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Continued Challenges Arising From SPAC-Related Litigation

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Special purpose acquisition companies, or SPACs, have grown in popularity over the past decade, and as a result, more than 30% of all transactions that took companies public in 2021 involved a de-SPAC merger. The rise in SPACs' popularity led to the rise of SPAC-related litigation, especially following the poor performance of many companies taken public by SPACs. Recent decisions by the Delaware Court of Chancery demonstrate that when a SPAC transaction and the disclosures surrounding it are challenged, defendants may face an uphill battle to prevail on a motion to dismiss, especially where breach of fiduciary duty claims have been asserted.

Understanding how SPAC transactions work is critical to understanding the challenges that defendants may face in litigation involving a SPAC. A SPAC is a company that lacks business operations and tangible assets, but is formed by a sponsor to raise capital through an initial public offering (IPO) for the purpose of merging with, or acquiring, an existing company. The sponsor, which oftentimes is a limited liability company, is also responsible for administering the SPAC, and is typically compensated in the form of founders shares from the SPAC's post-IPO equity, which are acquired at a large discount.

Funds that are raised in the initial IPO are placed in a trust account, and they cannot be disbursed except to facilitate an acquisition. Thus, the sponsor will cover items like the SPAC's underwriting fees and expenses. If an acquisition cannot be completed by the time specified in the SPAC's charter, then the funds in the trust account must be returned and the SPAC must be liquidated.

Investors can opt out of a SPAC by choosing to redeem their shares in the trust account after a merger target has been identified. This redemption right is at the price paid in the offering. The business combination between a SPAC and private company is called a de-SPAC transaction. Also sometimes referred to as "blank check companies," SPACs have recently focused on niche industries such as the biotech and technology markets, including in many cases, electric vehicle startups.

In recent years, investors have filed dozens of class actions against numerous companies involved in SPAC mergers, as well as their officers and directors. SPAC-related litigation often results in litigation in multiple forums consisting of both federal court securities class actions and Delaware Court of Chancery class actions. In federal

court securities class actions, plaintiffs typically allege that misstatements and omissions before and after the SPAC transaction violated Section 10(b) and Section 14(a) of the Exchange Act. Plaintiffs also sometimes challenge the disclosure of information by the SPAC's sponsor and directors, and allege claims for breaches of fiduciary duties, which often end up in Delaware Court of Chancery class actions. Derivative lawsuits on the heels of these class actions have often quickly followed in both state and federal courts, depending on any forum-selection clause that may exist in the company's bylaws or certificate of incorporation.

Federal Court Securities Class Actions

Many SPACs have found themselves the targets of securities class actions brought in federal court for alleged violations of the Exchange Act. Plaintiffs in these lawsuits often rely heavily on reports issued by short sellers, who profit when a company's stock value decreases, to help support their allegations. A pattern has emerged in which short-sellers publish inflammatory reports following business combinations involving SPACs. Shortly thereafter, investor groups then file securities class actions alleging that misrepresentations were made about the legacy company—for example, in the electric vehicle industry, the number of orders or reservations that existed for the company's main product—and the business combination in violation of Sections 10(b), 14(a), and 20(a) of the Exchange Act, using accusations from short-seller reports to bolster their allegations.

Delaware Court of Chancery Class Actions

Many of the SPAC-related class actions brought in the Court of Chancery have included allegations that stockholders were deprived of the right to make a fully informed decision about whether to exercise their redemption rights—rights that the Delaware Court of Chancery has described as the "central form of stockholder protection" in a SPAC merger. Defendants in these cases face several challenges at the motion to dismiss stage, as demonstrated by the Delaware Court of Chancery's recent denial of a number of motions to dismiss brought by SPAC boards and sponsors. The first of these cases was the now well-known *In re Multiplan Corporation Stockholders Litigation* action. In denying defendants' motions to dismiss in *In re Multiplan Corporation Stockholders Litigation*, Vice Chancellor Lori Will first held that "well-worn fiduciary principles" of Delaware law apply to decisions made by SPAC boards. The court then found that: the de-SPAC transaction was a conflicted controller transaction and the entire fairness standard of review therefore applied; a majority of the SPAC's board was conflicted due to the directors' relationship with the sponsor; and it was reasonably conceivable that a stockholder would have found certain information about the de-SPAC transaction, which was not disclosed in the offering or proxy, important when deciding whether to exercise his or her redemption rights. In reaching these conclusions, the court rejected all of the defendants' proposed grounds for dismissal, including that the plaintiffs actually pleaded derivative claims without alleging demand futility and that even if the plaintiffs' claims were direct, the claims were governed by contract and therefore their breach of fiduciary duty claims could not survive. MultiPlan entered into an agreement to settle the lawsuit for $33.75 million 10 months after its motion to dismiss was denied.

The Court of Chancery has denied the defendants' motions to dismiss similar breach of fiduciary duty claims in several other actions involving SPACs since *In re Multiplan*. These decisions continue to demonstrate the significant challenges that defendants face—namely, being able to show at the pleading stage that plaintiffs' breach of fiduciary duty claims are derivative rather than direct, and are contract claims rather than fiduciary claims. In addition, due to the way SPACs are created, in many cases the de-SPAC transaction will be viewed by

the court as conflicted, thus raising the standard for analysis to entire fairness, which eliminates the opportunity for defendants to prevail on a motion to dismiss.

Other Potential Challenges

As noted above, in addition to class action lawsuits, these suits often are accompanied by derivative litigation and demands in both federal and state courts, and often occur in multiple jurisdictions.

If the above-noted litigation did not present enough legal issues to consider, the U.S. Securities and Exchange Commission (SEC) proposed rules to enhance disclosure and investor protection in IPOs by SPACs and de-SPAC transactions in March 2022, and has been very active in investigating and bringing enforcement actions against SPACs and their officers and directors when there are disclosures and other violations of the federal securities laws.

SPAC-related litigation can also create challenges on the insurance front, such as determining which D&O insurance policies apply to different groups of the defendants and their alleged conduct at different points in the SPAC and de-SPAC transactions. As a result, disputes may arise between various carriers and insurance towers that may be challenging to resolve.

In light of the legal issues that exist surrounding SPAC and de-SPAC transactions, SPAC participants should be well-informed of the potential challenges and risks that often follow SPAC transactions and be sure to engage counsel that is knowledgeable and experienced in this area.

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