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Claims That SPAC Directors, Sponsor Breached Fiduciary Duties Survive Motion to Dismiss

In [*Delman v. GigAcquisitions3, LLC, et al.*](#), the Delaware Court of Chancery, in an opinion by Vice Chancellor Will, recently held on a motion to dismiss that it was reasonably conceivable that the directors of a special purpose acquisition company (SPAC) and its sponsor breached their fiduciary duties by disloyally depriving the SPAC public stockholders of information material to their decision on whether to redeem their shares in connection with the deSPAC transaction. Evaluating the claims under the stringent entire fairness standard, the court concluded that the SPAC's sponsor qualified as a controlling stockholder due to its control and influence over the SPAC, even though it held a minority interest, and that the SPAC directors lacked independence from the sponsor. In addition, entire fairness review was warranted based on the divergent interests between the sponsor and public stockholders that are inherent in the SPAC structure, including the sponsor's unique incentive to take a "bad deal" over a liquidation of the SPAC and returning the public stockholders' investment. The opinion provides important key takeaways for sponsors, directors and investors in Delaware SPACs.

Background

GigCapital3, Inc. (Gig3) was a Delaware corporation formed with a standard SPAC structure by its sponsor, GigAcquisitions3, LLC (Sponsor), in 2020. Among Gig3's features the court found to be "within the[] structural norms" for a SPAC were the facts that its Sponsor received a "promote" in the form of 20% of the post-IPO equity; that the Sponsor appointed all of the members of the SPAC board, who were partially compensated with promote shares; that public stockholders had redemption rights in connection with a deSPAC transaction allowing them to recoup their investment of \$10 per share while retaining their warrants (sold as a unit in the IPO) regardless of how they voted on the deSPAC transaction; and that the SPAC had a limited window (in Gig3's case, 18 months from its IPO) to complete a deSPAC transaction or liquidate.

Gig3 ultimately engaged in a deSPAC merger with Lightning eMotors Inc. Over 98% of the votes cast were in favor of the transaction, with 29% of the public stockholders electing to redeem. The proxy statement in connection with the stockholder vote included financial projections for the post-deSPAC public company that forecast dramatic growth. Less than two weeks after the merger closed, the company publicly announced revenue guidance that was more than 12% below the proxy's projections for the same time period, and over the following months its stock price fell to a fraction of the redemption price.

Plaintiff, a Gig3 stockholder, claimed the Gig3 board and Sponsor breached their fiduciary duties in connection with the public stockholders' redemptions rights.

Court's Ruling & Takeaways

The court denied the defendants' motion to dismiss the plaintiff's claims, concluding that entire fairness was the applicable standard of review and, under that standard, it was reasonably conceivable that the Sponsor and Gig3 board did not follow a fair process in connection with the redemption rights. Key takeaways from the court's analysis include the following:

Bases for Applying Entire Fairness Review. The court applied the entire fairness standard “due to inherent conflicts between the SPAC’s fiduciaries and public stockholders in the context of a value-decreasing transaction,” meaning a deSPAC transaction that would value the post-closing shares less than their \$10 redemption price.

- *Despite holding a minority of the voting power, the Sponsor was a controlling stockholder.* The court found that the Sponsor controlled Gig3, despite holding only approximately 22% of Gig3’s pre-merger voting power, because:
 - The Sponsor appointed the initial board, which remained in place through the merger;
 - The Sponsor-affiliated directors (including the Sponsor’s controller and his spouse) “dominated” the process to find a target, which was Gig3’s “sole objective,” and thereby exercised power over “the most crucial decision facing [Gig3]: merge or liquidate”; and
 - The IPO prospectus disclosed that the sponsor “may exert a substantial influence on actions requiring a stockholder vote” because most stockholder votes (including to approve the deSPAC transaction) required approval by a majority of votes *cast*, effectively increasing the Sponsor’s voting bloc as public stockholders abstained or did not vote.
- *The SPAC directors lacked independence from the Sponsor.* The court found numerous board level affiliations with the Sponsor, including that the Gig3 directors each had a number of ties to the Sponsor and its controller, such as employment with a Sponsor-related entity and past or current directorships on other Sponsor-related entities. The court wrote that it was “reasonably inferable that these directors would expect to be considered for directorships in companies—such as other SPACs—that [the Sponsor’s controller] launches in the future.”
- *The Sponsor was conflicted regarding stockholders’ redemption rights.* The court held that “the Sponsor’s interests diverged from public stockholders in the choice between a bad deal and a liquidation.” In the case of a “bad deal,” the Sponsor could still realize “enormous returns” but receive nothing in the case of a liquidation, whereas the public stockholders would suffer a loss if the post-deSPAC company stock price fell below \$10 but recoup their investment plus interest in a liquidation. Additionally, the Sponsor had an incentive to minimize redemptions to “ensure greater certainty” that the SPAC could satisfy a closing condition to the merger agreement that at least \$50 million be released to the combined company from the trust account at closing.
- *The conflict was not ameliorated by other protections to align the Sponsor’s interests.* The defendants argued that these “inherent” SPAC conflicts were ameliorated by, among other things, the facts that the Sponsor’s shares were the same class as the public’s with the same voting power, that the Sponsor’s shares were subject to a one-year lockup post closing, that the directors were partially compensated in cash and that the SPAC had 11 months of its 18-month completion window. The court reasoned that none of these facts ameliorated the disparate incentives. The class structure did not redress the conflict because “[t]he nature of the Sponsor’s promote incentivized it to complete a merger with Lightning, even if the deal proved disastrous for non-redeeming public stockholders.” As to the lockup, “unless Gig3 went bankrupt within a year,” the Sponsor’s promote “would well exceed” its investment after the lockup expired. Regarding the directors’ cash compensation, the court reasoned it did not resolve their lack of independence from the Sponsor. Finally, the time left in the completion window did not reduce the incentives to approve a “bad deal” because “the Sponsor might have desired to take the money in hand and focus on the next ‘Gig’ SPAC rather than continuing to seek a target for Gig3.”

Stockholder Votes Do Not Cleanse SPAC Conflicts. The court also rejected the defendants' argument that the stockholder vote in favor of the deSPAC transaction could cleanse the board-level conflicts.

- *Corwin cleansing not available for board level conflicts.* The court held that the framework established in *Corwin v. KKR Financial Holdings LLC* is not available to restore business judgment review in the case of SPACs board level conflicts due to the structure of the stockholder vote in deSPAC transactions. According to the court, fully informed and uncoerced stockholder votes are afforded deference under *Corwin* because stockholders are presumed impartial decision-makers with an actual economic stake in the outcome of the merger. The court observed that the Gig3 stockholder vote (like the typical vote in a deSPAC transaction) "could not reflect the investors' collective economic preferences [because] [s]tockholders' voting interests were decoupled from their economic interests" by virtue of their ability to both vote yes on the deSPAC transaction and redeem. "Moreover, redeeming stockholders remained incentivized to vote in favor of a deal—regardless of its merits—to preserve the value of the warrants included in SPAC IPO units. Because this vote was of no real consequence, its effect on the standard of review is equivalently meaningless."
- *Similarly, MFW is likely unavailable to cleanse SPAC sponsor conflicts.* In dicta, the court observed that the protections set forth in *Kahn v. M&F Worldwide Corp. (MFW)* should also not apply to cleanse controlling sponsor conflicts in deSPAC transactions. The court observed that *MFW* was designed to protect minority stockholders from the retribution of a controlling stockholder in a self-dealing transaction, specifically a squeeze-out merger. This threat of retribution does not exist in the SPAC structure, as public stockholders can simply choose to redeem their shares.

Unfair Interference with Redemption Rights. The court ruled that "[t]he plaintiff provided 'some facts' that public stockholders' redemption decisions were compromised by the defendants' unfair dealing," primarily relating to allegations that the stockholders were deprived of material information relevant to their redemption decision.

- *SPAC boards are expected to perform real due diligence and disclose conclusions in the proxy.* The court concluded the proxy issued in connection with the deSPAC transaction was misleading, in part, because the target's "lofty projections were not counterbalanced by impartial information." For example, the complaint alleged that the Gig3 board should have been able to tell that the business model on which the projections were based would be difficult to achieve. According to the court, "[t]he nature of Lightning's business model was 'knowable' through the sort of diligence and analysis expected of the board of a Delaware corporation undertaking a major transaction." Here, the court inferred that the defendants "knew (and should have disclosed) or should have known (but failed to investigate) that Lightning's production would be difficult to scale in the manner predicted."
- *Other indications of unfair process.* Having found the misleading disclosures sufficient to deny a motion to dismiss under the entire fairness standard, the court noted briefly several additional indicators of unfair dealing, including that:
 - The merger negotiations were directed by the Sponsor's controller and his spouse (also a SPAC director), who were "the two individuals who arguably stood to gain the most in a value-destructive deal";
 - The board's financial advisors were also its underwriters and thereby conflicted by their deferred underwriting fees as well as by holding private placement shares, both of which would be lost if the SPAC did not find a deal; and
 - The board did not obtain a fairness opinion or even an information presentation on the fairness of the transaction from its financial advisors.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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