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Delaware Finds Stockholder Claims Against SPAC Fiduciaries Subject to Entire Fairness Review

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As SPAC IPOs broke records – in both value and volume – in 2020 (and again in 2021), it was inevitable that stockholder litigation would follow. More than 50% of the SPACs that went public in 2020 and 2021 are incorporated in Delaware, giving particular significance to SPAC litigation filed in Delaware courts. On January 3, in *In re MultiPlan Corp. Stockholders Litigation* (Del. Ch. January 3, 2022), the Court of Chancery had the first opportunity, in connection with a motion to dismiss hearing, to consider application of Delaware law in the context of a deSPAC transaction. Applying the entire fairness standard of review, rather than the more deferential business judgment rule, Vice Chancellor Lori W. Will found that the plaintiffs had pled facts sufficient to support their claims that the SPAC's controlling stockholder, along with the SPAC's directors and CEO, violated their fiduciary duty of loyalty to the SPAC's public stockholders by failing to disclose certain material information regarding the SPAC's intended target.

Claims reviewed under the entire fairness standard have historically been virtually impossible to dismiss at the pleading stage, so Vice Chancellor Will's application of that standard "due to inherent conflicts between the SPAC's fiduciaries and public stockholders in the context of a value-decreasing merger" is particularly noteworthy. While future decisions may clarify the extent to which Delaware courts will scrutinize business combinations between SPACs and the target companies that they bring public, this decision serves as a reminder that SPACs and target companies alike must be prepared to fully disclose all material information regarding the target company, including any imminent risks it faces, to the SPAC's public stockholders.

Background

SPACs are public companies that raise capital for the express purpose of merging with a private company and taking it public (referred to as the "deSPAC transaction"). SPACs tend to adhere to a similar capital and governance structure, and the SPAC involved in this litigation, Churchill Capital Corp. III, is no exception. Churchill was incorporated in Delaware in October 2019 and closed its $1.1 billion IPO in February 2020. Churchill's public investors received Class A shares at a cost of $10 per share, and the proceeds raised from the public investors were placed into a trust account. Upon announcement of a deSPAC transaction, Churchill's public stockholders had the right to redeem their shares at the IPO price (plus interest), or keep their shares, which would be exchanged for shares in the combined company post-merger. The redemption right could be exercised regardless of whether the stockholder voted for or against the deSPAC transaction.

Meanwhile, Churchill's controlling stockholder (i.e., the SPAC's sponsor, who is referred to herein as the "Controller" or the "Sponsor"), Michael Klein, received Class B shares – representing 20% of the SPAC's pre-business combination overall capital structure – for a nominal price. The shares held by a SPAC's sponsor are often referred to as the "promote." If a deSPAC transaction was consummated, the Class B shares would convert to Class A shares. If a deSPAC transaction was not consummated within two years after the IPO, the IPO proceeds in the trust account would be returned to the public stockholders and the sponsor's Class B shares would be worthless. All of the directors serving on Churchill's board were appointed by the Sponsor and several of them were compensated for their board service with Class B shares.

In July 2020, Churchill management announced a proposed deSPAC transaction with MultiPlan Corporation, a company that specializes in healthcare cost management solutions. Most public investors (more than 90%) declined to exercise their redemption rights. The stockholders approved the deSPAC transaction with MultiPlan on October 7, 2020 and Churchill completed the transaction the next day. On the record date, Churchill's shares closed at $11.09. In November 2020, an equity research report disclosed that MultiPlan's top customer, UnitedHealth Group, was developing an in-house data platform that would cause UHG to end its relationship with and compete with MultiPlan. The proxy statement issued in connection with the deSPAC transaction had disclosed that MultiPlan earned 35% of its revenues from a single customer, but did not disclose UHG's identity or the fact that UHG was developing an in-house data platform. The day after the equity report was published, the value of the combined company's shares dropped to $6.27, an all-time low.

In April 2021, plaintiffs brought a class action complaint, alleging that Churchill's Sponsor, directors and certain officers

had breached their fiduciary duty of loyalty by failing to disclose the information regarding UHG, thereby impairing the plaintiffs' ability to make an informed decision about whether to exercise their redemption rights (and receive $10.04 per share before the closing of the merger, and prior to any reduction in value that occurred post-merger).

The court's analysis

The *Multiplan* opinion addresses several issues inherent to deSPAC transactions, and the SPAC structure more generally. At the outset (and not surprisingly), the court held that SPAC directors, like all directors of Delaware corporations, owe a duty of care and duty of loyalty to their stockholders. When fiduciaries communicate with their stockholders, the duty of care and duty of loyalty implicate a duty of disclosure, which is at issue here. The duty of disclosure becomes a duty of loyalty claim when it is reasonably conceivable that "the board lacked good faith in approving a disclosure." Given the misaligned incentives between the Controller and the board vis a vis the public stockholders (as discussed in more detail below), the court agreed that the plaintiffs' allegations of false and misleading disclosures implicated a duty of loyalty claim.

Entire fairness applied to review of defendants' actions

Arguably the most noteworthy aspect of the *MultiPlan* opinion is the court's determination that the defendants' actions should be reviewed under the entire fairness standard of review, which is a plaintiff-friendly standard that requires defendants "to demonstrate that the challenged act was entirely fair to the corporation and its stockholders." Application of entire fairness to fiduciary claims entails a fact-intensive inquiry, making it nearly impossible for defendants to succeed in dismissing those claims on a motion to dismiss.

Entire fairness is the default standard of review for conflicted transactions under Delaware law. In a transaction with a controlling stockholder, a conflict can exist if the controller is on both sides of the transaction or if the controller is competing with the other stockholders for consideration. Because Churchill and MultiPlan were unaffiliated parties involved in an arms-length transaction, this decision focuses on the latter. The defendants argued that the Sponsor did not compete for consideration with the public stockholders because the Sponsor's Class B shares would convert to Class A shares (the same shares held by the public stockholders) in connection with a deSPAC transaction. However, even when all stockholders nominally receive the same consideration, a controller can compete for consideration by receiving a "unique benefit" to the detriment of the other stockholders.

In the context of a deSPAC, the court found that a value-decreasing merger would present a unique benefit to the Sponsor given the Sponsor's promote. Specifically, the court reasoned that a merger would only have value to the SPAC's public stockholders if the shares of the combined company post-closing were worth at least $10.04 (i.e., the redemption price). However, because the Sponsor's shares were received for a nominal value, and the shares would expire without value if the SPAC did not consummate a merger, a merger would be valuable to the Sponsor at a value far less than $10.04 per share. The court also found that the Sponsor would have an incentive to discourage redemptions in a value-decreasing transaction ("issuing a share at $10.04—the effective result of a stockholder choosing not to redeem a Churchill share—is value enhancing to the existing stockholders"). As a result of the misaligned incentives in a value-decreasing merger, the court found it reasonably conceivable that the transaction was conflicted, making entire fairness the appropriate standard of review. The court was not dissuaded from this finding by the facts that Churchill still had 19 months left in which to consummate a merger, or that the "promote" is a feature of virtually every SPAC.

Entire fairness is also the default standard of review when the board is conflicted, meaning that less than a majority of the directors are independent and disinterested. The court found it reasonably conceivable that the SPAC's board was conflicted. Directors who received Class B shares as compensation for serving on the board suffered from the same misaligned incentives that the Sponsor did, making it reasonably conceivable that they were not disinterested (i.e., their interests differed from the public stockholders). Additionally, the court found it reasonably conceivable that a majority of the directors were not independent because they were appointed by the Sponsor (and could be unilaterally removed by him), and several of them served on boards of other SPAC entities formed by the Sponsor, giving them the right to receive valuable sponsor shares similar to the ones at issue here.

Applying entire fairness, the court found it reasonably conceivable that Churchill's Sponsor, directors and CEO had breached their fiduciary duties by failing to disclose UHG's plans to end its relationship with Churchill and create a competing product, and thus prioritized their own interests over those of the public stockholders. The court appeared to base this conclusion in substantial part on an allegation that Churchill management had disclosed it "communicated with senior leaders of several large customers" during its "extensive diligence" and, apparently, an inference from that allegation that Churchill could have learned of UHG's plans. Because the complaint adequately alleged that Churchill's management had failed to disclose material information in advance of the public stockholders' opportunity to exercise

their redemption rights, the court allowed the claims of fiduciary breach to proceed.

Other threshold arguments relating to deSPACs

The court also rejected three other "threshold arguments" raised by the defendants:

1. The defendants argued that under Delaware precedent, the plaintiffs' claims were "derivative" claims that could only be brought on behalf of Churchill, not its stockholders, and that the plaintiffs had failed to make a pre-suit demand of the Churchill, as required to bring a derivative claim. The court rejected this argument, finding that the stockholders had alleged direct harms, not harms to Churchill, insofar as the alleged failure to disclose UHG's plans impaired the stockholders' redemption rights, and that the plaintiffs had therefore adequately supported their "direct" claims.
2. The defendants argued that the stockholders' redemption rights were governed by contract – i.e., Churchill's charter – and that under Delaware precedent, fiduciary claims arising from contractual obligations should be dismissed as superfluous. The court rejected this argument too, reasoning that fair and full disclosure affecting an "investment decision" is a core fiduciary duty, and claims for violations of that duty are not foreclosed merely because it relates to the exercise of a contractual right.
3. The defendants argued that the plaintiffs had alleged mere "holder claims" – e., claims that a fiduciary breach caused a stockholder to merely hold their shares. Delaware courts have found holder claims cannot be brought on a classwide basis. The court rejected this categorization, again classifying the public stockholders' decision regarding whether to redeem as an affirmative "investment decision," not a passive "holder decision."

Key takeaways

- The court's holding that the defendants' actions should be reviewed under the entire fairness standard because of the misaligned incentives between the SPAC's sponsor and directors and the public shareholders is important, given that those misaligned incentives (created by the Sponsor's promote) are present in virtually all SPACs. While a single Court of Chancery opinion should not be understood to guarantee that entire fairness will be applied in all other challenges to deSPAC mergers (particularly without an alleged disclosure problem), it is certainly a signal that those challenges may be difficult to defeat at an early phase of the litigation, potentially leading to costly discovery for defendants.
- As Vice Chancellor Will emphasized, the court's denial of the motion to dismiss was not based on those misaligned incentives alone ("his conclusion does not address the validity of a hypothetical claim where the disclosure is adequate and the allegations rest solely on the premise that fiduciaries were necessarily interested given the SPAC's structure"). Critical to the court's decision to deny the motion was its finding that the *MultiPlan* plaintiffs had adequately alleged a failure to disclose material information to the SPAC's public stockholders. That said, this finding appears to be based in substantial part on a disclosure that Churchill's management had been in contact with MultiPlan's major clients, and not any allegation directly suggesting that Churchill was aware of UHG's plans. That the court was willing to draw an inference from the aforementioned allegation suggests that defendants in similar cases may face an uphill battle in defeating motions to dismiss.
- This decision may also make the prospect of serving on a SPAC's board less appealing to would-be directors, given the potential exposure to personal liability. Unlike duty of care claims, duty of loyalty claims (the type alleged here) are non-exculpable claims under Delaware law. Because a SPAC's sponsor is tasked with identifying a potential target, SPAC directors are generally appointed by the sponsor, making it likely that the directors would be considered conflicted (even without receiving a portion of the sponsor's promote as consideration for their service). This decision may also make it increasingly difficult for SPACs to obtain D&O insurance at a reasonable cost.

Practice points for SPACs and target companies

- The best way for a SPAC's management team to avoid the threat of litigation centered around inadequate disclosure is to perform extensive diligence of a target company, and then disclose all material information to the public stockholders in advance of both the public stockholders' opportunity to redeem their shares and the stockholder vote on the deSPAC transaction. Given the court's willingness to apply an entire fairness standard of review, SPAC fiduciaries should expect that would-be plaintiffs will be closely reviewing all disclosures in an effort to find potential errors and omissions.
- Likewise, target companies should be aware that, as part of the process of merging with a SPAC and going public, they will need to provide all material information about their business and any risks thereto. For many target companies, these disclosure obligations may substantially exceed what officers are accustomed to providing as private companies. Target companies should also carefully review any proxy statement/Form S-4 for

potential errors or omissions. While the target company was not a defendant in this case, it is not difficult to imagine a scenario in which plaintiffs bring an aiding and abetting claim against a target company for disclosure issues, which may be difficult to dismiss if the underlying claims against the SPAC's fiduciaries are subject to entire fairness review.
- While future opinions could clarify (and potentially limit) the extent to which Delaware courts will scrutinize deSPAC mergers, the *MultiPlan* opinion may be a reason for SPACs to consider organizing in jurisdictions other than Delaware (e.g., the Cayman Islands, the jurisdiction of choice for nearly all non-Delaware SPACs).

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