created a response that was disproportionate to [the] stated hypothetical threat." The court emphasized the unusual nature of the 5% trigger, noting that of the precedent rights plans identified by Williams' banker, only 2% had triggers below 10%. The court further noted that the Williams rights plan was one of only nine rights plans to ever use a 5% trigger (outside the NOL context). The court also expressed concern for certain other features of the rights plan, including the definitions of "beneficial ownership" and "passive investor."

The court was particularly critical of the "acting in concert" provision as being overly broad and vague, with a potential "chilling effect" on stockholder communications. In addition, the court described a "daisy chain" concept included in the rights plan that would trigger the plan if "stockholders act in concert with one another by separately and independently 'Acting in Concert' with the same third party" — which "operates to aggregate stockholders even if members of the group have no idea that the other stockholders exist." The court did not specifically discuss the inclusion of derivative interests in the definition of beneficial ownership, a provision that has become quite common in recent rights plans. Ultimately, the court concluded that the rights plan did not fall within a range of reasonable responses to the purported threat and enjoined the rights plan.

Key Takeaways

Despite the court's ruling in *Williams*, rights plans remain an important and valuable tool when companies are faced with an unsolicited tender offer or an activist threat. Given the approach the *Williams* court took, a corporate board contemplating adoption of a rights plan should be prepared for the Delaware courts to scrutinize its decision under a heightened standard and to ascertain whether there is a legitimate, identified threat to the corporation to support the decision to adopt a rights plan. Accordingly, rights plans should be appropriately tailored to both the company's particular circumstances and threat posed.

In light of the *Williams* decision, companies should exercise extreme caution before adopting a rights plan with a 5% trigger threshold (outside of the NOL context) and review closely "acting in concert" provisions that could be viewed as having a chilling effect on stockholder communications, similar to the Williams rights plan.

It is also noteworthy that the court appeared critical of the board's process leading to the adoption of the rights plan. Proper board preparation and discussion to ensure that directors have a clear understanding of all the key terms of a rights plan and how such terms may differ from other rights plans, and proper documentation of the reasons for a board's determination to adopt a rights plan, are therefore critical.

In order to be able to move expeditiously when circumstances warrant, it remains prudent practice to have a rights plan "on the shelf" that is carefully reviewed and understood by the board of directors (including through advice from outside counsel and other advisers in advance), and which can be tailored to the relevant circumstances at the time of adoption.

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