Quinn Emanuel Private Equity Litigation Practice Alert

Litigation Risk in the SPAC World

It seems that it is impossible to talk to any fund today without learning that a SPAC is planned or in process. SPACs are vehicles for taking companies public in a way that is potentially more efficient and quicker than a conventional direct or underwritten public offering. For all the enthusiasm for SPACs, however, there is little discussion of the potential for liability. There are conflicts and risks inherent in the typical SPAC which are little discussed. In fact, the SEC recently announced that it will be carefully scrutinizing SPACs, and particularly the incentives of SPAC sponsors, going forward.[1]

As in any market, as more deals are consummated, more deals will not work out. When deals do not work out, litigation will follow. The massive amount of SPAC capital being raised has created a huge demand for suitable acquisition targets. This dynamic—more capital chasing a fixed pool of deployment opportunities—presents heightened litigation risks for SPAC sponsors, investors, and targets alike. SPAC market participants must simultaneously navigate state and federal securities laws, the complex body of law governing mergers and acquisitions, as well as familiar contract issues raised in a unique context. In this Client Alert, we provide a preview of litigation risks that will arise in this red-hot market. We highlight general principles that may be gleaned from SPAC-related litigation to date, and forecast potential shifts in the litigation landscape as a result of the current influx of SPAC capital.

I. What if negotiations with a target break down?

Once a SPAC and target enter into serious negotiations, the breakdown of those negotiations can present a situation ripe for blame and even litigation.

The SPAC and the target company may sue each other for breach of contract or breach of the duty to negotiate in good faith.[2] From the SPAC's perspective, a suit alleging breach of contract or breach of the duty to negotiate in good faith must be brought by or on behalf of the SPAC itself. Generally, a sponsor will not be able to seek relief from a target for a failed acquisition unless the sponsor is independently a party to the negotiations or any written agreements. Of course, a sponsor may rationally choose to stay out of the contracts to limit its liability, but that will also tend to limit its ability to seek a remedy. For example, in *Bogart v. Israel Aerospace Indus. Ltd.*, No. 09 CIV. 4783 (LAP), 2010 WL 517582 (S.D.N.Y. Feb. 5, 2010), the court found that the SPAC's sponsor did not have standing to bring a claim for breach of the duty to negotiate in good faith because it could not establish an independent duty running from the target company to the sponsor.[3]

Even where standing exists, a duty to negotiate in good faith may not. A preliminary agreement will generally be required to find a duty, and whether a preliminary agreement is sufficiently definite to give rise to such a duty depends on "(1) whether the intent to be bound is revealed by the language of the agreement; (2) the context of the negotiations; (3) the existence of open terms; (4) partial performance; and

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1 *See* https://www.cnbc.com/video/2020/09/24/sec-chairman-jay-clayton-on-disclosure-concerns-surround-going-public-through-a-spac.html.

2 *See, e.g.*, *Bogart v. Israel Aerospace Indus. Ltd.*, No. 09 CIV. 4783 (LAP), 2010 WL 517582 (S.D.N.Y. Feb. 5, 2010).

3 By contrast, in *OpenGov, Inc. v. GTY Tech. Holdings Inc.*, No. 18-CV-07198-JSC, 2019 WL 978769 (N.D. Cal. Feb. 28, 2019), the Court declined to find that the sponsor was fraudulently joined in a case alleging claims for inducing breach of contract, fraud, and trade secret misappropriation.

(5) the necessity of putting the agreement in final form, as indicated by the customary form of such transactions."[4] A mere breakdown in negotiations does not necessarily indicate bad faith. Even this kind of preliminary agreement "does not guarantee that the final contract will be concluded [even] if both parties comport with their obligation, as good faith differences in the negotiation of the open issues may prevent a reaching of final contract."[5] Whether a duty to negotiate in good faith exists and has been breached is an inherently fact-intensive inquiry. The typical 18 month to two year runway a SPAC has to complete a business combination, and the financial consequences to the sponsors of missing that window, has itself been cited as evidence of bad faith.[6]

Finally, sponsors and targets may agree to shift deal-related fees and costs. For example, the SPAC may agree to reimburse the target for some of the costs it incurs while exploring the potential merger. If negotiations break down, there may be disputes about the costs and fees sought by the target, or the justification for non-payment by the sponsor, based on the circumstances of the break down.[7] Again, the success of these claims will turn on the facts of the case and the wording of the relevant contract. When sponsors or targets foresee a failed negotiation, they may be wise to seek independent litigation counsel early to provide a more objective perspective on the agreement and to assist dealmakers and their deal counsel in charting the remaining course of the negotiations.

The SPAC's shareholders may sue the SPAC's officers and directors for breach of fiduciary duty. The business judgment rule will ordinarily preclude SPAC shareholders from recovering on a theory that the SPAC's directors breached their duty of care in failing to consummate negotiations.[8] Absent a failure to act in good faith, the business judgment rule will excuse directors who (1) have acted or made a conscious decision not to act, (2) were disinterested, and (3) were not grossly negligent in informing themselves of the relevant information.[9] In most cases, the key question will be whether the director was grossly negligent in informing him or herself of the relevant information. Gross negligence is a difficult standard to meet. SPAC sponsors may also build exculpatory provisions into the SPAC's governing documents that can limit their liability.

In some cases the SPAC's directors may not be disinterested. For example, if the SPAC's directors reject a proposed merger that later goes to an affiliate of the sponsor, the directors may be determined not to be disinterested and the heightened scrutiny of the entire fairness rule may be applied.[10]

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[4] *Brown v. Cara*, 420 F.3d 148, 153, 157 (2d Cir. 2005) (citation omitted).

[5] *Id.* at 157(citation omitted).

[6] The potential target may also accuse the SPAC of entering into merger negotiations to steal the potential target's trade secrets while performing due diligence. For example, in *OpenGov, Inc.*, 2019 WL 978769, a potential target company sued the SPAC and its sponsors, alleging that the SPAC ran out of time to complete a business combination, so instead stole and executed the target's business development strategy. Such cases will be governed by the trade secret law of the relevant state, as well as the terms of any agreements executed between the SPAC and target company.

[7] *See, e.g.*, *Vanship Holdings Ltd. v. Energy Infrastructure Acquisition Corp.*, 65 A.D.3d 405, 406 (N.Y. App. Div. 1st Dep't 2009).

[8] *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984), *overruled on other grounds by Brehm v. Eisner*, 746 A.2d 244 (Del. 2000).

[9] *See id.*

[10] The SPAC's directors could also be liable for converting a corporate opportunity. *See Guth v. Loft, Inc.*, 23 Del. Ch. 255, 272-73 (Del. 1939) ("[I]f there is presented to a corporate officer or director a business opportunity which the corporation is financially able to undertake, is, from its nature, in the line of the corporation's business and is of practical advantage to it, is one in which the corporation has an interest or a reasonable expectancy, and, by embracing the opportunity, the self-interest of the officer or director will be brought into conflict with that of his corporation, the law will not permit him to seize the opportunity for himself."). Other consequences may result from a conflict over director disinterest; for example, in *Opportunity Partners, L.P. v. Transtech Serv. Partners Inc.*, No.

If the SPAC dissolves following a failed merger, the SPAC must return the shareholders' money to the shareholders. However, a SPAC's corporate documents generally permit the SPAC's management to collect fees first. The shareholders may challenge the management fees as excessive. For example, in *Ruffal v. Transtech Serv. Partners Inc.*, the defendant SPAC had obtained shareholder approval to dissolve following two failed attempts at a business combination. Certain shareholders, facing a loss on their investment in the company upon dissolution, challenged the fees being taken out of the deal by the sponsors. Although ultimately the Court concluded that the corporate charter did not place a limit on those fees, it did uphold a direct claim by the shareholders to enforce the terms of that charter.[11] The success of such actions will depend on the wording of the relevant corporate documents and the evidence regarding the reasonableness of the fees.

Investment banks or investment advisors may sue for unpaid fees. In a SPAC transaction, one or more of the parties may have engaged investment banks or other financial advisors. As compensation for this advice, parties typically agree to pay the bank or advisor a finder's fee. If the transaction falls through and the party fails to pay, the bank or advisor may sue.[12] These cases will also generally involve claims for breach of contract or breach of the implied covenant of good faith and fair dealing. In some cases, other parties to the transaction are sued for tortious interference with the bank or advisor's contract. Depending on deal-specific facts and the wording of the relevant contract, a party may argue that no fees are owed because the transaction never closed, or because the party located its potential partner on its own, or that the broker or advisor failed to provide the agreed-upon services with the appropriate standard of care.

Failed negotiations may generate accordion litigation. Once litigation over a failed merger is commenced, it may cascade into a series of claims relating to the circumstances of the break up under a variety of claims and theories. For example, in *Morgan Joseph TriArtisan, LLC v. BHN LLC*,[13] an investment bank sued the target company that had hired it for failure to pay fees based on the investment bank's successful introduction of the target company to a SPAC. The target company cross-claimed against the SPAC seeking reimbursement under their deal documents; this led to claims and cross-claims asserting conversion, misappropriation, and unjust enrichment. SPAC sponsors and targets may therefore be well advised to engage litigation counsel early on as potential disputes surface, to think through the downstream implications of any given dispute as well as assisting in documenting the parties' performance.

Current trends. Given the dynamics in the current SPAC market, with increasing amounts of capital looking to the same pool of opportunities, we expect litigation to arise when targets abandon negotiations with one SPAC for another SPAC making a different offer.

CIVA 4340-VCP, 2009 WL 997334 (Del. Ch. Apr. 14, 2009), a shareholder who objected to the proposed business combination successfully sued to force the SPAC to hold an annual meeting to elect directors, because the SPAC had failed to hold one, as required by Delaware law, in more than thirteen months.

11 *See, Ruffalo v. Transtech Serv. Partners Inc.*, No. CIV.A. 5039-VCP, 2010 WL 3307487 (Del. Ch. Aug. 23, 2010).

12 *See, e.g.*, *Morgan Joseph TriArtisan, LLC v. BHN LLC*, 651969/2014, 2017 WL 3951623 (N.Y. Sup. Ct. Aug. 21, 2017) (investment banks); *Threadstone Advisors, LLC v. LXR Prods. De Luxe Int'l, Inc.*, 17 Civ. 9255 (PGG), 2019 U.S. Dist. LEXIS 53283 (S.D.N.Y. Mar. 27, 2019) (investment advisors).

13 2017 WL 3951623.

II. What if the target company's shareholders object to the proposed merger?

Even if the SPAC and the target's management agree to merge, the target company's shareholders may object at the time of the merger. Historically, shareholders have used two strategies to block the merger or seek increased compensation.[14]

Target company shareholders may sue to exercise their statutory appraisal rights. When a SPAC targets a Delaware corporation, and the target's shareholders believe their compensation from the deal is insufficient, they may sue to exercise their statutory appraisal rights under Section 262(b)(1) of the Delaware Code.[15] Exceptions to appraisal rights, such as the "market out" exception, are generally only available if the target corporation is "either: (i) listed on a national securities exchange or (ii) held of record by more than 2,000 holders."[16] Because the SPAC merger is designed to take a private company public, most SPAC targets will not satisfy either criterion of § 262(b)(1).[17] Therefore, if the target is a Delaware corporation, some of their shareholders likely will be entitled to an appraisal.[18]

When a shareholder requests and is entitled to an appraisal, a Delaware court "shall determine the fair value of the [shareholder's] shares exclusive of any element of value arising from the accomplishment or expectation of the merger or consolidation," "tak[ing] into account all relevant factors."[19] Because there may be limited market evidence of value available for these largely privately held companies, this will frequently will require the Court to choose between dueling expert values (or set its own value in the middle).[20] Then, the corporation will be forced to purchase the shareholder's shares at the price identified by the Court.

A recent decision from the Delaware Chancery court is instructive. In *Manichaean Capital*, the SPAC faced significant redemptions in advance of the business combination closing, and had to scramble to arrange private investment in public equity ("PIPE") and other financing to ensure that it had sufficient capital to complete the combination. Ultimately, while the target company used one equity valuation for its investor presentations and lender pitches, the proxy statement filed for the business combination disclosed a much lower equity valuation that included a 25% "IPO discount," effectively seeking to bake in the capital that is often lost when companies go public through a traditional IPO.[21] A significant shareholder of the target company sought a statutory appraisal, and the Court determined that the fair value

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14 Shareholders in the target company may have additional claims after the merger is complete, in the event that the value of their holdings declines, as discussed in the next section.

15 *See, e.g.*, *Manichaean Capital, LLC v. SourceHOV Holdings, Inc.*, No. CV 2017-0673-JRS, 2020 WL 496606 (Del. Ch. Jan. 30, 2020), *reconsideration denied*, No. CV 2017-0673-JRS, 2020 WL 1166067 (Del. Ch. Mar. 11, 2020), and *judgment entered*, (Del. Ch. 2020).

16 8 Del. C. § 262(b)(1).

17 Moreover, SPAC transactions are generally too large to take advantage of the *de minimis* exception in § 251(f).

18 However, those who "vote[] in favor of the merger" or fail to properly request an appraisal cannot exercise their appraisal rights. 8 Del. C. § 262(a).

19 8 Del. C. § 262(h).

20 *Manichaean Capital, LLC*, 2020 WL 496606 ("[T]hese disagreements have placed the Court in the now familiar position of grappling with expert-generated valuation conclusions that are solar systems apart. Good times. ...").

21 Because IPO shares are first placed with private investors at a price that will ensure oversubscribed orders for the new stock, the stock is frequently undervalued and increases rapidly (or "pops") when public trading commences. While the price on the public markets likely reflects the "true" equity value of the company, the benefit of the difference between the private placement price and the publicly-traded price goes to the initial private investors in the IPO, and not to the company itself or its shareholders. Avoiding this capital loss is one of the most cited benefits of going public through a SPAC rather than a traditional IPO.

was closer to the non-discounted value. The company was then forced to buy the shareholder out at that price.[22]

Shareholders may sue for breach of fiduciary duty. Shareholders may also allege that the target's directors breached their fiduciary duty to the corporation. As with the fiduciary duty claims discussed above, these claims may likely be barred by the business judgment rule, but this will depend on whether the shareholders can allege bad faith or a conflict in the business combination pursued.

Current trends. While, historically, appraisal and fiduciary duty actions have been useful vehicles for shareholders of target companies who contend the company has been undervalued, in the current environment, there may be a greater risk that the target company is *overvalued*. Nonetheless, the availability of these actions must be borne in mind, particularly in cases like *Manichaean*, where the process of seeking SPAC shareholder approval results in serial renegotiations to reduce the target company's compensation. Obtaining litigation advice before a final agreement is reached may help to guard against the risk that stakeholders in the target will challenge the transaction.

III. What if the combined company goes south?

Most SPAC litigation, historically, and most likely going forward, occurs after the SPAC merger has been completed, and the new company has performed poorly. Because deal documents will usually grant a sponsor a "promote," whether the combined company is a success or not, there may be an incentive for sponsors to aggressively pursue questionable transactions. This may become an area for SPAC regulation. On September 24, 2020, SEC Chair Jay Clayton gave an interview to CNBC in which he made clear the agency would be carefully inspecting SPAC transactions going forward, and particularly the incentives of SPAC sponsors, after the rapid decline of shares in post-SPAC zero emissions truck company Nikola raised questions about the sufficiency of due diligence conducted by the SPAC sponsor in that case.[23] The case law reviewed below includes enforcement actions by the SEC, and may shed light on the SEC's possible approach in this arena.

SPAC shareholders may scrutinize the initial registration statement for misstatements. Because SPACs are blank-check companies with no operations, the initial IPO registration statement is generally regarded as a straightforward exercise with limited risk. However, tricky situations can arise when SPAC sponsors have identified a primary target or targets before going public. If a SPAC has identified a specific target, it is obligated to provide disclosure about that target in its registration statement (and might not qualify as a true SPAC in that case—indeed, the IPO would likely look more like a typical IPO for the target company). Instead, based on SEC guidance, most SPACs state in their registration statements that they have not identified any target.

Private equity firms will typically also add disclosures indicating that their employees involved in managing the SPAC are "continuously made aware of potential business opportunities, one or more of which the SPAC may desire to pursue for a business combination," but that "the SPAC will not consider a business combination with any company that has already been identified to the private equity group as a suitable acquisition candidate."[24]

SPAC shareholders may sue for securities fraud in the proxy statement. While the initial IPO registration statement sets forth the governing parameters of the SPAC, it is the proxy statement issued in connection with the de-SPAC transaction, soliciting shareholder approval, that comes under the most

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22 *Manichaean Capital, LLC*, 2020 WL 496606.

23 *See* https://www.cnbc.com/video/2020/09/24/sec-chairman-jay-clayton-on-disclosure-concerns-surround-going-public-through-a-spac.html.

24 *See* Harvard Law School Forum on Corporate Governance, "Special Purpose Acquisition Companies: An Introduction," July 6, 2018, *available at* https://corpgov.law.harvard.edu/2018/07/06/special-purpose-acquisition-companies-an-introduction/.

scrutiny in this context. Shareholders disappointed by the post-SPAC company's performance may claim SPAC managers' statements or written proxy statements are misleading or fraudulent, and may challenge them under Section 14(a) of the Exchange Act, and under Sections 10(b) and 20(a), and Securities Act Section 17(a) as well. Moreover, in circumstances where the business combination requires the issuance of new shares by the combined company, that company, its officers and directors, and the officers and directors of the SPAC may find themselves strictly liable for the accompanying registration statement under Sections 11 and 15 of the Securities Act.

Section 14(a) governs misstatements in proxy statements and sets a lower pleading bar than does Section 10(b) and Rule 10b-5. To prevail under Section 14(a) and Rule 14a-9, a plaintiff must show that the defendant "prepared a proxy statement containing a material misstatement or omission that caused the plaintiff's injury." The plaintiff must show the defendant acted negligently, but need not establish scienter. By contrast, to prevail under Section 10(b) and Rule 10b-5, a plaintiff must show "(1) a material misrepresentation or omission by the defendant; (2) scienter; (3) a connection between the misrepresentation or omission and the purchase or sale of a security; (4) reliance upon the misrepresentation or omission; (5) economic loss; and (6) loss causation."[25]

A number of recent decisions provide insight into how the securities fraud laws may apply in the SPAC context:

- A recent decision in the Southern District of New York scrutinized the 2015 merger between SPAC Cambridge Capital Acquisitions Corporation and Israeli target company Ability Computer & Software Industries. In that case, the target company used financial projections to support the merger that were based on a "backlog" of orders that were totally undocumented, primarily came from a single client where the individuals who had agreed verbally to the orders had been fired, and the primary asset, which the managers represented they owned, was actually licensed subject to a contract that gave 50% of revenues to the licensor and created stiff penalties for underperformance on sales.[26] Not only did the proxy statement share misleading (or overtly false) financial projections and statements about asset ownership, but it attached one diligence report commissioned by the SPAC sponsor that contained false statements about the documentary support for the financial projections, while omitting a second report that correctly reported there was no documentary support and noted that this created significant risk.

  The SEC settled violations of 14(a) and 17(a)(2) with the SPAC's CEO[27] and entered into a consent decree with the post-merger company itself,[28] and brought an enforcement action, *SEC v. Hurgin*, against the owner-managers of the target corporation, charging them with violation of 10(b) and Rule 10b-5, 14(a) and Rule 14a-9, and 17(a). In a ruling on September 4, 2020, Judge Vyskocil upheld all of these claims against the defendants' motions to dismiss, finding there were sufficient allegations of multiple materially misleading facts and representations, and that the sufficiency of the scienter allegations could not be resolved on a motion to dismiss.[29]

  One of the defendants challenged the sufficiency of the claims against them under 14(a) and 17(a), arguing that he was not sufficiently involved in the proxy statement issued by the SPAC to be found

[25] *In re Stillwater Capital Partners Inc. Litigation*, 858 F. Supp. 2d 277 (S.D.N.Y. 2012) (quoting *Ashland Inc. v. Morgan Stanley & Co., Inc*., 652 F.3d 333, 337 (2d Cir.2011)).
[26] *Sec. & Exch. Comm'n v. Hurgin*, No. 19-CV-5705 (MKV), 2020 WL 5350536 (S.D.N.Y. Sept. 4, 2020).
[27] U.S. Securities & Exchange Commission, *SEC Settles Charges Against Former CEO of A Special Purpose Acquisition Corporation*, *available at* https://www.sec.gov/enforce/33-10651-s.
[28] *Hurgin*, 2020 WL 5350536, at *1.
[29] *Id.* at *6-9.

liable under those Sections. The court rejected this argument, finding that "none of these claims requires the Commission to allege that [the defendant] personally made allegedly misleading statements or personally prepared the proxy materials" and the defendant "put his reputation in issue in the proxy materials such that he owed a duty to the [SPAC] shareholders" because his name was mentioned repeatedly, including as an intended director of the merged corporation.[30] ***Thus, not only do SPAC sponsors face risk in connection with proxy statements, but Courts will not hesitate to hold target company managers responsible, particularly in fairly clear-cut cases of fraud.***

- On September 8, 2020, an amended complaint was filed in a consolidated class action in the Eastern District of New York against Akazoo, S.A, the product of a merger between Akazoo Ltd. and a SPAC called Modern Media Acquisition Corp., along with several of its officers and directors.[31] The Complaint alleges liability under 14(a) (on behalf of SPAC shareholders eligible to vote on the merger), 10(b) and 20(a) (as to the control persons) (on behalf of other purchasers of Akazoo shares, including through the SPAC's PIPE offering agreement), and Sections 11 and 15 of the Securities Act (on behalf of purchasers of Akazoo common stock traceable to the Company's registration statement and prospectus, as both were issued in connection with the merger) (discussed in more detail below). The complaint alleges numerous false statements regarding the financial results, geographic reach, and number of subscribers of Akazoo, an emerging markets music streaming service. While no decision has been rendered in the case, the allegations target the merged company itself and its officers and directors, who were a mix of managers from the target company and managers from the SPAC who took leadership roles post-merger.

- In a 2011 decision, *Murdeshwar v. Search Media Holdings*, the Court considered a target company which discovered fraud and accounting irregularities in the form of falsely inflated income based on fictitious contracts and transactions, which required revisions to their financial statements following the SPAC merger. Although the plaintiffs did not allege that the defendant SPAC and its managers had actual knowledge that the financial information included in the proxy statement had been false, the Court found it sufficient that plaintiffs alleged objective falsity.[32] Additionally, plaintiffs' allegations of failure to "conduct sufficient due diligence leading up to the Merger" and failure to notice "red-flags" of these financial irregularities were sufficient to state a claim for negligence.[33] ***While the facts of this case involve undisputed fraud, the holding indicates that even if a SPAC sponsor does not have actual knowledge of false statements or financial results in the proxy statement, the sponsor will be called upon to demonstrate adequate diligence and investigation of any "red-flags."***

- A pair of 2012 cases considered shareholder claims of fraud under Sections 10(b), 14(a), and 20(a). In the first of the two, *In re Stillwater Capital Partners Inc. Litigation*, the plaintiffs argued that the proxy statement released in connection with de-SPAC transactions violated Section 10(b) and Rule 10b-5 because it failed to disclose that two of three transactions were related-party transactions, and because it overstated the financial health of the SPAC and a target company. The Court had initially concluded that the fact the defendants would face a loss if no transaction was completed before the SPAC's expiration date was not sufficient, standing alone, to prove scienter. However, once the plaintiffs added allegations concerning additional factors such as the resignation and

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30 *Id.* at *11-12.

31 *See In re Akazoo S.A. Securities Litigation*, No. 20-cv-1900, Dkt. No. 15 (E.D.N.Y. 2020).

32 *Id.* at *20.

33 *Id.*

replacement of numerous officers and directors at the SPAC, "alleged personal profits by [SPAC] insiders from the related-party transactions" and "[the SPAC]'s transfer of all real estate assets to [a company] in exchange for a minority interest in the joint venture," the court held that the plaintiffs had adequately raised an inference of scienter.[34] ***Thus, while SPAC defendants may not be liable under 10b-5 if only the SPAC's time-limited structure is cited as incentive for fraudulent behavior, SPAC defendants will still have to be wary if there are other actions that can be combined with this unique SPAC trait to create an inference of intent.***[35]

- In the second *Stillwater* case, however, which considered claims under Section 14(a), Judge Scheindlin ruled that Section 14(a) did not apply because the SPAC was a foreign private issuer, citing Exchange Act Rule 3b-4.[36] While that rule is a useful exemption for foreign private issuers, Rule 3b-4 excludes from the definition of foreign private issuer companies where "[m]ore than 50 percent of the issuer's outstanding voting securities are directly or indirectly held of record by residents of the United States" and either "(i) The majority of the executive officers or directors are United States citizens or residents; (ii) More than 50 percent of the assets of the issuer are located in the United States; or (iii) The business of the issuer is administered principally in the United States."[37] Accordingly, it may have limited use to SPAC sponsors who intend to have a significant US presence.

SPAC or post-SPAC shareholders may sue for securities fraud in the business combination registration statement. As described above, a SPAC's initial registration statement is typically bare bones. But in some circumstances the SPAC merger requires issuance of shares by the merged company, and thus necessitates a registration statement. In those circumstances, the merged company may face significant risk in the form of strict liability for the contents of the registration statement. For example, in *Welch v. Meaux*, investors in a post-SPAC company brought a suit alleging that the company and the SPAC had conspired to inflate financials for the local meal delivery app Waitr in order to obscure the fact that it had no meaningful path to profitability.[38] These statements obscured a dire financial situation that required the company to issue new stock very shortly after the SPAC merger was completed, which was shortly followed by a precipitous drop in the company's shares. The complaint asserts fraud in the proxy statement that accompanied the merger, under Section 14(a), 10(b), and 20(a) and fraud in the registration statement for the second stock issuance under Sections 11, 12(a)(2), and 15, asserting strict liability against the post-SPAC company and claims against the company, the investment bank that underwrote the stock offering, and the company and SPAC officers and directors who were responsible for issuance. The case has been consolidated with a companion case and is currently proceeding.[39]

Likewise, the complaint in *In re Akazoo S.A.* alleges Section 11 and 15 liability against the post-SPAC company and many of its directors and managers, as well as directors of the SPAC. According to the complaint, the Registration Statement issued along with the business combination, which required the issuance of new shares in the merged company, contained much of the same information as the Proxy/Prospectus, which is alleged to contained significant false information. The complaint alleges that, although Akazoo was the registrant, the remaining Section 11 defendants were responsible for its contents and dissemination. Accordingly, it alleges that Akazoo is strictly liable for the contents of the Registration

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34 *In re Stillwater Capital Partners Inc. Litigation*, 858 F. Supp. 2d 277, 288 (S.D.N.Y. 2012).

35 *See also Murdeshwar v. Search Media Holdings*, No. 11-Civ-20549, 2011 WL 7704347, at *18 (S.D. Fl. Aug. 8, 2011) (finding financial pressure of having invested in SPAC insufficient to establish scienter).

36 *In re Stillwater Capital Partners Inc. Litig.*, 853 F. Supp. 2d 441, 457-58 (S.D.N.Y. 2012).

37 17 C.F.R. § 240.3b–4(c).

38 No. 19-cv-1260, Dkt. No. 1 (W.D. La. Sept. 26, 2019).

39 No. 19-cv-1427, Dkts. No. 1, 20 (W.D. La. Sept. 26, 2019); *Welch v. Meaux*, No. CV 19-1260, 2020 WL 4758269, at *1 (W.D. La. Aug. 17, 2020).

Statement, while alleging the other Section 11 defendants are liable because they failed to make "a reasonable investigation or possess[] reasonable grounds for the belief that the statements contained in the Registration Statement were true and without any omissions of any material facts and were not misleading." ***While these cases are in the early stages, they suggest that strict liability for any registration issued in connection with a merger is a real risk.*** This may be a particular concern for SPACs forced to rely on PIPE financing, which may require the issuance of new stock at the time of merger.

SPAC shareholders may sue for breach of fiduciary duty. The SPAC's shareholders may also sue the SPAC's directors for breach of fiduciary duty.[40] In many of these suits, the business judgment rule will not bar the litigation because the directors are not disinterested.[41] The sponsor—which selects the directors—usually receives part of the target if the acquisition occurs. To collect this payment, the sponsor has a motive to merge with a target, even if that merger might harm shareholders. Moreover, the SPAC's sponsor and directors often have warrants in the SPAC. If the SPAC dissolves without making an acquisition, those warrants will be valueless. To protect the value of these warrants, the SPAC's sponsor and directors may enter into a questionable deal. Accordingly, the directors' decision to enter the merger could potentially be reviewed under the less-deferential "entire fairness" standard, which requires that the deal meet the tests of both fair dealing and fair price.[42] "Fair dealing 'embraces questions of when the transaction was timed, how it was initiated, structured, negotiated, disclosed to the directors, and how the approvals of the directors and the stockholders were obtained.'"[43] Likewise, "[f]air price 'relates to the economic and financial considerations of the proposed merger, including all relevant factors: assets, market value, earnings, future prospects, and any other elements that affect the intrinsic or inherent value of a company's stock.'"[44] How the SPAC's directors fare under this standard is a highly fact-intensive question.

The post-SPAC company may be forced into bankruptcy. If the post-SPAC company declines to the point where it is no longer solvent, it may even be forced to file for bankruptcy. In that situation, creditors of the company may have latitude and standing to sue, and litigation decisions may be taken away from management, including the managers and directors appointed by the SPAC sponsor. Additionally, in this context the conduct of the company's directors may come under careful scrutiny, and the directors may find themselves susceptible to a fiduciary duty suit under the standards described in the preceding paragraph. For example, in *AP Services, LLP v. Lobell*, the trustee for a post-SPAC company in bankruptcy brought suit against the former directors of the SPAC that had merged into it.[45] The Court upheld the trustee's claims that the SPAC directors had breached their duty of loyalty based on allegations that they stood to benefit from entry into the SPAC merger (and to lose out if no merger was consummated before the SPAC's window elapsed), and had breached their duty of care based on allegations that they ignored red flags suggesting the target's financial statements were inflated.

Dissenters may seek to exercise contractual rights. Finally, SPAC shareholders may sue to vindicate their contractual rights. For example, the target company may have promised certain

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40 *See, e.g.*, *Hamilton Partners, L.P. v. Englard*, 11 A.3d 1180 (Del. Ch. 2010).

41 *See Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984), *overruled on other grounds by Brehm v. Eisner*, 746 A.2d 244 (Del. 2000).

42 *See In re Trados Inc. S'holder Litig.*, 73 A.3d 17, 55 (Del. Ch. 2013) ("A reviewing court deploys the entire fairness test to determine whether the members of a conflicted board of directors complied with their fiduciary duties."). If so, a court will look to see whether the SPAC's directors engaged in "fair dealing" and whether they secured a "fair price." *Id.* at 56 (citation omitted).

43 *Id.* (citation omitted).

44 *Id.* (citation omitted).

45 2015 WL 3858818, 2015 N.Y. Slip Op. 31115(U) (N.Y. Sup. Ct. 2015).

shareholders a minimum level of proceeds from any sale,[46] which they may sue to vindicate if they are not happy with their level of compensation. Or, they may sue to enforce the specific terms of their redemption rights; in *Oliveira v. Quartet Merger Corp.*, a SPAC shareholder sued the SPAC for failure to honor his redemption right, based on his failure to deliver his shares to the SPAC for redemption.[47] Although the SPAC's prospectus, the merger proxy statement, and several other documents that were provided to shareholders indicated that delivery was required (or might be required), the Court permitted the shareholder to enforce the terms of the SPAC's certificate of incorporation—under Delaware law, a contract between a corporation and its shareholders—which provided for a redemption right with no mention of a delivery requirement.[48]

IV. What should you be doing, and how can we assist?

The recent flood of capital into the SPAC market creates pressure to complete deals quickly, potentially leading sponsors and targets to overlook red flags. While the cases surveyed above present relatively clear-cut examples of accounting irregularities and allegations of outright fraud, they set up useful guideposts for all market participants. For example, although the proxy statement is typically issued by the SPAC to solicit the votes of its own shareholders, the officers and directors of the target company who participate in its issuance, provide content, and are held out as future officers or directors of the post-SPAC company, may well be held liable for the proxy statement's contents. Moreover, a SPAC sponsor may be liable for the contents of the proxy statement under *both* Section 10(b) and Section 14(a). In the former case, something more than simple time pressure and financial investment in closing a deal is required to demonstrate scienter, although *Stillwater* suggests that only minimal additional facts may be sufficient. Meanwhile, allegations that the SPAC conducted insufficient due diligence and ignored "red-flags" may well be sufficient to establish negligence under Section 14(a) and survive a motion to dismiss. SPAC sponsors would therefore be well advised to keep these standards in mind in structuring the deal, conducting due diligence, and issuing proxy and registration statements.

Sophisticated clients are increasingly getting litigation counsel involved early on as the potential for dispute first becomes apparent in a particular deal. As we have noted in other contexts, getting litigation counsel involved can provide fresh thinking and prophylactic insights alongside the client's deal lawyers who drafted the documents and lived through the deal, while helping clients to establish a thoughtful record and game plan in the event that litigation ensues.[49] We can assist in evaluating and guarding against litigation risk (i) at the SPAC IPO stage, (ii) when identifying and negotiating with targets, and (iii) when the post-SPAC company underperforms or faces unfavorable scrutiny. Targeted advice in the early stages can help our clients ensure they have developed a record that will be favorable to them if litigation becomes necessary, and puts them in a position to act quickly and decisively when a deal begins to go south.

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46 *See, e.g.*, *In re Oxbow Carbon LLC Unitholder Litig.*, No. CV 12447-VCL, 2018 WL 818760 (Del. Ch. Feb. 12, 2018), *aff'd in part, rev'd in part sub nom. Oxbow Carbon & Minerals Holdings, Inc. v. Crestview-Oxbow Acquisition, LLC*, 202 A.3d 482 (Del. 2019).

47 *See, e.g.*, *Oliveira v. Quartet Merger Corp.*, 126 F. Supp. 3d 424, 425 (S.D.N.Y. 2015), *aff'd*, 662 F. App'x 47 (2d Cir. 2016). While redemptions are a common way to express dissatisfaction with a proposed business combination that often does not lead to litigation, significant redemption levels may cause the business combination to be renegotiated in a way that opens the door to other litigation, as in the *Manichaean* case described above, where shareholders in the target company became unhappy with the price offered following renegotiation, and sought to exercise their statutory appraisal rights.

48 *Id.*

49 *See* Brian Timmons and Meredith Mandell, "Think Twice Before Using Deal Counsel as Litigation Counsel," LAW360, April 17, 2020, *available at* https://www.law360.com/articles/1261252/think-twice-before-using-deal-counsel-as-litigation-counsel.

With our deep bench of experienced corporate, securities, and bankruptcy litigators, we are well suited to help clients manage the legal risks associated with SPAC-related litigation.

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If you have any questions about the issues addressed in this Client Alert, or if you would like a copy of any of the materials we reference, please do not hesitate to contact us:

Ellison Ward Merkel
Email: ellisonmerkel@quinnemanuel.com
Phone: +1 212-849-7362

Andrew Rossman
Email: andrewrossman@quinnemanuel.com
Phone: +1 212-849-7282

Brian Timmons
Email: briantimmons@quinnemanuel.com
Phone: +1 213-443-3221

Christopher Kercher
Email: christopherkercher@quinnemanuel.com
Phone: +1 212-849-7263

With special thanks to summer associates Jake Todd and Hanna Kostamaa for their contributions to this Client Alert.