

Article

SPAC Litigation: What Happens if the “Blank Check” Bounces?

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The demand for Special Purpose Acquisition Company (SPAC) formations in the Cayman Islands increased through the first quarter of 2021 following robust performance in 2020. Whilst the second quarter of 2021 has seen a slowdown from this unprecedented frenetic pace, it is unlikely that the overall demand for this bespoke structure will subside in the near future.

As the number of speculative SPAC formations continues to grow and sponsors search for target companies in an effort to consummate transactions in a relatively short timeframe, it is inevitable that the risk of litigation will grow in parallel. In this briefing, we highlight the relevance of director’s duties in relation to SPAC transactions and some of the issues that may arise as a matter of Cayman Islands law.

What is a SPAC and Why Cayman?

A SPAC is a vehicle formed and listed on an exchange with no specific business purpose other than to raise funds for some future undefined object. In the United States, these types of vehicles are often referred to as “blank check” or “cash shell” companies. Unlike in a traditional initial public offering (IPO), the SPAC model is unique in that, at the time of the IPO, a SPAC vehicle will have no portfolio investments, substantive operations or any investments earmarked for acquisition. Upon listing, the net capital proceeds of the IPO are generally placed in a third party escrow / trust account, and a SPAC then has around 24 months in which to source and consummate a transaction, failing which the venture must normally be wound-up and the funds returned to investors. Once the SPAC has raised funds through its IPO and an appropriate target business has been identified, a business combination is effected that normally results in the target business being acquired by or merged into the SPAC. Following this “de-SPAC-ing” process, a more conventional operating business structure exists and the surviving entity continues to operate as a publicly listed company under the rules of the relevant stock exchange.

Although the majority of US-listed SPACs are incorporated using Delaware corporations, a SPAC incorporated in the Cayman Islands is often seen as a good alternative as it may offer a more efficient structure and remove any additional US tax, legal or regulatory implications that may arise as a consequence of using a US vehicle. The NYSE and Nasdaq allow listings by SPAC entities formed in most of the leading offshore jurisdictions, including the Cayman Islands.

The Important Role of the SPAC Directors

There are several important milestones in a typical SPAC transaction. During the standard lifecycle, there will be interactions between sponsors, investors, potential target companies, existing shareholders and regulators in different jurisdictions. Various contractual obligations are assumed as part of the process, including warranties and commitments to use best endeavours to consummate the business combination.

A key feature of a SPAC is the requirement for shareholders to vote on and approve the business combination transaction identified by the sponsor. In connection with this shareholder meeting, it is common for the directors of the SPAC to expressly recommend to shareholders that they should vote in favour of the merger transaction. The requirement to make this recommendation, amongst various other confirmatory statements regarding the transaction, is included as a contractual covenant in the business combination agreement between the SPAC and the target.

The directors of the SPAC will often have interests in the merger that may conflict with the interests of the shareholders. These interests may include indemnification arrangements after closing, financial incentives and specific rights attached to the “Founder Shares” in the SPAC which are held by the sponsor. Accordingly, directors of the SPAC are often placed in a difficult and nuanced position, with overarching fiduciary duties and underlying self-interest.

The investor shareholders are heavily reliant on due diligence being carried out and representations being made by the directors of the SPAC. This has, only very recently, led to an increase in the number of special committees being formed to ensure that there is an appropriate degree of independence and objective oversight in the decision-making processes of the SPAC when considering undertaking a business combination.

There have been many US cases concerning allegations of impermissible coercion by and/or misrepresentation claims against directors of SPACs, which generally analyse the duties of the directors as a matter of New York or Delaware law. Given the amount of activity in this space over the past 12 months and the sheer number of Cayman-domiciled-SPACs, it is likely that the Cayman courts will be asked to grapple with similar issues as a matter of Cayman law in the near future.

Director's Duties

At a high level, directors of Cayman Islands companies have the following duties:

- a duty to act in good faith in the best interests of the company;
- a duty to exercise powers in the company's interest (and not for any collateral, personal or improper purpose);
- a duty not to fetter the future exercise of their powers;
- a duty not to make secret profits;
- a duty to avoid actual or potential conflicts of interests; and
- a duty of skill, care and diligence.

Each of these duties, as well as additional statutory obligations, will need to be carefully analysed in bringing or defending a claim against directors of a SPAC domiciled in the Cayman Islands.

The default position in relation to conflicts of interest is that directors have a duty not to place themselves in a position where an actual or potential conflict exists between their duties to the company and their personal interests or duties to third parties. The director is obligated to disclose the conflict to all interested parties and obtain ratification on an informed basis. As a matter of Cayman Islands law, the SPAC, as the beneficiary of the fiduciary duty owed by the director, may waive conflict rules. However, such waiver may only be given by the SPAC in a general meeting (i.e. by the shareholders in a majority vote, after the director has fully disclosed the conflict or potential conflict).

There are fundamental differences between director's duties as a matter of Cayman Islands law and director's duties as a matter of US law. For example, in contrast to the United States, the position in the Cayman Islands is that the duty of care and skill is not treated as a fiduciary duty. The rationale for that distinction is that the essence of fiduciary duties is honesty and fidelity, whilst the duty of care and skill is focused on competency and is treated as a tortious duty.

Weaving Macro Fixed Income Fund v. Ekstrom & Peterson is one of the leading and most high-profile judgments in this area in the Cayman Islands. In *Weaving*, it was not alleged that the directors acted in breach of their fiduciary duties to exercise their powers properly and to avoid conflicts. The case against them was that they had acted in breach of their duty to exercise independent judgment and to exercise reasonable care, skill and diligence. The decisions handed down as a result of the *Weaving* litigation are likely to be especially relevant to formulating and defending claims against directors of SPACs.

As always, every case will turn on its facts. As part of the preliminary analysis, it will be necessary to review the governing law and jurisdiction position. For example, it is common that, as part of the business combination process, the SPAC may be continued out of the Cayman Islands and into the US (or Canada). It is possible that a change in domicile of the SPAC may have an impact when deciding on the most appropriate and convenient forum for any potential dispute.

Comment

Conyers attorneys have acted and continue to act on many SPAC IPO's and subsequent business combination transactions in the Cayman Islands and have experience advising sponsors, investors, directors and target companies. Accordingly, we are intimately familiar with the process, structures and issues that might arise as a matter of Cayman Islands law on any given transaction.

Conyers attorneys have also prepared a “Director’s Playbook” which explains the statutory and common law duties and obligations of Cayman Islands directors, the majority of which will be relevant to the directors of a SPAC and those seeking to analyse the duties for the purposes of bringing a prospective claim.

A copy of the “Director’s Playbook” is available upon request by email to the authors of this article.

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