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Chancery Court Applies Onerous Entire Fairness Standard in First SPAC-Related Decision



In one of the first decisions to analyze fiduciary duty claims in the context of a special purpose acquisition company (SPAC) merger, the Delaware Chancery Court recently sustained the legal viability of a putative shareholder class action brought against a SPAC's directors, officers, controlling shareholder, and financial advisor based on an allegedly false and misleading proxy statement.^[1] The court concluded that the plaintiffs had successfully pleaded "a reasonably conceivable impairment of public stockholders' redemption rights—in the form of materially misleading disclosures." The decision—which marks the first time that the Chancery Court has applied Delaware law in the SPAC context—is important for several reasons we highlight below and may provide a roadmap for plaintiffs' attorneys in crafting SPAC-related lawsuits that are sure to be filed in the coming months and years. Most notably, the decision suggests that the existence of the SPAC public shareholders' right of redemption prior to a de-SPAC transaction—often thought of as a key mitigating factor against conflict of interest claims—will not shield SPAC fiduciaries from liability where they have failed to disclose information to the public shareholders that is material to their decision of whether to redeem their SPAC shares or convert them to shares in the combined public company. As we discussed in a [prior publication](#), complete and accurate disclosure is one of the keys to avoiding liability in connection with both U.S. Securities and Exchange Commission (SEC) investigations and shareholder lawsuits focusing on de-SPAC transactions.

Background

With the explosion of SPACs and related de-SPAC transactions over the past two years, there has been a corresponding surge in SPAC-related litigation, with over 80 lawsuits filed since June 2021. This litigation surge is almost certain to continue throughout 2022 in light of the marked increase in SPAC activity in 2021, which

saw over 600 SPAC Initial Public Offerings (IPO), totaling over \$600 billion in proceeds, and over 260 de-SPAC transactions. Although scores of lawsuits have been filed, many remain in the early stages and few decisions have been issued. The recent decision by the Delaware Chancery Court is notable as one of the first substantive decisions in this area and as a likely template for future claims by SPAC shareholders.

The Lawsuit

The case centers on the October 2020 merger between a private healthcare data analytics firm (the Firm) and Churchill Capital Corp. III (Churchill), a SPAC sponsored by a former bank executive that had raised \$1.1 billion in a February 2020 IPO. Plaintiffs allege that Churchill's directors, officers, and controlling stockholder—motivated by financial incentives not shared with public stockholders—breached their fiduciary duties by withholding material information in the proxy statement concerning the Firm and the proposed de-SPAC transaction. Plaintiffs allege that the fiduciary defendants failed to disclose that the Firm's largest customer—which accounted for 35% of its revenues—was building an in-house platform that would compete with the Firm and cause it to move its key accounts away from the Firm. Shortly after the merger closed, an equity research firm issued a report about the Firm that discussed, among other things, the customer's creation of a competing platform and allegedly caused the Firm's stock price to drop by over 40%. Plaintiffs also allege that the SPAC's financial advisor—a wholly owned subsidiary of the SPAC sponsor—aided and abetted the fiduciary defendants' breaches.

The Decision

In moving to dismiss the complaint, the defendants argued principally that (1) the plaintiffs alleged derivative (not direct) claims but failed to plead demand futility and (2) the claims are barred by Delaware's business judgment rule.

With respect to the first issue, the defendants argued that the plaintiffs alleged a duty of loyalty claim arising from defendants' alleged overpayment for the Firm that should be viewed as "exclusively derivative" under *Tooley v. Donaldson, Lufkin & Jenrette, Inc.*, 845 A.2d 1031 (Del. 2004). The court rejected this argument, holding that the allegations do not amount to a "typical overpayment or dilution case." Rather, the complaint centers on the impairment to the public stockholders' informed exercise of their redemption right—a right exclusive to the public stockholders. The harm suffered by the stockholders as a result of the defendants' "purposefully and materially misleading disclosures" was thus "independent of and not shared with Churchill." Moreover, the court found that the public shareholders, rather than the company, would receive the benefit of the recovery sought, which is based on the stockholders' lost redemption right of a guaranteed \$10 per share.

With respect to the second issue, the court concluded that the business judgment rule should not apply. Instead, it found that "entire fairness," which is Delaware's "most onerous standard of review," applies. As the entire fairness standard requires intensive factual inquiries into both the economics of the transaction (the fair price test) and the process leading to the transaction (the fair dealing test), motions to dismiss fiduciary duty claims where the standard is found to apply are rarely granted.

In support of its application of the entire fairness doctrine, the court first ruled that plaintiffs adequately alleged a "conflicted controller" transaction based on the "unique benefit" that the SPAC sponsor would receive from consummation of the transaction with the Firm. Specifically, the shares and warrants held by the sponsor would be worthless if Churchill did not complete a deal. As of the closing date, the sponsor's warrants were worth roughly \$51 million and its founder shares were worth approximately \$305 million, representing an immense gain on the sponsor's mere \$25,000 investment. The SPAC's public stockholders, on the other hand, would have received \$10 per share—which was the price of the IPO—if they had chosen to redeem or if Churchill had failed to consummate a merger and therefore liquidated; instead, those that did not redeem received shares in the combined public company, which dropped significantly in value following the transaction. As with the sponsor, the director defendants would similarly benefit from virtually any merger that would "convert their otherwise valueless interests in Class B shares into [public] shares." Second, the court found that plaintiffs adequately alleged that a majority of the board lacked independence given that all of the directors were appointed by the controlling stockholder to the Churchill board, as well as to the board of other SPACs sponsored by the same individual.

Finding that the entire fairness standard applied, the court denied the motion to dismiss the claims against the fiduciary defendants.

In addition, the court also upheld the aiding and abetting claim against the SPAC's financial advisor, which, according to plaintiffs, "knew that [the valuation analyses] were materially misleading." Critical to the court's analysis was the fact that the financial advisor was not an independent third party, but rather an entity controlled by Churchill's controlling stockholder that plaintiffs allege was engaged simply to provide a "patina of financial analysis."

Takeaways

- **Full and accurate disclosure of all material facts is key to mitigating liability.** In upholding the plaintiffs' fiduciary duty claims, the court made clear that its decision that the plaintiffs' claims are viable was "not simply because of the nature of the transaction or resulting conflicts"—which are inherent in most de-SPAC transactions—but "because the complaint alleges that the director defendants failed, disloyally, to disclose information necessary for the plaintiffs to knowledgeably exercise their redemption rights." Thus, the court's 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." Indeed, "one can imagine a different outcome" if public SPAC stockholders were given "all material information about the target, [and] had chosen to invest rather than redeem."
- **Application of "entire fairness" in other cases is unclear.** Given the fact-intensive nature of the court's decision—which is based almost entirely on the SPAC's alleged defective and misleading disclosures—it is too early to tell whether the onerous entire fairness standard applied by the court will apply to other fiduciary duty challenges to de-SPAC transactions. What is clear from the opinion, however, is that those involved in a de-SPAC transaction are well-advised to ensure robust and accurate disclosures. Plaintiffs' lawyers are likely to use the decision as a roadmap in crafting complaints going forward by, among other things, highlighting "material" disclosure violations and the various conflicts inherent in a de-SPAC transaction.

- **Maximize director independence.** To reduce the likelihood that the entire fairness standard of review will apply, and to increase the odds of a successful motion to dismiss, a majority of the SPAC board should be independent of the sponsor or controlling shareholder. In addition, the economic interests of the independent board members in the outcome of the de-SPAC transaction should be as closely aligned as possible with the interests of the SPAC's public shareholders.
- **Use independent advisors where possible.** The court's decision to uphold the aiding and abetting claim against the SPAC's financial advisor was clearly driven by the fact that the financial advisor was owned and controlled by the controlling stockholder of the SPAC. In light of this alleged conflict, the court concluded that it was "reasonably conceivable" that the financial advisor "participated" in the board's decision or "otherwise caused the board to make the decision" to "approve the merger while withholding material information from stockholders." To avoid such conflict claims, SPACs should consider engaging third-party advisors who are independent of the sponsor to provide valuation reports with respect to the target company. In addition to the engagement of an independent financial advisor, SPACs should consider adopting other procedural safeguards typically used in the traditional merger context to help mitigate risk, such as using an independent third-party advisor to conduct due diligence, obtaining a fairness opinion as to the value of the target company, and potentially creating an independent special committee to review the proposed transaction.

Endnotes

[1] A copy of the Chancery Court's decision can be found [here](#).

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