Quinn Emanuel Private Equity Litigation Practice Alert

Recent Cases Highlight Supply and Demand Imbalance In the SPAC Market

By mid-2020, special purpose acquisition companies ("SPACs") had already set records, with over $22 billion in deal value.[1] The massive amount of SPAC capital being raised has created a huge demand for suitable acquisition targets. A SPAC is a shell company with no operations that raises capital in an initial public offering ("IPO") for the purpose of merging with and taking public an unspecified existing company. This can be a faster and more efficient method of going public than a conventional direct or underwritten public offering, which has made SPACs increasingly popular investments.

But that deluge presents heightened litigation risks. With more and more SPACs entering the market, the number of potential targets has not increased in kind. At the same time, SPACs are under pressure to consummate a deal because of the 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. With the market pressure of a potential oversupply of SPACs relative to targets, and pressure to ink a deal, some SPACs are settling for smaller stakes in the combined companies. This may result in disappointed investors, and opportunities for plaintiffs and short sellers to apply pressure to SPACs and their directors before reverse-mergers can close.

I. Recent Challenges to "Diluted" Stakes In Combined Company

Two recently-filed cases show that plaintiff firms are scrutinizing "reverse merger" SPAC transactions, where the target is significantly larger than the SPAC, resulting in smaller stakes for the SPAC's shareholders.

Kensington Capital and QuantumScape. On October 2, 2020, a shareholder in Kensington Capital Acquisition Corp. ("Kensington Capital"), a publicly traded SPAC, filed a class action lawsuit against the company and certain of its directors and officers, on behalf of all public Kensington Capital stockholders.[2] The case relates to the company's efforts to arrange a reverse merger transaction with QuantumScape Corporation ("Quantumscape"), a company developing lithium batteries for electric vehicles.

The complaint alleges that the individual director and officer defendants breached their fiduciary duties by agreeing to sell Kensington Capital to QuantumScape. Under that deal, Kensington Capital shareholders will retain only 5.1% of the combined company, compared to the QuantumScape shareholders who will retain approximately 82.4%. A further 12.5% of the post-close company will go to investors who provide private investment in public equity ("PIPE") funding to the transaction, to ensure there is sufficient capital to complete the transaction. The complaint alleges that Kensington Capital directors and officers agreed to the reverse merger for reasons that conflict with their duties to shareholders—namely, in order to translate their holdings of SPAC stock into the more liquid combined company's publicly traded shares, in percentages greater than other Kensington shareholders will achieve.

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1 *See* https://www.sifma.org/wp-content/uploads/2020/08/SIFMA-Insights-Spotlight-SPACs.pdf.

2 *Felipe Sanchez v. Kensington Capital Acquisition Corp. et al.*, Index No. 654941/2020 (Sup. Ct. N.Y. Cty Oct. 2, 2020).

The Plaintiff also alleges an insufficient sale process, without a committee of independent board members to scrutinize the deal, and that the SPAC's advisor on the PIPE funding (Goldman Sachs) was then hired by the target as its financial advisor. The complaint further alleges that the company's registration statement was deficient for failing to explain these and other process points. The suit asks the New York Supreme Court to stop the planned reverse merger.

Social Capital and Clover Health. In another class action filed on October 29, 2020, a shareholder in Social Capital Holdings Hedosophia Corp. III ("Social Capital") filed a class action lawsuit against the company and its board on behalf of all public Social Capital stockholders.[3] Again, the complaint alleges the SPAC's directors breached their fiduciary duties to public stockholders in their efforts to sell the company to Clover Health Investments, Corp. ("Clover Health"), a technology-focused Medicare Advantage healthcare insurer that uses data and a proprietary platform to control cost. The suit asks the New York Supreme Court to stop the planned reverse merger.

The plaintiff alleges that the future financial success of the combined company, spurred on by Social Capital's cash, will be at the expense of Social Capital's shareholders, because they will own only approximately 18.7% of the combined company. The plaintiff alleges that the board entered into the agreement for conflicted reasons—to unlock their own large portions of the SPAC's stock, that would be rolled over in higher percentages of the surviving entity than other Social Capital shareholders. Plaintiff also alleges a flawed sale process that did not include an assessment by a committee of independent directors, and a deficient registration statement that omits or misrepresents the sale process and the financial projections relied on by the board.

These claims rely on allegations of bad faith to avoid the business judgment rule. The business judgment rule ordinarily precludes SPAC shareholders from suing merely because they disagree with the choice of target or the details of a deal struck. 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.[4] However, the Kensington Capital and Social Capital complaints allege that the SPAC directors and officers there were not disinterested in the transaction, on the theory that they stand to gain from converting their stock, and preferred their interests to other public stockholders. If a court accepts this theory, then the directors may be determined not to be disinterested and the heightened scrutiny of the entire fairness rule may be applied.

SPACs can be vulnerable to well-timed claims. Even when claims are thin, they can be dangerous when brought on at key inflection points. The mergers in these cases have been announced and registration statements filed, but they have not closed. The plaintiffs have chosen their timing carefully and moved quickly, applying additional pressure to the SPACs by asking a court to pause the transaction that is already in train. The threat of enjoining the merger may encourage the SPAC sponsors to the negotiation table with plaintiffs.

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[3] *Paul Chaplin v. Social Capital Hedosophia Holdings Corp. III et al*, Index No. 655802/2020 (Sup. Ct. N.Y. Cty Oct. 29, 2020).

[4] *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).

II. Increased SPAC Litigation Risk For Directors

As more SPAC deals are proposed, there will be more attempts to find ways to hold up those deals for better terms, by litigation. And as more SPAC deals are consummated, more deals will not work out, and litigation will follow. The dynamic of more capital chasing a fixed pool of opportunities presents litigation risks for SPAC sponsors, investors, and targets alike. But as the Kensington Capital and Social Capital complaints highlight, SPAC directors are increasingly in the spotlight. The same is true of the recent complaint against Nikola Corporation, the zero-emission vehicle company acquired by the SPAC VectoIQ Acquisition Corp.[5] Moreover, plaintiff law firms are trawling for information and potential representative-plaintiff stockholders on recently announced de-SPAC merger transactions.[6] And insurers offering director and officer ("D&O") policies are reportedly increasing insurance premiums, reducing coverage layers and limits, and applying more scrutiny.[7] All of these factors point to a more difficult and litigious environment for SPAC directors.

III. What You Should Be Doing—And How We Can Help

As we highlighted in our Private Equity Litigation Practice Alert, "Litigation Risk In The SPAC World," 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.

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.[8] We can assist in evaluating and guarding against litigation risk (i) at the SPAC IPO stage, (ii) when identifying and negotiating with targets, (iii) defending a deal against litigation designed to derail a merger, and (iv) if 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.

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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[5] The class action complaint alleges securities fraud and in so doing borrows heavily from a report about Nikola published by the short seller firm Hindenburg Research, which alleged fraud and deceptions related to the capability of the company's vehicles and battery technology. *See Salem v. Nikola Corporation et al.*, 2:20-cv-04354-GRB-SIL (E.D.N.Y Sep. 16, 2020).

[6] *See e.g.,* https://www.businesswire.com/news/home/20201009005547/en/RMG-ACQUISITION-INVESTOR-ALERT-Attorney-General-Louisiana.

[7] *See e.g.,* Kevin LaCroix, *Rain on the SPAC Parade?* https://www.dandodiary.com/2020/10/articles/director-and-officer-liability/rain-on-the-spac-parade.

[8] *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.

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:

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