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Pill with 5% Trigger Too Poisonous to Address Hypothetical Stockholder Activism

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Who Needs to Know

Boards of directors of Delaware corporations contemplating the adoption of a stockholder rights plan (a/k/a poison pill).

Why It Matters

This article discusses a recent decision in which the Delaware Court of Chancery invalidated a poison pill because its features — including a 5% trigger threshold, an expansive definition of “acting in concert,” and a narrow definition of “passive investor” — were not reasonable in relation to the threat identified by the board — the hypothetical threat of stockholder activists’ rapid and undetected accumulation of company stock during the pandemic.

The decision makes clear that while poison pills remain an important tool to protect long-term corporate value, rights plans with aggressive features not tied to specific, imminent threats are susceptible to legal challenge, even in response to unprecedented events, such as the COVID-19 pandemic.

In a recent decision,[1] the Delaware Court of Chancery struck down a stockholder rights plan — more commonly referred to as a “poison pill” — that was adopted to deter certain stockholder activism during the COVID-19 pandemic.

Specifically, the court invalidated the pill because its “unprecedented” and “extreme” features — including a 5% trigger threshold, an expansive definition of “acting in concert,” and a narrow definition of “passive investor” — were not reasonable in relation to the threat identified by the board — the hypothetical threat of stockholder activists’ rapid and undetected accumulation of company stock during the pandemic.

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Background

Poison pills were developed in the 1980s as a means to fend off hostile takeover attempts that threatened corporate value. Since then, they have been upheld as viable mechanisms available to boards of directors to protect the long-term interests of a corporation. Poison pills with trigger thresholds of 20%,[2] 15%,[3] 10%,[4] and

even 5%^[5] have been upheld in various contexts and in response to various threats to corporate policy.

In March 2020, concerned that the significant decline in its stock price due to the COVID-19 pandemic made it a target for stockholder activism, the Williams Companies (the Company) adopted a poison pill. The terms of the poison pill plan included:

- a one-year duration;
- a 5% trigger threshold, the calculation of which included ownership of derivative securities, such as options and warrants;
- an expansive definition of “acting in concert” that would capture not only stockholders who act “in concert,” but also those who act “in parallel” to one another; and
- a narrow carve-out for “passive investors.”

The Company’s directors testified that the purposes of the pill were to:

- prevent stockholder activism during a time of market uncertainty and a low stock price;
- protect the Company’s long-term interests against potential stockholder activists that might pursue short-term agendas; and
- force stockholders that might stealthily and rapidly accumulate over 5% of the Company’s stock to negotiate with the board.

Notably, the Company’s board did not identify any specific activist threat that existed at the time of the pill’s adoption. Nor did it identify any evidence thereof, such as suspicious trading activity. Instead, the board was “acting pre-emptively to interdict hypothetical future threats.”

Analysis

The Delaware Court of Chancery struck down the Company’s poison pill plan under *Unocal*^[6] enhanced scrutiny. Under that standard, a pill will be upheld only if: (1) the board had reasonable grounds for concluding that a threat to the corporation existed; and (2) the pill and its features are reasonable in relation to the threat posed. Both prongs must be met.

The court recognized that in determining the validity of poison pills under *Unocal*, “Delaware law has handled these ‘nuclear weapon[s] of corporate governance’ with the delicacy they deserve.” As such, the court “views poison pills as situationally specific defenses” designed to ward off specific, identifiable “present threats” to corporate policy.

With these principles in mind, the court found that the Company’s pill failed the second prong of *Unocal*. To reach this conclusion, the court examined the threats identified by the Company’s board and compared them to the features and effects of the pill at issue to evaluate whether there was a “reasonable relation” between the threats, on one hand, and the pill, on the other.

In analyzing the former, the court found that while the “rapid, undetected accumulation of stock … at a time when stock price undervalues the corporation” is a cognizable threat under Delaware law, the threat was not particularly significant in this case because the Company’s board did not identify “any specific activist plays afoot.” Rather,

the identified threat was “purely hypothetical.”

In contrast, the terms and effects of the Company’s poison pill were both real and substantial. As the court explained, the terms of the pill — including the 5% trigger threshold, the expansive definition of “acting in concert,” and a narrow definition of “passive investor” — were “unprecedented” in that they were “a more extreme combination of features than any pill previously evaluated by [the] court.” In addition, the court raised serious concerns regarding the notable “chilling effect” that the “acting in concert” definition would have on a stockholder’s ability to communicate with other stockholders.

Juxtaposed against the hypothetical threat identified by the board, the court found that the “extreme” features and tangible effects of the Company’s poison pill were “disproportionate” and not reasonable. Thus, the pill failed the judicial test articulated in *Unocal*.

Takeaway

Poison pills remain an important tool to protect long-term corporate policy and value. As Delaware law recognizes, poison pills can be particularly effective at forcing activist stockholders and stockholders seeking control to negotiate with a target’s board, which, in turn, may enable the board to secure a higher price from the acquiring stockholder.

However, pills with aggressive features not tethered to specific, imminent threats to corporate policy are vulnerable to invalidation. Thus, poison pills should be utilized as a “situationally specific defense” to address an identifiable “present threat” to corporate policy, and the terms thereof should be tailored as narrowly as possible to address the particular threat that the company faces.

[1] *The Williams Companies S’holder Litig.*, C.A. No. 2020-0707-KSJM (Del. Ch. Feb. 26, 2021).

[2] See e.g., *Moran v. Household Int’l., Inc.*, 500 A.2d 1346 (Del. 1985) (upholding 20% trigger); *Yucaipa Am. All. Fund II, L.P. v. Riggio*, 1 A.3d 310 (Del. Ch. 2010), aff’d, 15 A.3d 218 (Del. 2011) (same).

[3] *Air Prod. & Chemicals, Inc. v. Airgas, Inc.*, 16 A.3d 48 (Del. Ch. 2011) (upholding 15% trigger).

[4] *Third Point LLC v. Ruprecht*, 2014 WL 1922029 (Del. Ch. May 2, 2014) (upholding 10% trigger).

[5] *Versata Enters., Inc. v. Selectica, Inc.*, 5 A.3d 586, 607 (Del. 2010) (upholding a poison pill with a 4.99% trigger to protect a corporation’s net operating loss carry forwards).

[6] *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985).

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