

LEGAL UPDATES

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Entire Fairness Review First Applied to Fiduciary Duty Claims Against a SPAC's Sponsor and Directors

Overview

On January 3, 2022 the Delaware Court of Chancery issued a decision in *In re MultiPlan Corp. Stockholders Litigation* addressing certain claims against the sponsor and directors of Churchill Capital Corp. III (Churchill), a Special Purpose Acquisition Company, or “SPAC.” The case involved claims brought by Churchill’s public shareholders against (i) Churchill itself, (ii) its sponsor entity controlled by Michael Klein (Sponsor) and (iii) its board of directors for breaches of fiduciary duty stemming from the failure of Churchill to make adequate disclosures in its proxy statement and other documents related to the SPAC’s merger with its target company. This decision was the first Delaware Court of Chancery decision to apply traditional fiduciary duty principles in the context of a de-SPAC transaction. The court ultimately denied the defendants’ motion to dismiss, allowing their fiduciary duty claims to proceed against the Sponsor and directors, and their aiding-and-abetting claims to proceed against its financial advisor, The Klein Group.

The Court carefully emphasized that its decision was informed primarily by the well-pled allegations of disclosure failures, rather than any inherent conflicts between a SPAC’s public shareholders and its insiders. Nevertheless, statements in the decision concerning conflicting financial incentives between public stockholders and fiduciaries heighten the risk of enhanced scrutiny of future SPAC transactions.

Background

SPACs are publicly traded investment vehicles, which raise capital for the express purpose of merging with a private company – commonly referred to as

a “de-SPAC transaction.” This transaction is often structured as a reverse merger in which the target operating company merges with and into the SPAC. The combined company following the transaction is a publicly traded company and carries on the target’s business and operations. SPACs represent an alternative to traditional IPOs, offering efficient access to financing and public markets.

Immediately prior to effecting a de-SPAC transaction, SPACs allow their shareholders to redeem their shares if the shareholders would rather receive their investment back than hold stock in the surviving public company. The sponsors are charged with identifying one or several target companies and receive “founder shares” at a nominal price. If no transaction is completed by the end of the SPAC’s term, the founder shares and warrants have no value, and the public shareholders are redeemed and get their money back. Once the sponsor has identified a target, the SPAC will circulate a proxy statement via a filing with the Securities and Exchange Commission (SEC).

This structure results in the sponsors and shareholders having divergent interests. The sponsors receive founder shares and warrants that are valuable only if a transaction occurs, regardless of the post-closing trading price of the combined enterprise. Shareholders, on the other hand, will want to make sure, based on the information available in the proxy statement, that the proposed acquisition will increase the value of their initial investment in the SPAC, or else they will seek redemption.

Churchill was a SPAC founded by and controlled by Michael Klein through a sponsor entity, which received founder shares constituting 20% of Churchill’s total equity. Churchill’s directors were associated with Mr. Klein and were compensated with economic interests in the Sponsor, and Public shareholders received the other 80% of its capital stock in the SPAC’s IPO. If Churchill had been unable to complete a business combination transaction within two years of its IPO, it would have liquidated with the founder shares expiring and the public shareholders redeemed.

Churchill’s proposed merger with MultiPlan, Inc. (Multiplan), a provider of data analytics and cost management solutions for the healthcare industry, was approved by the SPAC shareholder, with only a few exercising their redemption right. The proxy statement disclosed that MultiPlan was dependent on a single customer for 35% of its revenues. What it did not mention, however, is that such customer intended to create an in-house alternative to MultiPlan’s services that would result in the termination of its engagement with MultiPlan. After the closing of the de-SPAC, a research firm issued a report discussing the issue, and the trading price of the surviving entity’s stock fell significantly. The shareholders then filed a class action alleging that Churchill’s sponsor and directors breached their fiduciary duties by approving the merger and issuing a misleading proxy statement, which failed to disclose the imminent problem of the customer’s new data platform. The shareholders argued that they had been deprived of their right to a fully informed decision on whether to redeem their shares or hold them and approve the deal.

The plaintiffs also claim that Churchill's financial advisor aided and abetted the breaches of fiduciary duties through its preparation of valuation analyses of MultiPlan and its knowledge of various alleged conflicts of interest.

Standard of review

In considering the defendant's motion to dismiss, the court first addressed the applicable standard of review. It concluded that the onerous "entire fairness standard," rather than the more deferential "business judgment rule," applied to determining whether the defendants breached their fiduciary duty.

The standard of review is often dispositive of whether a complaint will proceed into discovery or be dismissed at the pleading stage of litigation. The default standard in Delaware for a breach of fiduciary duty is the "business judgment rule," which presumes that a corporation's board of directors acted on an informed basis, in good faith and in the honest belief that the action was taken in the best interest of the corporation. If applied, a Delaware court will almost always side with the board and will not substitute its own judgment for the judgment of the directors. However, absent certain procedural safeguards, such as independent board committees, the "business judgment rule" will not apply in the presence of conflicts of interest. Where such conflicts of interest exist – such as when an officer or director of a company has a personal interest in a transaction involving the company – courts will apply the "entire fairness" standard.

The entire fairness standard is Delaware's "most onerous standard of review" and shifts the burden of proof to the defendant "to demonstrate that the challenged act or transaction was entirely fair to the corporation and its stockholders." In doing so, directors must prove that both the price of the transaction and the course of dealing – including structure, negotiations, disclosures and timing – were fair. The entire fairness inquiry is fact intensive, making it nearly impossible for defendants to succeed in dismissing those claims on a motion to dismiss.

The court in *MultiPlan* confirmed that entire fairness applied for two independent reasons:

Conflicted Transaction. The Sponsor, a "conflicted controller," had an interest in the de-SPAC merger different from the public shareholders because unlike public shareholders who benefit from a de-SPAC only if the post-closing stock price is higher than their original investment price, the Sponsor would benefit from virtually any de-SPAC transaction, even if the merger was value-decreasing. Additionally, the fewer shareholders redeem after receiving the proxy statement, the more funds remain available for use to fund de-SPAC closing. Importantly, the court rejected the defendants' argument that proxy statement disclosures related to the SPAC's structure and the Sponsor's

diverging incentives neutralized the conflicted nature of the actions. In other words, the SPAC still had the obligation to disclose all material facts relating to the merger in a non-misleading proxy statement, which Churchill had failed to do.

Conflicted Board. The SPAC directors were self-interested and not independent because they had conflicts similar to those of the Sponsor due to their also having an interest in the founder shares. The directors had also been appointed – and could be unilaterally removed – by Mr. Klein.

Based on the above, the court denied the defendants' motion to dismiss. It held that the plaintiffs' claims were viable, principally because they alleged that the Sponsor and directors failed to disclose information necessary to exercise their redemption rights on an informed basis. On the aiding and abetting claim, the court found that allegations of a close alignment between Churchill and its financial advisor supported a finding that the advisor knowingly participated in the fiduciary breach.

Takeaways

The case illustrates that, while many SPAC commentators have suggested that the unique structural features of SPACs – specifically the redemption feature – can mitigate fiduciary issues and conflicts of interests, Delaware courts do not view these features as a shield when facing an alleged breach of fiduciary duties, at least when plaintiffs can plead inadequate disclosures in a proxy statement. SPAC sponsors and directors are still required to provide shareholders with all material information and allow them to exercise their redemption rights on a fully informed basis.

The legal analysis in *MultiPlan* is highly fact-specific and based heavily on Churchill's alleged disclosure violations. The court decision hinged on adequate allegations that defendants disloyally withheld material information from the SPAC's proxy statement. The decision suggests that accurate and sufficient disclosures could defeat a claim regarding redemption rights. As such, disclosure of all material information regarding the proposed de-SPAC transaction is the chief deterrent for viable claims against SPAC sponsors and directors. This case heightens the importance of rigorous due diligence and fulsome disclosure in proxy statements.

SPAC sponsors and directors should consider appropriate procedural steps to mitigate risk in a SPAC business combination transaction, with the advice of sophisticated counsel. These can include full disclosure of all material information regarding the target company, re-examining the independence and compensation of non-sponsor directors, and independent third-party fairness opinions as to the value of the target business and the terms of the business combination.

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Husch Blackwell continues to monitor the relevant caselaw affecting SPACs and its implications for our clients. Should you have any questions, please do not hesitate to contact Yuefan Wang, Remy Fesquet, Chengzhuo He, or your Husch Blackwell attorney.