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Delaware Court Addresses De-SPAC Merger Claims

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In an important decision, the Delaware Court of Chancery, in *In re Multiplan Corp. Stockholders Litigation*, 2022 WL 24060 (Del. Ch. Jan. 3, 2022), in denying the defendants' motion to dismiss, addressed claims against the sponsor and other insiders of a special purpose acquisition company or "SPAC" for breach of fiduciary duties in connection with a de-SPAC merger. As we mentioned in our QuickStudy, *"SPACs and the Implications for D&O Insurance*,*"* the *Multiplan* decision was highly anticipated and is significant because it was the first time the Delaware courts had to grapple with the unique structure of SPACs and determine how to apply fundamental principles of Delaware fiduciary duty law to them. In this case, while acknowledging that when they invest stockholders of SPACs are well aware of the inherent conflicts of the SPAC's sponsor, the Court still applied the entire fairness review standard and decided that the plaintiffs adequately pled an intentional failure of disclosure that was material to the plaintiffs' decision as stockholders of the SPAC whether to accept the shares in the merger or exercise their redemption rights to receive back their investment.

Factual Background

Churchill Capital Corp. III, a Delaware corporation, was formed as a SPAC in October 2019 during the SPAC boom and completed its $1.1 billion initial public offering in February 2020. As is typical for SPACs, (i) the sponsor received founder's shares representing 20% of the SPAC's equity and warrants for nominal consideration, and (ii) the public stockholders purchased units consisting of common stock and warrants for $10 per unit, with the proceeds placed in trust. The SPAC sponsor chose the SPAC's outside directors, each of whom served as directors in other SPACs formed by the sponsor and had other relationships with the sponsor. As compensation, the directors received interests in the sponsor, which represented indirect interests in the SPAC.

As part of the SPAC structure, the SPAC had two years to effect a merger with an operating company or liquidate by returning the trust proceeds to the public stockholders. If a merger was effected, public stockholders had the right to have their stock redeemed at the $10 IPO price, while they kept their warrants.

Shortly after its IPO, the SPAC identified Multiplan, Inc. as a merger target and successfully executed an agreement for the de-SPAC merger in July 2020. The proxy statement for seeking the necessary stockholder approval was distributed in September and the merger was approved at a stockholders meeting in October 2020, following which the merger was promptly completed. The proxy statement informed the SPAC stockholders of their redemption right if the merger was completed. If the stockholders voted, either for or against the merger, they could chose to have their shares redeemed at the $10 IPO price plus interest rather than accepting shares in the merger. Fewer than 10% of the public stockholders exercised the redemption right. The proxy statement disclosed that Multiplan was dependent on its largest customer for 35% of its revenues but, according to plaintiffs' allegations, did not disclose that the customer intended to create its own in-house capability that would enable it to move its business from Multiplan and compete with it. When a research firm published a report on Multiplan in November 2020 that discussed the largest customer's plans, the Multiplan stock price fell almost 40% to several dollars below the $10 redemption price. This lawsuit then followed as a class action on behalf of the SPAC's stockholders who retained their shares in the de-SPAC merger rather than exercising the redemption right.

The Court's Analysis

The Court first ruled that the action was properly brought as a direct claim rather than a derivative action because the redemption right, which was the basis of the claim, was an individual right of the stockholders. The Court also ruled that, although the redemption right in the certificate of incorporation was contractual, the claim was not for a breach of contract but rather a breach of the fiduciary duty of disclosure in allegedly denying the stockholders information material to their decision whether to exercise the redemption right.

The Court then ruled that the entire fairness review standard, the most onerous standard, rather than business judgment, applied to determining whether the defendants breached their fiduciary duty for two reasons: (1) the sponsor, as a controlling person, had an interest in the de-SPAC merger different from the public stockholders because (i) it could only realize value if a de-SPAC merger was completed, (ii) it could realize value even if the SPAC overpaid for the target company, and (iii) more funds would be available for use in connection with the merger if there were fewer redemptions; and (2) the SPAC's directors, who also were defendants, were self-interested because they had conflicts similar to those of the sponsor due to their also having an interest in the founder shares and warrants, as well as not being independent of the sponsor, and they were exposed to material liability if the plaintiffs' breach of fiduciary duty claims against them prevailed.

Applying the entire fairness standard, based on the facts as pled by the plaintiffs, the Court held that the plaintiffs' claims were viable, principally because they allege that the sponsor and director defendants disloyally failed to disclose information necessary for the stockholders to exercise their redemption rights triggered by the de-SPAC merger on an informed basis.

Takeaways

Although a significant decision, the holding in *Multiplan* is in fact limited. The decision focuses on the adequacy of the disclosure made to stockholders in the proxy statement for the de-SPAC merger and their decision whether or not to exercise the redemption right. The Court characterized the redemption right as a fundamental protection for the public stockholders, a key feature of the SPAC structure to ameliorate the sponsor's inherent conflicts that made the disclosure given to the stockholders all that more important, analogizing it to disclosure in connection with voting to approve a transaction with a controlling stockholder. The Court carefully avoided deciding whether entire fairness would have been the standard of review and whether there could be viable claims based solely upon the conflicting interests of the sponsor and other insiders, and in fact signaled that it might have dismissed the claims if the disclosure in connection with the de-SPAC merger had been adequate.

There are a number of lessons that can be drawn from the *MultiPlan* decision, including the following:

- Claims based on breach of fiduciary duties in connection with the redemption rights included in the SPAC structure are direct rather than derivative claims because the rights are those of the stockholders individually.
- The inherent conflicts of the sponsor might not alone result in entire fairness review or as the basis for viable

claims. This assumes, however, that those conflicts are adequately disclosed and that an effective redemption right exists that gives stockholders a second opportunity to exercise an investment decision.

- Because of the importance of the redemption right to mitigate the inherent sponsor conflicts with respect to the de-SPAC transaction, the quality of the disclosure regarding the de-SPAC merger and the acquisition target takes on increased importance.
- While federal securities law applies to the adequacy of disclosure, the quality of the disclosure is also relevant under Delaware law to determine whether the fiduciary duty of disclosure has been met. Therefore, the Delaware courts also have a role in assessing the adequacy of disclosure as a matter of Delaware law.
- Directors who have equity interests similar to those held by a SPAC's sponsor are likely to be considered as having a similar self-interest and therefore as not being independent directors. It is possible to consider a different form of compensation for directors that is more aligned with the interests of the public stockholders in order to avoid this conflict. Also, selecting directors that do not have longstanding relationships with the sponsor can help ensure independence. With sufficient independent directors, it would be possible to use a special committee structure like the one often used for conflicted transactions with a controlling stockholder, but use of such a structure likely would be inconsistent with the desire of the sponsor to control the de-SPAC merger process and the expectations of investors regarding the lead role of the sponsor.
- A proliferation of state law corporate breach of fiduciary duty claims, alongside securities class action lawsuits for violation of the securities law antifraud rules, in connection with de-SPAC mergers has been a concern. It remains to be seen what impact the *Multiplan* decision will have on that. It is possible that the narrow holding in *Multiplan* focused on the adequacy of disclosure with respect to the redemption right, while recognizing the inherent sponsor conflicts typical in a SPAC structure as well-known to SPAC investors, could serve to mitigate that proliferation. In any event, as noted in our prior QuickStudy, having adequate D&O insurance should be an important part of the protective arrangements in SPAC transactions.

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