[University of Arkansas at Little Rock Law Review](https://lawrepository.ualr.edu/lawreview)

Volume 44
Issue 2 *The Ben J. Altheimer Symposium: Protecting the Ballot: Today's Election Law and Voting Rights Issues*

Article 3

2021

# Business Judgment Rule or Due Diligence? How to Reduce Vicarious Liability for SPAC Directors and Officers

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## Recommended Citation

Beau Duty, *Business Judgment Rule or Due Diligence? How to Reduce Vicarious Liability for SPAC Directors and Officers*, 44 U. ARK. LITTLE ROCK L. REV. 251 (2021).
Available at: https://lawrepository.ualr.edu/lawreview/vol44/iss2/3

BUSINESS JUDGMENT RULE OR DUE DILIGENCE? HOW TO REDUCE VICARIOUS LIABILITY FOR SPAC DIRECTORS AND OFFICERS

## I. INTRODUCTION

When market volatility is high, private companies seeking to go public typically shy away from Initial Public Offerings (IPOs) because it is hard to gauge whether investor interest will remain stable long enough for the IPO to succeed. The market volatility of 2020, coupled with uncertainties about long-term valuations and PIPE[1] capital availability, encouraged companies to pursue special purpose acquisition company (SPAC) transactions as an alternative to traditional IPOs. For instance, sports gaming company DraftKings went public with a SPAC in April of 2020 in a $2.7 billion deal that allowed investors to trade DraftKings's stock on the Nasdaq.[2] Just five months later, in September of 2020, DraftKings's share price had increased by over 250%.[3] When asked about going public in 2020, DraftKings's CEO Jason Robins suggested if DraftKings "had been considering a traditional IPO, it's possible [the company] would have decided that [2020] wasn't the right time."[4] While 2020 delivered many successful IPOs, including Airbnb and DoorDash,[5] SPACs nevertheless outpaced traditional IPOs by volume in that year.[6]

SPACs are shell companies formed to take a private company public through a merger transaction.[7] They are created through a traditional IPO, the proceeds of which are placed in a trust account until used to purchase an existing but unspecified company—the target company.[8] SPACs typically have

1. Troy Segal, *What Is a Private Investment in Public Equity (PIPE)?*, INVESTOPEDIA (updated Nov. 7, 2020), https://www.investopedia.com/terms/p/pipe.asp (explaining that a "[p]rivate investment in public equity . . . is when an institutional or an accredited investor buys stock directly from a public company below market price[,]" a strategy that saves "companies time and money" and helps them "raise funds more quickly").

2. Matthew Waters, *Draftkings Goes Public After Shareholder Approval, Business Combination*, LEGAL SPORTS REP. (Apr. 23, 2020), https://www.legalsportsreport.com/40250/draftkings-vote-going-public/.

3. Connor Smith, *DraftKings Is Poised for 'Hyper-Growth.' Why Its Stock Could Be Like Tesla, Amazon, and Netflix.*, BARRON'S (Sept. 24, 2020), https://www.barrons.com/articles/draftkings-stock-can-outperform-macquarie-analyst-says-51600967115.

4. Callum Borchers, *DraftKings CEO Jason Robins On What It's Like To Take a Company Public In a Pandemic*, WBUR (updated Apr. 24, 2020), https://www.wbur.org/bostonomix/2020/04/24/draftkings-public-ipo-jason-robins.

5. Andrew Willis, *The 10 Biggest IPOs of 2020*, MORNINGSTAR (Dec. 15, 2020), https://www.morningstar.com/articles/1014850/the-10-biggest-ipos-of-2020.

6. Elliot Bentley, *The SPAC Boom, Visualized*, WALL ST. J. (updated Feb. 10, 2021), https://www.wsj.com/articles/the-spac-boom-visualized-in-one-chart-11612962000.

7. E. RAMEY LAYNE ET AL., VINSON & ELKINS, SPECIAL PURPOSE ACQUISITION COMPANIES: AN INTRODUCTION 2 (2020), https://docplayer.net/199944433-special-purpose-acquisition-companies-an-introduction-summer-2020.html.

8. *Id.*

a deadline of about two years to acquire a target company and complete a merger transaction.[9] If the SPAC does not acquire a target within two years, the SPAC dissolves, liquidates the trust fund, and returns the capital to the SPAC's original IPO investors.[10]

While SPACs allow many companies to quickly secure committed capital in unpredictable markets, they are not entirely new to the investment industry.[11] Modern SPACs evolved from an investment vehicle known as "blank check companies," and the industry now uses the terms somewhat interchangeably.[12] In the 1980s, blank check companies were the preferred investment vehicle for capitalizing on penny stock "pump-and-dump schemes."[13] "Pump-and-dump" describes when an investor promotes (pumps) a stock he holds (and often practically controls) to increase the share price and then sells (dumps) his shares when the stock reaches an inflated price.[14]

The pump-and-dump schemes gave blank check companies a reputation as an unsafe investment vehicle.[15] As a result, Congress passed the Penny Stock Reform Act of 1990[16] mandating enhanced requirements for blank check companies by the Securities Exchange Commission (SEC).[17] In the decade that followed, blank check companies significantly declined in popularity.[18] By the late 1990s, the industry realized that smaller private companies could go public by merging with a blank check company more affordably than with a traditional IPO.[19] Thus, today SPACs serve primarily as an IPO alternative.[20]

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9. *Id.* at 14.

10. *Id.*

11. *See* Crystal Tse, *Blank Check IPOs, the Status Symbol of 2020, Have Raised $32 Billion This Year*, BLOOMBERG (Aug. 27, 2020), https://www.bloomberg.com/news/articles/2020-08-27/what-are-spacs-the-hottest-stocks-of-2020.

12. Tim Castelli, *Not Guilty by Association: Why the Taint of Their "Blank Check" Predecessors Should Not Stunt the Growth of Modern Special Purpose Acquisition Companies*, 50 BOSTON COLL. L. REV. 237, 238–39 (2009).

13. *Id.* at 239.

14. The Investopedia Team, *How Does a Pump and Dump Scam Work?*, INVESTOPEDIA (updated Jan. 29, 2021), https://www.investopedia.com/ask/answers/05/061205.asp.

15. *See* Usha Rodrigues & Mike Stegemoller, *Exit, Voice, and Reputation: The Evolution of SPACs*, 37 DEL. J. CORP. L. 849, 875 (2013).

16. ALAN R. BROMBERG ET AL., 7 BROMBERG & LOWENFELS ON SECURITIES FRAUD § 13:143 (2d ed. 2021).

17. Castelli, *supra* note 12, at 250.

18. *Id.* at 239.

19. *Id.* at 239–40.

20. E. RAMEY LAYNE ET AL., VINSON & ELKINS, SPECIAL PURPOSE ACQUISITION COMPANIES: AN UPDATE 12 (2020), https://docplayer.net/191472628-special-purpose-acquisition-companies-an-update-summer-2020.html [hereinafter LAYNE ET AL., *SPAC Update*] (referring to the two footnotes at the bottom of the blog that differentiate between "blank check companies" and SPACs) [hereinafter SPAC Update].

2020 was a record year for SPACs, with $77 billion raised in about 230 IPOs, a fivefold increase over the previous record year of 2019.[21] Until recently, litigation involving SPACs occurred infrequently, but with the recent market surge, pre-closing strike suits are proliferating, and the insurance costs for SPACs directors and officers are skyrocketing.[22] Post-closing litigation brought after the merger with the target company has left plaintiffs and courts somewhat confused about whether plaintiffs should bring claims under corporate fiduciary laws or the appropriate securities laws.[23] This confusion stems from the difficulty plaintiffs and courts have in defining and understanding the roles of SPAC directors and officers.[24]

This Note proposes limiting SPAC directors' and officers' corporate fiduciary duties to align with underwriters' liability in a traditional IPO. Part II distinguishes SPACs from traditional IPOs.[25] Part III of the Note outlines Delaware's corporate fiduciary duties laws and then explains why courts should not apply those laws uniformly to SPAC directors and officers due to the lack of accurate precedent.[26] Part IV shows why plaintiffs should have brought suits against SPACs under the applicable securities laws instead of for breach of corporate fiduciary duty.[27] Part V suggests proper perspectives and procedures to reduce SPAC directors' liability to match IPO underwriters' liability.[28] Ultimately, this Note argues that because SPACs differ fundamentally from traditional mergers, trying most SPAC cases under the appropriate securities laws—rather than under Delaware's corporate fiduciary duty regime—will promote judicial economy and overall fairness.

## II. SPACs: How They Differ from IPOs and Why That Matters

With the origin of SPACs detailed above, this Part will now describe the traditional IPO's leading players and outline its basic deal structure. Then the Note will similarly examine SPACs.

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21. Stephen Amdur et al., *The SPAC Explosion: Beware the Litigation and Enforcement Risk*, JD SUPRA (Dec. 16, 2020), https://www.jdsupra.com/legalnews/the-spac-explosion-beware-the-94550/.

22. Priya Cherian Huskins, *Guide to D&O Insurance for SPAC IPOs (and How to Save Money on Your D&O Insurance Premium)*, WOODRUFF SAWYER (Mar. 10, 2021), https://woodruffsawyer.com/do-notebook/insurance-coverage-spacs-2021/.

23. *See infra* Part IV (contrasting a case brought against the directors for breach of fiduciary duties against a case brought against directors for securities fraud).

24. *See infra* Part II.D.

25. *Infra* Part II.

26. *Infra* Part III.

27. *Infra* Part IV.

28. *Infra* Part V.

### A. Basic IPO Structure

IPOs are the traditional route to going public, and even though a SPAC is considered an IPO alternative, IPOs are a significant step in the formation of SPACs.[29] The IPO process begins when a company seeking to go public (issuer) begins working with an investment bank, also commonly referred to as the underwriter.[30] The underwriter starts gathering information from the issuer to evaluate the company's ideal IPO share price.[31] To assemble the necessary financial data, the issuer relies upon a team of experts.[32] This team comprises the investment bank's analysts, employees, third-party lawyers, accountants, and other advisors.[33] The team helps the issuer prepare to meet the reporting requirements of both the SEC and the stock exchange.[34] Once the issuer's information has been reviewed and compiled, the team files its S-1 Registration Statement (S-1).[35] The S-1 is an SEC filing that includes the issuer's prospectus, which is the key document that investors rely upon to evaluate the company's financial results, position, and prospects.[36] Once the S-1 has been reviewed by the SEC and revised in response to SEC comments, the underwriter and issuer begin a roadshow, which is the underwriter's effort to market the issuer's securities to investors.[37] Over some weeks, the underwriter will proceed with the roadshow and gauge market demand for the issuer's securities.[38] The team sets the IPO's offering price by balancing its value and estimating market demand from investors.[39] At the end of the roadshow, the underwriter will select an IPO issuance date to offer the securities to the public.[40] Often, at the roadshow's conclusion, underwriters make a firm commitment to purchase the shares of the issuing company and are liable on the IPO issuance date to purchase all outstanding shares.[41]

29. *See* Daniel S. Riemer, *Special Purpose Acquisition Companies: SPAC and SPAN, or Blank Check Redux?*, 85 WASH. U. L. REV. 931, 951–52 (2007).

30. Jason Fernando, *Initial Public Offering (IPO)*, INVESTOPEDIA (updated Mar. 1, 2021), https://www.investopedia.com/terms/i/ipo.asp.

31. *Id.*

32. *Id.*

33. *Id.*

34. *See id.*

35. *Id.*

36. *See* Fernando, *supra* note 30.

37. Jason Gordon, *Roadshow (IPO) - Explained*, THE BUS. PROFESSOR (updated July 10, 2021), https://thebusinessprofessor.com/lesson/roadshow-ipo-definition/.

38. *See* Caleb Christensen, *The Costs of Going Public*, IPOHUB (Mar. 27, 2018), https://www.ipohub.org/costs-going-public.

39. Fernando, *supra* note 30.

40. *See id.*

41. *In re* Am. Bank Note Holographics, Inc. Sec. Litig., 93 F.Supp.2d 424, 438 (S.D.N.Y. 2000) (explaining how firm commitment underwriting works).

### B. Basic SPAC Structure

SPACs help a private company go public in a manner different from a classic IPO. A SPAC is a shell company with no pre-existing operations, so it does not require a devoted team of experts to organize its financial data before going public.[42] Instead, a third party known as a sponsor forms the SPAC by registering it as a corporation, giving it a board of directors, providing the necessary startup capital, and completing the SPAC's IPO.[43] The sponsor forms the SPAC for the express purpose of taking public a currently unidentified company.[44] The SPAC keeps the IPO proceeds in a trust account and begins searching to purchase a target company within a specified period, typically two years or less.[45] Most of the time, a SPAC acquires a privately held target company.[46] The resulting merger between the SPAC and the target company allows the underlying private company to become publicly traded.[47] The SPAC's merger with the private company is referred to as the "de-SPAC transaction."[48] Similar to how companies file an S-1 in an IPO, the SPAC will file a proxy statement or a joint form S-4/prospectus during the de-SPAC transaction that includes much of the same information as a traditional IPO prospectus, effectively providing investors a level of disclosure equivalent to traditional IPOs.[49]

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42. *See* LAYNE ET AL., *supra* note 7, at 3.

43. *Id.* SPACs are typically incorporated as Delaware corporations but occasionally as Cayman Corporations. *See id.* at 9. The initial capital the SPAC will use to purchase a target company is raised in the SPAC's IPO during "Phase 1" of the SPAC process. *See infra* note 50 and accompanying figure.

44. *Id.* at 2.

45. *See* SPAC Update, *supra* note 20, at 7.

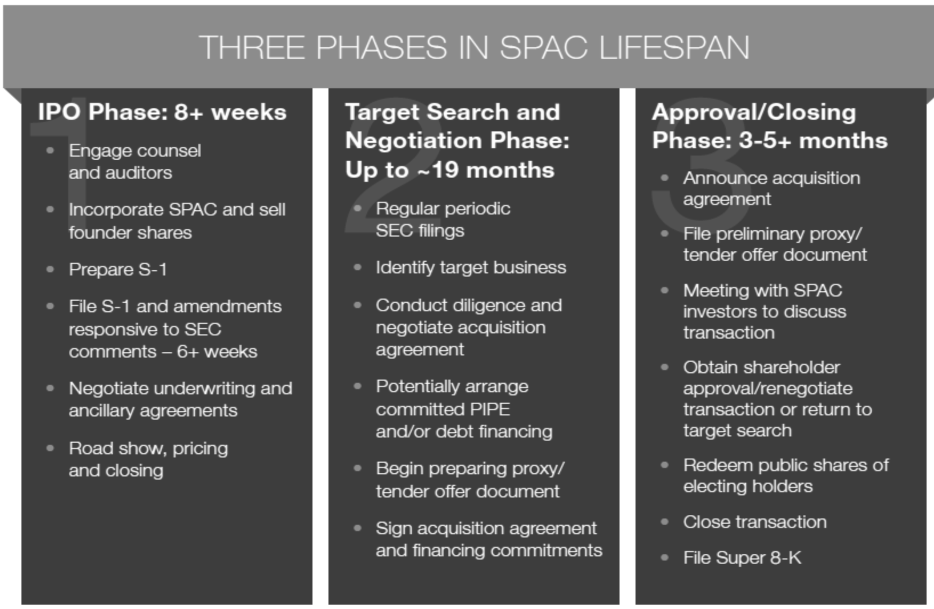
46. LAYNE ET AL., *supra* note 7, at 17.

47. *Id.* at 3.

48. *Id.* at 17.

49. *See id.* at 16.

Figure 1 - Three Phases of SPACs[50]




SPAC investors at the IPO phase—or in the aftermarket before the SPAC identifies a target company (Target Search and Negotiation Phase)—invest in the likelihood that the SPAC management will source a good deal.[51] Effectively, the SPAC management team markets itself based on its network and investment thesis.[52] Investors are willing to invest because they think the team will find a good deal, and the investor has downside protection through the redemption rights and an equity kicker (in the form of warrants).[53]

A great example of this is the SPAC Pershing Square Tontine Holdings run by Bill Ackman.[54] It was the largest SPAC of 2020, raising over $4 billion at the SPAC IPO.[55] The investors were betting on Ackman's ability to acquire

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50. Ramey Layne & Brenda Lenahan, *Special Purpose Acquisition Companies: An Introduction*, HARV. L. SCH. F. ON CORP. GOVERNANCE (July 6, 2018), https://corpgov.law.harvard.edu/2018/07/06/special-purpose-acquisition-companies-an-introduction/.
51. *See* Rodrigues & Stegemoller, *supra* note 15, at 871.
52. *See id.*
53. LAYNE ET AL., *supra* note 7, at 2, 8.
54. SPAC Update, *supra* note 20, at 5 (outlining the deal structure of Ackman's SPAC, Pershing Square Tontine Holdings).
55. *Id.* (explaining that Pershing Square Tontine Holdings is considerably larger than existing SPACs).

a valuable target company successfully.[56] If Ackman could not find a good deal or close a merger on time, the investors carried the enhanced protection afforded by the SPAC's redemption rights and warrants.[57]

### C. Why SPACs Outperformed IPOs in 2020

Several factors that differentiate SPACs from the traditional IPO drive their growing appeal. As a whole, SPAC advantages offer private companies a lower barrier to entry to the public capital markets.[58] SPACs provide a lower barrier to entry because they are practically always more affordable to the private company on the front end than IPOs.[59] SPACs are also attractive to private companies because those companies receive a valuation from the SPAC in a private negotiation based on a multi-year forecast, instead of having their financials marched around and marketed to potential investors in a traditional IPO roadshow.[60] Additionally, private companies that use a SPAC can secure committed PIPE capital much more quickly, generally within 4–6 weeks (versus 4–6 months to obtain committed capital in a traditional IPO).[61]

Also, SPACs are attractive because they have several measures in place to protect investor capital.[62] SPACs have better investor protection because they have retained many safeguards against fraud instituted by the Penny Stock Reform Act (PRSA).[63] While SPACs are not technically required to utilize the safeguards of the PRSA, they have kept them in place to provide increased investor security.[64] SPACs voluntarily adhere to most of the requirements of SEC Rule 419; IPO proceeds are held in a trust account and disbursed for only certain purposes, i.e., to redeem outstanding shares or to complete the purchase of the SPAC's target company.[65]

The two most prominent safeguards of SPACs outside of the trust account regulations are: (1) the investor's ability to vote via a proxy statement

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56. Reuters Staff, *Breakingviews - Capital Calls: Bill Ackman's SPAC Surges*, REUTERS (Feb. 18, 2020), https://www.reuters.com/article/us-global-finance-breakingviews/breakingviews-capital-calls-bill-ackmans-spac-surges-idUSKBN2AI283.

57. *See* LAYNE ET AL., *supra* note 7, at 2–8.

58. *See* David M. Smith et al., *Reverse Mergers and Nanotechnology*, 4 NANOTECHNOLOGY L. & BUS. 87, 93 (2007).

59. *See* Castelli, *supra* note 12, at 239–40.

60. *See* Fernando, *supra* note 30 (explaining the roadshow process); *see also* Castelli, *supra* note 12, at 257–58 (explaining that a private company can use a SPAC to avoid the uncertainty of how the "public will react to its offering").

61. *See* SPAC Update, *supra* note 20, at 7 (discussing the availability of PIPE capital for SPAC transactions).

62. *See generally* Rodrigues & Stegemoller, *supra* note 15, at 890–920.

63. Castelli, *supra* note 12, at 248–51.

64. *See id.*

65. *See id.* at 254–57; *see also* LAYNE ET AL., *supra* note 7, at 5.

on the proposed business combination and (2) the investor's ability to redeem the purchased shares before an acquisition.[66] The first of these safeguards allows investors to vote either for or against the target company's acquisition.[67] The second enables investors to redeem shares at a pro rata price before the de-SPAC transaction if they consider the capital better utilized elsewhere. [68]

These protections favor investors much more than those of a traditional IPO.[69] For example, compared to the SPAC investor's ability to redeem shares before the de-SPAC transaction, traditional IPO underwriters or investors that make a firm purchase commitment before the IPO date do not have an option to withdraw from the deal before the IPO.[70] In a de-SPAC, the investor can make the redemption decision after watching how the transaction trades on the market and knowing how the public views the deal.[71] In contrast, in a traditional IPO, the investor will not see how the market likes the deal until the launch.[72]

Lastly, a SPAC's board of directors is bound by corporate fiduciary duties to the shareholders before the de-SPAC transaction.[73] In contrast, the underwriters and issuers in an IPO are not necessarily bound by corporate fiduciary duties to the investors that purchase shares in an IPO.[74] Since investors that make purchases in an IPO are dealing with the underwriters via contract, if the underwriters or issuers were to mislead the investors, their only grounds for legal action after the IPO would likely be based on the statutory provisions of the Securities Exchange Act.[75] However, for SPACs, the investors that own the SPAC's shares on the record date for the de-SPAC vote could sue the directors and officers for breach of corporate fiduciary duty or statutory liability under the Securities Act of 1933 and the Securities Exchange Act of 1934.[76]

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66. Castelli, *supra* note 12, at 271.

67. *Id.*

68. *Id.*

69. *Id.* at 270–71.

70. Patrick M. Corrigan, *The Seller's Curse and the Underwriter's Pricing Pivot: A Behavioral Theory of IPO Pricing*, 13 VA. L. & BUS. REV. 335, 347–48 (2019).

71. Borchers, *supra* note 4 (discussing how the CEO of DraftKings was able to watch shares trade and gauge how the public liked the idea of DraftKings going public).

72. *See* Michael J. Dillon, *SPAC Directors Cannot Take the Protection of the Business Judgment Rule for Granted*, LEXOLOGY (Oct. 23, 2015), https://www.lexology.com/library/detail.aspx?g=71b5afb1-8eee-487f-b7bb-11ef55191573.

73. *See infra* Part IV.A.

74. *See* Corrigan, *supra* note 70, at 365, 409–10.

75. *See* Fischman v. Raytheon Mfg. Co., 188 F.2d 783, 788 (2d Cir. 1951); *see also* 111 A.L.R. Fed. 83 (1993).

76. 15 U.S.C. § 77a et seq.; 15 U.S.C. § 78a et seq.; *see also infra* note 122 (citing specific portions of the Acts that deal with securities fraud).

## D. Why SPAC Directors Are Like IPO Underwriters

As shown above, the SPAC structure often allows SPACs to outperform IPOs by getting private companies to market more quickly and better protecting investor capital.[77] However, because the end goal for both SPACs and IPOs is to take a company public, the roles of the key players in SPACs and IPOs are analogous. For instance, a SPAC works with a team to gather the target company's financial data and then markets its shares, as an underwriter would do for the issuing company in an IPO.[78] The SPAC directors and officers then relay the target company's information to the SPAC's shareholders via a proxy statement so shareholders can determine whether to remain in the deal.[79] This step of the SPAC process is analogous to IPO underwriters' marketing the issuing company's shares to investors during the roadshow.[80] Additionally, the target company in a SPAC is like the issuer in a traditional IPO because the target company can go public in a de-SPAC transaction just as an issuer can go public with a traditional IPO.[81] In other words, the target company in a SPAC and the issuer in an IPO often share the same end goal of becoming traded publicly and accessing as much capital as possible.[82]

Grasping the above analogy is critical to understanding why corporate fiduciary duties should be amended (or the SPAC structure revised) to make the SPAC directors' liability match that of IPO underwriters. Clarifying any distinction between underwriters' liabilities versus SPAC directors' and officers' liabilities is essential since the two play very similar roles in taking private companies public.[83] The key difference is that SPAC directors owe fiduciary duties to the SPAC's shareholders before and after the de-SPAC transaction. In contrast, the IPOs' underwriters owe no fiduciary duties to the purchasers of their IPO shares at any time.[84] Underwriters do not have a fiduciary duty because they rely upon the information provided to them by the private company seeking to go public when they promote the private

77. *See supra* Part II.C.

78. See *supra* Part II.A and accompanying text.

79. Riemer, *supra* note 29, at 952.

80. *See supra* Part II.A (discussing that the underwriters pitch the securities of the issuing company to institutional investors on a roadshow).

81. *See supra* Part II (stating that IPOs go public on the offering date and that SPACs go public in a de-SPAC transaction).

82. *See supra* Part II.

83. *See* Riemer, *supra* note 29, at 952; Richard Harroch et al., *10 Key Questions And Answers About SPACs*, FORBES (Nov. 11, 2020), https://www.forbes.com/sites/allbusiness/2020/11/11/10-key-questions-and-answers-about-spacs/?sh=4203914b2f83 (stating that "the SPAC will do extensive due diligence on the target company, similar to due diligence in M&A or IPO transactions").

84. *See supra* Part II.C.

company's stock.[85] Suppose the issuing company provides underwriters with false information the underwriters could not verify through reasonable care. In that case, the law does not hold underwriters liable for the issuing company's misrepresentation when making securities based on statements that the underwriters reasonably believed to be accurate.[86] Hence, IPO underwriters are afforded the protection of the "due diligence defense" under Section 11(b) of the Securities Act, which absolves them of liability for misstatements made in registration statements if "after reasonable investigation" they believed the statements to be true at the time of filing.[87]

Likewise, SPAC directors rely upon the target company to provide accurate financial reports and data to make an informed business acquisition.[88] Assuming a SPAC's directors and officers have exercised reasonable due diligence, any negligence or fraudulent misrepresentation will likely be the target company's fault.[89]

Therefore, because SPAC directors are similarly situated to the underwriters in a traditional IPO, it is equitable for SPAC directors' and officers' liability to match that of IPO underwriters. Namely, SPAC directors should enjoy the due diligence defense afforded to IPO underwriters, to protect them from litigation after the de-SPAC transaction. Additionally, corporate fiduciary duties in a merger context spring from the fact that directors have higher duties because they are acting on behalf of all shareholders, and the majority can bind minority holders.[90] However, in a de-SPAC, every public holder has the right to opt out via redemption, so even if a majority decision binds, minority shareholders retain an exit option.[91]

The immediate solution is to change the SPAC structure to mitigate liability for breach of SPAC directors' and officers' corporate fiduciary duties, to reflect that SPAC directors' and officers' motives differ fundamentally from those of directors and officers in traditional mergers. It is also imperative that courts understand that the fundamental differences of SPACs, as compared to traditional mergers, ensure that the majority cannot force minority shareholders into the merger.

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85. *See* Corrigan, *supra* note 70, at 345–48.
86. 15 U.S.C. § 77k(b).
87. *Id.*; *In re* WorldCom, Inc. Sec. Litig., 346 F. Supp. 2d 628, 662 (S.D.N.Y. 2004).
88. *See* Riemer, *supra* note 29, at 952.
89. *See generally* AP Servs., LLP v. Lobell, No. 651613/12, 2015 N.Y. Misc. LEXIS 2314 (N.Y. Sup. Ct. June 19, 2015).
90. *See* Gantler v. Stephens, 965 A.2d 695, 708 (Del. 2009).
91. *See* Rodrigues & Stegemoller, *supra* note 15, at 914.

## III. DELAWARE: CORPORATE FIDUCIARY DUTIES, THE RELEVANT STANDARDS OF REVIEW, AND WHY THEY SHOULD NOT APPLY TO SPACS

Because most SPACs are Delaware Corporations, Part III.A of this Note will focus on the relevant Delaware laws governing corporate fiduciary duties and why they should not apply uniformly to SPACs.[92] Part III.B will address potential inherent conflicts of SPAC directors and officers. Part III.C will explain why the business judgment rule should apply when plaintiffs sue SPACs for breach of fiduciary duty.

### A. Delaware's Laws Governing Corporate Fiduciary Duties

Delaware imposes the duties of care and loyalty upon the directors and officers of its corporations.[93] First, the duty of care requires directors to avoid gross negligence when making business decisions.[94] A director breaches his duty of care to the corporation and its stockholders when he fails to act with the level of care attributable to an ordinarily careful and prudent person in a similar circumstance.[95]

When a plaintiff asserts that a director has breached his duty of care or duty of loyalty, the court applies the business judgment standard of review.[96] The business judgment standard of review is the general assumption that the directors of the corporation have exercised judgment "on an informed basis, in good faith, and in the honest belief that the action taken was in the best interests of the company."[97] A plaintiff seeking to rebut the business judgment standard of review by showing a breach of the duty of care is required to show that the directors were grossly negligent by ignoring red flags or failing to use all the information available to them in making a business decision.[98]

The duty of loyalty requires the directors to act in good faith, to act in the best interest of both the corporation and its shareholders, and to refrain

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92. *See* SPAC Update, *supra* note 20, at 10 (noting that many SPACs are domiciled in the Cayman Islands).

93. *See* 1 R. FRANKLIN BALOTTI ET AL., DELAWARE LAW OF CORPORATIONS AND BUSINESS ORGANIZATIONS § 4.19 (John Mark Zeberkiewicz & Blake Rohrbacher eds., 4th ed. 2020 & Supp. 2021).

94. RONALD J. COLOMBO, LAW OF CORPORATE OFFICERS & DIRECTORS: RIGHTS, DUTIES, & LIABILITIES § 2:5 (2020–2021 ed. 2020).

95. *Id.*; Thomas A. Uebler, *Shareholder Police Power: Shareholders' Ability to Hold Directors Accountable for Intentional Violations of Law*, 33 DEL. J. CORP. L. 199, 208 (2008) ("[A] court will only conclude that a director has breached his duty of care based on the substance of his decision if no rational person would make the decision under the circumstances.").

96. COLOMBO, *supra* note 94, at § 2:16.

97. *Id.*

98. *Id.*

from any act of self-dealing.[99] Breach of the duty of loyalty most often occurs when directors have conflicts of interest or additional conflicting corporate opportunities.[100] When a director has breached his duty of loyalty, the court applies the entire fairness standard of review.[101] The entire fairness standard of review is a higher level of scrutiny than the business judgment rule and requires the court to determine whether the transaction was fair and the product of fair dealing.[102] While plaintiffs bear the burden of proof under the business judgment rule, directors bear the burden of proof under the entire fairness standard of review.[103]

Directors wishing to avoid carrying the burden of proof under the entire fairness standard of review can "cure" the transaction by (1) having the transaction approved by a majority of the minority shareholders or (2) having the transaction approved by a majority of the disinterested directors.[104] If the directors cure the transaction with one of these two procedural safeguards, then the burden will shift back to the plaintiff to show that the transaction was unfair.[105]

Section B will show that the duty of loyalty is of more immediate concern to SPAC directors because the directors have potential inherent conflicts requiring the court to apply the entire fairness standard of review. Section C will address the duty of care and how it should be amended for SPAC directors.

### B. Inherent Conflicts of SPAC Directors: Why the Procedural Safeguards Are Redundant

The board of directors of a SPAC is more susceptible to liability for breach of the fiduciary duty of loyalty because of the inherent potential for conflicts of interest that arise due to the SPAC's compensation structure.[106] The directors are not compensated unless the SPAC merges with the target company.[107] If the merger fails or does not occur at all, the directors are not compensated for the two or more years of work they have performed.[108] This compensation structure coupled with the deadlines required to complete the

99. *Id.* § 3:1.
100. *Id.* § 3:5.
101. *Id.* § 3:23.
102. COLOMBO, *supra* note 94, at § 3:23.
103. Cinerama, Inc. v. Technicolor, Inc., 663 A.2d 1156, 1163 (Del. 1995) (stating that the directors must demonstrate value of the price offered, not the plaintiffs).
104. *See* Mary A. Jacobson, *Interested Director Transactions and the (Equivocal) Effects of Shareholder Ratification*, 21 DEL. J. CORP. L. 981, 989 (1996).
105. *Id.* at 1009.
106. Rodrigues & Stegemoller, *supra* note 15, at 904.
107. *Id.* at 904–05.
108. *See id.*

merger can arguably motivate the directors to push for the deal to go through before the SPAC's charter expires.[109] Depending on the court's view of the materiality of the compensation, the compensation structure can make the directors' interests differ from the public's interest and, therefore, subject to the entire fairness standard of review.[110] While conflicts of interest can arise with almost any merger transaction, SPACs have instituted strong procedural safeguards to mitigate the inherent conflicts of interest of the SPAC fiduciaries.[111]

The procedural safeguard most SPACs utilize to protect investors is approval by the majority of shareholders.[112] Because SPACs hold most of the capital raised at the SPAC IPO in a trust account (often over 95%), the capital is well protected and at low risk of loss before the de-SPAC transaction.[113] Additionally, SPACs often make a tender offer to purchase the shares of investors that wish to exit before the de-SPAC transaction.[114] These tender offers are often financed by PIPE capital, allowing de-SPAC transactions to close in a timely fashion.[115] When the de-SPAC transaction is not approved, or the SPAC lacks sufficient capital to close the deal, the trust account is liquidated and distributed to the shareholders.[116]

Shareholders will often have standing to sue if the transaction did not perform according to their expectations.[117] They could bring suit based on a breach of corporate fiduciary duty, alleging that the directors had conflicts of interest, with the case potentially subject to review under the entire fairness standard.[118] The overt problem with this is that the only way SPAC directors could conceivably breach their duty to shareholders would be by misleading shareholders with misinformation about the target company.[119] And the only way directors could provide such misinformation would be by negligently failing to complete due diligence, relying on misinformation supplied by the target company, or fraudulently misleading the shareholders through

109. *See id*. at 899.

110. *See supra* Part III.A.

111. *See* Iman Anabtawi, *The Twilight of Enhanced Scrutiny in Delaware M&A Jurisprudence*, 43 DEL. J. CORP. L. 161, 171 (2019) (explaining that Delaware has begun to allow procedural safeguards to bring directors' decisions from enhanced scrutiny down to the business judgment standard of review); *e.g.*, Rodrigues & Stegemoller, *supra* note 15, at 910–12.

112. Rodrigues & Stegemoller, *supra* note 15, at 910–12.

113. *Id.* at 914–15.

114. *Id.* at 912.

115. LAYNE ET AL., *supra* note 7, at 3.

116. Rodrigues & Stegemoller, *supra* note 15, at 914.

117. Kramer v. W. Pac. Indus., Inc., 546 A.2d 348, 353 (Del. 1988) (explaining that shareholders can bring a derivative cause of action for director mismanagement).

118. *See supra* notes 101–05.

119. *See supra* Part II.D.

intentional misrepresentation of the target company's information.[120] The Securities Exchange Act has provisions that allow shareholders to recover in each scenario; therefore, it would be redundant to hold directors liable for breach of fiduciary duty.[121] Furthermore, as interpreted in most case law, corporate fiduciary duties do not adequately function when applied to shell companies like SPACs because most caselaw involves traditional mergers between two operating companies.[122]

Part III.C. will show why the business judgment rule should apply when reviewing SPAC directors' and officers' decisions in most cases of material misrepresentation. Additionally, it will show that even when SPAC directors and officers mislead their investors, the investors' best remedy will likely be under the Securities Exchange Act.

## C. Business Judgment Rule: Why it Should Apply Instead of the Entire Fairness Standard of Review

As mentioned in Part III.A, the business judgment rule is the court's presumption that the directors have acted in the shareholders' best interest, and its purpose is to mitigate liability for directors and officers of corporations.[123]

The most accessible argument that a frustrated investor can put forward under Delaware laws of corporate fiduciary duty is that the directors and officers have inherent conflicts of interest and have violated their duty of loyalty.[124] Regarding this primary argument, the fact that the directors and officers have interests that differ from the public's should not equate to a breach of the duty of loyalty, for two reasons. First, the shareholders entered the transaction understanding that the SPAC's purpose is to acquire a target company within a specified period.[125] Second, the shareholders entered the deal knowing that the SPAC's directors are not compensated if a target is not acquired.[126]

Because shareholders voluntarily invest in SPACs with full knowledge of the SPAC's purpose to acquire a target company and of how the SPAC

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120. *See supra* Part II.D (explaining how the roles of SPAC directors and officers are analogous to the roles of IPO underwriters, in that both must perform due diligence in determining the value of the target company or issuing company respectively).

121. *See infra* Part IV.B (starting at note 198 regarding the applicable provisions of the 1933 and 1934 Acts).

122. *See generally* Christopher Kercher et al., *Litigation Risk in the SPAC World*, (Oct. 1, 2020), JD SUPRA, https://www.jdsupra.com/legalnews/litigation-risk-in-the-spac-world-88058/#_ftnref11 (stating that "the SEC recently announced that it will be carefully scrutinizing SPACs" and then analyzing the likely types of litigation that will surround SPACs).

123. *See supra* Part III.A.

124. *See supra* Part III.B.

125. *See supra* Part III.B.

126. *See supra* Part III.B.

directors are compensated, courts should assume that the shareholders' interests align with the directors' and officers' interests. Additionally, the majority cannot force the minority shareholders into the de-SPAC transaction because, aside from the proxy vote, minority shareholders can exercise rights to redeem their shares voluntarily.[127] Therefore, SPAC directors should be liable only for negligently or intentionally committing securities fraud. If the shareholders need to sue for either reason, they have the means to do so under the appropriate securities laws.[128]

The second argument shareholders might bring is that the directors and officers have breached their duty of care by being grossly negligent in reviewing the target company, ignoring red flags, or providing the shareholders with materially false information in the proxy filings.[129] Regarding this argument, a court will need to determine whether the directors and officers have applied the level of care attributable to an ordinarily careful and prudent person in a similar circumstance.[130] When analyzing the directors' judgment, the judiciary should recall that the directors and officers of SPACs are more similarly situated to the underwriters of an IPO than to directors and officers of traditional mergers.[131] SPAC directors are more like IPO underwriters because they rely on the target company's information (verified to the extent reasonably possible by the directors and the SPAC's advisors) to make a purchase decision just as underwriters rely on the information of an issuing company.[132] Therefore, directors and officers of a SPAC often do not have firsthand knowledge of the target company's operations. This lack of knowledge means that the target company could mislead SPAC directors and officers with inaccurate financial reports. False or misleading reports, unverifiable through reasonable due diligence, would, in turn, cause the SPAC directors and officers to mislead the SPAC's shareholders.[133] Considering that directors and officers lack inside knowledge of the target company, a court should revert to the business judgment rule for challenges to the breach of the duty of care absent a showing that the SPAC's directors and officers misled the SPAC shareholders either fraudulently or by gross negligence.

Because the directors and officers of SPACs primarily rely on the target company's reported information, they need a defense like the due diligence

127. *See supra* Part III.B.

128. *See infra* Part IV.C.

129. *See* AP Servs., LLP v. Lobell, No. 651613/12, 2015 N.Y. Misc. LEXIS 2314, at *23–24 (N.Y. Sup. Ct. June 19, 2015) (explaining that the plaintiff's first cause of action included breach of the duty of care for failing to heed "red flags").

130. *See supra* Part III.A.

131. *See supra* Part II.D.

132. *See supra* Part II.D.

133. *See supra* Part II.D (explaining that directors and officers of SPACs do not have unrestricted access to the target company's information, making them susceptible to being misled by information that appears facially accurate).

defense afforded to IPO underwriters, in two circumstances. The first is when plaintiffs sue after the de-SPAC transaction for breach of the fiduciary duties of care and loyalty. The second is when plaintiffs sue for securities fraud.

Part IV will review two lawsuits against SPACs, one for breach of fiduciary duties and the other for securities fraud.

## IV. CASE STUDY: CORPORATE FIDUCIARY DUTIES ECLIPSED BY SECURITIES LAWS AS REMEDY FOR HOLDING SPAC DIRECTORS LIABLE FOR SECURITIES MANIPULATION

Shareholders dissatisfied with the outcome of the de-SPAC transaction can pursue the SPAC directors and officers for a claim of breach of corporate fiduciary duties or a claim of securities fraud under the Securities Exchange Act.[134] Part IV.A discusses the importance of a New York Superior Court case where creditors brought a breach of corporate fiduciary duties claim and the court held that the plaintiffs had pled sufficient facts to successfully rebut the business judgment standard of review. Part IV.B examines a case from the Southern District of New York brought by the SEC for securities fraud, to show how securities laws more appropriately address most issues that will arise from fraudulent or grossly negligent behavior on the part of SPAC directors and officers.

### A. Case 1: *AP Servs., LLP v. Lobell* – Shareholders Sue for Breach of Fiduciary Duties

One of the more recent lawsuits involving a SPAC and the business judgment rule is *AP Servs., LLP v. Lobell*.[135] This opinion is the New York Superior Court's ruling on the defendant's motion to dismiss for failure to state a claim.[136] In this case, the plaintiff, AP Services LLP ("AP Services"), brought an action for breach of the fiduciary duty of care and the duty of loyalty against the directors of the SPAC, Paramount Acquisition Corp ("Paramount").[137] AP Services alleged that the directors of the SPAC had a conflict of interest stemming from the compensation structure of the SPAC.[138] AP Services explained that Paramount's directors would not receive compensation if a target company was not acquired by October 2007.[139] In January of 2007, the merger that Paramount's directors had in the works fell through, leaving

134. *See supra* Part II.C.

135. AP Servs., LLP v. Lobell, No. 651613/12, 2015 N.Y. Misc. LEXIS 2314 (N.Y. Sup. Ct. June 19, 2015).

136. *Id.* at *1–2.

137. *Id.* at *1.

138. *See id.*

139. *Id*. at *3–4.

just under ten months for them to complete a merger.[140] AP Services alleged that Paramount's directors then "'began frantically searching for a new merger target.'"[141] Paramount's directors signed over twenty new non-disclosures with potential targets in their search for the new merger and eventually settled on Chem Rx.[142] Paramount's directors signed a merger agreement with Chem Rx after achieving board approval in a two-hour meeting.[143] Paramount then managed to get 80% shareholder approval after making concessions to the larger shareholders, namely $30 million in put options.[144]

Once the shareholders approved the deal, AP Services alleged that Paramount's directors ignored red flags in "an intentional dereliction of their fiduciary duties" to the corporation's shareholders.[145] AP Services stated that the red flags were the "untrustworthy and incomplete" financial statements of the target company, an exorbitant $4.63 million "advisory fee" paid to Chem Rx's original auditor, a pre-LBO payment to one of Chem Rx's largest suppliers, and the $30 million in put options afforded the largest shareholders.[146] In ignoring the red flags, AP Services alleged that Paramount's directors caused Chem Rx to become "saddled" with "massive debt" that caused the company to go bankrupt in 2010.[147] AP Services brought the action on behalf of Chem Rx's litigation trust as mandated by the bankruptcy court.[148]

The court determined that the plaintiffs had pled sufficient facts that, taken as true, would successfully rebut the business judgment rule.[149] The court then explained within the footnotes that it might have held differently concerning the standard of review if the parties had cited legal authority to specifically address the interests of SPAC directors, or if the defendants had cited legal authority to establish a defense.[150] Faced with legal authority supporting either contingency, the court would have stood willing to reverse its opinion that the plaintiffs had rebutted the business judgment standard of review at this stage of the proceedings.[151]

There are four key points to highlight from this case. First, the alleged negligence is that the SPAC's directors and officers overlooked the target company's inflated financials.[152] Second, the court held that the plaintiffs pled

140. *Id.*
141. *Lobell*, 2015 N.Y. Misc. LEXIS 2314, at *4 (internal quotations omitted).
142. *Id.*
143. *Id.* at *5–6.
144. *Id.* at *7.
145. *Id.* at *10–11.
146. *Id.* at *10 (internal quotations omitted), *22–33.
147. *Lobell*, 2015 N.Y. Misc. LEXIS 2314, at *1, *9.
148. *Id.* at *9.
149. *Id.* at *18.
150. *Id.* at *18–20.
151. *See id.*
152. *See id.* at *1.

sufficient facts to show the directors and officers to have conflicts of interest stemming from the SPAC's compensation structure.[153] Third, the conflicts of interest, taken as true, meant that the lower court should consider whether the entire fairness standard applied.[154] And fourth, the court would likely have ruled differently had the defendants cited legal authority for some type of curing defense.[155]

### 1. *The "Red Flags" Were the Immediate Responsibility of the Target Company's Directors and Officers*

Among the red flags plaintiffs cited were 'untrustworthy and incomplete' financial statements.[156] But these 'untrustworthy and incomplete' financial statements belonged to the target company, not to the SPAC.[157] Therefore, the target company should be held directly liable for its misleading financial statements that the SPAC directors and officers reported in the Proxy Statement and Stock Purchase Agreement.[158] Interestingly, in an attempt to protect itself from this exact scenario, the SPAC included an exculpatory clause in its articles of incorporation to preclude its shareholders from suing for breach of fiduciary duty.[159] The court determined the SPAC had exculpated itself from litigation for breach of the duty of care for ordinary negligence, but not for gross negligence.[160] For this reason, the court focused on determining whether the directors and officers of the SPAC had failed to exercise proper oversight by ignoring red flags in a grossly negligent manner.[161]

The Court's analysis in *Lobell* illustrates that target companies should in some way be held liable for providing misleading statements. It also indicates that SPACs can exculpate themselves from liability for breach of the duty of care. However, it is not wrong to hold SPAC directors and officers liable when they have committed gross negligence in ignoring prominent red flags.[162]

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153. *Lobell*, 2015 N.Y. Misc. LEXIS 2314, at *18.

154. *Id.*

155. *Id.* at *19–20.

156. *Id.* at *10 (internal quotations omitted).

157. *Id.* (internal quotations omitted).

158. *See infra* Part IV.B (arguing that directors of target companies should be held liable for securities fraud).

159. *Lobell*, 2015 N.Y. Misc. LEXIS 2314, at *24. Exculpatory clauses of this nature prevent recovery by plaintiffs suing for breach of fiduciary duty unless the director has breached his duty of loyalty, acted in bad faith, or for various other enumerated exceptions as explained in Delaware law. *See* DEL. CODE ANN. tit. 8, § 102(b)(7) (2020).

160. *Lobell*, 2015 N.Y. Misc. LEXIS 2314, at *24–25 (explaining how the directors cannot be held liable for simple negligence due to their having included an exculpatory clause in the articles of incorporation).

161. *Id.* at *25.

162. *See id.* at *26–27.

Therefore, the only way the SPAC directors could have been held liable for breach of the duty of care in ignoring the red flags was for the plaintiffs to establish that the SPAC directors did so either intentionally or with gross negligence.[163] Assuming the court finds a SPAC's directors have ignored the red flags and included the "untrustworthy and incomplete" financial statements in a grossly negligent manner, the directors' conduct would be a breach of the duty of care.[164] However, their conduct would be more accurately described as securities fraud under both the Exchange Act and the Securities Act.[165]

Because a court could hold SPAC directors liable for securities fraud for filing proxy statements in an intentionally fraudulent or grossly negligent manner, holding them accountable for a breach of the duty of care in the same scenario is redundant. Additionally, the SEC is better equipped to decide whether securities fraud exists, as implicated by (1) the SEC's mission statement[166] and (2) the existence of the business judgment rule.[167] For these reasons, courts should hold SPAC directors and officers responsible for securities fraud under the Securities Act of 1933 or the Securities Exchange Act of 1934 rather than the laws of corporate fiduciary duties.

### 2. *The Potential Inherent Conflicts of Interest Should not Immediately Invoke the Entire Fairness Standard of Review for SPACs*

The *Lobell* court held that the plaintiffs had pled sufficient facts to show that the SPAC's directors and officers had inherent conflicts of interest.[168] In holding that inherent conflicts were likely present, the court relied primarily upon two factors presented in the plaintiff's brief. First, the court relied upon an unpublished Delaware opinion that briefly mentioned the potential inherent conflicts created by SPAC compensations structures.[169] Second, the court relied upon the SPAC's Proxy Statement, which also acknowledged that directors and officers might face conflicts due to compensation structure.[170] As noted above, the court expressed its willingness to reinstate the business judgment standard of review if the defendants had cited some legal authority that

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163. *See id.* at *25–27.

164. *Id.* at *10, *35–36.

165. *See* Kercher et al., *supra* note 122 ("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.").

166. *About the SEC*, U.S. SEC. AND EXCH. COMM'N (Nov. 22, 2016), https://www.sec.gov/about.shtml ("The mission of the SEC is to protect investors . . . .").

167. *See supra* Part III.A.

168. *See Lobell*, 2015 N.Y. Misc. LEXIS 2314, at *18.

169. *See id.* at *19.

170. *See id.* at *4, *19.

specifically addressed SPAC directors' interests, or some legal authority to establish an applicable defense.[171]

The *Lobell* court acknowledged that there was little support for its ruling that the plaintiffs had pled sufficient facts to show that the directors and officers of the SPAC had inherent conflicts of interest.[172] The *Lobell* court found the lower court's citation of an unpublished case to be weak, because the lower court cited a party's argument rather than an established holding.[173] The lower court's holding does not mention any conclusion on potential conflicts of the SPAC directors and officers.[174] Because the *Lobell* court relied on the petitioner's argument in an unpublished Delaware case as persuasive authority for holding that SPAC directors are inherently conflicted, courts should disregard this specific point of reasoning in the *Lobell* opinion.[175]

Second, the court in *Lobell* relied on statements in the SPAC's filings that acknowledged the directors and officers might face conflicts due to the SPAC's compensation structure.[176] Found in the Proxy filing, the first statement mentions that the directors may "have interests in the Transaction that may be different from [the shareholders]" due to the directors' compensation method.[177] The second statement in the Registration Statement explains that the directors may have "a potential conflict of interest" because of the possible loss of the directors' investment.[178] Other SPACs, including DraftKings, provide similar statements to reduce liability for non-disclosure of potential risks mandated by the bespeaks caution doctrine.[179]

Since proxy statements explain directors' and officers' interests in the transaction, shareholders enter the deal knowing how the directors and officers are to be compensated and that the deal must close within a specified period.[180] Additionally, if shareholders wish to exit the deal, they can redeem their shares before the de-SPAC transaction.[181]

171. *See id.* at *18–20.

172. *See id.*

173. *See id.*

174. Opportunity Partners, L.P. v. TransTech Serv. Partners, Inc., No. 4340-VCP, 2009 WL 997334, at *7 (Del. Ch. Apr. 14, 2009) (holding that the SPAC should hold an annual meeting before a specified date, and omitting any positive determination that the underlying structure of SPACs is positive identification of inherent conflicts of interest).

175. *Lobell*, 2015 N.Y. Misc. LEXIS 2314, at *18–20.

176. *Id.* at *16–18.

177. *Id.* at *17 (internal quotations omitted).

178. *Id*. (referring to the loss of compensation if the directors are unable to complete a de-SPAC transaction).

179. *See* HAROLD S. BLOOMENTHAL & SAMUEL WOLFF, SECURITIES AND FEDERAL CORPORATE LAW § 12:57 (2d ed. 2021); Diamond Eagle Acquisition Corp., Proxy Statement (Schedule 14A) 77–78 (Apr. 15, 2020) https://www.sec.gov/Archives/edgar/data/1772-757/000110465920046722/tv539133-defm14a.htm#TOC.

180. *See* Diamond Eagle Acquisition Corp., *supra* note 179, at 77–78.

181. LAYNE ET AL., *supra* note 7, at 17.

Because shareholders know the SPAC's compensation structure on the front end and that its purpose is to acquire a target within a specified time, this Note argues that courts should consider the interests of shareholders and SPAC directors and officers to be aligned. Additionally, the SPAC's directors and officers owe fiduciary duties to the shareholders and the corporation.[182] Delaware's laws reflect this principle, repeatedly "refer[ring] to directors owing fiduciary duties to the corporation and its shareholders."[183] Because the directors also owe fiduciary duties to the corporation, whose sole purpose is to acquire a target company within a specified period, the directors should not be held liable for breach of fiduciary duties for striving to accomplish the SPAC's fundamental purpose. This argument does not posit that SPAC directors and officers should not be held liable for fraud or gross negligence. But as pointed out above, the most likely type of fraud or gross negligence in a SPAC will be securities fraud because the SPAC is a shell company with no operations,[184] and its goal is to take a private company public.

In the absence of a conclusive opinion from the Delaware Supreme Court explicitly addressing the business judgment rule's application to SPACs, a court should note five factors when deciding what standard of review to apply. First, the court should note that SPAC directors must complete an acquisition within a short period. Second, the court should acknowledge that the shareholders entered the deal knowing how SPACs compensate their directors and officers. Third, the court should appreciate the directors' and officers' upfront disclosure of possible conflicts of interest, pursuant to the bespeaks caution doctrine. Fourth, the court should understand that SPAC directors and officers are analogous to underwriters in a traditional IPO; therefore, any cause of action for breach of fiduciary duty will likely involve securities fraud. Lastly, the court should appreciate that it is not the SPAC's information in the proxy and registration statements that is most susceptible to material misrepresentation, but rather the target company's information.

For these reasons, a court analyzing an action for breach of the duty of loyalty against SPAC directors and officers should not immediately apply the entire fairness standard of review. Additionally, a court should note that plaintiff's lawyers should bring any action to recover for securities fraud under the Securities Exchange Act's appropriate measures, to enhance judicial economy and overall fairness.

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182. *In re* Trados Inc. S'holder Litig., 73 A.3d 17, 36–37 (Del. Ch. 2013) (establishing that the directors and officers also owe a duty to the corporation, as indicated by the formulation of Delaware's laws of corporate fiduciary duties).

183. *Id.* at 36 (internal quotations omitted).

184. LAYNE ET AL., *supra* note 7, at 25.

### B. Case 2: *Sec. & Exch. Comm'n v. Hurgin* – SEC Sues for Securities Fraud

In *Sec. & Exch. Comm'n v. Hurgin*, the SEC brought an action against a company that went public through a SPAC.[185] The SEC brought an action for securities fraud and violation of proxy solicitation rules against Ability Inc. (the merged company), its Chief Executive Officer (CEO), and its Chief Technology Officer (CTO) as joint defendants.[186] The target company's CEO and CTO were named defendants because they participated in soliciting the de-SPAC transaction's proxies and consent materials.[187]

The relevant facts are that the target company had, through the CEO and CTO, misrepresented to investors its financial projections and other material facts.[188] The CEO represented that Ability owned proprietary technology unavailable to its competitors, and that Ability had over $65 million in backlogged revenue evidenced by signed purchase orders.[189] Ability ultimately projected to investors that it would generate up to $110 million in revenue in 2016.[190]

Based on the target company's projections, the SPAC and Ability entered into a merger agreement signed by the CEO and CTO.[191] The agreement expressly permitted using the CEO and CTO's names for solicitation of proxies and consents.[192] The merger agreement also stipulated that Ability and the SPAC would be jointly responsible for preparing proxy materials, and required Ability's representations to be true and correct at the time of the agreement.[193]

After signing the merger agreement, the SPAC conducted due diligence toward the target company by hiring two auditing agencies.[194] One of the agencies returned a report consistent with Ability's revenue predictions.[195] However, the other auditing agency reported that signed purchase orders supported only about a third of the backlogged revenue, that most of the orders were from a single client, and that these two issues "could indicate a significant risk."[196]

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185. SEC v. Hurgin, 484 F. Supp. 3d 98, 103–04 (S.D.N.Y. 2020).
186. *Id.* at 104–07.
187. *Id.* at 105–06 ("Specifically, each signed a form on November 17, 2015, . . . consenting to the use of his name in the Proxy Statement." (internal quotations omitted)).
188. *Id.* at 107.
189. *Id.* at 104.
190. *Hurgin*, 484 F. Supp. 3d at 104.
191. *Id.* at 105.
192. *Id.*
193. *Id.* at 106–07.
194. *Id.* at 105.
195. *Id.*
196. *Hurgin*, 484 F. Supp. 3d at 105.

The SPAC and Ability included only the auditor's report that echoed Ability's revenue predictions in its investor presentations.[197] They omitted the auditor's report revealing the purchase order discrepancy and small client base.[198] Even worse, the SPAC and Ability included materials from the CEO's presentation regarding projected revenues and proprietary technology ownership.[199] After completing the de-SPAC transaction, Ability's revenue decreased rapidly because its largest client decreased orders and eventually dissipated in 2017.[200] In Ability's 2015 Form 20-F report with the Commission, it "disclosed publicly for the first time" that it did not own the proprietary technology but sold it under a reseller agreement.[201]

After Ability filed the report, the SEC filed a complaint alleging that the defendants violated Section 10(b) of the Exchange Act, Rule 10b-5, Section 17(a) of the Securities Act, Section 14(a) of the Exchange Act, and Rule 14a-9, to which the defendants responded by filing motions to dismiss the claims.[202] The court pointed out in reviewing the motions to dismiss that scienter is required to establish claims under Section 10(b), Rule 10b-5, and Section 17(a)(1); but that scienter is not required to establish claims under Sections 17(a)(2)–(3), Section 14(a) of the Exchange Act, or Rule 14a-9.[203] Additionally, while the provisions requiring scienter demand a showing of "reckless disregard for the truth,"[204] Sections 17(a)(2)-(3) only require "a 'showing of negligence.'"[205]

The SEC alleged that the defendant CEO's claim of Ability's exclusive in-house ownership of proprietary technology was untrue.[206] The defendants were only resellers of the technology for three years under an undisclosed reseller agreement with the true owner.[207] The SEC also alleged that the target company had based its financial growth projections on a sales pipeline that the defendants had fraudulently stated was backed by signed purchase orders.[208] Finally, the SEC claimed that the defendants had wrongfully omitted from the proxy filing the report of an auditing agency that uncovered a lack of signed purchase orders, but had included another auditor's report that was favorable.[209]

197. *Id.* at 106.
198. *Id.*
199. *Id.*
200. *Id.* at 107.
201. *Id.*
202. *Hurgin*, 484 F. Supp. 3d at 107–08.
203. *Id.* at 109.
204. *Id.* (internal quotations omitted).
205. *Id.* (quoting SEC v. Ginder, 752 F.3d 569, 574 (2d Cir. 2014)).
206. *Id.* at 107.
207. *Id.*
208. *Hurgin*, 484 F. Supp. 3d at 107.
209. *Id.*

The defendants argued that the misstatements were immaterial and that some of the statements were not actionable under the bespeaks caution doctrine.[210] The bespeaks caution doctrine states that "forward-looking statements are not actionable if the speaker discloses the contingency that lies at the heart of the alleged misrepresentation."[211] The defendant CEO's arguments that the statements were immaterial did not persuade the court at this initial stage of the pleadings.[212] In response to the defendant's use of the bespeaks caution doctrine, the court pointed out that the doctrine does not apply to situations where the potential problems disclosed have already materialized.[213] In this case, the potential problems of a thin client base and unsigned purchase orders already existed and could not be mitigated by a disclaimer that they might arise.[214]

The court ultimately concluded that the SEC had pled sufficient facts to survive a motion to dismiss.[215] Also, the court noted that although the SEC might have failed to plead sufficient facts to prove scienter, scienter is best determined by a finder of fact, and it is not usually "appropriate for a district court to decide questions of scienter as a matter of law."[216]

Securities laws offer a more comprehensive remedy for any negligence or fraud on the part of SPAC directors and officers. The following subsection will explain why SPAC litigation should be heard in federal court to enhance judicial economy and overall fairness, by using securities laws instead of the laws of corporate fiduciary duties to help plaintiffs recover. The second subsection will explain why directors and officers of target companies are often more liable for any misrepresentation of material facts than the directors and officers of SPACs.

#### 1. *SPAC Litigation Should be Heard in Federal Court to Enhance Judicial Economy and Enhance Plaintiffs' Likelihood of Recovery*

SPAC litigation such as *Hurgin* and *Lobell* should be brought in federal court because the federal courts are better equipped to decide issues that turn upon federal securities law.[217] Litigating in federal court under the securities laws rather than Delaware laws of corporate fiduciary duty is good for

210. *Id.* at 111.
211. *Id.* at 111 (internal quotations omitted).
212. *Id.*
213. *Id.* at 111–12.
214. *Hurgin*, 484 F. Supp. 3d at 112.
215. *Id.* at 113.
216. *Id.*
217. *See* NACCO Indus., Inc. v. Applica Inc., 997 A.2d 1, 24–25 (Del. Ch. 2009) (explaining that plaintiffs can bring cases of common law fraud in state courts for fraud surrounding securities filings, but that if plaintiffs want to seek damages based on the federal securities laws those claims must be brought in federal court).

plaintiffs and judicial economy because a plaintiff's suit is less likely to be dismissed.[218] For instance, at the 2019 ACE Legal Panel discussing securities litigation, the moderator asked Jeremy Lieberman of Pomerantz why the Federal courts have approximately 400 securities cases filed each year instead of the 200 or so cases that were being filed in years prior.[219] Lieberman stated in response that the obvious factor was "the Delaware courts became much more . . . restrictive when it came to . . . merger cases . . . so a number of those cases fled Delaware and now come to federal courts . . . throughout the country."[220]

Securities laws are better for plaintiffs' SPAC litigation because their cases are less likely to be dismissed than if brought under Delaware laws of corporate fiduciary duties.[221] The pleading requirements when seeking recovery under securities laws are less burdensome than the pleading requirements for breach of corporate fiduciary duty. For several of the securities statutes, the plaintiff need only prove negligence instead of a "reckless disregard for the truth" on the directors' part, as shown by the court's analysis in *Hurgin*.[222] The court specifically cited Section 14(a) as potentially imposing a duty on any party that consents to using his name in Proxy Statements.[223] While the analysis in *Hurgin* regarding rule 14(a) does not guarantee that plaintiffs can hold target companies and their directors and officers liable for fraud or material misrepresentation of its financials, it shows plaintiffs can recover from a target company under the securities laws.[224] Because plaintiffs are less likely to have their suits dismissed in the federal courts, and because plaintiffs have a lower bar to meet in pleading, the securities laws provide plaintiffs with a better path to recovery.

### 2. *Why Directors of Target Companies Must be Held Liable for Material Misrepresentation*

It is noteworthy that the *Hurgin* target company's directors were held liable for violations of proxy solicitations filed before the de-SPAC transaction.[225] The court's opinion is interesting because, before the de-SPAC

218. *See* NCPERS, *ACE19: Legal Panel: Securities Litigation*, YOUTUBE (July 25, 2019), https://www.youtube.com/watch?v=Nq1mFLlAkrs&t=1511s.

219. *Id.*

220. *Id.*

221. *See id.*

222. SEC v. Hurgin, 484 F. Supp. 3d 98, 109 (S.D.N.Y. 2020); *see also supra* Part IV (contrasting *Lobell* and *Hurgin*—in *Lobell* the plaintiff had to show gross negligence or reckless disregard for the truth to overcome the business judgment rule, whereas in *Hurgin* the plaintiff simply had to show simple negligence).

223. *Hurgin*, 484 F. Supp. 3d at 117 ("Section 14(a) imposes such a duty on anyone who consents to the use of his name to solicit proxies.").

224. *See id.*

225. *Id.* at 104.

transaction, a SPAC does not require the target company's directors to be involved in the SPAC's proxy and solicitation process.[226] However, the court held that the target company's directors were involved and reachable for several reasons.[227] Namely, the directors signed and consented to using their names in the SPAC's proxy filings in the merger agreement.[228] The target company's CEO also delivered a misleading keynote lecture while aiding the SPAC directors in soliciting investors before closing the de-SPAC transaction.[229]

The court took time to explain why the target company's directors should be held liable for actions taken before the de-SPAC transaction.[230] United States securities laws hold directors and officers of operating companies liable for fraudulently manipulating their proxy statements and reports to shareholders for financial gain.[231] A target company can similarly exploit shareholders by misrepresenting its finances to a SPAC with reports filed in the SPAC's proxy statement. The SPAC's subsequent reliance on the target company's information is not the primary problem; instead, the problem is the target company's misrepresentation of its value to the SPAC. Additionally, since SPACs are shell companies with little to no operating figures to report, it is unlikely that a SPAC would inaccurately state its financial information in a proxy statement.

The target company's directors and officers have an apparent motive to report false financial information, making them the most likely source of inaccurate information. Courts should seek to hold directors and officers of target companies liable for misrepresenting material facts to SPAC directors and officers. However, when SPAC directors and officers work with the target company's directors and officers to mislead the SPAC's shareholders, both should be held liable. Still, when SPAC directors and officers have completed due diligence, and securities fraud is perpetrated solely by the target company, only the target company should be held liable for the fraud.

In sum, directors and officers of target companies have a motive to report false or misleading financial statements to increase the perceived values of their companies. SPAC directors and officers should not be held liable when after reasonable due diligence they fail to discover that a target company's financial statements are misleading. Instead, SPAC directors and officers should include the directors and officers of the target company in proxy filings if possible. In the alternative, courts should recognize that SPAC directors and

226. *Id.* at 117.
227. *Id.* at 117–18.
228. *Id.*
229. *Hurgin*, 484 F. Supp. 3d at 106–07, 113.
230. *Id.* at 117–18.
231. *See id.* at 107–09.

officers should be afforded the due diligence defense as liberally as it is afforded to underwriters in traditional IPOs.

## V. MAKING SPAC DIRECTORS' LIABILITY MORE CLOSELY MATCH THAT OF IPO UNDERWRITERS

Part V will show why SPAC directors' and officers' liability should be limited to match that of IPO underwriters. Part V.A will explain why SPAC directors and officers should be entitled to a due diligence defense as are underwriters in traditional IPOs. Part V.B will show that the lack of precedent for applying the business judgment rule to SPAC mergers does not justify courts' blind reliance on the precedent established in cases regarding traditional mergers.

### A. Why the Due Diligence Defense Should Apply More Liberally to SPAC Directors and Officers than to the Directors and Officers of Operating Companies

Section 11 of the Securities Act holds parties that "play a direct role in a registered offering" liable for failure to fully and fairly disclose material information regarding the offering and the issuer under Section 5.[232] Generally, any party can assert a due diligence defense except an issuer.[233] The law can afford the due diligence defense to inside directors if they can show that they were not the issuer as defined in 15 U.S.C. § 77b[234] and met the due diligence requirements set forth by 15 U.S.C. § 77k.[235] Directors and officers of corporations usually face a high standard when asserting a due diligence defense.[236] The leading cases hold that inside directors and officers "will be liable in practically all cases of misrepresentation," and that "[t]heir liability approaches that of the issuer as guarantor of the accuracy of the prospectus."[237] The due diligence defense operates on a sort of sliding scale, rarely protecting inside directors, occasionally protecting outside directors and low-level managers, but often protecting underwriters and other third-party players in the

232. Herman & MacLean v. Huddleston, 459 U.S. 375, 381–82 (1983); *see also* William K. Sjostrom, Jr., *The Due Diligence Defense Under Section 11 of the Securities Act of 1933*, 44 BRANDEIS L.J. 549, 551 (2006).

233. Sjostrom, Jr., *supra* note 232, at 554.

234. 15 U.S.C. § 77b(a)(4) (2020) (defining "issuer" to mean "every person who issues or proposes to issue any security . . . .").

235. 15 U.S.C § 77k(b)(3).

236. *See* Sjostrom, Jr., *supra* note 232, at 575–77.

237. *Id.* at 577 (internal quotations omitted).

issuing process.[238] It is understandable for courts to be stricter on operating companies' directors and officers since they have firsthand knowledge of daily operations. However, it does not make sense to do the same for the inside directors of SPACs because they do not have inside knowledge of the target company's operations. Instead, courts should afford SPAC directors and officers the due diligence defense as liberally as it is afforded to lead underwriters in traditional IPOs.[239] Courts afford lead underwriters the due diligence defense if they can show that they exercised a "high degree of care in investigation and independent verification of the company's representations."[240]

Because the due diligence defense is rarely effective for inside directors, SPACs should mitigate liability where they can. For example, SPAC directors and officers could use the merger agreement to get a contractual commitment from the target company that its directors will sign the proxy statement, to expose the target company's directors to liability for misstatements in the SPAC's proxy filings.[241] Ultimately, courts should modify the standard of pleading the due diligence defense for SPAC directors to match the standard of pleading afforded to traditional IPO underwriters.

### B. Why the Court Should not Uniformly Apply Precedent Regarding Traditional Mergers to SPACs

The court in *Lobell* accurately noted a lack of precedent that speaks specifically to SPAC directors' and officers' interests and how courts should evaluate them.[242] The recent uptick in SPAC IPOs and SPAC mergers is sure to remedy that situation shortly. Still, in the meantime, courts should understand that SPAC mergers are fundamentally different from traditional mergers. First, traditional mergers almost always are between two operating companies, whereas a SPAC is a publicly-traded shell company merging with an operating target company.[243] Second, the SPAC's stated reason for being is to acquire a target company within a specified period, and the SPAC's directors and officers are not compensated if a de-SPAC transaction does not occur.[244] Third, shareholders invest in a SPAC with knowledge of the SPAC's goal and

238. *Id.* at 599 (stating that courts are stricter on defendants that are more involved with the issuing company and less strict on defendants that are not directly involved in the target company, in a sliding scale approach).

239. *Id.* at 588–89.

240. *Id.* at 588.

241. *See id*. at 558.

242. AP Servs., LLP v. Lobell, No. 651613/12, 2015 N.Y. Misc. LEXIS 2314, at *18–19 (N.Y. Sup. Ct. June 19, 2015) (stating that the parties failed to supply accurate precedent for how Delaware's corporate laws should apply to SPACs).

243. *See supra* Part II.D.

244. *See* SPAC Update, *supra* note 20, at 7.

compensation structure.[245] And fourth, the most likely litigation involving SPACs will be securities fraud since the SPAC is an empty shell company seeking to take a private company public.[246]

Therefore, courts should not immediately apply the entire fairness standard of review to SPACs because the shareholders knowingly joined the investment, and the shareholders can exit if they wish. Based on this knowledge, courts should dismiss most cases under the business judgment standard of review and refer cases to the federal courts for litigation under the appropriate securities laws.

## VI. CONCLUSION

SPACs are increasing in popularity for three primary reasons. First, they are the only method for many companies to reach the public markets. Second, they are quicker for private companies than an IPO. And third, they have procedural and structural safeguards that protect investor capital. This Note illustrated how the procedural safeguards afforded SPAC investors eclipse those afforded to the same investors in a traditional IPO. The Note then explained how one of the structural safeguards, the corporate fiduciary duties of SPAC directors and officers, can expose the company to unwarranted litigation if the company's stock performs poorly after the de-SPAC transaction. While many corporations' directors appropriately have been held to this standard to reduce the likelihood of solitary investors' being unjustifiably forced into a merger, the SPAC's procedural safeguards afford all its investors the ability to redeem shares before the de-SPAC transaction. It is inequitable to allow the investor that approved the de-SPAC transaction and consciously chose to remain an investor to later sue the directors and officers if the company's stock should perform poorly after the de-SPAC transaction.

Furthermore, if directors and officers should mislead investors by failing to disclose the target company's financial status adequately, investors are not left without a remedy. They have the same protections afforded to all shareholders by the Securities Exchange Act of 1934. Since the investors of SPACs already receive enhanced safeguards compared to traditional IPOs, courts should amend the duties of SPAC directors and officers and the defenses afforded to them to match the responsibilities of IPO underwriters and issuers. Ultimately, this approach would promote judicial economy and overall fairness while also protecting companies that go public with SPACs from frivolous lawsuits brought by disappointed investors who seek merely to recover capital after a deal they approved goes south.

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245. *See supra* Part III.A.
246. *See supra* Part III.C.

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