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DELAWARE CHANCERY COURT DECISION HIGHLIGHTS RISKS OF LIABILITY FOR DIRECTORS IN SPAC DEALS

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A recent Delaware Chancery Court decision highlights the liability risks faced by directors and sponsors of special purpose acquisition companies ("SPACs") and the importance of robust disclosure in protecting against those risks.

As often in litigation, a key question is the standard by which defendants' conduct is reviewed – here, whether the business judgment rule applies to directors' conduct. In a decision earlier this month in *In re MultiPlan Corp. Stockholders Litigation*, CA No. 2021-0300, the first major Chancery Court decision following the recent surge in SPAC transactions, Vice Chancellor Lori Will rejected SPAC directors' plea for application of the business judgment rule, and instead applied the more demanding entire-fairness standard of review.

Vice Chancellor Will denied motions to dismiss by the SPAC directors and the SPAC sponsor and its principal. She held that stockholders of Churchill Capital Corp. III could move forward with their breach-of-fiduciary claims in connection with Churchill's $5.8 billion merger with data analytics company MultiPlan, Inc.

In addition to rejecting business judgment review, Vice Chancellor Will rejected the SPAC defendants' argument that the shareholders' claims relating to alleged misleading disclosures by Churchill were direct claims of the corporation, and thus could not be made by shareholders derivatively on the corporation's behalf. Her rejection of that argument means plaintiffs were spared the need either to make a demand that the corporation bring the lawsuit, or show that such a demand would be futile – often a heavy lift for plaintiffs.

Background

Churchill is a SPAC that went public in February 2020, raising $1.1 billion. It was structured similarly to many SPACs: it had 24 months to acquire an operating business in a "deSPAC" transaction; the SPAC's sponsor received 20% of the SPAC's overall pre-transaction capital in exchange for a nominal amount of $25,000; and the directors of the SPAC were appointed by the sponsor and were compensated for their service with SPAC shares.

In July 2020, Churchill selected MultiPlan, Inc. as its target and entered into a merger agreement. Churchill issued a proxy statement to its shareholders seeking approval of the merger, including extensive disclosure regarding MultiPlan's business. The proxy statement disclosed that MultiPlan was dependent on a single customer for 35% of MultiPlan's revenues. In their complaint, plaintiffs contend the proxy contained a material omission: that the major customer was developing its own data analytics platform, which would compete with MultiPlan and result in the customer moving its business from MultiPlan.

A distinctive feature of SPACs is that investors have the right to redeem their shares in the company in connection with the de-SPAC transaction. In this case, shareholders overwhelmingly approved the MultiPlan merger, and fewer than 10% chose to redeem.

After the de-SPAC transaction closed, an analyst report was published that disclosed the threat of MultiPlan's losing its largest customer. MultiPlan's stock price declined, falling to below the price holders would have received if they had redeemed. Shareholders then filed suit, alleging claims that the SPAC directors had breached their fiduciary duties through misleading proxy disclosures.

Defendants argued that the claims should be evaluated under the business judgment rule. In rejecting that argument, the Court found that plaintiffs adequately alleged that the directors were conflicted because the SPAC sponsor had differing interests than public stockholders. The public holders would only benefit if the post-merger value of their shares exceeded their redemption value. But, as is common in SPAC transactions, the SPAC sponsor had only invested a nominal amount to receive its shares and would benefit from any de-SPAC transaction, even one in which the post-merger value of its shares was much lower than the redemption value. The Court emphasized that in the context of a value-decreasing merger, the sponsor has an incentive to discourage redemption because non-redeemed amounts would accrue to the benefit of the post-merger entity.

The Court also held that plaintiffs adequately alleged that a majority of the directors were conflicted because they were either self-interested or lacked independence from the SPAC sponsor. The Court relied on the fact that they were (i) appointed and removable by the SPAC sponsor, (ii) compensated with founder shares, and (iii) potential beneficiaries of other SPACs that the sponsor controlled.

Because of these conflicting interests, the Court held that the breach of fiduciary claims were subject to the entire-fairness standard of review. That puts the burden on defendants to show that the transaction was entirely fair to the corporation and its stockholders, both as to "fair price and fair dealing." This is a significant burden at any stage of the case, but particularly, as the court noted, on a motion to dismiss based on the pleadings. Applying the entire-fairness standard to plaintiffs' claims that the misleading disclosures breached defendants' fiduciary duties, the court found that plaintiff had pleaded facts sufficient to state a claim for breach of both duties of loyalty and care.

Vice Chancellor Will made clear, however, that the claims were "viable not simply because of the nature of the transaction or resulting conflicts." She said she was also relying on the specific allegations of deficient disclosures regarding the looming loss of a major customer, such that "the director defendants failed, disloyally, to disclose information necessary for the plaintiffs to knowledgeably exercise their redemption rights."

The decision discussed the materiality of the alleged non-disclosure of the identity of MultiPlan's largest customer and of that customer's plans to move its business and compete with MultiPlan. Interestingly, it did not analyze the defendants' state of mind regarding this omission, such as whether it was intentional or negligent, as would have been required for a claim of fraud or securities fraud. It did note that the customer had itself publicly discussed its plans for creating its own data analytics platform prior to issuance of the Churchill proxy.

Defendants also argued that the breach of duty claims brought by plaintiffs were corporate claims, not direct claims. But the Court accepted plaintiffs' argument that the shareholders were injured in their individual capacities by the misleading disclosures and therefore could sue directly. Because plaintiffs alleged that they were induced to forego exercising their personal redemption rights, the Court found their claims akin to direct claims for interference with a stockholder's right to vote. The Court also noted that the alleged damages suffered flowed directly to stockholders, not the corporation, because the damages reflected investors' lost opportunity to recover the redemption price.

Along with rejecting the SPAC defendants' business judgment and derivative-vs.-direct defenses, the court rejected two other defenses asserted. One was that the claims were contractual in nature because the right of redemption was provided for in Churchill's certificate of incorporation. The court said the fact that stockholders had a right to redeem their shares did not alter the defendants' obligations as fiduciaries in making full disclosure to stockholders who were exercising that right. Second, defendants' lawyers argued that the claims were passive "holder" claims (which cannot be pursued in a class action) under Delaware law, because stockholders did not take action but simply declined to act on their right to redeem. The court, however, disagreed, calling the decision whether to redeem or not an "investment decision," and also noting that it was coupled with a vote on whether to approve the merger.

The court also held that plaintiffs had stated a claim against a financial advisory firm also allegedly controlled by the SPAC sponsor's principal for aiding and abetting the other defendants' breaches of fiduciary duty. It did, however, dismiss claims against the Chief Financial Officer of Churchill, on the basis that insufficient facts had been pleaded to suggest a breach of duty by him. It also dismissed claims against MultiPlan Corporation, the acquired company.

Key Takeaways

The application of entire-fairness review is significant. Corporate lawyers will be watching to see if this standard is applied in future cases involving de-SPAC transactions. It also is important to remember that the judge's decision was ultimately based on plaintiffs' allegations regarding misleading disclosures. This case illustrates the importance of due diligence and providing robust disclosures in de-SPAC transactions.

The decision may prompt SPACs and their sponsors to consider the potential advantages of additional procedural and governance measures in the de-SPAC acquisition process that could support arguments for application of the less onerous business judgement rule rather than entire-fairness review. In the non-SPAC context, Delaware courts have adopted principles under which, even where a company is engaging in an arguably conflicted transaction, defendants can still obtain business judgment review by incorporating procedures such as independent committees with power to make transaction decisions. Along these lines, we may see SPACs consider engaging additional independent directors. Yet it is also possible the specter of entire-fairness standard could prompt some SPACS to form in jurisdictions other than Delaware.

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