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Delaware Update: Court of Chancery Opens Door to Entire Fairness Review of SPAC Mergers

January 13, 2022

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On January 3, 2022, in a case of first impression,[1] the Delaware Court of Chancery examined the viability of fiduciary duty claims against special purpose acquisition company (SPAC) directors in the context of a de-SPAC transaction. Addressing a complaint brought by former stockholders of Churchill Capital Corp. III, a SPAC, alleging that material facts were omitted from the proxy statement issued in connection with its de-SPAC merger with Multiplan, Inc., the Court held that the stockholders stated a plausible claim for breach of fiduciary duty, thus impairing stockholders' right to make an informed decision on whether to redeem their shares. The Court also found that the entire fairness standard of review – and not the more lenient business judgment rule – applied to the de-SPAC merger due to "inherent conflicts between the SPAC's fiduciaries and the public stockholders in the context of a value-decreasing transaction."[2]

In February 2020, Churchill Capital Corp. III, a SPAC sponsored by former Wall Street executive Michael Klein, completed its $1.1 billion initial public offering. After searching for a de-SPAC opportunity, the SPAC merged with MultiPlan in October 2020. The central allegation of the stockholders' complaint was that the proxy statement issued in connection with the Merger omitted the fact that MultiPlan's largest customer, UnitedHealth Group, Inc., which accounted for 35% of MultiPlan's revenues, intended to create a data analytics platform that would compete with MultiPlan and cause UnitedHealth Group to stop working with MultiPlan in the future.[3] The stock of the combined company closed at $11.09 per share when the merger was completed but fell to $6.27 per share within a month.

[1] *In re MultiPlan Corp. S'holders Litig.*, 2022 WL 24060, at *1 (Del. Ch. Jan. 3, 2022)

[2] *Id.* at *19.

[3] *Id.* at *6.

I. Threshold Issues

In analyzing the motions to dismiss, the Court first looked at three threshold questions. First, it analyzed whether plaintiffs' claims were direct or derivative. The plaintiffs' claims were asserted as direct, but the defendants argued that they were derivative, and therefore subject to dismissal for failure to comply with the demand requirement. Using the well-established standard from *Tooley v. Donaldson, Lufkin & Jenrette, Inc.* analysis the Court found that the claim that the stockholders' right to choose redemption of their shares was direct.[4] The harm from impairment of the redemption choice was personal to the stockholders, and any recovery would go directly to stockholders, as opposed to the company.

Second, the defendants argued that the case should be dismissed because the plaintiffs' lawsuit was a contract claim, not a fiduciary duty claim. Fundamentally, plaintiffs' complaint was not based on the company's offer to redeem or the stockholders' acceptance of that offer. Instead, plaintiffs' claim was that the directors took actions to impair stockholders' ability to make an informed choice with respect to the contractual right to redeem.

Lastly, the Court ruled that the plaintiffs' claims are not holder claims - claims that a stockholder was wrongfully induced to hold stock instead of selling it – which are generally not recognized under Delaware law. The Court found that rather than a decision to hold or sell, the stockholders had to make an active choice to "divest or invest in the post-merger entity, approve or disapprove the merger."[5]

II. Breach of Fiduciary Duty Claim and Entire Fairness Review

Turning to the central breach of fiduciary duty theory, the Court found that the appropriate standard of review was entire fairness, rather than the business judgment rule. The Court outlined two independent paths toward application of the entire fairness standard of review.

A. Conflicted Controller

The parties agreed that Klein, as controller of the Sponsor, was Churchill's controlling stockholder. Consistent with precedent, the Court found that entire fairness would apply only if Klein engaged in a conflicted transaction – one in which Klein received a unique benefit by "extracting something uniquely valuable to the controller, even if the controller nominally receives the same consideration as all other stockholders to the detriment of the minority."[6]

In determining that any de-SPAC merger would be a conflicted transaction, the Court examined the differing incentives between Klein and the Class A, or public, stockholders. Because Klein's Founder Shares (he indirectly owned 70% of the Class B shares) and Private Placement Warrants would gain him a significant return on his $25,000 investment if any merger were consummated, while they would be worthless if Churchill did not complete a transaction, Klein was motivated to complete a merger.[7] Churchill's public stockholders, on the other hand, would receive either $10.04 upon redemption, or merger consideration worth more or less than that depending on the success of the combined company if a deal were consummated, or would still receive $10.04 per share if Churchill failed to close on a merger

[4] 845 A.2d 1031 (Del. 2004).

[5] *In re MultiPlan Corp. S'holders Litig.*, 2022 WL 24060, at *16 (Del. Ch. Jan. 3, 2022).

[6] *Id.* at *17.

[7] *Id.*

and liquidated instead.[8] As such, the Court found that the Complaint adequately alleged that Klein engaged in an interested transaction.[9]

Importantly, the Court rejected the argument that disclosure in the proxy of the structure of the SPAC and Klein's differing interests and incentives neutralized the interested nature of Klein's actions. Despite the disclosure of the potential conflicts, the Company still had an obligation to disclose all material facts relating to the merger.

B. Director Self-interest and Lack of Independence

The Court also found that the entire fairness standard of review was separately applicable because a majority of the directors were interested and not independent. The Court found that Klein had the power to appoint the whole SPAC board, each director had familial or financial ties to Klein, and each received economic interests in a substantial number of Founder Shares, which incentivized them to engage in a de-SPAC transaction. The court agreed with the plaintiffs that there was both self-interest and a lack of independence, requiring the application of entire fairness.[10]

III. Key Takeaways

- Given the typical structure of SPACs, sponsors will generally be considered controlling stockholders given their superior voting rights. The "entire fairness" standard of review will apply to a transaction effected by a controlling stockholder only if it is an interested transaction. The *MultiPlan* Court found that any de-SPAC transaction proposed by the Sponsor would be an interested transaction because the Sponsor was motivated to complete a transaction. Thus, the entire fairness standard of review will apply to claims that a SPAC impaired the stockholders' ability to make a decision about redemption.
- Given the Court's holding that the entire fairness standard of review applies, and given the uncertainty with how that standard will be applied to a disclosure claim, sponsors should consider appointing at least some independent and disinterested directors to the Board who could act as a Special Committee to review the proposed de-SPAC transaction. This may at least shift the burden to a challenging stockholder to show that the directors acted in an interested fashion.
- Compensating SPAC directors with Founder Shares, while seemingly the norm, will likely compromise the independence of those directors for purposes of fiduciary duty claims. Consideration should be given to compensating at least some of the directors with other forms of consideration, including cash and Class A shares. In addition, service on multiple SPAC boards for the same Sponsor may adversely affect a director's independence.
- Disclosure of all material facts regarding the proposed de-SPAC transaction is the chief deterrent for viable claims against SPAC directors. More than once in the opinion the Vice Chancellor

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[8] *Id.* at *18.

[9] The Court rejected defendants' arguments that certain provisions intended to align Klein's interests with the Class A stockholders were sufficient to insulate the transactions from a potential conflict of interest. Specifically, the Court was not swayed by the defendants' arguments that having the Founder Shares locked up and an "unvestment" of 45% of the founder shares insulated the transaction from a potential conflict of interest, because while these measures did lower Klein's potential gain, the Court could not say that they would negate it. *Id.*

[10] The court also denied a motion to dismiss an aiding and abetting claim brought against the investment bank that advised the SPAC. Plaintiffs alleged that the Klein Group, the financial advisor group controlled by Klein's brother, knew that its analysis in the proxy was materially misleading. The court permitted the claim to stand because Klein's knowledge on these matters, which had been adequately alleged, could be imputed to the Klein Group. *Id.*

noted that the motion to dismiss would have been decided differently absent the allegation that a material fact was not disclosed. From a deal perspective, this obviously puts an emphasis on thorough due diligence and fulsome disclosure in deal proxies.

- The good news is that unlike the typical merger litigation, where disclosure claims arise from the decision of stockholders whether to vote for or against the merger, and whether to seek appraisal, claims brought in the SPAC context will focus on the decision of the SPAC stockholders whether to submit their shares for redemption. Defeating such a claim is a matter of providing appropriate disclosure, which is far easier than proving fair process and fair price with respect to the merger transaction.
- The *MultiPlan* opinion was decided on a motion to dismiss. As such, there remain outstanding questions, including how the entire fairness elements of fair process and fair price will be applied to a disclosure claim, and how damages will be calculated, assuming plaintiffs prevail on liability.

Milbank advises on special purpose acquisition company (SPAC) transactions. Our team represents SPAC sponsors and underwriters in structuring SPACs and completing their IPOs; SPACs and target companies in SPAC business combination transactions; and investors considering investments in SPACs. We also help clients navigate SPAC litigation and enforcement matters, and claims brought under the Investment Company Act. Our attorneys have a deep understanding of not only the legal issues impacting SPACs, but also the business, marketing, and industry issues that affect the success of SPACs.

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