

# Client Alert

March 2021

## Delaware Chancery Court Invalidates “Anti-Activist” Poison Pill in a Class Action Suit Led by Olshan’s Steve Wolosky

On February 26, 2021, the Delaware Court of Chancery issued a landmark decision invalidating a stockholder rights plan, commonly known as a “poison pill,” that was adopted by the board of directors of The Williams Companies, Inc., an NYSE listed company (“Williams” or the “Company”), at the outset of the COVID-19 pandemic. Steve Wolosky, the co-chair of Olshan’s Shareholder Activist Group, was a lead plaintiff in the class action lawsuit seeking to invalidate the pill. The Williams pill was one of many rights plans adopted by dozens of public companies during the pandemic, purportedly in response to specific control threats and/or precipitous drops in share price due to extreme market volatility.

The Williams pill, however, was “unprecedented” in that it was adopted purely as an “anti-activist pill” and contained a series of extreme features, including a 5% trigger and expansive “acting in concert” language that included a “daisy chain” provision. In the class action lawsuit, the certified class of plaintiffs asserted that the board of directors of the Company (the “Board”) breached its fiduciary duties when adopting the pill. In an 89-page opinion written by Vice Chancellor McCormick, the Court held that this unprecedented pill could not be justified given the Board’s motivations for its adoption and the “extreme combination of features” it possessed.

The Court’s decision represents a significant win for stockholder activists. The Williams Board crossed the line of responsible corporate governance by adopting, under the cover of a pandemic, the most extreme version of a poison pill this firm has ever seen. What’s more troubling is that the Board armed itself with a “nuclear weapon” specifically and unabashedly designed to insulate itself from “all forms of stockholder activism,” despite the absence of any actual threat from an activist.

Vice Chancellor McCormick’s opinion serves as a reminder to all public company boards that their decision to adopt and implement exotic or extreme poison pills will not only be subject to enhanced scrutiny of the

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courts, but will also attract the watchful eyes of the major institutional investors and proxy advisory firms, such as BlackRock and ISS in the case at hand.

### **Background**

In March 2020, Williams' share price experienced extreme downward pressure and fluctuations as a result of the COVID pandemic and turbulence in the oil markets. In response to this, one of Williams' outside directors spearheaded an effort to put in place a less than conventional pill. Though this director acknowledged that poison pills were "the nuclear weapon of corporate governance," he nonetheless sought to implement a pill that would "impose a 'one-year moratorium' on activism of any type." He purported to justify this by asserting that the "uncertainty" in the market necessitated "insulat[ing] management from activists 'who were trying to influence control of the company.'"

The Company sprung to action, revising its on-the-shelf pill, and quickly circulating a draft revised pill among senior management, and then to the Board. The Board held an emergency meeting on March 18, 2020, and though "the Board did not receive a draft of the [Rights] Plan before or during the March 18 meeting," it nonetheless voted to approve it. The Board formalized this vote the next day.

Notably, at the March 19 meeting, with Williams' legal advisors present, Williams' financial advisor made a presentation to the Board that discussed in great detail the purpose of the pill, and its claimed merits. The tenor was unmistakable: the purpose of the pill was anti-activism. The executive summary of the presentation stated: "'well-known activists are expected to continue'" their campaigns, and the pill would "'deter an activist from taking advantage of the current market dislocation.'" The summary further stated: a key benefit of the pill "'is to prevent an opportunistic party from ... substantial influence or control without paying a control premium ...'" and to limit "'an activist[']s ability to accumulate a large stake.'"

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### **Features of the Pill**

The pill, which the Company's directors admitted "was not a traditional shareholder rights plan" had a duration of one year, and 4 critical (and problematic) features:

1. **5% Trigger** – the pill would be triggered by a "Person" acquiring "beneficial ownership" of 5% or more of the Company's stock, or commencing a tender or exchange offer that would result in ownership reaching the 5% threshold.

2. **Beneficial Ownership Definition** – the pill’s definition of “beneficial ownership” for purposes of calculating the 5% ownership threshold extended beyond the definition set forth under the SEC’s Section 13(d) rules.
3. **Acting In Concert Provision** – The pill contained a broad “acting in concert” provision (“AIC Provision”) that extends the actions of one person to another deemed to be acting in concert with another.

This AIC Provision is commonly referred to as a “wolfpack” provision, a reference to hedge funds acting in parallel strategies in an effort to avoid group status under Section 13(d) of the Securities Exchange Act of 1934.

The AIC Provision did not require an express agreement between two parties in order for a board to conclude that the parties are “acting in concert” for purposes of calculating the pill’s ownership trigger through “parallel-conduct” intended to change or influence control of the company.

The AIC Provision also included a “daisy chain” concept where if Party A and Party B are each separately and independently “acting in concert” with Party C, Party A and Party B are deemed to be “acting in concert” with one another.

Finally, the AIC Provision was asymmetrical; it excluded actions by officers or directors, thereby allowing incumbents to act in concert without suffering the consequences of the pill.

4. **Passive Investor Definition** – in an effort to ensure that truly passive stockholders were exempt from the ownership limitation, the pill contained a carve-out for “Passive Investors” from the definition of “Acquiring Person.” However, though intended to exclude Schedule 13G filers, the carve-out was actually “far more exclusive.” And, even if read to align with the Schedule 13G definition, Williams had only three such filers in its stock at the time the Board adopted the pill; thus, “the Passive Investor Definition would include at most those three investors.”

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### The Lawsuit

Steve Wolosky, a long-standing stockholder in Williams, commenced suit on August 27, 2020, alleging breach of fiduciary duty, and seeking declaratory and injunctive relief regarding the validity and enforceability of the pill. Another stockholder also filed suit, and the Court consolidated the actions, certified a class of stockholder plaintiffs, and held a three-day trial in January 2021.

## Two Gating Procedural Issues: *Direct v. Derivative* and *Standard of Review*

### *Direct v. Derivative*

The Defendants asserted that Plaintiffs' claim was derivative (i.e., the claim belonged to the Company) and should be dismissed because Plaintiffs failed to make a pre-suit demand on the Board or demonstrate that demand was futile.

The Court rejected this argument, and reached its conclusion by performing the two-part inquiry set forth in *Tooley* for determining whether claims are direct or derivative:

1. Who suffered the alleged harm – the corporation or the suing stockholder?; and
2. Who will benefit from a recovery or remedy in the case?

When answering the questions posed in the *Tooley* test, the Court drew from the reasoning set forth in *Gaylord*, and concluded that poison pills work an injury on stockholders “by interfering with at least two fundamental stockholder rights” – namely, the right to vote and the right to sell one's stock.

The Court noted that the Williams pill went even further, also harming stockholders by: (a) limiting their right to communicate with one another; and (b) restricting their right to nominate directors.<sup>1</sup>

Based on these findings, the Court concluded the harm imposed by the Williams pill flows to the stockholder, and not the Company, and is thus a direct claim.

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### *Standard of Review*

Though Delaware courts have for more than thirty years “*exclusively*” analyzed contested rights plans under the enhanced scrutiny analysis set forth in *Unocal*, the Defendants nonetheless argued that the more deferential business judgment standard should apply because their pill was designed to address stockholder activism rather than hostile takeover attempts.

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<sup>1</sup> The Court noted that “no decision since *Tooley* has addressed whether a claim seeking to enjoin a stockholder rights plan is derivative.” Its conclusion, therefore, that the harm imposed by poison pills flows to stockholders, and not the Company, is a critical one.

The Court quickly disposed of this argument, noting “there are many possible responses to Defendants’ attempt to parse finely the concept of entrenchment, but for present purposes, it suffices to say that Defendants’ contention runs contrary to [] Delaware Supreme [precedent],” which makes clear that all poison pills “‘by . . . nature,’ have a potentially entrenching ‘effect.’”<sup>2</sup> And, that it is “settled law that the Board’s compliance with their fiduciary duties in adopting” the pill must be assessed under *Unocal*.

### **The Court’s *Unocal* Analysis**

*Unocal* calls for a two-pronged inquiry:

1. Whether the Board had reasonable grounds to conclude that a threat to the corporation existed; i.e. – whether the Board had a “legitimate corporate purpose”; and
2. Whether the defensive measures taken by the Board were “reasonable in relation to the threat posed.”

#### ***Unocal Prong 1 – The Directors’ Reasons for Acting***

Under *Unocal*, the board has the burden of demonstrating that it conducted a good faith and reasonable investigation, which ultimately provided the board with a basis to conclude that a threat to the corporate enterprise existed. In other words, the board is required to show that it “sought to serve a legitimate corporate objective by responding to a legitimate threat.”

The Williams pill, however, “was not adopted to protect against any *specific* threat at all.” Rather, the Board was “acting pre-emptively to interdict hypothetical future threats.” In fact, according to one director’s email to management, the Board adopted the pill because “Activists always push the needle in the wrong direction . . . so we are being proactive to prevent an activist from making a lot of short term money....”

As the Court noted, one director testified candidly that the pill was designed, not to respond to a specific threat, but rather “to insulate the Board and management from all forms of stockholder activism during the uncertainty of the pandemic.”

Another director’s testimony echoed this, stating that the Plan was to “avoid raiders – activists getting involved at the company.”

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<sup>2</sup> Indeed, the Court further noted that as the Board’s purpose in adopting the pill was to “insulat[e] the Board and management from stockholder influence during a time of uncertainty, [t]his conduct [] seems to fit the definition of entrenchment.”

From the evidence at trial, the Court distilled three reasons for the Board’s actions:

- The desire to prevent stockholder activism during a time of market uncertainty;
- The desire to insulate the Board from activist investors that might pursue short-term agendas or distract management; and
- The concern that activists might swiftly accumulate over 5% of the shares.

While each of these “threats” were “purely hypothetical,” the Court nonetheless was tasked with determining “whether these hypothetical threats presented legitimate corporate objectives under Delaware law.”

### *Threat of Stockholder Activism*

The Court first addressed whether stockholder activism in general could constitute a cognizable threat to a corporation under the first prong of *Unocal*.

The Court quickly rejected this assertion.

Under Delaware law, directors are not permitted to justify their actions by arguing that without board intervention, stockholders would “vote erroneously out of ignorance or mistaken belief” in the election of directors; this is known as the “we-know-better” justification.

Viewing all stockholder activism as a threat would be an “extreme manifestation” of the “we-know-better” justification. The Court stated:

[C]ategorically concluding that *all* stockholder efforts to change or influence corporate direction constitutes a threat to the corporation runs directly contrary to the ideological underpinnings of Delaware law.

### *Threat of Short-Termism and Distraction*

Next, the Court addressed whether general concerns that activists may pursue short-term agendas or distract management could constitute cognizable threats to a corporation under the first prong of *Unocal*.

The Court rejected this threat as well.

The Court reached this conclusion by noting that while short-termism and disruption could potentially rise to the level of cognizable threats under *Unocal*, “hypothetical versions of these justifications cannot.”

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The Court stated:

When 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.

### *Threat of Accumulation of Stock*

Finally, the Court discussed the third justification for the pill, which was the concern that activists might rapidly accumulate more than 5% of the stock, and the belief that a poison pill could serve as an early-warning device to “plug the gaps” left by the existing federal disclosure regime.

Under the Schedule 13D rules, stockholders are required to publicly disclose their ownership positions within 10 calendar days after crossing the 5% threshold. Because the Schedule 13D rules do not prohibit stockholders from continuing to acquire securities during the 10-day period and are not designed to flush out so-called “wolf pack” activity, the Court acknowledged that these rapid accumulations of stock could go undetected.

The Court analyzed whether the Board’s desire to fill the gaps in the Schedule 13D rules by way of the early-warning feature of the pill constituted a legitimate corporate objective under *Unocal*. Digging deeper, the Court considered whether “gap filling” becomes “more viable in the face of market uncertainty or a precipitous stock drop resulting in a stock price that undervalues the corporation.”

The Court stated that “reasonable minds can dispute whether a gap-filling purpose standing alone is a legitimate corporate purpose under *Unocal*,” and determined that the decision need not decide the issues. Instead, the Court *assumed* for purposes of analysis that the legitimate corporate purpose under *Unocal* was established, and turned to the second prong of the *Unocal* analysis, which examines “whether the Plan was a proportional response to the assumedly valid threat.”

### *Unocal Prong 2 – Proportionality of the Response*

The second part of the *Unocal* review requires the board to demonstrate that the defensive measures it utilized were reasonable in relation to the threat posed. The board’s power to act is not absolute and it does not have unbridled discretion to quell any perceived threat by any means available.

Thus, the Williams Board was obligated to demonstrate that its actions in adopting the pill fell within the “range of reasonable responses” to the threat of a rapid stock accumulation.

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In analyzing the proportionality of the Board’s response, the Court noted that “the thirty-thousand-foot view look[ed] bad for Defendants.” Each of the factors of the pill – the 5% Trigger, Beneficial Ownership definition, AIC Provision and Passive Ownership definition – were all “extreme.”

For example, the “5% trigger alone distinguished the Plan; only 2% of all pills identified by [the Company’s financial advisor] had triggers lower than 10%.” The pill’s Beneficial Ownership and Passive Investor definitions were also extreme, as they each exceeded federal law.

Finally, the AIC Provision was also extreme, as it also went beyond federal disclosure rules requiring an express agreement between two parties, and instead allowed the Board to make the determination whether the parties are “acting in concert” through “parallel-conduct” for purposes of calculating the pill’s ownership trigger. The additional “daisy chain” feature further broadened the scope of the AIC Provision by aggregating ownership of stockholders who may not even be aware of the other’s activity.

Indeed, the Court noted that the AIC Provision is “the primary offender,” given (i) the “broad discretion” it imbues to the Board to determine whether an exchange of information is innocuous or not, and (ii) the resulting “stifling impact the Plan has on stockholder communications, a chilling effect that exists whether the Board triggers the Plan or not.”

The Court noted that these individual “extreme” components of the pill, when viewed collectively, amounted to a “nuclear missile” with a “range of a considerable distance beyond the ordinary pill.”

Accordingly, as to the second prong of *Unocal*, the Court held that the Defendants failed to demonstrate that “this extreme, unprecedented collection of features bears a reasonable relationship to their stated corporate objective.”

### **Conclusion**

The Court concluded that the members of the Board breached their fiduciary duties under *Unocal*, declared the pill unenforceable and invalid, and permanently enjoined the continued operation of the pill.

Please contact the Olshan attorney with whom you regularly work or one of the attorneys below if you would like to discuss further or have questions.

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