SPACs & Entire Fairness: What Standard of Review Applies to the de-SPACing Transaction

Insight

December 11, 2020

While litigation against special purpose acquisition companies ("SPACs") has been historically rare, the increase in SPAC offerings and transactions portends increased litigation, particularly with respect to a SPAC's acquisition of a target company (*i.e.*, the "de-SPACing" transaction). To date, the sparse case law and commentary on SPAC litigation has primarily focused on federal securities lawsuits, including the sort of Pavlovian-disclosure lawsuits that commonly follow any public M&A transaction. Much less focus by courts and commentators has thus far been paid to the potentially more significant risk that is the subject of this article: Whether the de-SPACing transaction is subject to entire fairness scrutiny?

This issue is somewhat undeveloped. Plaintiffs may advance several arguments for applying entire fairness on the ground that SPAC founders and directors are conflicted in the transaction, including because they usually receive so-called “founders’ units,” which convert into publicly tradable securities only if an acquisition is completed. Thus, goes the theory, the SPAC’s founders and directors are uniquely incentivized to close any transaction possible, even if it means overpaying or pursuing a transaction that is not in the SPAC stockholders’ best interests. Though there is no Delaware case relating specifically to a de-SPACing transaction, it is our view that (absent a transaction with an entity under common control with a SPAC or some extreme circumstances) there are multiple reasons why entire fairness could be foreclosed or be otherwise inapplicable to a de-SPACing transaction.[1]

Overview of Entire Fairness Standard and When It Applies

Ordinarily, Delaware courts review a stockholder challenge to a board’s approval of a transaction under the deferential business judgment rule. Application of business judgment review almost always defeats the stockholder challenge. However, in certain circumstances posing a material conflict of interest, courts will instead review such a challenge under the exacting entire fairness standard. Entire fairness review places the burden on the defendants to prove that both the price and the process of the challenged transaction were entirely fair to the company’s stockholders. This standard is significant not only because it increases the likelihood of liability, but also because it decreases the likelihood of the lawsuit’s dismissal at its early stages.

To trigger entire fairness review, it is insufficient for a stockholder to allege that the directors had *some* incentive in the transaction which differed from stockholders generally. Rather, the stockholder must allege that a majority of the directors suffered from a *disabling* conflict.[2] The question thus becomes when a differing incentive amounts to a disabling conflict, which Delaware courts have most commonly found where:

1. a majority of the board received *material* personal benefits not shared generally by stockholders as a result of the challenged transaction;

2. a majority of the board were beholden to a controller or were dominated by another director who was pursuing the transaction for such a purpose; or

3. a majority of the board or a controller competes with the common stockholders for consideration.[3]

Entire Fairness and Founders' Units in a De-SPACing Transaction

Though such challenges to a de-SPACing transaction have thus far been rare, a stockholder may well argue that entire fairness applies due to the conflicts implicated by the founders' units to be received by the SPAC's founders and directors upon the completion of the de-SPACing transaction. That theory was sustained in *AP Services, LLP v. Lobell*, a 2015 New York state court opinion that refused to dismiss Delaware entire fairness claims against a SPAC and its directors alleging such a conflict.[4] However, despite the court's denial of the defendants' motion to dismiss, *AP Services* has not led to additional filings to our knowledge. Nor, in our view, should it be viewed as an indication that courts will reflexively deny motions to dismiss complaints alleging fiduciary duty claims against SPAC directors.

First, the notion that founders' units alone trigger entire fairness ignores that the standard only applies where the alleged conflict is so significant in light of the directors' circumstances that their judgment is disabled. If it sufficed to show that directors had *some* unique incentive, many (if not most) transactions would be subject to entire fairness — since directors and officers of targets are often considered for at least similar positions in the post-merger company, and receive accelerating vesting of equity awards or other potential benefits. Delaware courts have repeatedly found that those types of benefits do not trigger heightened scrutiny, absent a clear allegation of materiality.[5] The real test is not whether such benefits or potential conflicts exist, but whether the plaintiff's allegations are of such specificity and the benefits / potential conflicts are of such materiality that they permit an inference that a director could not have impartially approved the transaction. This is not a low bar.

Second, defendants can show that they do not suffer a conflict or compete for consideration by establishing that the "fiduciary receives the same consideration for her shares as the rest of the shareholders."[6] SPACs are usually structured so that founders' shares convert into public shares and are compensated on the same terms as other stockholders. Founders receive no preference or bonus above other stockholders for consummating a transaction. In fact, typically the only difference is that these recipients did not have to purchase their shares in the initial offering.

Third, *AP Services* expressly noted that the defendants did not submit briefing on issues that we believe would be game-changing today, including "a requirement that a majority of IPO shareholders approve a business combination or that initial shareholders agree to a lock-up provision committing them to hold the stock for a fixed period."[7] As discussed below, whether entire fairness would otherwise apply or not, such approval would cleanse any of the foregoing conflicts.

A Fully Informed, Uncoerced Vote of Disinterested Stockholders Would Foreclose Application of Entire Fairness Absent a Transaction with a Controller

In October 2015, the Delaware Supreme Court held in *Corwin v. KKR Financial Holdings LLC* that the business judgment rule applied to a transaction because it was approved by a fully informed, uncoerced vote of the disinterested stockholders — even though, but for that vote, a heightened standard of review would have applied.[8] The Delaware Court of Chancery has subsequently applied *Corwin* to hold that "the only transactions that are subject to entire fairness that cannot be cleansed by proper stockholder approval are those involving a controlling stockholder," and proper stockholder approval will result in business judgment review where allegedly "the majority of the directors who approved it were grossly negligent, acting in bad faith, or tainted by conflicts of interest."[9]

Since SPACs generally (i) grant founders only 20% of the voting stock, (ii) require all stockholders to approve the acquisition of a target, and (iii) allow investors to redeem their initial investment (in many cases irrespective of how one votes), this line of cases could be a powerful defense to potential breach of fiduciary duties claims challenging a de-SPACing transaction. The SPAC providing fulsome disclosures for an informed stockholder vote on the de-SPACing transaction is therefore critical not only to protect against disclosure claims but also to avail the defendants of business judgment review available under *Corwin*.

The Structure of SPACs Undermines the Rationale for Entire Fairness

Finally, though it may not alone preclude entire fairness review, the SPAC structure and purpose provides important context. Unlike traditional public companies, where stockholders make investment decisions based on the earnings potential of a company's operating assets, SPACs have no operations until the de-SPACing transaction is completed. The entire reason stockholders invest in a SPAC is because they believe the management of the SPAC can find, acquire and operate a company within the scope of the SPAC's governing documents.

Moreover, the entire economic arrangement, including a SPAC's bylaws and the inherent conflicts that might be argued to implicate entire fairness, are disclosed to investors during the initial offering.

Last, investors have several procedural protections. For example, organizational documents often limit the types or size of targets a SPAC may pursue. Investors' money is placed into a trust that may be used only for a SPAC's acquisitional purposes or ultimately returned to investors if they elect not to approve a transaction. Founders' units align founders' and stockholders' interests; the more value the founders' unlock from a transaction, the more both founders and stockholders profit. And if a suitable target is located by management, investors have the option of getting their initial investment returned (in many cases irrespective of whether investors voted for or against the transaction).

These protections, as well as the transparency behind the ultimate goal for a SPAC and the front-end disclosure, suggest to us that a court should be particularly reluctant to apply the highest level of scrutiny to a de-SPACing transaction. Investors participate in SPACs specifically because they believe in the founders' and managements' business judgment to identify and improve targets. Absent some extreme circumstances (or a transaction with the controller), applying entire fairness undermines that premise and favors holdouts who simply want to settle for a premium above the ultimate share price.

Conclusion

Fulsome disclosure and informed approval by a majority of disinterested stockholder is the best way to insulate SPACs and their directors from the anticipated increase in fiduciary duty lawsuits challenging de-SPACing transactions.

[1] We also note that individual directors may have additional defenses to any lawsuit, including the application of any exculpatory provision to disinterested directors. *See, e.g., In re Cornerstone Therapeutics Stockholder Litig.*, 2014 WL 4418169 (Del. Ch. Sept. 9, 2014). While we do not address those defenses below, they are the subject of a well-developed body of case law.

[2] *Orman v. Cullman*, 794 A.2d 5, 25 & n.50 (Del. Ch. 2002).

[3] *See*, *e.g.*, *In re Merge Healthcare, Inc.*, 2017 WL 395981, at *6 (Del. Ch. Jan. 30, 2017) (identifying situations involving disabling conflicts, including competing for consideration); *NJ Carpenters Pension Fund v. InfoGROUP, Inc.*, 2011 WL 482588 at *11 (Del. Ch. 2011) (involving allegations that a majority of the board was dominated by another director who was pursuing a sale due to document, highly-material personal liquidity needs); *In re Trados Inc. S'holder Litig.*, 2009 WL 2225958, at *4-*6 (Del. Ch. 2009) (involving allegations that a majority of the directors received material personal benefits and had other interests in the transaction that created disabling conflicts).

[4] 2015 WL 3858818 (N.Y. Sup. Ct. June 19, 2015).

[5] *City of Miami General Emps. v. Comstock*, 2016 WL 4464156 (Del. Ch. Aug. 24, 2016); *In re General Motors (Hughes) S'holder Litig.*, 2005 WL 1089021 (Del. Ch. May 4, 2005), *aff'd*, 897 A.2d 162 (Del. 2006); *In re OPENLANE, Inc*., 2011 WL 4599662, at *5 (Del. Ch. Sept. 30, 2011).

[6] *In re Synthes, Inc. S'holder Litig.*, 50 A.3d 1022, 1035 (Del. Ch. 2012).

[7] 2015 WL 3858818, at *6 n.1.

[8] 125 A.3d 304 (Del. 2015).

[9] *Larkin v. Shah*, 2016 WL 4485447, at *8, *10 (Del. Ch. Aug. 25, 2016).

Key Contacts

Partner

Michael C. Holmes

+1.214.220.7814

mholmes@velaw.com

Senior Associate

Jeffrey Crough

+1.214.220.7940

jcrough@velaw.com

Senior Associate

Bryan Gividen

+1.214.220.7821

bgividen@velaw.com

Related Series

- Special Purpose Acquisition Companies

Related Capabilities

- Shareholder Litigation & Enforcement

Related Insights

Insight

Rate Expectations: SEC Charges Credit Ratings Agency for Undisclosed Adjustments to Ratings

The V&E Report

February 24, 2021

Insight

Is the Regulatory Sheriff Looking at Robinhood? FINRA Increases Focus on “Game-Like” Securities Trading Apps

The V&E Report

February 10, 2021

V&E+

A Top Prosecutor's Next Chapter: Zach Terwilliger Joins V&E's White Collar Defense Practice

February 9, 2021

Insight

Beware of SEC Requests to Include Non-Monetary Conditions When Settling Enforcement Matters

The V&E Report

February 4, 2021

This information is provided by Vinson & Elkins LLP for educational and informational purposes only and is not intended, nor should it be construed, as legal advice.