SPAC Attack: An Examination of SPAC Director Compensation and Its Legal Implications

Hunter Fortney*

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Abstract

Special Purpose Acquisition Company ("SPAC") directors are compensated with economic ownership of founders shares, shares which have value if the SPAC combines with an operating business and which expire worthless if that does not occur. By analyzing the public filings of the 248 SPACs that IPOed in 2020, I create a dataset of SPAC director compensation, which is the first of its kind. I find that a director of the median SPAC receives approximately 30,000 founders shares (estimated value $300,000) and a director of the average SPAC receives approximately 40,000 founders shares (estimated value $400,000). I then demonstrate how the current director compensation subjects SPACs and their directors to greater litigation risk under Delaware law. Specifically, SPAC directors may not be considered independent under Delaware law because of the structure and quantum of compensation via founders shares. Furthermore, under Delaware law, if SPAC directors are not independent, legal claims surrounding the SPAC merger may be examined under the exacting entire fairness standard rather than the deferential business judgement rule because potential procedural safeguards of the SPAC, such as the shareholder vote, may not be sufficiently "cleansing." Finally, I propose changes in SPAC director compensation to improve director independence.

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I. Introduction

For the world, 2020 was the year of COVID; for financial markets, 2020 was the year of the SPAC, an acronym for Special Purpose Acquisition Company. [1] In short, a SPAC is a publicly listed, shell company created by a "Sponsor" that raises a pool of capital with the intent to then combine the shell company with a private operating business and take that business public. Proponents of SPACs see SPACs as an alternative to the "broken" IPO process, allowing a company to choose its investors, exercise more control over pricing, and benefit from a quicker and lower cost route to the public markets.[2] Opponents of the current SPAC structure, however, see SPACs as principally enriching the SPAC Sponsors, who often receive equity worth tens or hundreds of millions of dollars, irrespective of performance, and view SPACs as a more expensive route to the public markets than via a traditional IPO.[3] Additionally, opponents see SPACs as vehicles for regulatory arbitrage that allow nascent companies to make wildly optimistic forward-looking projections—projections they would not make in a traditional IPO prospectus due to legal liability—with impunity.[4]

Regardless of their merits or deficiencies, SPACs exploded onto the scene in 2020 and are likely to be part of the financial fabric going forward. Beyond the broader question of whether SPACs are good for investors or companies, the SPAC structure raises interesting questions of corporate law, including issues related to SPAC director compensation. This paper addresses these director compensation-related issues and attendant consequences. Specifically, the paper examines the compensation of SPAC directors and the implications of that compensation on the independence of SPAC directors under Delaware law. Furthermore, this paper explores the potential that, as a result of the director compensation structure and quantum, legal claims related to deSPAC transactions will be adjudicated under the exacting "entire fairness" standard rather than the deferential "business judgement" rule—a decision that will be highly influential on the final dispensation of such claims.

The remainder of the paper proceeds as follows. Part II provides a brief overview of the SPAC structure. Part III provides an overview of how SPAC directors are paid and includes SPAC director compensation benchmark data—which, until now, has not been officially compiled—based on SPACs that IPOed in 2020. To put SPAC director compensation in context, Part IV compares SPAC director compensation to director compensation for other public companies. Part V examines some of the legal implications of SPAC Director compensation. It

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[1] For reference, from 2012 to 2016 there was an average of 12 SPAC IPOs per year; in 2017, 34; in 2018, 46; in 2019, 59; and in 2020, 248. In other words, there were more SPAC IPOs in 2020 than in the prior ten years combined. Data from https://www.spacanalytics.com/. (Henceforth, "SPAC Track Data.") The list was prepared by examining and cross referencing data from FactSet and SPAC Track.
[2] John Lambert, Why so many companies are choosing SPACs over IPOs, KPMG SPAC Intel hub, https://advisory.kpmg.us/articles/2021/why-choosing-spac-over-ipo.html (last visited Jul. 21, 2021).
[3] Michael Klausner, Michael Ohlrogge, and Emily Ruan, Article, *A Sober Look at SPACs*, Yale J. on Reg. (forthcoming). (accessed at http://dx.doi.org/10.2139/ssrn.3720919). Henceforth, "A Sober Look at SPACs."
[4] Ortencia Aliaj, US Regulator Turns Spotlight on SPAC Projections, Financial Times (Apr. 8, 2021), https://www.ft.com/content/e892b37f-fe31-46ff-ad25-2b6344db0d54.

first provides examples of potential legal claims. Then, for the Delaware law claims, it explores whether the compensation renders directors conflicted under Delaware law, and, if the directors are conflicted, whether the claims arising from conflicted directors will be evaluated and adjudicated under the entire fairness standard, or whether procedural elements of a SPAC, such as the shareholder vote, obviate the need for entire fairness review. Part VI proposes some modifications to the SPAC director compensation structure to improve director independence.

II. SPACs -- A Brief Overview

A SPAC or Special Purpose Acquisition Company is a publicly traded pool of funds raised to consummate a future business combination with an unknown target. A Sponsor—typically a seasoned deal-maker or industry executive—raises an initial pool of funds via the SPACs initial public offering ("IPO"). [5] In the SPAC IPO, public investors buy units, typically at $10 a share, with the proceeds being deposited in the SPACs trust account. In exchange for their $10, the public investor receives: (1) a share of stock that gives the holder the right to (a) own a share of the future company with which the SPAC will combine or (b) the right to redeem the initial $10 investment upon the earlier of either the consummation of a business combination or two years, (a "Public Share" or "Public Stock"); and (2) a detachable warrant to purchase a fraction of a share of stock (a "Public Warrant.")[6][7]

The Sponsor also contributes capital to fund the SPAC. The Sponsor contributes capital equal to 2% of the IPO trust account plus $2 million by purchasing warrants at $0.5-$1.5 per warrant, ("Founder Warrants.")[8] These warrants are like the Public Warrants except that they are typically not callable. The proceeds from the Founder Warrants are used to fund banker expenses for the SPAC IPO and to provide working capital for the SPAC, while it searches for a target. The Sponsor also purchases shares equal to 25% of the Public Shares for a nominal sum of $25,000 ("Founder Shares.") Like Public Shares, Founder Shares can convert to a share of the future company with which the SPAC combines. However, unlike Public Shares, Founder Shares cannot be redeemed for cash. To provide a quantitative example, if a SPAC IPO raises $800 million by selling 80 million public units, the Sponsor will acquire $18 million of Founder Warrants (2% x $800 million + $2 million) and an additional 20 million Founder Shares for the nominal amount of $25,000 (<$0.01 per share).

After the SPAC IPO, the Sponsor begins to look for a target with which to combine. Once a target business has been identified, the owners of the target business and the SPAC Sponsor

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[5] A number of celebrities have also become SPAC Sponsors or part of the Sponsor group, including Shaquille O'Neil, a famous, former professional basketball player, and Alex Rodriguez, a famous, former professional baseball player.

[6] Technically the investor is entitled to a refund of their $10 plus the interest from the trust account, which has been invested in U.S. Treasuries. Because interest rates are currently so low, this is typically only a few cents, and for the sake of simplicity, the paper will ignore any interest that might be earned and assume $10 in redemption proceeds.

[7] The warrant typically entitles the holder to purchase 1/3 of a share of stock for $11.50 a share; however, the warrants for some SPACs entitle the holder to purchase ½ or even a full share of stock. The Public Warrant can be called by the company at a share price of $18 a share.

[8] The pricing of the warrant depends on how many shares for which each warrant can be exercised. If each Founder Warrant entitles the holder to 1/3 of a share of stock, the price is usually $0.50 per warrant. If it entitles the holder to a full share, it is usually $1.50 a warrant.

negotiate the terms of the deal: *e.g., W*hat is the valuation of the business for the transaction? How much of the transaction funds will be used to purchase shares from the owners of the target business (secondary purchase of stock) vs. how much will be used to pay down debt or place on the balance sheet of the business (primary investment)? The SPAC will almost always raise additional capital—called PIPE (Private Investment in Public Equity) financing—to augment the funds from the trust account, which often are depleted by investor redemptions. Whereas the IPO investors were investing in a SPAC that would find an unknown target, the PIPE investors are investing in the particular target at hand.

The Sponsor will consult with the SPAC's Board of Directors to ensure they approve of the terms of the deal, and, if they do, the Board will vote to approve the deal and recommend the deal to the public shareholders. The SPAC will then file a proxy containing details of the proposed transaction to inform the SPAC shareholders, and the transaction will be put to a shareholder vote.[9] If the shareholders vote in favor of the merger, the transaction will almost always be consummated.[10] Each holder of Public Stock then has the option to invest in the combined company or redeem their shares for $10 per share, regardless of whether the shareholder voted to approve the transaction. The merger between the publicly traded SPAC shell company and the private operating business is called the "deSPAC" transaction.[11]

All participants are incentivized to consummate a transaction. The Sponsor (and anyone holding Founder Shares or Founder Warrants) is highly incentivized, because if no deal is completed, the Founder Warrants and the Founder Shares expire worthless, and the Sponsor loses its millions of dollars in investment. In contrast to the holders of Public Shares, there is no ability for holders of Founder Shares to redeem their shares for cash. Similarly, the investors in the SPAC IPO are also incentivized to consummate a deal. The Public Warrants will have some value upon deal consummation, but will be worthless if no deal is reached. Additionally, if a deal is consummated, the Public Shareholders have the option to invest in the deal or redeem their shares for $10 in cash, which would be the same result if no deal was consummated. Thus, compared to the no-deal situation, the Public Shareholder gets a free option to invest.

III. SPAC DIRECTOR COMPENSATION

[9] There has never been a SPAC shareholder vote that has failed.
[10] If too many public shares redeem and the Sponsor is unable to raise sufficient PIPE financing, the SPAC may not have sufficient cash to close the transaction. However, the target may waive the contractually negotiated minimum cash requirement.
[11] There are numerous variations on the SPAC structure, and this description is meant to describe a typical SPAC. A fuller primer on SPACs, upon which this paper relies, can be found at, Special Purpose Acquisition Companies: An Introduction, by Ramey Layne and Brenda Lenahan, HARVARD LAW SCHOOL FORUM ON CORPORATE GOVERNANCE, https://corpgov.law.harvard.edu/2018/07/06/special-purpose-acquisition-companies-an-introduction/, (last updated Jul. 6, 2018).

A. SPAC Director Compensation Overview

Directors of SPACs are compensated, but not directly by the SPAC. Instead, SPAC directors are compensated by being granted the right to purchase at cost a certain number of Founder Shares from the Sponsor —a nominal price that is in the order of magnitude of one thousandth of the "market value."[12] In 2020, the director of an average SPAC was granted 39,086 Founder Shares. As noted above, these Founder Shares are economically equivalent to the shares for which public shareholders who invest in the deSPAC transaction are foregoing $10 to accept.[13] Thus, the average SPAC director receives approximately $400,000 in director compensation if the SPAC consummates a transaction, but receives nothing if no deal is completed.

The payout structure of SPAC Director compensation is materially different than director compensation at most publicly traded companies. In contrast to SPAC directors, public company directors typically are paid cash or a mix of cash and stock,[14] and the payment does not depend on the occurrence of a particular event, such as a merger.

B. SPAC Director Compensation Data Analysis - Methodology

While there are numerous sources that compile and analyze director compensation for the S&P 500, Russel 3000, or other public companies,[15] there has been no published compilation or analysis to date on SPAC director compensation. To analyze director compensation at SPACs, I used an initial list of the 248 SPACs that IPOed in 2020.[16] From this list I went through the SPACs corporate filings with the SEC to determine the compensation of directors. Many of the SPACs that IPOed in 2020 provided a breakout of the director compensation in their initial prospectus documents, such as the 424B4. Others made separate filings to notify investors of directors' economic ownership of Founder shares. Finally, SPACs that have identified a target

[12] Because the nominal purchase price typically works out to a few hundred dollars for tens or hundreds of thousands (or even millions) of dollars' worth of stock, this paper describes the stock as being "granted" or "given" to the directors, even though in a technical sense it is purchased at a nominal amount that is a miniscule fraction of the market value.

[13] There are a number of ways of valuing the "Founder Shares." Most simply, as noted above, Public Shareholders are foregoing $10 to accept the share, so Founder Shares are worth *at least* $10 a share. Many SPACs have stock that trades at more than $10 a share, so the Founder Shares could be worth more. One could argue that when purchased, Founder Shares are worth $10 a share multiplied by the expected probability that the SPAC will consummate the deal, which, historically, has been a probability of *almost* 100%. Alternatively, one could argue that the Founder Shares could be the value the IPO shareholder received less the value of the warrant, which could be worth ~$0.50 to ~$1.50, less the value of the cash redemption right, which the Founder Shares lack, or ~$8.00 to ~$9.00. Under this construct, the Founder Shares would be worth $8.50 to $9.50 less some value of the cash redemption option. However, this paper does not intend to provide in-depth analysis on valuation and thus uses $10 throughout as a simple proxy for the value.

[14] Rebecca Burton and Peter Kim, S&P 500 Director Compensation Trends in 2020, WILLISTOWERSWATSON (Dec. 15, 2020), https://www.willistowerswatson.com/en-US/Insights/2020/12/S-P-500-director-compensation-trends-in-2020.

[15] Matthew Friestedt, Marc Trevino, and Melissa Sawyer, Trends in SPAC Director Compensation, HARVARD LAW SCHOOL FORUM ON CORPORATE GOVERNANCE (Aug. 16, 2020), https://corpgov.law.harvard.edu/2020/08/16/trends-in-u-s-director-compensation/.

[16] The SPACs that IPOed in 2020 is a relevant sample set to understand the current market conditions. Notably, there were more SPAC IPOs in 2020 than in all the rest of the prior ten years combined. SPAC Track Data.

and are attempting to complete (or have completed) a deSPAC transaction sometimes disclose the directors' ownership of Founder Shares in the pre-vote proxy materials.

Thus, from the set of 248 SPACs that IPOed in 2020, my data set includes compensation data for 168 SPACs.

SPAC Director Compensation Data

		Trust Account Size		
	ALL	**>= $100M**	**>=$250M**	**>=$400M**
Count (Total)	248	231	136	69
Count (w/ Data)	168	157	100	55
Min	1,739	5,000	5,000	5,000
Q1	25,000	25,000	25,000	25,000
Q2	29,375	30,000	30,000	30,000
Q3	36,375	37,500	40,000	50,000
Max	300,000	300,000	300,000	300,000
Average	38,981	40,222	42,010	47,633

Based on 248 SPACs that IPOed in 2020.

Based on this data, the director of the median SPAC received 29,375 Founder Shares, while the director of the average SPAC received 38,981 Founders Shares. There are, however, a few high paying SPACs that skew the average up. If one looks at SPACs with larger trust accounts, the average increases slightly (40,222 for SPACs with trust Accounts greater than or equal to $100M; 42,010 for SPACs with trust Accounts greater than or equal to $250M; and 47,633 for SPACs with trust Accounts greater than or equal to $400M) but the median stays consistent at ~30,000. The middle 50% of SPACs (*i.e.*, from the bottom of the second quartile to the top of the third quartile) award their directors with between 25,000 Founder Shares, on the low end, to between 36,375 and 50,000 on the high end, depending on the size of the SPAC.

A Few Notes on the Data

Obtaining SPAC director compensation data for approximately 75 SPACS was impossible, and the filings for many others could create a misapprehension on the compensation of directors. In a number of SPACs, the directors do not own Founder Shares directly, but instead they indirectly own a pecuniary interest in an undisclosed number of Founder Shares via ownership in the Sponsor entity. Due to this indirect ownership, the directors are not technically the *beneficial* owners of Founder Shares (even if they are still pecuniary owners of a number of shares, *i.e.*, owners in the economic sense).[17] Thus, in the case of such indirect ownership, the 424B4 filings, which enumerate "shares beneficially owned," reflect zero shares for directors, and the Form 3

[17] The technical definition of beneficial ownership centers on the right to vote or dispose of shares. It is likely that in these cases the directors cannot unilaterally vote or dispose of their shares, and, instead, the primary member of the SPAC Sponsor has this authority. A pecuniary interest is a monetary interest.

filings of the directors explicitly state that "no securities were beneficially owned." Occasionally, a filing explicitly discloses that the lack of beneficial ownership does not mean a lack of economic ownership, noting that the zero shares by directors in the 424B4 table "[d]oes not include any shares indirectly owned by this[director] as a result of his or her partnership interest in [the] sponsor or its affiliates."[18] In other instances, a blank Form 3 notes that "[t]he reporting person has an indirect pecuniary interest in shares of Class B common stock of the Issuer through her membership interest in … [the Sponsor entity], over which the reporting person does not have voting or dispositive control."[19] More frequently, however, directors' indirect ownership interest in the Sponsor is not specifically noted in the disclosure provisions. Moreover, almost all SPAC filings include language along the lines of "none of our officers [or] directors … have received *any cash compensation* for services rendered to us,"[20] and "*[n]o compensation of any kind…will be paid by us* to our initial stockholders, officers, directors or members of our strategic advisory group… for services render prior to or in connection with our initial business combination."[1] Thus, the disclosures, non-disclosures and disclaimers noted above might lead one to conclude that directors are not compensated. However, as discussed above, the directors are compensated in a non-cash way by receiving Founder Shares directly or indirectly. via ownership interest in the Sponsor entity.[21]

Furthermore, there are numerous examples of SPACs that do not provide director compensation information even in the proxy prior to the vote by shareholders.[22] For example, Vesper Healthcare Acquisition Corp., which merged with The Beauty Health Company on May 5, 2021, does not disclose in their proxy the number of shares held by the directors. The proxy informs investors that "[i]n considering the recommendation of our Board to vote in favor of the Business Combination, stockholders should be aware that aside from their interests as stockholders, our Sponsor and certain members of our Board and officers have interests in the Business Combination that are different from, or in addition to, those of other stockholders generally."[23] The proxy further notes that the Sponsors, officers and directors *in the aggregate* will hold a certain number of warrants and Founder Shares, but there is no breakout of director compensation specifically.[24] Thus, Vespar Healthcare Acquisition Corp. appears to have gone from formation to deSPAC without disclosing the compensation of its directors in *any* filing. This situation is far from unique.

In a number of SPACs, directors were not compensated equally. For two dozen SPACs, the directors received varying amounts of Founder Shares within a relatively narrow band. It appeared that these differentials resulted when one director served as the lead director or where a director was more experienced than others. For example, at Climate Change Crisis Real Impact I Acquisition Corp. ("CLII"), one director received no Founder Shares, two directors received

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[18] Horizon Acquisition Corp. II, Prospectus (424B4), at 122 (Oct. 21, 2020).
[19] Carney Technology Acquisition Corp II, Initial Statement of Beneficial Ownership for Goode Carol (Form 3) (Dec. 9, 2021).
[20] Golden Falcon Acquisition Corp., Prospectus (424B4), at 136 (Dec. 21, 2020).
[21] In the case of Golden Falcon Acquisition Corp., the directors received 36,000 Founder Shares.
[22] Some have disclosed director compensation previously in a Form 4, while others have not.
[23] Vesper Healthcare Acquisition Corp., Proxy Statement (DEFM14A), at 4 (Apr. 7, 2021).
[24] Ibid. at 21.

25,000 Founder Shares, and the Chairperson received 30,000 Founder Shares. At Sandbridge Acquisition Corp. ("SBG"), one director received 25,000 Founder Shares, while another received 40,000 Founder Shares. In these situations, I calculated the mode number of Founder Shares from the directors that received a non-zero number of shares and used that as the director compensation number for the SPAC. Thus, for CLII, the number used in the general dataset was 25,000, while for SBG, it was 32,000. In a few SPACs, directors received vastly different numbers of Founder Shares. For example, in Vistas Media Acquisition Company Inc., one director received 18,000 Founder Shares, two directors received 28,000, and one director received 225,000. In situations with "outlier" directors (which I defined as greater than five times the mode, excluding that director) I calculated the company's figure excluding the "outlier" director.

Finally, it is worth noting that there was a particularly large range of director compensation among the biggest SPACs. For example, at William Foley's Foley Trasimene Acquisition Corp II (Trust Account ~$1,500M), which merged with Paysafe, directors received 25,000 Founder Shares; at Chamath Papatiya's Social Capital Hedosophia Holding V, which merged with SoFi, directors received 100,000 Founder Shares; and, at Michael Klein's Churchill Capital III, which merged with MultiPlan, directors received 294,985 Founder Shares. The latter number of shares is second only to the Founder Shares provided to directors of Michael Klein's Churchill Capital Corp. IV, which is slated to merge with Lucid Motors.

IV. SPAC vs. Corporate Director Compensation

Generally, SPAC directors are more highly compensated than directors at typical public companies. In 2019, the average director of an S&P 500 company received $290,053 in compensation, of which $107,500 was cash and the remainder was stock or options.[25] This is ~25% less than the average SPAC director earns. Additionally, the SPAC director is typically more highly compensated despite overseeing a smaller enterprise. The median S&P 500 company had a market cap of more than $29 billion,[26] while the median trust account of SPACs that IPOed in 2020 was $253M.[27] Even if one assumes that the appropriate metric for the SPAC is the deSPAC-ed business, which, according to research, is ~2.5x larger than the trust account,[28] SPAC directors preside over meaningfully less valuable enterprises (30x+ smaller) than their less highly compensated public company director peers.

Furthermore, SPAC directors have more limited responsibilities than typical corporate directors. Many of the SPAC committees are largely *pro forma* since the SPAC is a corporate shell without an operating business. For example, the SPAC audit committee reviews the audit of the shell company's financials, *i.e.*, the expenses spent searching for a deal and not the actual

[25] Rebecca Burton and Peter Kim, S&P 500 Director Compensation Trends in 2020, WillisTowersWatson (Dec. 15, 2020), https://www.willistowerswatson.com/en-US/Insights/2020/12/S-P-500-director-compensation-trends-in-2020.
[26] S&P 500 Companies by Weight, Slickcharts, https://www.slickcharts.com/sp500 (accessed on Jul. 8, 2021).
[27] SPAC TRAC Data.
[28] *A Sober Look at SPACs* at 10.

financials of an operating business. Instead, the bulk of the work of SPAC directors is focused on facilitating or evaluating a potential deSPAC transaction and determining whether it is best to merge with an operating business or liquidate and return the funds to public shareholders.

Thus, despite overseeing a less valuable economic organization and having a narrower range of responsibilities, SPAC directors are more highly compensated than their typical public company peers.

V. Legal Implications of SPAC Director Compensation

A. Potential Legal Claims against a SPAC, its Sponsor, and Directors

While SPACs have only become prevalent recently, and litigation will likely follow SPAC deals gone sour, there already have been a couple of examples of claims that provide a preview of the litigation that is likely to come.

One stylized version of a Plaintiff's claim with respect to bad mergers is: *an incentivized Sponsor and a conflicted board teamed up to approve a bad merger, thereby breaching their fiduciary duties. Then, by disclosing an overly rosy picture of the merger, they induced shareholders to approve the merger, not to redeem their $10 of cash and instead to invest into the merged company, which soon became worth meaningfully less than $10 when the quality (or lack thereof) of the enterprise emerged*." There is an example of these allegations fashioned as a direct breach of fiduciary duty claim under Delaware law. [29] However, the allegations could also likely be fashioned as a derivative claim.

Another stylized version of a plaintiff's claim is: *A SPAC and their target made a series of untrue statements about the potential merger that made the SPAC stock price go up from $10 a share to $20 a share. Even though the untrue statements were corrected before the deSPAC and the stock price returned to $10 a share, certain investors bought the SPAC stock at the higher price based on the untrue statements and lost money when it returned to $10 a share*. These claims, based upon federal securities laws, would be a SPAC variant of the run-of-the-mill "stock-drop" cases.[30]

The focus of this paper is on the Delaware law claims and not on the federal securities law claims. For all Delaware claims based on fiduciary duty, plaintiffs are likely to focus on attempting to establishing a couple of key points, namely: (1) that the SPAC directors for the case at hand are not independent and (2) because of non-independent directors, the particular claims should be reviewed under the enhanced "entire fairness" standard rather than the default, deferential business judgment rule.

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[29] See, e.g., Churchill Capital III. Verified Class Action Compl., *Kwame Amo v. Multiplan Corp et al.*, No. 2021-0258 (Del. Ch.).
[30] See e.g., Stable Road Acquisition Corp. Verified Class Action Compl., *Keith Jensen v. Stable Road Acquisition Corp. et al.*, No 2:21-cv-05744 (C.D. Cal.)

B. SPAC Director Independence Under Delaware Law

The compensation of SPAC directors has implications with respect to the independence of SPAC directors under Delaware law. [31] Moreover, the independence, or lack thereof, of SPAC directors is a significant factor in determining the standard of review for legal claims and thereby the outcome of adjudicated claims related to deSPAC transactions.

From an economic standpoint, the SPAC directors are aligned with the Sponsor—both get paid if a transaction is consummated and receive nothing if a transaction is not completed. The SPAC Directors, however, are not necessarily aligned with the common shareholders. For example, if a SPAC with an $800 million trust account consummates a transaction and then the share price falls to $5 a share, the Sponsor will make almost $100 million on the equity from the Founder Shares. Assuming the SPAC director receives the average share count of ~40,000 Founder Shares, the SPAC director will receive ~$200,000, while the public shareholders will collectively lose $400 million.[32]

Delaware Courts have examined non-SPAC cases where directors had economic payoffs that were not completely aligned with common equity holders and made determinations about the independence of the directors. Delaware Courts have held that a director is interested, *i.e*., not independent, if (1) "he or she will receive a personal financial benefit from a transaction that is not equally shared by the stockholders" and (2) the non-shared benefit is "of a sufficiently material importance, in the context of the director's economic circumstances, as to have made it improbable that the director could perform her fiduciary duties … without being influenced by her overriding personal interest."[33] In *In re Trados Inc.*, the Delaware court found that a $2.34 million dollar payment that was 23-47% of a director's net worth was material, as was a $1 million payout to another director. [34] Similarly, the court determined that a $220,633 payout to an officer was material, as it was double his annual salary, despite being only 3.7-5.5% of the officer's net worth.[35] In *Orman v. Cullman*, the court found material a $75,000 contract with one director and a $3.3 million dollar fee to a company that another director owned, and therefore, the directors involved were not independent. [36] In *Frederick Hsu Living Tr. v. ODN Holding Corp*, a $587,184 bonus was, at the pleading stage, sufficient to constitute a conflict for directors. [37] And, recently, in *In re Saba Software, Inc. S'holder Litig.*, the court found that the immediate vesting and conversion of $270,000 worth of equity awards was sufficient to support an

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[31] A number of SPACs are incorporated in the Cayman Islands, and the fiduciary duty standards are similar to those in Delaware. However, class action litigation is not permitted in the Caymans, and it is not cost effective – both for plaintiff lawyers and their clients –to bring individual plaintiff, fiduciary duty challenges.

[32] For simplicity, all transaction fees are ignored. Assumes (1) 20 million Founder Shares (25% of the 80 million sold in the IPO) x $5 per share = $100 million and (2) Sponsor owns all Founder Shares not owned by directors. Even if the Sponsor's $18 million of warrant purchases is worthless because of the reduced share price, the equity more than offsets it.

[33] *In re Trados Inc. S'holder Litig*., 73 A.3d 17, 45 (Del. Ch. 2013).

[34] Ibid.

[35] Ibid.

[36] *Orman v. Cullman*, 794 A.2d 5, 30 (Del. Ch. 2002)

[37] *Oak Hill. Frederick Hsu Living Tr. v. ODN Holding Corp.*, No. CV 12108-VCL, 2017 WL 1437308, at *30 (Del. Ch. Apr. 14, 2017), as corrected (Apr. 24, 2017)

inference of materiality because the compensation constituted the only equity of the directors.[38] For many SPAC Directors, the only equity they have is Founder Shares.

However, in other business contexts, Delaware courts have found that differences in economic alignment were not sufficiently material to render the directors conflicted. In *In re General Motors Class H Shareholder Litigation*, the court did not find directors materially interested in spite of the fact that the directors collectively owned approximately two times as much of one class of common stock as another.[39] In *Globis Partners, L.P. v. Plumtree Software, Inc.*, accelerated vesting of options for the Plumtree directors was deemed not to be a "disabling interest" in a cashout acquisition of Plumtree Software by BEA systems. [40] In *Globis*, however, the directors' accelerated vesting was worth less than $50,000 per director, and the directors had meaningful common stock holdings.[41] Similarly, in *In re Staples, Inc. Shareholder Litigation*, the Delaware Court found a $187,500 profit per board member not of sufficient material importance in the context of the directors' economic circumstances, stating:"[w]hile this is not a trifle, the outside directors are persons of means and reputation, and the plaintiffs have not demonstrated that the prospects of a one-time gain of this sort would be a material consideration to most, if any, of them."[42]

Beyond looking at the incentive discontinuity between common shareholders and directors, Delaware courts may consider that in the SPAC context, directors are being compensated *not* by the corporation, but by a group of interested shareholders - *i.e.*, the Sponsor - that unilaterally appointed the directors, thus making the directors even less likely to be considered independent from the Sponsor.

Thus, the open question with respect to SPACs is whether the Founder Shares will be sufficiently material so as to create a conflict of interest for the directors. [43] On the one hand, directors are receiving, on average, $400,000 from a single company, and some individual directors are receiving more than $1,000,000 worth of Founder Shares. Furthermore, certain directors may participate in multiple SPACs of the same Sponsor, and thus the total compensation from the relationship with the Sponsor may be multiples greater.[44] On the other hand, many of these directors are quite wealthy and perhaps "in the context of the director's economic circumstances" the Founder Shares-based compensation is not sufficient to make the

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[38] *In re Saba Software, Inc. S'holder Litig.*, No. CV 10697-VCS, 2017 WL 1201108, at *22 FN 136.
[39] *In re Gen. Motors Class H S'holders Litig.*, 734 A.2d 611, 618 (Del. Ch. 1999).
[40] *Globis Partners, L.P. v. Plumtree Software, Inc.*, No. CIV.A. 1577-VCP, 2007 WL 4292024, at *8 (Del. Ch. Nov. 30, 2007).
[41] Ibid.
[42] *In re Staples, Inc. S'holders Litig.*, 792 A.2d 934, 951 (Del. Ch. 2001).
[43] The ownership of Founder Shares is almost certainly "something personal to the directors that is not shared by the other stockholders." Though the Founder Shares convert into the same security as that owned by the Public Shareholders, the binary nature of their value is different; Public Shareholder shares have value via a redemption right whether the merger is consummated or not, and Founder Shares do not.
[44] E.g., Michael Klein's SPACs have a number of repeat directors, with multiple directors serving on the boards of five different SPACs, some of whom have received almost $3,000,000 worth of Founder Shares as compensation for serving on a single Board. This repeat director issue was raised in a lawsuit filed by Bernstein Litowitz against Churchill Capital III. Verified Class Action Complaint, *Kwame Amo v. Multiplan Corp et al.*, No. 2021-0258 (Del. Ch.).

director unable to render independent judgement.[45] This is a question that Delaware courts will soon decide.[46]

C. Implications of Interested Directors on deSPAC Claims

i. Standard of Review Overview

In evaluating shareholder claims, Delaware courts apply different standards of review, depending on the circumstances. The presumptive standard in Delaware is the highly deferential, business judgement rule, which "is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company."[47] This standard largely prevents courts from second guessing the decision-making of independent and disinterested directors that acted with due care, regardless of subsequent events or consequences. However, the more exacting "entire fairness" standard is triggered when the majority of directors approving the transaction are interested, *i.e.*, not independent.[48] Under the entire fairness standard, the court scrutinizes the transaction to ensure that the Board of Directors has discharged its duties with regard to "fair dealing," *i.e.*, a fair process, and a "fair price." The two factors are both examined but "the paramount consideration, however, is whether the price was a fair one."[49]

However, Delaware courts have held that even where directors are conflicted, an informed, un-coerced vote by a majority of un-conflicted stockholders "cleanses" the transaction (absent a controlling stockholder sitting on both sides of the transaction), and claims that otherwise would have been evaluated under the "entire fairness" standard are instead adjudicated based on the more deferential business judgement rule. [50]

Procedurally, after a SPAC Board approves a merger, the SPAC releases a proxy statement informing the shareholders about the merger, and the merger is put to a shareholder vote. Only after the shareholders approve the merger is the merger consummated. Thus, to overcome the "cleansing" of the vote and invoke the "entire fairness" standard, plaintiffs need to show that (1) there was not support by a majority of the un-coerced, un-conflicted shareholders, (2) the vote was not sufficiently informed by the disclosures in the proxy, or (3) that the SPAC vote was essentially a sham vote and should be disregarded entirely.

ii. Lack of Shareholder Support

While most shareholder votes on deSPAC transactions pass by a wide margin, a large majority of the votes may be from conflicted shareholders. Many SPAC Sponsors are likely to be

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[45] The slightly discomforting logical reaction would encourage SPACs to select only very wealthy directors.
[46] The Author speculates that courts will be more willing to find director conflicts where directors receive greater than average compensation or are repeat directors in the same Sponsor's SPACs. This will allow courts to allow *some* claims to proceed without subjecting all SPACs to substantial legal liability.
[47] *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984), overruled on other grounds by *Brehm v. Eisner*, 746 A.2d 244 (Del. 2000)
[48] *In re Trados Inc. S'holder Litig*., 73 A.3d 17, 36 (Del. Ch. 2013)
[49] *Americas Mining Corp. v. Theriault*, 51 A.3d 1213, 1244 (Del. 2012).
[50] *In re Merge Healthcare Inc.*, C.A. No. 11388-VCG, 2017 WL 395981 (Del. Ch. Jan. 30, 2017), which extended the logic of *Corwin v. KKR Financial Holdings* LLC, 125 A.3d 304 (Del. 2015).

more conflicted than directors because, in addition to their ownership of Founder Shares, they often hold shares of Public Stock as well, which they contractually pre-commit to vote to approve the merger, and these votes are counted alongside common shareholders that do not receive Founders Shares. Furthermore, many of the Public Shareholders also hold Public Warrants, which would expire worthless in the absence of a transaction. Delaware courts have found that holders of options can have "materially different incentives …than if they were simply holders of ... common stock," and thus could be excluded from being counted in the majority of the un-conflicted shareholder vote.[51] However, in a typical deSPAC vote, the results are so heavily in favor of a transaction that unless almost all the votes are set aside as conflicted, there would be a majority of minority approval.[52]

iii. Insufficient Disclosure

Material disclosure issues also give rise to application of the "entire fairness" doctrine. Under Delaware law, directors must "disclose fully and fairly all material information within the board's control,"[53] and Delaware has adopted the federal securities law standard for materiality. Namely, information is material, if "there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote" or "from the perspective of a reasonable stockholder, there is a substantial likelihood that it significantly alters the 'total mix' of information made available."[54] Most often disclosure issues arise as a result of (1) inadequate or misleading disclosure of the risks or facts of the investment or (2) inadequate disclosure of the conflicts that the board members or the Sponsor may have. For example, claimants might allege failure to disclose a material negative event (e.g., departure of a key customer) or that disclosure on the dilution in a SPAC deal was either lacking or incomprehensible. [55] Similarly, claimants might allege a failure to disclose director compensation, a practice which, as noted above, is not uncommon among a number of SPACs. As noted above, while these SPACs typically disclose in their proxy filings that directors may have additional or conflicting interests, they often do not include any specific information on the magnitude of these conflicts. [56] Directors holding 1,000, 10,000, 100,000, and 1,000,000 Founder Shares could have conflicts of meaningfully different magnitudes.

[51] Certain stockholders also had rights under a "put" agreement to receive potentially higher payments in a change of control situation than the offer price available to common stockholders. *In re Pure Res., Inc., S'holders Litig.*, 808 A.2d 421, 426 (Del. Ch. 2002).
[52] For example, in the DiamondPeak Holdings Corp. combination with Lordstown Motors, the tally was 18,324,571 votes for the merger, 9,602 votes against, and 7,129 abstentions. In other words, 99.9% of shareholders that voted, voted to approve the deal. DiamondPeak Holdings Corp., Current Report (Form 8K) (Oct. 22, 2020). In Gigcapital2 Inc.'s combination with UpHealth, there were 13,016436 votes in favor, 772,021 against, and 205 abstentions, or 94.4% in favor. GigCapital2 Inc., Current Report (Form 8K) (Jun 4, 2021).
[53] *In re Trulia, Inc. S'holder Litig.*, 129 A.3d 884, 899 (Del. Ch. 2016).
[54] *In re Trulia, Inc. S'holder Litig.*, 129 A.3d 884, 899 (Del. Ch. 2016).
[55] See generally *A Sober Look at SPACS* for challenges in calculating dilution. For example, in a lawsuit against Churchill Capital III, the plaintiffs allege that the proxy was deficient because *inter alia,* (1) it failed to mention the departure of a key customer that was switching to a competitor, (2) it provided intentionally misleading projections, and (3) it mischaracterized a key owner's commitment to continuing to own the business. Verified Class Action Complaint, *Kwame Amo v. Multiplan Corp et al.*, No. 2021-0258 (Del. Ch.).
[56]Vesper Healthcare Acquisition Corp., Proxy Statement (DEFM14A), at 22 (Apr. 7, 2021).

iv. A Sham Vote

Finally, plaintiffs could allege that the SPAC shareholder vote is essentially a sham vote and should be disregarded entirely—regardless of whether it is supported by a majority of the un-coerced, un-conflicted shareholders or whether there is adequate disclosure—because, due to the redemption right, shareholders do not actually have any "skin in the game." The Delaware Court has noted that "[e]conomic incentives matter, particularly for the effectiveness of a legitimizing mechanism like a majority-of-the-minority tender condition or a stockholder vote."[57] At the point of the vote, a rational Public Shareholder would likely *never* oppose the transaction. If the deal is voted down, the SPAC will either search for another target or wind down and the Public Shareholder will get $10 a share. If the deal is approved, the Public Shareholder can still redeem her share for $10 on the consummation of the deSPAC, and there is the potential that the share price might rise above $10, based on perceptions of the value of the combined business, in which case the Public Shareholder can sell her share for a greater profit.[58] The incentive of the Public Shareholder with Public Warrants is even more obvious, since that shareholder has the benefit of the same $10 downside protection, while at the same time enjoying the incremental upside of the option value of the Public Warrant, if a deal is completed. The fact that *no* SPAC shareholder vote has ever failed, despite numerous instances where 90%+ of the shareholders that voted for the deal decided to redeem their shares rather than invest in the deal—suggesting that shareholders do not think the deal is worth investing in—is evidence that shareholders are not evaluating the economic merit of the purchase price at the time of the vote (but instead are evaluating it at the time of the redemption choice).[59]

In some ways the SPAC shareholder vote could be compared, in a structural sense, to tender offers that the Delaware courts have found coercive, because the shareholder is effectively forced to accept, "regardless of the economic merits of each proposal."[60] In each case, there is an economically dominant strategy (either to vote for the transaction or tender) that applies *regardless* of the deal price for the SPAC or price for the tender. This structural dynamic prevents the shareholder vote from being a true affirmation of the value being offered in exchange.

D. Redemption Rights and other SPAC features

Even if the redemption right does not render meaningless the shareholder vote, it does not provide legal protection for the SPAC, Sponsors, or directors. In fact, it may just set a reference point for damages. The $10 redemption right will simply set the goal post for determining how

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[57] This was the logic underlying a Delaware court's holding that a shareholder that was economically indifferent to the transaction because of other holdings should be excluded from the majority of the minority vote. *In re CNX Gas Corp. S'holders Litig.*, 4 A.3d 397, 416 (Del. Ch. 2010).

[58] Thus, the only potential rationale for not voting for the deal is that shareholders hope that the SPAC Sponsor will seek a transaction that either is, or is perceived by others as, more attractive. The actual voting behavior of shareholders suggests that this consideration is vastly outweighed by the downside protection on all deals and the chance of having upside (either from share price appreciation or warrants) in the deal at hand.

[59] *A Sober Look at SPACs* at 22.

[60] In this situation, the shareholder effectively was forced to take the corporation's self-tender, regardless of the economic merits of each proposal. *Gradient OC Master, Ltd. v. NBC Universal, Inc.*, 930 A.2d 104, 120 (Del. Ch. 2007).

much was lost by shareholders who alleged that they were wrongfully induced into investing into the deal.

VI. Potential Director Compensation Changes to Improve Independence

There are a couple of relatively straightforward changes that would reduce the likelihood that SPAC directors would be considered interested. First, even within the current compensation construct of the Founder Shares, SPAC sponsors who have multiple SPACs could limit the overlap of directors among SPACs. In addition, director compensation limited to average levels of 30-50,000 Founder Shares ($300,000-500,000) would invite less scrutiny and be less likely to give rise to a conflict than, for example, the 100,000+ Founders Shares ($1,000,000+) of compensation some SPAC directors are receiving.

Second, SPACs could compensate directors with Founder Warrants rather than Founder Shares. While compensation in warrants would still create some incentive to consummate a transaction, (the warrants will have *some* option value with a consummated transaction and none without one), it would reduce that incentive, because the option value would be small if the stock price remained at the deal price of $10. Further, if the share price halved, the option value of the warrants would be even more significantly reduced. This is in sharp contrast to the use of Founder Shares, where a director receiving 40,000 Founder Shares would still receive approximately $200,000 if the stock price were halved. However, there is a downside to transferring Founder Warrants to the directors in lieu of Founder Shares because it results in a bit of a "zero-sum game" in terms of interest alignment. Every additional Founder Warrant transferred to directors from the Sponsor is one fewer warrant the Sponsor owns. As a result, the Sponsor's fortunes depend more heavily on deal consummation at all costs, rather than on consummating a deal at an attractive valuation with the belief that the share price will rise in the future.

Third, the SPAC could compensate directors with cash (or at least partially in cash) that is not dependent on deal consummation, much like typical public directors. To ensure SPACs have sufficient funds for the directors' cash compensation, Sponsors would need to put in additional funds on SPAC formation by buying incremental warrants; however, the cost would not be particularly material. For example, if Sponsors are currently putting in 2% of the trust account (which averages ~$200M for 2020 SPAC IPOs) plus $2M or $6M on average, they would now need to put in 2% plus $2.5M or $6.5M (an increase of <10%) to give three SPAC directors at least $150,000 of cash compensation, irrespective of deal closure.

Fourth, the SPAC sponsor could purchase Public Shares at $10 a share, contribute the proceeds to the trust account and distribute the Public Shares to the directors. [61] This would also require cash from the Sponsor. The directors with Public Shares might be the least incentivized to do a deal because they would receive $10 a share if no deal is consummated, and, while they technically *could* redeem their Public Shares for cash instead of investing in the deal, the optics

[61] For the purposes of this paper, potential tax consequences are ignored.

would likely force the directors to invest in whatever deal they recommend. Under this construct, SPAC directors would be personally incentivized to only recommend deals that they thought were worth more than $10 a share. Furthermore, SPAC directors would be fully aligned with common shareholders.[62]

Of course, SPAC Sponsors may not like the latter two proposals for the same reason Delaware courts will, as both proposals reduce the alignment between the Sponsor and the Board and change the existing dynamic, where the Board, like the Sponsor, is incentivized to consummate a deal in order to be paid.

VII. CONCLUSION

There were more SPACs formed in 2020 than in the previous 10 years combined. And, in the next year or two, there will likely be more SPAC-related litigation that in the previous 10 years combined. The structure (i.e., binary payout of founders shares) and quantum (i.e., median of ~$300,000 and average of ~$400,000) of SPAC director compensation—as it is considered in the context of a determination of director independence – will likely play a role in that litigation. While the results of any litigation will depend on a facts and circumstances intensive inquiry for each situation, there is certainly a possibility that in certain circumstances Delaware courts will find the directors conflicted due to the compensation. And with that finding, Plaintiffs may be able to successfully convince Delaware courts to apply entire fairness to their claims. Thus, the current SPAC director compensation structure and quantum meaningfully increases the possibility of successful claims. SPAC Sponsors, directors and perspective directors, providers of director and officer insurance, and their legal advisors should assess whether the current structure is worthwhile or whether it should be adjusted—either by some of the ways proposed by this paper or others to increase the independence of SPAC directors. While Sponsors may not want to contribute more cash into the formation of the SPAC to compensate directors differently (and may not want directors to be less highly motivated to approve a deal), it may be in their best interests to do so.

[62] N.B. while they may be aligned with public stockholders they may not be aligned with public stocholders that also own warrants.