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Court Issues Highly Anticipated Decision Regarding the Treatment of SPAC Sponsors and Directors

January 10, 2022 | Blog | By **John F. Sylvia**, **Patrick E. McDonough**

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In a long-anticipated decision, the Delaware Court of Chancery answered several pending questions regarding the treatment of special purpose acquisition company ("SPAC") sponsors and directors under Delaware corporate law. In ***In re Multiplan Stockholders Litigation***, Vice Chancellor Lori Will issued a decision addressing claims against a SPAC's sponsor and its directors. In Vice Chancellor Will's decision, she denied the defendants' motion to dismiss, allowing the claims to proceed against the SPAC's sponsor and directors, as well as an aiding and abetting claim against its financial advisor. The decision was the first Chancery Court opinion addressing direct claims asserted in connection with SPAC shareholder litigation. Importantly, Vice Chancellor Will noted that while the issues the Court addressed were novel in that they involved a SPAC (a structure relatively untested under Delaware corporate law), the Delaware fiduciary principles were well established. The decision also sets forth certain principles that should guide the public disclosures made by SPAC sponsors and directors in their proxy statements concerning target companies.

The case involved claims brought by the SPAC's public shareholders against the SPAC itself, the SPAC's sponsor (Michael Klein of the Churchill Group and numerous SPACs under its umbrella), and the SPAC's Board for breaches of fiduciary duty stemming from the failure to make adequate disclosures in the de-SPAC transaction's proxy statement and other documents. Defendants moved to dismiss Plaintiff's claims in full earlier in 2021, and after the Court heard oral argument in September 2021, it issued its decision late Tuesday.

Background

As noted in the decision, Michael Klein (noted investor, formerly of Citigroup) formed the SPAC at issue in October 2019, as well as the Sponsor. The Sponsor received founders' shares of 20% of the SPAC's equity for nominal value ($25,000), and Klein hand-picked the directors of the SPAC. As is traditional within a SPAC structure, Klein's interests as the SPAC sponsor would liquidate without completion of a combination transaction within 24 months. The 20% equity assigned to the Sponsor was in non-public Class B shares in the SPAC. The SPAC went public in February 2020, raising $1.1 billion at IPO with 110M shares sold at **$10/unit** (each of which also received a ¼ warrant with an exercise price of $11.50). These shareholders received the remaining 80% equity in the SPAC in public Class A shares. The Sponsor's 20% equity interest in Class B shares would convert into Class A shares at a 1-to-1 ratio upon consummation of the combination transaction (if one occurred). The Sponsor also had the option to purchase an additional 23 million warrants at $1 each, with the exercise price of $11.50.

Klein selected all members of the SPAC's board through his exclusive power, granting them membership interests in the Sponsor's 20% equity stake in the SPAC and granting them additional warrants that did not dilute the Sponsor's control of the SPAC. In total, Klein held roughly 80% of the outstanding interests in the Sponsor, while the Board held the remaining 20%.

The Transaction

The SPAC identified Multiplan as the target combination in mid-2020. Multiplan is a healthcare industry-focused data analytics and cost management solutions provider. According to the Complaint, during the due diligence conducted by the SPAC, the Board learned that Multiplan's biggest customer (35% of its business) intended to create and roll out a technology platform that aimed to directly compete with Multiplan in the same industry.

The proxy issued by the SPAC in support of its decision to recommend the combination transaction did not disclose this particular fact unearthed in due diligence. The proxy listed multiple reasons for recommending the combination transaction, and also noted that the SPAC had done "extensive due diligence" on Multiplan, including multiple communications with "large customers" of Multiplan. The proxy failed to disclose that 35% of Multiplan's business was in fact dependent on a single customer, and that this customer intended to move "all key accounts" away from Multiplan and onto its own platform by the end of 2022. The proxy also did not include any independent 3rd party valuation of the transaction; it contained only a financial analysis prepared by SPAC management with the assistance of a financial advisory company owned and controlled by Mr. Klein.

In conjunction with the combination transaction, the combined company entered into a PIPE transaction whereby the PIPE investors would purchase 19.2% of the combined company's outstanding shares (up to $1.3 billion in valuation). That left 60.5% of the combination's shares held by former Multiplan shareholders, 16% held by the Class A shareholders in the SPAC, and 4.2% held by the Class B shareholders (i.e., the SPAC Sponsor and the Board members).

The transaction closed in October 2020. Less than 10% of the SPAC shareholders elected to redeem their shares in the SPAC held by the trust. At close, the total value of the Class B shares (convertible into Class A) held by the SPAC's Sponsor was roughly $305 million, for consideration paid of only $20,000. $230 million of this value was held by Klein alone.

After the close of the combination transaction, the shares of the combined entity declined immediately to below $10/share (i.e., below the redemption price that shareholders in the SPAC would have received had they redeemed their shares), on the basis of a short-sellers' research report that detailed, in part, the fact that Multiplan's customer was creating a competing technology platform. This litigation followed shortly thereafter in March 2021, brought by shareholders in the SPAC who had not exercised their rights of redemption prior to the approval of the combination transaction.

Lawsuit

The lawsuit alleged that the SPAC fiduciaries (Klein and the Board) were motivated by financial incentives not shared with SPAC shareholders, and the fiduciaries actively impaired the SPAC shareholder's right to divest shares prior to combination by withholding information gleaned during due diligence (i.e., that target's largest customer was building an in-house platform to compete with Multiplan). The Complaint asserted direct claims for breaches of fiduciary duty against the SPAC directors, its officers, and its controlling shareholder (Klein). The claims asserted that the fiduciaries made material misstatements and omissions in the Proxy that impaired public shareholders' redemption rights prior to the combination transaction, which inured to the fiduciaries' benefit (due to a low volume of redemptions and the consequent ability to close the transaction). Because this was a "value-decreasing" merger, non-redemptions added value to those holding founders' shares in the SPAC.

The first issue the Court disposed of was the fiduciaries' argument that these claims were derivative in nature—not direct—and thus subject to the demand futility requirement of Rule 23.1 in Delaware. According to the Court, the injury suffered by the Class A shareholders in the SPAC was ***not*** to the corporation, but to the shareholders themselves. The injury was "independent of any alleged injury to the corporation" because of the inherent nature of the SPAC structure and the right of redemption held by the Class A shareholders. Because the SPAC Board impaired the shareholders' right to an ***informed*** exercise of their redemption rights, the injury was to the shareholders directly and ***not*** to the SPAC overall. Moreover, the financial harm suffered by the Class A shareholders was "independent of and not shared with the SPAC" because the shareholders sought return of the cash they invested in the SPAC that they chose not to redeem. As the Court noted, "the plaintiffs are not suing because Churchill did not combine with Multiplan on more favorable terms" (i.e., a derivative claim), but rather "because the defendants, purportedly for self-serving purposes, induced Class A stockholders to forgo the opportunity to convert their [SPAC] shares into a guaranteed $10.04 per share in favor of investing in" the combined entity.

Next, the Court determined these direct claims (for breaches of the duty of loyalty and disclosure) required the application of the entire fairness test, rather than the business judgment rule. The duty of loyalty and duty of disclosure claims were "inextricably intertwined" and that entire fairness applied to them for two reasons: (1) because the combination transaction, with the opportunity to redeem, constituted a "conflicted controller transaction" under Delaware law; and (2) the majority of the SPAC board was self-interested and/or lacked independence from the conflicted controller (Klein).

Under the Court's perspective, this type of SPAC transaction constituted one where the controller receives a "unique benefit" from the transaction, that is, something "uniquely valuable to the controller … ***to the detriment of the minority***" even if the controller received "nominally the same consideration as all other stockholders." For support, the Court pointed to the inherent nature of a SPAC, in which there are sometimes a "misalignment of interests" between the SPAC Sponsor and the public shareholders as existed here. Even though Klein and other Board members of the SPAC participated in the combination transaction on the same terms as the Class A shareholders (because the Class B shares converted to Class A shares at a 1-to-1 ratio), the Sponsor's interests were ***not aligned*** because the combination transaction was valuable to the non-redeeming shareholders ***only*** if their shares post-combination were worth $10.04 or more (the value of their redemption rights). Because the Sponsor's shares would have expired worthless absent a combination, ***any*** merger with a target company would have been valuable to the Sponsor (not so for the public Class A shareholders). For example, Klein would have lost $350 million had the combination transaction not occurred, which was a 1,219,900% gain on his initial investment of $25,000. In effect, SPAC sponsors like Klein can do very well in a value-decreasing deal, whereas sponsors would lose everything in a liquidation; for public investors in SPACs, liquidations are often better for them than a value-decreasing merger. Thus, the transaction constituted a "conflicted controller transaction" because of the unique financial benefit enjoyed by SPAC sponsors.

The Court also found that the majority of the SPAC board was clearly interested in the combination transaction and lacked independence from Klein for a number of reasons, including the fact that many of them had been nominated to other SPAC boards by Klein himself. Thus, entire fairness applied to the transaction under either prong.

The Court then held that the Plaintiff properly pleaded non-exculpated claims for breach of fiduciary duty for breaches of the duty of loyalty and disclosure. For example, the Court determined that even though the Class A shareholders agreed to invest in the SPAC with the knowledge that the Sponsor obtained its Class B shares for nominal consideration, and that the Class A shareholders retained the option of making the decision whether or not to redeem prior to the transaction, the shareholders did not ***waive*** the right to require "all material information when the time came to make that choice." Because the Board failed to "disclose the information necessary for Plaintiffs to knowledgeably exercise their redemption rights," this constituted a properly pled claim for breach of the duty of disclosure. As the Court noted, had the Class A stockholders been "in possession of all material information about the target" at the time of the proxy vote and still "chosen to invest rather than redeem," there would likely be a different analysis (i.e., business judgment) applied; however, "that is not the universe alleged in the Complaint."

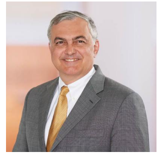
Important Points to Note

There are two critical points to note from the decision:

1. Vice Chancellor Will noted in a footnote that with respect to the issue of the Sponsors being aligned with the Class A shareholders, SPAC sponsors ***may*** bring themselves into closer alignment through their participation in any PIPE transaction necessary to complete the transaction. While not outright held, given it was not an issue on the motion, Vice Chancellor Will seemed to suggest that had Klein (and thus other SPAC sponsors in other cases) participated in the PIPE on equal footing with other public investors, those founders ***may*** properly align themselves through the PIPE and thus negate application of entire fairness to the transaction. While the Court did not provide any discussion of what might be a sufficient amount necessary to invest to ensure interests are aligned, doing so may negate any advantage a Sponsor receives through the lack of consideration it pays for its founders/sponsors shares.

2. With respect to SPAC combination transactions moving forward, the decision clarifies how critical it is for SPACs to ensure they make sufficient and adequate disclosures in the Proxy and other public statements about ***all information*** gleaned in due diligence on the target company. Indeed, SPAC Sponsors and the Board should be diligent in disclosing all information with respect to both potential conflicts ***and*** the information from due diligence. Doing so will help SPACs mitigate risk of litigation that implicates the duty of disclosure. The Court's decision ensures that any future litigation (and motion practice) will focus on the appropriateness of the disclosures made by the SPAC Sponsor and Board in the documents recommending the combination transaction.

Authors



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