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Ripples Following the SPAC Wave:
Litigation and Regulatory Risks

The Capital Commitment on **May 2, 2023**

It's a pattern we often see in boom-and-bust cycles—disputes rising in the period after a wave crests. SPAC deal volume hit an unprecedented high in 2021, but then slowed down in 2022 alongside IPOs. However, the fallout from the SPAC wave will continue to unfold this year, generating increased regulatory attention and a growing number of disputes.

The beginning of 2023 saw a new 1% excise tax applicable to certain SPAC redemptions go into effect under the Inflation Reduction Act. This year is also certain to see various SEC rule proposals take further shape. Predictably, the increase in activity and media attention and the follow-on regulatory focus have also inspired a surge in disputes. These disputes have given rise to further developments in the case law surrounding SPACs, some of which may increase the risk of and posed by new disputes moving forward.

Regulatory Scrutiny

Although the market has cooled, the SEC is examining historical practices by advisers who sponsored SPACs during the recent SPAC boom. The SEC's 2023 exam priorities include a focus on advisers that sponsored SPACs. Likewise, the Enforcement Division is particularly interested in SPAC sponsors that participated in the equity of a SPAC, through founder shares or a "promote," focusing on potential conflicts of interest. With hindsight, they are focused on historical practices over the past few years by private fund advisers in the space.

In September 2022, the SEC settled its first SPAC enforcement action against a private fund adviser, alleging that the adviser failed to adequately disclose conflicts of interest regarding affiliate ownership of SPAC sponsor shares where the fund also invested in the SPACs. The SEC asserted that beneficial ownership of founder shares by the adviser's employees was a conflict of interest requiring disclosure. The SEC announced a settlement of another, similar SPAC enforcement action concerning alleged conflicts of interest in April.

Private Litigation

On January 4, 2023, the Delaware Chancery Court denied a motion to dismiss a complaint claiming that SPAC directors and the SPAC sponsor breached their fiduciary duty of loyalty to the SPAC's public stockholders. The complaint alleged that the directors and sponsor failed to provide information material to the stockholders' decision whether to redeem their stock before consummation of a de-SPAC transaction.

Joining a line of recent Delaware decisions on SPAC transactions, the Chancery Court highlighted potential conflicts of interest in the SPAC structure and emphasized the importance of full disclosure to shareholders' redemption rights. In particular, the Court noted that the SPAC sponsor is incentivized to enter into a transaction even on less-than-favorable terms because, if no transaction is carried out, the sponsor would take a loss (while the public stockholders would recoup their initial investments). In line with this incentive, the SPAC sponsor may also be motivated to provide inadequate or overly optimistic disclosures about the merger to discourage public stock-holder redemptions (which would deplete funds available for the merger), ensuring that the merger closes. Due to the misalignment in incentives, among other factors, the Court held that the sponsor and directors' decision to enter the transaction was not entitled to "business judgment" deference, and instead they would have to show the transaction was entirely fair to shareholders, a high bar to meet under Delaware law.

The Court also noted the "decoupl[ing]" between the SPAC stockholders' voting rights and economic interests because of the stockholders' ability to redeem their shares but still vote in favor of the merger. The Court noted that SPAC shareholders arguably always have an incentive to vote in favor of a merger even when they redeem because they generally also receive warrants that will not have any value absent a merger. In addition to incentivizing increased disclosures for SPAC sponsors and directors in the lead-up to redemption-eligible deals, this case provides another indicator that Delaware courts are willing and ready to apply plaintiff-friendly "entire fairness" review to SPACs carrying out de-SPAC transactions. Indeed, the Delaware Court of Chancery applied the entire fairness standard once more in a follow-on March 1, 2023 decision against the same SPAC sponsor, and echoing the same reasoning. These developments, in conjunction with other trends such as the increased liquidation of SPACs in 2022—another ready-source of disputes—and continuing heightened regulatory scrutiny, makes SPACs an area of risk for sponsors and directors to watch closely once more in 2023.

Read more of our Top Ten Regulatory and Litigation Risks for Private Funds in 2023.

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