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Limiting SPAC-Related Litigation Risk: Disclosure and Process Considerations

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Introduction

2020 marked an incredible surge in the prevalence of Special Purpose Acquisition Company ("SPAC") initial public offerings and business combinations ("deSPAC transactions"). In 2020, there were 248 SPAC IPOs (raising total gross proceeds of over $83 billion) and 66 deSPAC transactions, as compared with 2019's 59 SPAC IPOs (raising approximately $13.6 billion in gross proceeds) and 28 deSPAC transactions. [1] And the pace continues to skyrocket in 2021 with 160 SPAC IPOs in the first two months of the year and 13 completed deSPAC transactions. [2] This spectacular rise, and the related profits, has unsurprisingly garnered attention from both the United States Securities and Exchange Commission ("SEC") and plaintiffs' law firms. Most recently, the SEC's Division of Corporation Finance released guidance [3] (the "SEC's SPAC Guidance") concerning disclosure obligations for SPAC IPOs and deSPAC transactions, highlighting many process and disclosure-related issues that plaintiffs' lawyers typically raise and have focused on in recent SPAC lawsuits. As we anticipate that plaintiffs' firms will continue to hone in on SPAC-related litigation in 2021 (likely using the SEC's SPAC Guidance as its new and more tailored playbook), SPAC sponsors, their boards of directors, and the directors and officers of acquisition targets should all be focused on key steps to limit litigation risks and minimize costs associated with these risks.

Disclosure-Based Claims and the SEC's SPAC Guidance

Given that SPAC transactions have not historically been the subject of significant litigation, particularly as compared to traditional IPOs and public-to-public M&A transactions, plaintiffs' firms played catch-up in this area during 2020, largely recycling their traditional M&A playbook. Accordingly, following the filing of the initial Form S-4 in connection with the deSPAC transaction, plaintiffs' firms have alleged disclosure-based claims under Section 14(a) of the Exchange Act, claiming that the proxy statements issued are deficient due to the failure to disclose financial projections for the SPAC entity, immaterial details relating to negotiations or pursuit of other potential acquisition targets, reasoning for not hiring a financial advisor, or financial analyses that the SPAC board considered. *See Wheby v. Greenland Acquisition Corp.*, C.A. No. 1:19-cv-01758

[1] See SPACInsider, SPAC IPO Transactions: Summary by Year, available at https://spacinsider.com/stats/.
[2] Id. (as of Feb. 22, 2021).
[3] CF Disclosure Guidance No. 11 (Dec. 22, 2020), available at https://www.sec.gov/corpfin/disclosure-special-purpose-acquisition-companies.

(D. Del. Sept. 19, 2019) (basing Section 14(a) action on alleged failure to make disclosures related to line items and reconciliations underlying financial statements, the target's financial projections, terms of a non-disclosure agreements and letters of intent with potential targets, the basis for not hiring a financial advisor, and communications regarding future employment of the SPAC sponsors). More recently, however, plaintiffs' firms are couching such pre-closing disclosure-based claims as breach of fiduciary duty claims, often filing in New York state courts, and are honing in on the unique aspects of SPACs and deSPAC transactions.

To proactively combat such disclosure-based claims, it is critical that SPACs and the deSPAC target work together to ensure that proxy disclosures made in connection with the deSPAC transaction are materially complete and accurate. If a potential deficiency is raised before the deSPAC transaction is completed, it can often be addressed through an amendment to the SPAC's proxy statement, supplementing the prior disclosures with relatively minor additional disclosures, and the payment of a "mootness" fee to the plaintiffs' lawyers. In *Wheby*, for instance, one week after the complaint was filed, the SPAC revised its proxy statement to include additional information mooting the investor's claims and the investor voluntarily dismissed his complaint (with plaintiffs' counsel reserving its right to seek a mootness fee in connection with the supplemental disclosures). [4]

This said, plaintiffs are also pursuing SPAC-related litigation for purportedly false and misleading disclosures post-closing in instances where the surviving operating company's performance turns out to be disappointing despite optimistic representations in SEC filings made in connection with the deSPAC transaction. In these instances, in addition to Section 14(a) claims, plaintiffs have alleged claims under Section 10(b) and Rule 10b-5 of the Exchange Act, which prohibit intentional or reckless material misstatements or omissions in connection with the purchase or sale of a security. Perhaps most notably, the acquisition of Nikola Corp., the hydrogen-powered electric truck startup, by VectoIQ, a SPAC led by former General Motors executives, in June 2020, has recently led to a number of securities fraud class actions asserting Section 10(b) claims. [5] Following the deSPAC transaction, a detailed short seller report was published alleging that "Nikola is an intricate fraud built on dozens of lies." [6] Based on this short seller report, lawsuits now target VectoIQ's statements regarding its due diligence of Nikola in connection with the deSPAC transaction. Additionally, one of the lawsuits names the former CEO of the pre-merger SPAC as an individual defendant, alleging that he made misstatements during and subsequent to the announcement of the partnership with Nikola, including that VectoIQ had been on a "two-year quest to find a partner that was a proven technology leader" and that "Nikola's vision of a zero-emission future and ability to execute were key drivers in our decision." [7] The Nikola litigation, as well as other recent post-deSPAC transaction closing class actions [8] , highlight the critical importance of SPACs conducting robust due diligence in connection with any

[4] *See* Stipulation and Order of Dismissal, *Wheby v. Greenland Acquisition Corp.*, No. 1:19-cv-01758-MN (D. Del. Oct. 14, 2019), ECF No. 4.

[5] *Malo v. Nikola, et al.*, C.A. No. 5:20-cv-02168 (C.D. Cal. Oct. 16, 2020); *In re Nikola Corp. Deriv. Litig.*, C.A. No. 1:20-cv-1277 (D. Del. Sept. 23, 2020); *Borteanu v. Nikola et al.*, C.A. No. 2:20-cv-01797-PHX-JZB (D. Ariz. Sept. 21, 2020); *Wojichowski v. Nikola, et al.*, No. 2:20-cv-01819-DLR (D. Ariz. Sept. 17, 2020); *Salem v. Nikola, et al.*, No. 2:20-cv-04354 (E.D.N.Y. Sept. 16, 2020).

[6] *See, e.g.,* Complaint at 30-31, *In re Nikola Corp. Deriv. Litig.,* C.A. No. 1:20-cv-1277 (D. Del. Sept. 23, 2020).

[7] *Id*. at 29.

[8] *See, e.g., Pitman v. Immunovant, Inc. et al.*, Case No. 1:21-cv-00918 (E.D.N.Y. Feb. 19, 2021) (post-closing class action complaint filed against post-deSPAC public company, its CEO, its CFO, and former President and CEO of pre-merger SPAC alleging Section 10(b) and Section 20(a) claims focused on due diligence by SPAC).

deSPAC transaction, and detailed disclosures regarding that due diligence, to mitigate post-closing litigation risks.

The SEC has also shown recent interest in investigating completed deSPAC transactions where short-sellers make allegations about purported misleading disclosures. For example, on February 4, 2021, Hindenburg Research (the same short-seller who published the report on Nikola) published an article about the recently completed business combination between Clover Health Investments, Corp. ("Clover") and Social Capital Hedosophia Holdings Corp. III. The report alleged that Clover failed to disclose that it was under active investigation by the Department of Justice ("DOJ") in connection with alleged issues related to kickbacks, marketing practices, and third-party deals. [9] The following day, Clover announced that it had received a letter from the SEC indicating that the SEC had commenced an investigation regarding the contents of the short-seller report and requested related documents. [10] Following this announcement, class action lawsuits and a shareholder derivative action were brought against Clover and its officers and directors in federal courts asserting violations of the Exchange Act (Sections 10(b) and 20(a) and Rule 10b-5), violations of the Securities Act (Sections 11 and 15), breaches of fiduciary duties, and waste of corporate assets. [11]

The SEC's SPAC Guidance also provides plaintiffs' firms with guidance about the unique structural components of SPAC transactions, particularly as they relate to disclosures of potential conflict of interests, that will likely inform demand letters and lawsuits moving forward. With respect to SPAC IPOs, the SEC raised a number of questions focusing on the incentives of SPAC sponsors in light of the limited timeframe set for completion of an initial business combination; deferral of underwriting compensation and other underwriting related fees and services; fees and services to directors, officers and related parties; issuances of securities to SPAC sponsors and affiliates; voting control by the SPAC sponsor; other planned financing transactions; and related matters. In the context of the deSPAC transaction, the SEC highlighted the importance of disclosures surrounding financing undertaken concurrent with the deSPAC transaction and the terms of, and participation by affiliates in, such financings. The SEC's SPAC Guidance also emphasized disclosures surrounding potential conflicts between SPAC sponsors, directors and officers, and the interests of public shareholders in connection with the target company selected.

As plaintiffs' firms are now armed with a roadmap from the SEC regarding disclosures in the context of SPAC IPOs and deSPAC transactions, now, more than ever, it is critical that SPACs and their counsel ensure that disclosures are robust and accurate, particularly as they relate to deSPAC transactions. Disclosure-based risks are particularly heightened given that many D&O insurers have increased costs and decreased coverage capacity over the last year due to the historic pace of SPAC IPO filings. Accordingly, failing to address potential disclosure-based claims at the outset may lead to challenges that continue post-closing of the deSPAC transaction,

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[9] *Clover Health: How the "King of SPACs" Lured Retail Investors Into a Broken Business Facing an Active, Undisclosed DOJ Investigation*, Hidenburg Research (Feb. 4, 2021), available at https://hindenburgresearch.com/clover/.

[10] Clover Health Investments, Corp., Form 8-K (filed Feb. 5, 2021), available at https://www.sec.gov/Archives/edgar/data/1801170/000119312521029629/d29087d8k.htm.

[11] *Bond v. Clover Health Investments, Corp., et al.*, 3:21-CV-00096 (M.D. Tenn. Feb. 5, 2021); *Kaul v. Clover Health Investments, Corp., et al.*, 3:21-CV-00101 (M.D. Tenn. Feb. 5, 2021); *Yaniv v. Clover Health Investments, Corp., et al.*, 3:21-CV-00109 (M.D. Tenn. Feb. 10, 2021); *Fuhrman v. Garipalli, et al.*, 1:21-CV-00191 (D. Delaware Feb. 10, 2021).

which have a far greater likelihood for protracted, expensive litigation (and may not be covered by insurance or may cause insurance to become cost prohibitive).

Additional Process-Based Claims and the SEC's SPAC Guidance

SPAC litigation in 2021 will also likely see an increase in process-based claims given the SEC's focus on potential conflict of interests. As a general matter, under Delaware law, strategic decisions made by directors are typically afforded the protection of the deferential business judgment rule, which is a presumption that the directors "acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the Company." [12] However, this presumption may be rebutted if, among other things, it is shown that the directors had a conflict of interest in making the decision or breached their fiduciary duties (the duty of care or the duty of loyalty), in which case the burden shifts to the directors to defend the decision under the entire fairness standard. Entire fairness is the highest level of judicial scrutiny that, unlike the business judgment rule, examines the actual substantive merits of the Board's decision to determine whether that decision was inherently fair to shareholders. The Board must demonstrate that both the transaction process that was followed and the price that was achieved were both entirely fair to the Company's stockholders. As a practical matter, once that burden shifts, it is exceptionally difficult to get such claims dismissed at the initial stages of litigation.

Applying this to the SPAC context, certain structural terms of SPACs, highlighted in the SEC's SPAC Guidance, can make these transactions more prone to potential conflicts. For example, under its incorporating documents, a SPAC typically has a limited timeframe from the date of its IPO to either find a suitable target company or liquidate and return funds to investors. Where a deSPAC transaction is entered into near that liquidation deadline, and the share price suffers post-transaction, shareholders may allege that SPAC management rushed into an unfavorable transaction to avoid liquidation. An ongoing lawsuit arising out of the November 2018 acquisition of Waitr, a food delivery service, by the SPAC, Lancadia Holdings, Inc., demonstrates this potential risk. [13] *See Welch v. Meaux et al.*, No. 2:19-CV-1260 (W.D. La.). In particular, plaintiffs have alleged that the SPAC sponsors "raced to enter a merger agreement with Waitr" to avoid being "forced to return $250 million" and "to protect their reputations as high-power deal-makers." *Welch* Compl. 89.

The SEC's SPAC Guidance may also increase the likelihood of plaintiffs contending that the interests of SPAC sponsors are not sufficiently aligned with stockholders to warrant the business judgment presumption as SPAC sponsors generally lose their "founder's shares" in connection with liquidation, a theory endorsed by at least one state court at the pleading stage, but not recently tested. [14] Recent complaints filed in New York state courts in connection with deSPAC transaction disclosures have included allegations challenging the interests of SPAC directors who

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[12] *Orman v. Cullman*, 794 A.2d 5, 19-20 (Del. Ch. 2002). Although some SPACs have been domiciled in Delaware, they are more typically incorporated in the Cayman Islands ("Cayman") such that Cayman law would apply to breach of fiduciary duty claims brought by SPAC stockholders. Under Cayman law, a director is a fiduciary with respect to the corporation and owes the corporation a duty to act in its best interests and refrain from self-dealing, abuse of power, and conflicts of interest. *See* 9 Fletcher Corp. Forms § 35:163 (5th ed.).

[13] *See Welch v. Meaux et al.*, No. 2:19-CV-1260 (W.D. La.).

[14] *See AP Services, LLP v. Lobell,* No. 651613/12, 2015 WL 3858818, at *6 (N.Y. Sup. Ct. June 19, 2015) (allegations regarding SPAC structure—in which a majority of SPAC directors held stock and warrants that would be rendered worthless absent a deSPAC transaction—sufficient at the pleading stage to rebut presumption of business judgment).

allegedly stood to lose founders' shares and warrants in the event a business combination did take place. Conflicts may also arise when private equity and venture capital firms form SPACs and then ultimately acquire one of the sponsor's portfolio companies. Although an increasingly common phenomenon, these transaction pose a much higher risk of potential conflicts as there may be overlap in directors of the SPAC and directors on the target portfolio company's Board and the sponsor may have blocking rights or financial interests in the portfolio company that deviate from the other investors' interests.

Accordingly, for SPAC business combinations, perhaps even more so than in the traditional M&A context, adherence to a thorough and well-documented transaction process is critical. Although each transaction presents its own unique circumstances that should be considered, in general, we recommend consideration of the following:

- **Board meetings**. SPAC boards should endeavor to regularly hold board meetings in accordance with standard formalities, including the taking of minutes (which should be reviewed by counsel). These meetings should also increase in frequency upon the identification of a likely target and engagement with this target. Board meeting discussions should include: (i) the board's review of various alternative transactions; (ii) the board's fiduciary duties; (iii) disclosure of all potential conflicts of interest that the directors may have and how the board and its advisors are addressing such potential conflicts of interest; (iv) due diligence efforts and progress; and (v) in certain circumstances (as described in more detail below), the potential engagement of a financial advisor.
- **Board materials**. The SPAC board should also review written materials (reviewed by counsel and its financial advisor if applicable) that reflect valuation analyses, projections, transaction terms and negotiation thereof, interests of the sponsors/promoters in the transaction, and alternatives that were considered.
- **Special transaction committee**. In certain circumstances, a board may consider forming a special transaction committee to analyze potential operating companies and to evaluate and negotiate the deal under certain circumstances. This safeguard may be particularly useful and advisable in instances in which a private equity or venture capital firm is considering its portfolio company as a potential target.
- **Management guidelines**. A board should establish appropriate guidelines regarding communications between members of SPAC management and the target company related to employment with the target without board authorization to avoid any perceived conflicts relating to such discussions.
- **Due diligence**. Due diligence efforts should be thorough and well-documented such that, if necessary, they can be accurately reflected in disclosures in connection with the deSPAC transaction.
- **Financial advisor**. In certain circumstances that are more ripe for conflicts, a SPAC board may want to consider whether to engage an independent financial advisor to provide a fairness opinion, which SPAC boards can obtain for a flat opinion fee versus a contingent transaction fee based on a percentage of deal value. In public M&A transactions, the retention of a financial advisor, including in connection with material buyside transactions, is customary given financial advisors' expertise to evaluate the potential transaction and other alternative transactions, conduct valuation analyses, and assist the board in negotiations. However, courts have indicated that where a board consists of highly sophisticated members, as is generally the case in the SPAC-context, a

board is not required to seek the assistance of a financial advisor. Thus, fairness opinions are typically not necessary or obtained in connection with deSPAC transactions. Nonetheless, to the extent there are anticipated conflict of interest concerns, particularly in the context of potential overlap in relationships between the SPAC and the target company, engaging an independent financial advisor may provide additional protection for the board. If retained, the financial advisor should complete a customary conflicts questionnaire and the board should document its discussion relating to the rationale for selecting the particular financial advisor and any conflicts or lack of conflicts on the part of the financial advisor.

- **Transaction resolutions**. The SPAC board should adopt appropriate resolutions approving the transaction and related matters.
- **Target company**. The operating company target also should be engaging in a similar, robust process, as it too could be subject to a post-closing breach of fiduciary duty claim from the operating company's stockholders, and the SPAC sponsor could be named as defendants in an aiding and abetting breach of fiduciary duty claim.
- **Disclosures**. The SPAC board and the target company should also work together to ensure that disclosures related to the business combination are materially complete and accurate to reduce the risk of protracted and expensive litigation.
- **D&O Insurance**. The SPAC board and the target company should also carefully analyze the combined company's D&O coverage (with input from counsel) and consider whether the amount and scope of insurance are appropriate and understood by the company. In addition to the consideration of any deal specific issues, the SPAC board and target company should focus on whether: (i) all operating entities are covered not only for post-closing liabilities, but also pre-combination liabilities (which typically involves runoff or tail insurance for both the SPAC and operating companies, as well as go-forward coverage for the combined entities); (ii) there is appropriate coverage for directors and officers; (iii) the definition of securities claim in the combined policy is as broad as possible in the market; and (iv) any exclusions are as narrow as available in the market.