Katten

Delaware Chancery Court Issues *Delman* Decision Potentially Increasing Scrutiny of the Actions of SPAC Sponsors and Boards

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On January 4, the Delaware Chancery Court issued a second decision suggesting that SPAC sponsors and directors proceed with care in connection with de-SPAC transactions (and potentially future SPAC formation). As a result of the recent decision in *Delman v. Gigacquisitions3, LLC, et al.* and the prior opinion in *In re Multiplan Corp. Stockholders Litig.*, sponsors and directors of SPACs should consider if their policies and procedures around proxy statement disclosures, diligence, board discussions, financial valuations, capital raising and de-SPAC transactions could be potentially subject to criticism after the fact if litigation arises.

The opinion in *Delman v. Gigacquisitions3, LLC, et al.*, Case No. 2021-0679 (*Delman*), came approximately one year after the first such opinion in *In re Multiplan Corp. Stockholders Litig.*, Case No. 2021-0300 (*Multiplan*), and was decided by the same vice-chancellor as Multiplan. The basic facts alleged in *Multiplan* were similar to *Delman*. Both SPACs had sponsors who paid less for their shares of stock in the SPAC than the public stockholders and who forfeited their shares of stock if there was no de-SPAC transaction, allegedly lacked independent directors, closed a de-SPAC transaction without obtaining a fairness opinion from an independent financial advisor, failed to disclose allegedly material facts about the target company, ascribed valuations to the target company that were tied to aggressive growth projections, and saw the price of their shares drop significantly after the merger.

Background in *Delman*

GigCapital3, Inc. (Gig3 or the SPAC) was formed as a SPAC with GigAcquisitions3, LLC as its sponsor (Sponsor) in February 2020 and completed its IPO in May 2020. Avi Katz was the founding managing partner, Chief Executive Officer and Executive Chairman of GigCapital Global; he also held a controlling interest in the Sponsor; and he was the managing member of the Sponsor as well. Katz was Gig3's Executive Chairman, Secretary, President, and CEO. As is typical in the formation of SPACs, the Sponsor held a 20 percent equity interest in the SPAC, which it obtained for a cash payment of $25,000. Through the Sponsor Katz selected Gig3's initial directors and officers, which consisted of Katz, his spouse, and his associates at GigCapital Global.

After its IPO, the SPAC identified Lightning eMotors, Inc. (Lightning), an electric vehicle manufacturer focused on zero-emission medium duty vocational vehicles and shuttle bases, as its merger target. Katz and his spouse allegedly led the negotiations with the target. In connection with the de-SPAC transaction, two of Gig3's IPO underwriters were hired to serve as Gig3's financial advisers. As is typically the case, the payment of the majority of the underwriting compensation to the underwriters ($8 million) was contingent upon the completion of a de-SPAC transaction. In addition, the underwriters had collectively purchased 243,479 private placement units during the IPO that would be worthless if Gig3 did not complete a merger. Gig3's board did not obtain a fairness opinion in connection with the transaction.

In the proxy provided to the SPAC's shareholders by which they determined whether to redeem their shares or not, the value per share that the target stockholders were to receive was described as Gig3 stock valued at $10 per share. The proxy also contained projections prepared by Lightning that forecasted dramatic growth, including revenues rising from $9 million in 2020 to more than $2 billion in 2025 and profits growing from zero in 2020 to over $500 million in 2025. In connection with the redemption election and vote, approximately 29 percent of the public stockholders elected to redeem their shares, and 98 percent of the votes were cast in favor of the merger. The disparity between the redemption election and the votes against the merger result from the typical decoupling of economic and voting interests in the SPAC structure. Stockholders who elect to redeem their shares still own warrants in the company and can vote in favor of the transaction. These stockholders are actually incentivized to vote in favor of the transaction because deal approval provides them with both a return of the cash they invested plus interest and warrants in the merged entity. In contrast, if the stockholders do not approve the deal, the stockholders who elected to redeem must wait for the SPAC to search for another target (and wait for such deal to be approved and close) or until the end of the term of the SPAC to get back the money that they invested (and, if the SPAC's term ends without a deal, the warrants expire worthless).

The merger closed on May 6, 2021. Shortly thereafter, the company reduced its 2021 revenue guidance, and in August 2021, a lawsuit was filed against the SPAC's directors and officers, alleging breach of fiduciary duty claims. The complaint alleges that the Sponsor served as a controlling stockholder of the SPAC and that the Sponsor and members of the board were conflicted. It also alleged that the proxy contained false and misleading statements concerning the value per share of the SPAC and the target's projections. As a result, the defendants moved to dismiss.

Holdings in *Delman*

(1) *The Court Held Disclosing Board Conflicts Is Not Sufficient for Estoppel in a Conflicted de-SPAC Transaction*

While the facts alleged were not as extreme as in *Multiplan*, in *Delman* the court held that the Sponsor was a controlling stockholder through its minority ownership interest, selection of the members of the board, close ties to and influence over each of the directors, and "unrivaled authority over the [SPAC's] business affairs." It held that the Sponsor's interests differed from the public stockholders because it had not paid the same amount as the public stockholders for its initial shares and had an interest in minimizing redemptions. The court also held that the directors who were not employees of the Sponsor were conflicted because they had multiple positions within the enterprise of the Sponsor, even though these directors were paid in cash and not in shares of stock of the SPAC. With respect to both of these issues, the court further held that the disclosure of these conflicts in the proxy did not amount to estoppel because "Delaware corporate law 'does not allow for a waiver of the directors' duty of loyalty.'" The court thus held that the entire fairness standard of review applied to the transaction. Delaware courts rarely, if ever, grant motions to dismiss where a transaction is subject to entire fairness review. Thus, the holding that entire fairness review applies makes it very difficult for SPAC sponsors and directors to win a motion to dismiss and potentially avoid burdensome discovery.

(2) *The Court Held the Current Method of SPAC-share Valuation Is Misleading*

The court also held that the proxy by which stockholders in the SPAC decided whether to exercise their redemption rights was misleading for two reasons. First, the court held that the net cash per share that the SPAC was investing in the target was not $10 per share because of various costs and dilution by sponsor shares of stock in the SPAC and other equity interests. In so doing, the court relied upon an analysis set forth by Professor Michael Klausner, who was also acting as co-counsel for the plaintiff in *Delman*. The analysis was described in two academic papers published in 2022 (Klausner Valuation Methodology) though the court did not adopt any specific valuation methodology.[1] Second, the court held that the target projections in the proxy were too "lofty" and "not

[1] Michael Klausner, Michael Ohlrogge & Harold Halbhuber, "Net Cash Per Share: The Key to Disclosing SPAC Dilution," 40 Yale J. Reg. 18 (2022); Michael Klausner, Michael Ohlrogge & Emily Ruan, "A Sober Look at SPACs," 39 Yale J. Reg. 228 (2022).

counterbalanced by impartial information" such that the SPAC stockholders knew the risks of the new company in which they would be investing if they did not redeem their shares. The court thus held that the proxy was misleading.

(3) *The Court Held Corwin Cleansing Is Not Available for Transactions With Decoupled Shareholder Votes*

Under *Corwin v. KKR Financial Holdings LLC*, conflicted transactions are still subject to business judgment review, the standard by which courts do not second guess and defer to the directors' decisions, as long as the transactions are approved by a stockholder vote of fully informed stockholders. A stockholder vote is afforded deference under Delaware law because stockholders are presumed to be "impartial decision-makers" with an "actual economic stake in the outcome" of the merger.[2] However, the *Delman* court found that *Corwin* cleansing was not available to the de-SPAC transaction. First, as discussed above, it held that the proxy was materially misleading and as a result the stockholder vote was not fully informed. Second, it held that the shareholder vote in a de-SPAC does not reflect its investors' collective economic preference because stockholders' voting interests are decoupled from their economic interests. The court noted, "[t]he vote could have held greater importance if stockholders' voting and economic interests had been 'recoupled' by requiring redeeming stockholders to vote against the deal." Thus, it seems that even if the court held that the proxy was not misleading, *Corwin* cleansing would not work, the transaction would not be subject to business judgment review, and entire fairness would still apply.

The court's ultimate conclusion was to deny the defendants' motion to dismiss. It is presently unknown whether the defendants in *Delman* will attempt to appeal the court's decision. There was no appeal of the similar decision in the *Multiplan* case, which then settled for $33.75 million.

Next Steps and Recommended Best Practices

As a result of the decisions in *Delman* and *Multiplan*, sponsors and directors of SPACs should consider if additional procedural structures and substantive protections in connection with a de-SPAC are warranted. These protections may include the following:

- Enhanced disclosure of the potential conflicts of interest that exist between the SPAC Board, the Sponsor, the target company, the financial advisors, the underwriters, and any other parties that have a meaningful role in the valuation or approval of the de-SPAC transaction.
- A description of the cash value per share calculated in accordance with the principles underlying the Klausner Valuation Methodology discussed in *Delman*, or additional metrics detailing the total amount of dilution and the amount of cash on hand after the completion of the de-SPAC transaction.
- More careful disclosure concerning target projections, including underlying assumptions and risks to such projections.
- Meaningful discussions between the board members about the various options for the potential target, the target's potential value, and the risks to that valuation.
- A comprehensive diligence process conducted on the target and its projections, and appropriate documentation of the diligence process.
- A fairness opinion from an independent investment bank whose compensation is not contingent on the closing of the de-SPAC merger.
- For newly formed SPACs, consideration as to whether to appoint directors free from business and personal conflicts and how directors' independence may be affected by the form of their compensation, whether in cash or equity interests in the SPAC or the sponsor.

[2] *Corwin v. KKR Financial Holdings LLC*, 125 A.3d 313-314 (Del. 2015).

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