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NAVIGATING EMERGING SECURITIES AND GOVERNANCE RISKS

Addressing Developments In The SEC, Securities Litigation, And Delaware Law

Dailey LLP

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Presenters:

Jeffery A. Dailey
Gay Parks Rainville
Andrew H. Sauder
Dailey LLP





Michael S. Yecies
Continental



Dailey LLP

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Presenters' Contact Information

Jeffery A. Dailey
Dailey LLP
jdailey@DaileyLLP.com
215-282-5172

Michael S. Yecies
Continental
michael.yecies@continental.com
330-472-2407

Gay Parks Rainville
Dailey LLP
grainville@DaileyLLP.com
215-282-5176

Andrew H. Sauder
Dailey LLP
asauder@DaileyLLP.com
302-468-5007

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Overview

- **SEC Regulatory & Enforcement Activity**
  - Guidance and enforcement activity involving SPACs
  - Other recent guidance and enforcement actions
- **Private Securities Litigation Update**
  - SPAC-related litigation and other trends
- **Recent Delaware Law Developments**
  - Stockholder inspection of corporate documents
  - Oversight liability (*Caremark* Claims)
  - D&O insurance

What is a SPAC?

- A **S**pecial **P**urpose **A**cquisition **C**ompany is a newly formed company with no business operations set up for the sole purpose of raising capital through an initial public offering with the goal of buying (merging with) an existing private company (target company), effectively taking that company public while avoiding the traditional IPO process.

Also Referred to as a "Blank Check Company"

- Because SPACs hold no material assets other than cash before completing an acquisition, they are often referred to as "public shell companies" or "blank check companies."
- The target company is not identified until after completion of the fund raising.

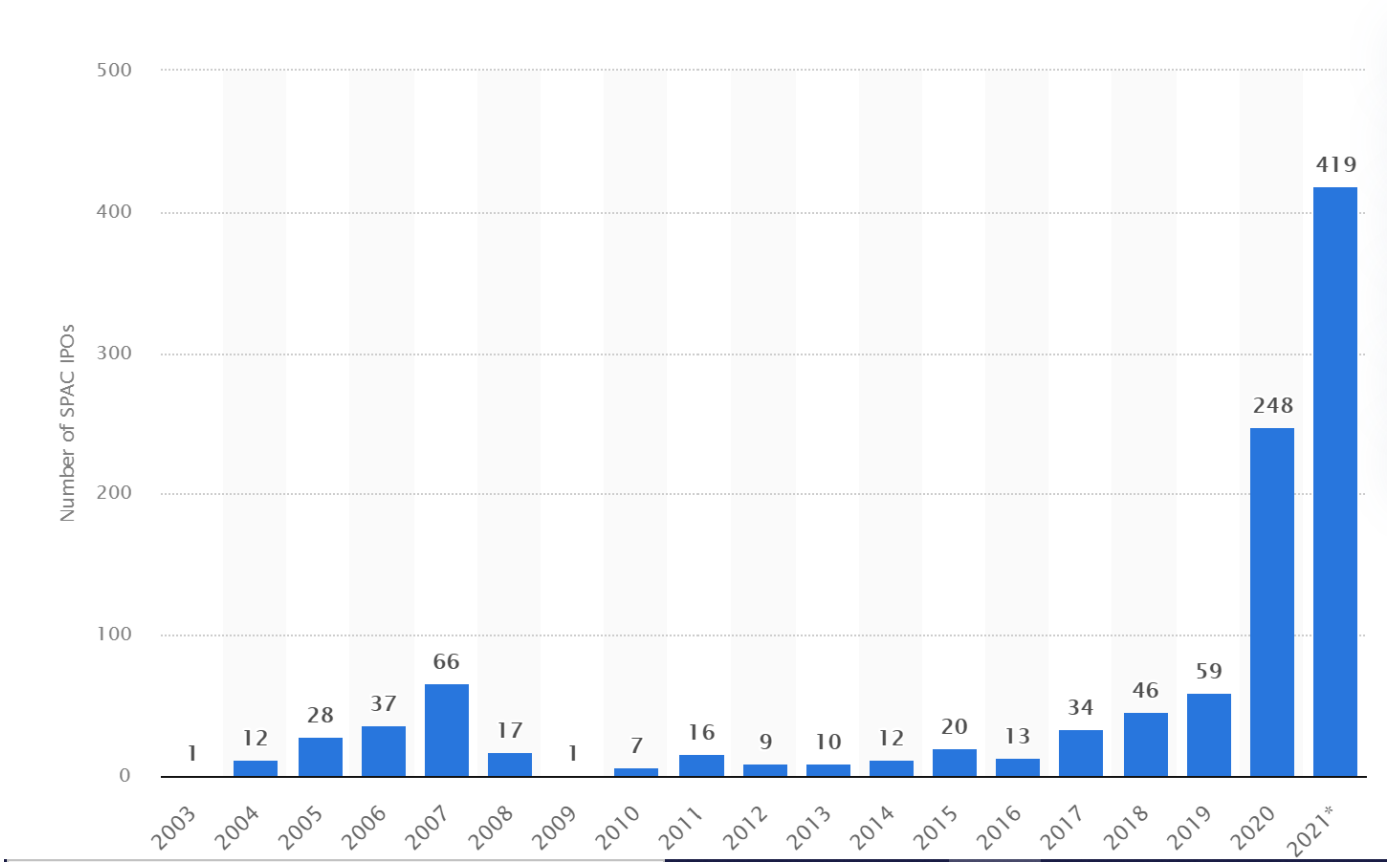
Benefits of a SPAC for the Target Company

- Traditional IPOs take a very long time (9-12 months) and are sensitive to market volatility.
- In a SPAC transaction, the funds already exist (raised by sponsors), the price is set before completing the transaction, and, for the target, the process can take as little as 3-4 months.
- SPAC sponsors file paperwork with regulators and provide target companies with a ready-made public listing.

Surge in SPAC Popularity

- The surge in SPAC IPOs in 2020-2021 has coincided with widespread economic uncertainty since the coronavirus pandemic began.
- Target companies can negotiate directly with their acquirers rather than take their chances on a volatile IPO market, where valuations can sink on down days.
- Boom in SPACs has attracted SEC scrutiny.

Number of SPAC IPOs Between 2003 and September 1, 2021
(Source: Statista)



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Investing in a SPAC

- In the SPAC IPO, investors (mostly hedge funds and other institutional investors) give money to the SPAC's sponsor without knowing exactly how the sponsor will invest it.
- Typically, these initial investors pay $10 for a unit consisting of a share in the SPAC and a detachable warrant (with a typical exercise price of $11.50).
- The SPAC's sponsor then typically has two years from the initial investment to use the investor's cash to merge with the target company (business combination or de-SPAC transaction).

Role of the SPAC sponsor

- SPAC sponsors range from large private equity funds to former Fortune 500 CEOs and senior executives to individuals with no particularly relevant background, including celebrities.
- Prior to the SPAC's IPO, the sponsor acquires a block of shares at a nominal price (*e.g.*, $25K) that will amount to 25% of IPO proceeds (or 20% of post-IPO equity) – compensation known as the "sponsor's promote" or "founder shares."
- In addition, the sponsor purchases SPAC warrants, shares, or both at prices estimated to represent fair market values to cover the cost of the IPO and operating costs while the SPAC is searching for a merger target.

What happens to the cash raised in the IPO?

- The proceeds of a SPAC's IPO are placed in a trust account and invested in relatively safe, interest-bearing instruments.
- Cash in the trust can be used only to (a) acquire a company, (b) contribute to the capital of a company with which the SPAC merges, (c) distribute to shareholders in liquidation if the SPAC fails to consummate a merger, or (d) redeem shares.
- If the SPAC does not merge within two years, it liquidates and distributes the funds in the trust to the public shareholders.
- If the funds are liquidated, the sponsor loses its investment.
- Between 2009 and April 2021, about 10% of SPACs liquidated.

Investors' right to redeem

- When a SPAC proposes a merger, its shareholders have a right to redeem their shares.
- The redemption price is the IPO price of the SPAC units plus interest that has accumulated in the trust.
- Shareholders that redeem their shares keep the warrants and rights that were in the units sold in the SPAC's IPO.
- The warrants and rights are used to attract IPO investors by compensating them for parking their cash in the SPAC for two years.

The Dilution Problem

- According to a study of the 47 SPACs that merged between January 2019 and June 2020 (*A Sober Look at SPACs)*, the percentage of IPO investors who redeemed when the mergers took place was 58% (mean) and 73% (median); over a third of merging SPACs had redemption rates of over 90%.

Dilution Results in Less Cash in Trust

- Also, according to this study, although SPACs issue shares for roughly $10 and value their shares at $10 when they merge, by the time of the merger the median SPAC holds cash of just $6.67 per share, leaving substantially less cash available to help the acquired company grow.

But Sponsor Teams Have Improved More Recently, Resulting in Less Dilution

- However, according to a more recent Harvard Business Review study (*SPACs: What you need to know*), for the 70 SPACs that found a target from July 2020 through March 2021, the average redemption rate was just 24%, amounting to 20% of total capital invested. And over 80% of the SPACs experienced redemptions of less than 5%.
- The authors attribute this performance to the improved quality of sponsor teams.

Minimum Cash Closing Condition

- Because a SPAC's shareholders have the right to redeem shares, there can be uncertainty regarding the amount of cash available to pay target shareholders and for post-close operations.
- Therefore, SPACs and targets often negotiate a "minimum cash" closing condition.
- Consequently, SPAC acquisitions often include private investment in public equity (PIPE) deals involving private placements to select groups of accredited investors upon consummation of the merger.

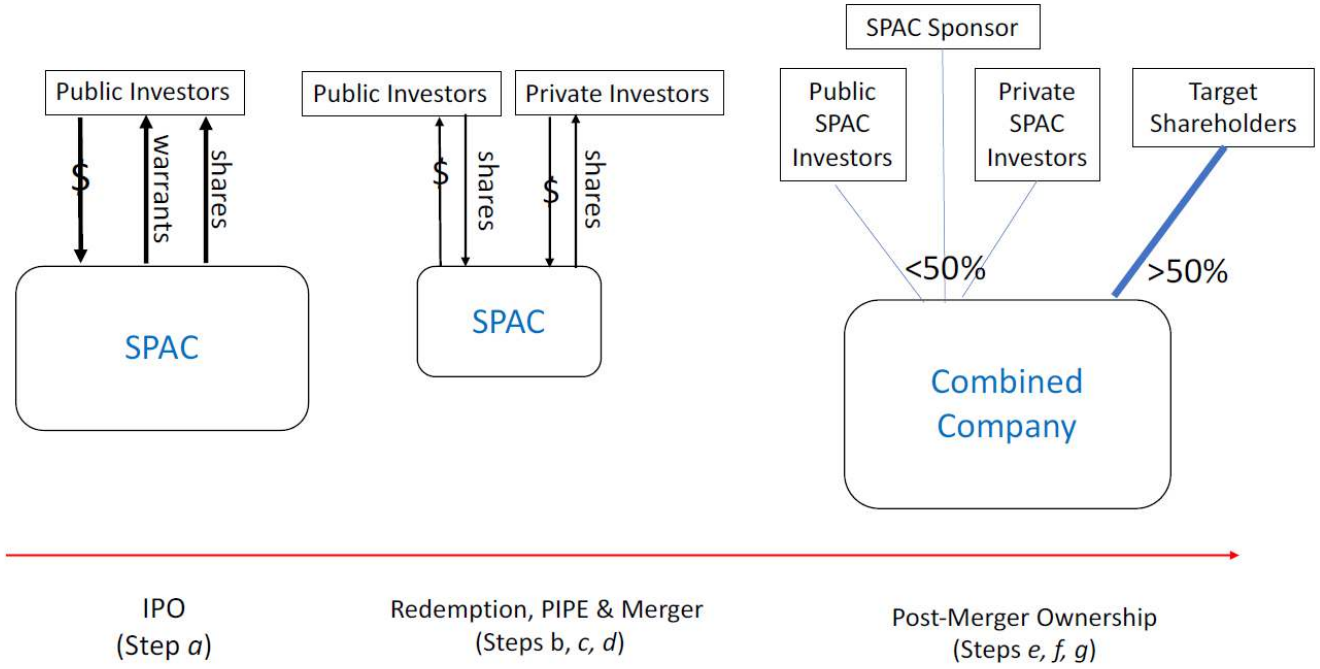
Meeting Target's Minimum Cash Requirement When Redemptions are High

- The sponsor itself can make an additional investment at the time of the merger.
- Investments by third parties in PIPEs conditioned on consummation of the proposed merger.
- Side payment to certain investors in exchange for commitment not to redeem shares.
- Investment by large shareholder of target.

The Result of a De-SPAC Transaction

- The target private company becomes a public company, with a shareholder base comprised of the target's rollover shareholders, the SPAC sponsor, the SPAC's public investors, and any private investors that participate in the deal through private investment in public equity (PIPE).

The SPAC Merger Process
(Source *A Sober Look at SPACs*)



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Sponsor's Incentive to Complete a Merger

- The potential loss of a sponsor's investment in a SPAC may create an incentive for sponsors to complete a de-SPAC transaction regardless of the quality of the pool of targets available for acquisition.
- Public investors in the SPAC need to stay alert to the potential financial pressure on the sponsors created by this risk.

Surge in Popularity of SPACs Fueling Innovation

- To differentiate themselves from the competition, some SPACs have offered more enticing deal terms to IPO investors and target companies, such as:
  - Reducing or eliminating warrants
  - Reducing or eliminating the sponsor promote
  - Providing incentives to IPO investors not to redeem

SPAC Boom Has Drawn SEC Scrutiny

- **December 22, 2020:** SEC's Division of Corporation Finance issued guidance on SPACs' disclosure of conflicts of interests.
- **March 31, 2021:** SEC issued a staff statement reminding SPACs that they must comply with existing SEC filing requirements as well as books and records and internal controls requirements.
- **April 8, 2021:** The SEC also issued a statement that cautioned SPACs against believing that the de-SPAC process allows forward-looking statements that could not be made in a conventional IPO.

SPAC Boom Has Drawn SEC Scrutiny, cont.

- **April 12, 2021:** SEC issued accounting guidance that would classify SPAC warrants as liabilities instead of equity.
- **May 26, 2021:** In testimony, SEC Chair Gary Gensler advised that additional rules and recommendations are under consideration to protect SPAC investors.
- **June 11, 2021:** SEC announced that its regulatory agenda includes proposing SPAC rule amendments in April 2022.

SEC Disclosure Guidance for SPACs

- **A SPAC IPO should consider disclosing, *e.g.*:**
- The sponsors', directors' and officers' potential conflicts of interest arising from their fiduciary or contractual obligations to other entities, such as organizations that might compete with the SPAC for merger opportunities or that have competing financial interests;
- Any conflicts insiders may have related to their SPAC compensation or financial incentives to complete the merger within a specified time.

SEC Disclosure Guidance for SPACs, cont.

- Details regarding the de-SPAC transaction terms and process, such as: the percentage of the vote for the merger controlled by the insiders, whether modifying the time to find a target and other actions can be taken without shareholder consent, details on the prior experience of the sponsors and other insiders, compensation agreements between the SPAC and underwriter, whether additional funding may be needed, and the terms of any forward purchase agreements.

SEC Disclosure Guidance for SPACs, cont.

- Financing terms of the de-SPAC transaction, such as terms of additional financing, terms for conversion of convertible securities, details of the selection process for a target company, SPAC insiders' conflicts of interests with the target company, whether additional services are being provided to the SPAC by the underwriter of the IPO, and a fairness opinion assessing if the merger is in the best interests of shareholders.

SEC Warns That PSLRA Safe Harbor may not apply to De-SPAC Transactions

In its April 8, 2021 public statement, the SEC cautioned:

- "[T]he PSLRA safe harbor should not be available for any unknown private company introducing itself to the public markets. Such a conclusion should hold regardless of what structure or method it used to do so. The reason is simple: the public knows nothing about this private company. Appropriate liability should attach to whatever claims it is making, or others are making on its behalf."
- "[T]he PSLRA excludes from its safe harbor 'initial public offerings,' and that phrase may include de-SPAC transactions."

SEC's Guidance on Accounting for Warrants Issued by SPACs

- On April 12, 2021, the SEC issued a staff statement explaining that warrants issued by SPACs may be required to be accounted for as a liability rather than equity under generally accepted accounting principles (GAAP) if there is a provision to change the settlement amount of the warrant, or if the holder of the warrant is entitled to receive cash in a tender offer and holders of common stock do not have the same right.
- This could require a restatement of prior financial statements for many companies.

SEC Filed Major Enforcement Action Against SPAC

- Further demonstrating its heightened focus on SPACs, on July 13, 2021, the SEC brought charges against the SPAC Stable Road Acquisition Company, its sponsor SRC-NI, its CEO Brian Kabot, the SPAC's proposed merger target Momentus Inc., and Momentus' former CEO Mikhail Kokorich.
- The SEC alleged, *inter alia*, that the SPAC misrepresented in its public filings that Momentus' key technology had been successfully tested, when in fact it failed to meet Momentus' own criteria for success.

SEC Filed Major Enforcement Action Against SPAC, cont.

- The SEC also alleged that the SPAC failed to disclose in its public filings that the Committee on Foreign Investment in the United States had ordered Kokorich to divest his interest in Momentus two years earlier, or that the Commerce Department had denied the CEO's application for an export license—which was necessary for the CEO to access part of Momentus' technology—for reasons related to national security.

SEC Filed Major Enforcement Action Against SPAC, cont.

- The SEC further alleged that the SPAC's due diligence was insufficient in that: (1) the SPAC did not ask its technology consulting firm to review Momentus' product test; and (2) the SPAC did not review documents related to the CFIUS divestiture order against Kokorich (which the SPAC had requested but Momentus falsely claimed it did not possess).
- In announcing the action, SEC Chair Gary Gensler stated that "[t]he fact that Momentus lied to Stable Road does not absolve Stable Road of its failure to undertake adequate due diligence to protect shareholders."

SEC Filed Major Enforcement Action Against SPAC, cont.

- All but Kokorich settled with the SEC. They agreed, *inter alia*, to pay penalties of $1 million for the SPAC, $7 million for Momentus, and $40,000 for the SPAC's CEO.
- The SEC also imposed targeted equitable remedies, including (1) agreement by the Sponsor to forfeit 250,000 founder shares (approximately 6% of the total founder shares), (2) agreement by the SPAC and Momentus to let PIPE investors terminate their commitments, and (3) agreement by Momentus to governance-related undertakings, including the creation of an independent board committee and the retention of an internal compliance consultant for a period of two years.

Other SEC Developments of Note

- In March 2021, the SEC announced the creation of a Climate and ESG Task Force in the Division of Enforcement which will develop initiatives to proactively identify ESG-related misconduct.
- The task force's initial focus will be to identify any material gaps or misstatements in issuers' disclosure of climate risks under existing rules. The task force will also analyze disclosure and compliance issues relating to investment advisers' and funds' ESG strategies.

Other SEC Developments of Note, cont.

- In August 2021, the SEC approved Nasdaq's proposed rules regarding board diversity, which take a "comply or explain" approach, requiring most Nasdaq-listed companies to either (a) include on their boards of directors at least two "diverse" directors, or (b) explain why they do not meet these diversity benchmarks. The rules also require Nasdaq-listed companies to disclose aggregate board diversity data.

Other SEC Developments of Note, cont.

- Also in August 2021, the SEC sanctioned eight firms in three actions for failures in their cybersecurity policies and procedures that resulted in email account takeovers exposing the personal information of thousands of customers and clients at each firm.
- In September 2021, the SEC communicated enhanced disclosure requirements in letters sent to individual companies commenting on inadequacy of their disclosures regarding climate change.

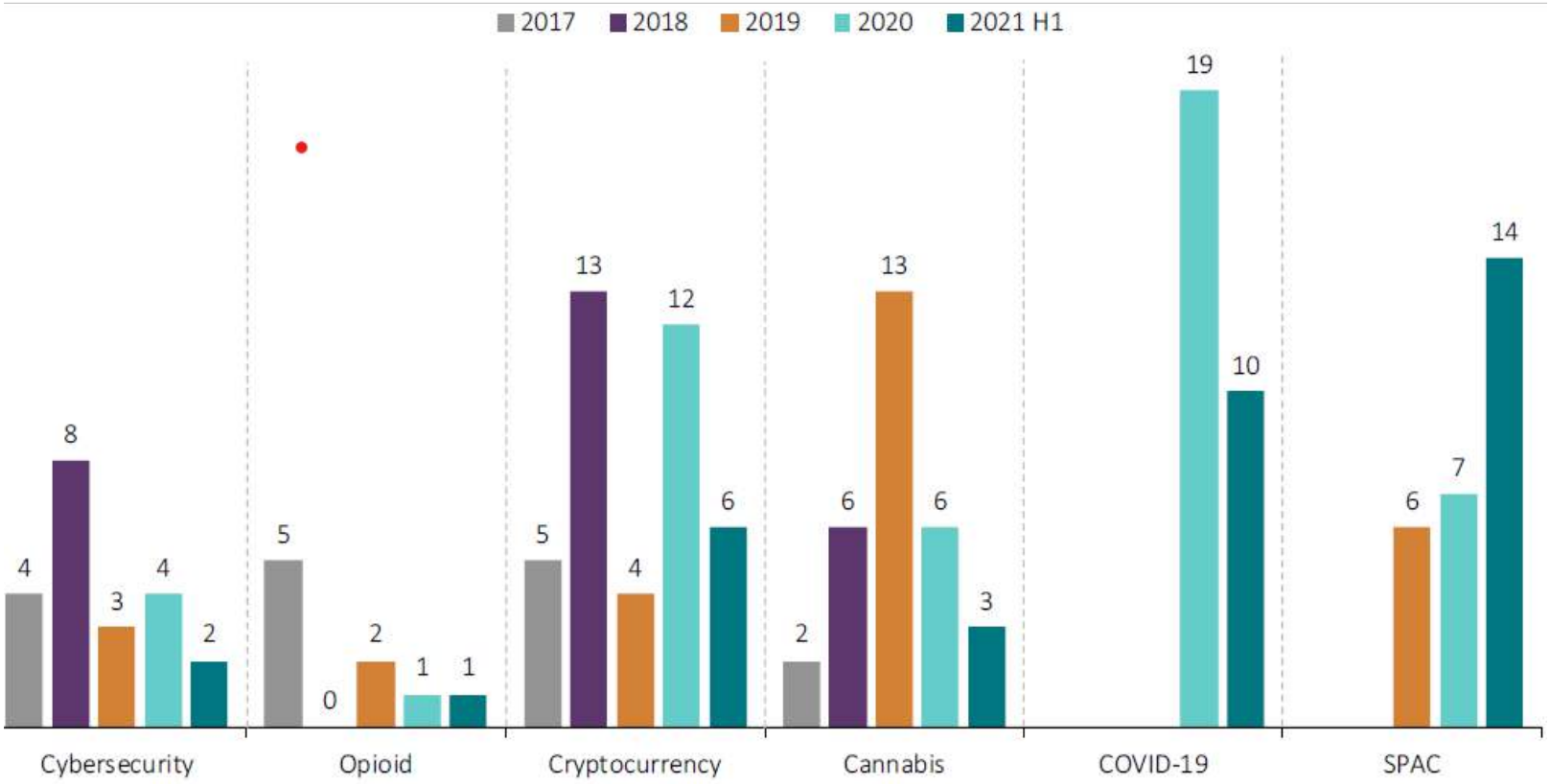
Private Securities Litigation Trends

- Plaintiffs filed 112 new securities class actions in federal and state courts in the first half of 2021, down 25% relative to 2020.
- This is the lowest number since the first half of 2015.
- This trend was driven primarily by the sharp drop in merger objection, federal Section 11, and state 1933 Act filings.

Private Securities Litigation Trends

- Covid-19 related filings were largely concentrated in the first four months of the year and have declined since.
- Cases involving cannabis companies and cases stemming from the opioid epidemic have continued to decline.
- Cryptocurrency cases are on pace to match the high level of 2020.
- So far, filings pertaining to cybersecurity remain low.

Private Securities Litigation Trends
(Source: Cornerstone Research)



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Filings Related to SPACs Have Increased Sharply

- There were twice as many SPAC filings in the first half of 2021 (14 cases) as there were in all of 2020 (7 cases).
- According to the Stanford Law School Securities Class Action Clearinghouse, 25 actions pertaining to SPACs have been filed this year as of October 15, 2021.
- Most of these complaints contain Rule 10b-5 claims, alleging a false or misleading statement or omission of material facts.
- Not surprisingly, a securities class action complaint was filed against Stable Road Acquisition Corp., the SPAC the SEC sued in July.

Types of Misstatements & Omissions Alleged in SPAC Class Actions

- Overstatement of viability of target company's technology.
- Failure to disclose internal or external investigations related to the actions of the company and/or its officers and directors.
- Failure to disclose supply chain threats, unavailability of raw materials, lack of inventory or suppliers, deficient numbers of personnel, and the inability to scale the business.
- Inflated sales projections or inaccurate production timelines.

Delaware Governance Issues

Stockholder Inspection – Fee Shifting

- The Court of Chancery shifts fees to dissuade unduly aggressive defenses to inspection requests
- *Pettry v. Gilead Sciences, Inc.* (Del. Ch. Nov. 24, 2020)
  - In a post-trial opinion, the Court grants Plaintiffs inspection and opens the door for Plaintiffs to seek fees.
  - Plaintiffs raised the issue of fee shifting in the pre-trial stipulation, but did not raise it in either of their post-trial briefs.
  - The Court relies on academic research suggesting that by defending Section 220 proceedings, defendants "place obstacles in the plaintiffs' way to obstruct them from employing it as a quick and easy pre-filing discovery tool."

Stockholder Inspection – Fee Shifting, cont.

- Eight months later, the Court of Chancery issues a 6-page letter decision that grants a motion to shift fees. *Pettry v. Gilead Sciences, Inc.*, (Del. Ch. Jul. 22, 2021) (ORDER).
  - Holds that the defendant's behavior was "glaringly egregious" and justified fee-shifting because:
    - Gilead argued that Plaintiffs had not met the credible basis requirement to investigate wrongdoing despite extensive evidence suggesting wrongdoing;
    - Gilead claimed that Plaintiffs were not entitled to inspection because follow-on claims about the wrongdoing would be dismissed, contrary to a recent Delaware Supreme Court decision removing this requirement;
    - Gilead pursued a defense that was not supported by the record, and the Court found that Gilead otherwise misrepresented the record; and
    - Gilead took aggressive positions in discovery in this summary proceeding.
  - Led to a payment of $1,757,075.25 to Plaintiffs' counsel.

Stockholder Inspection – Fee Shifting, cont.

- Does *Gilead* Signal A New Era of Fee Shifting?
  - The Chancellor laid the groundwork for *Gilead* in a prior decision.
  - Fee shifting will not be automatic. There has been one further case in which one of the Plaintiff-side firms involved in *Gilead* sought fee-shifting. In *Gross v. Biogen*, the Court refused to shift fees. *Gross v. Biogen Inc.* (Del. Ch. Oct. 14, 2021).
- Defendant corporations should:
  - Give serious consideration to making at least some production in response to an inspection demand; and
  - Carefully evaluate whether to mount a broad rather than targeted defense to an inspection action.

Oversight Liability

Development of the *Caremark* Claim

- Rooted in *Caremark*, which explained that an oversight claim is "possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment."
- In *Stone v. Ritter*, the Delaware Supreme Court affirmed oversight liability as described in *Caremark.* There are two prongs of potential *Caremark* liability:
  - (1) "the directors utterly failed to implement any reporting or information system or controls;" *or*
  - (2) "having implemented such a system or controls, [the directors] consciously failed to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention."
  - For both prongs, Plaintiffs must allege scienter.
- Directors can bear personal liability for damages suffered by the corporation. The numbers can get very large.

Oversight Liability – Recent Trend

A Series of *Caremark* Cases Survive Motions to Dismiss

- *Marchand v. Barnhill* (Del. June 18, 2019)
  - Listeria outbreak at Blue Bell ice cream factory led to three customer deaths.
  - Prong one claim: the directors allegedly failed to establish a formal system governing reporting of safety issues, leaving safety for management to handle.
  - Also upholds claim that officers failed to react to red flags
- *In re Clovis Oncology, Inc. Deriv. Litig.* (Del Ch. Oct. 1, 2019)
  - Prong two claim: directors of biotech development corporation allegedly failed to monitor the development of its only promising drug. Reported results were at odds with information the Board received and the Board did not act.
- *Hughes v. Hu* (Del. Ch. Apr. 27, 2020)
  - Prong one claim: directors allegedly failed to "act in good faith to maintain a board-level system for monitoring the Company's financial reporting." This led to a restatement of the company's financials.
- *Teamsters Local 443 v. Chou*, (Del. Ch. Aug. 24, 2020)
  - Prong two claim: directors allegedly failed to react to information that its drug was delivered through syringes which had contamination issues.

Oversight Liability - *Boeing*

The Boeing Company Derivative Litigation, (Del. Ch. Sept. 7, 2021)

- This case arose from two crashes of 737 MAX airplanes: one in October 2018 and another in March 2019. Both crashes killed everyone on board.
- "The primary victims of the crashes are, of course, the deceased, their families, and their loved ones. While it may seem callous in the face of their losses, corporate law recognizes another set of victims: Boeing as an enterprise, and its stockholders. The crashes caused the Company and its investors to lose billions of dollars in value. Stockholders have come to this Court claiming Boeing's directors and officers failed them in overseeing mission-critical airplane safety to protect enterprise and stockholder value."
- This opinion considered a motion to dismiss arguing that demand was not excused. "In order for the stockholders to pursue the claim, they must plead with particularity that the board cannot be entrusted with the claim because a majority of the directors may be liable for oversight failure. This is extremely difficult to do."
- The Court refuses to dismiss the claim against the board, but does dismiss the claim against Boeing's officers, along with an additional claim about the CEO's retirement and compensation.

Oversight Liability – *Boeing's* Board

The Complaint's Allegations About Board Structure

- Boeing's board had five committees, none were formally charged with addressing airplane safety.
  - "Although the Audit Committee was tasked with handling risk generally, it did not take on airplane safety in particular."
  - Audit Committee materials did not mention safety in connection with the 737 MAX, from its development through its grounding in 2019.
  - The Audit Committee's "Enterprise Risk Viability" process provided senior management and the Board an annual "comprehensive view of key Boeing Risks and the actions taken to address them…."
  - Safety risks were not discussed at the Board, Audit Committee, or ERV, except in some management presentations that "focused primarily on the business impact of airplane safety crises and risks."
  - Board had no reporting process established to receive internal complaints about airplane safety.
  - A former board member stated that the "board doesn't have any tools to oversee safety."

Oversight Liability – *Boeing* Background

The Complaint's Allegations About What Happened

- The Complaint alleges that around 2000, Boeing shifted from being an engineer-driven company to pursuing a cost-cutting business model, with a series of safety issues over the following decades.
- As new planes were developed, the Board focused on achieving revenue targets and expected the engineers to help hit the targets. This pressure, allegedly, led to a number of safety incidents and later affected the 737 MAX.
- The claim at issue focuses on three time periods:
  - Before the first crash, the Board utterly failed to implement any reporting or information systems or controls.
  - The first crash was a red flag that the Board ignored.
  - Further, even after the first crash, the Board continued to utterly fail to implement any reporting or information systems or controls.

Oversight Liability – Product Safety

Caremark Prong One Claims In the Product Safety Context

- The Court distinguished between monitoring for financial wrongdoing (*e.g.*, accounting fraud) and the Board's responsibility to monitor the company's operations that affect product safety.
- *Marchand* – Board of ice cream company failed its obligations under prong one because it left food safety issues to management's discretion.
- The same factors relied on in *Marchand* were present here regarding plane safety: (i) no board committee addressing food safety; (ii) no requirement of management communication to board regarding food safety; (iii) no schedule for board to consider food safety risks; (iv) management received red or yellow flags that were not mentioned in the relevant board minutes; (v) board received only rosy information about food safety from management; (vi) board meetings did not mention food safety.
- The Court also pointed to evidence in this case that the Board knew it had not discharged its duties: an email after the second crash discussing the need to address safety issues at the board level; and "the Board's public crowing about taking specific actions to monitor safety that it did not actually perform."

Oversight Liability – After A Red Flag

A *Caremark* Claim After the First Crash

- Plaintiffs alleged a claim under both prong one and prong two after the first crash. "To state a prong two *Caremark* claim, Plaintiff must plead particularized facts that the board knew of evidence of corporate misconduct—the proverbial red flag—yet acted in bad faith by consciously disregarding its duty to address that misconduct."
- The Court held that the complaint stated a claim under prong one and did not formally hold that the complaint stated a claim under prong two, though the Court discussed why the allegations might support a prong two claim.
- The Board learned of the crash and its causes from the media but did not react or investigate the issues that were reported.
- The crash occurred in October. The board held a meeting to discuss it, but the meeting was optional. The full board did not address the crash as an agenda item until its regularly scheduled Board meeting in December 2018. At that time, the Board's focus "was on the continued production of the 737 MAX, rather than MCAS, potential remedial steps, or safety generally."
- In February 2019, the Board formally considered whether to investigate safety issues, and decided to delay any investigation until "the conclusion of the regulatory investigations or until such time as the Board determines that an internal investigation would be appropriate."

Oversight Liability – Practical Steps

- The time to act is before a problem occurs.
- Boards must expressly oversee risks, including identifying risks, establishing a system to monitor risks, and reacting to risks.
  - Cannot rely on management's judgment to determine what to report.
- Safety issues must be separately and expressly addressed.
  - Measures aimed at "risks" generally are not enough to address safety issues.
- Boards must react when problems are raised.
- Board documents – agendas, minutes, and resolutions forming committees – should reflect these efforts.
  - Consider effect on a Rule 12(b)(6) motion after a production of documents made in response to a stockholder demand.
  - Minutes should show risks were considered, a process to monitor and address risks was established, the board regularly checked on that system, and the board addressed any red flags.
- There is no safe harbor for small companies.

D&O Insurance – Fraud

RSUI Indem. Co. v. Murdock (Del. Mar. 3, 2021)

- The Delaware Supreme Court held that a directors & officers insurance policy that covers fraud is enforceable and is not contrary to the public policy of Delaware.
  - Addresses other issues as well:
    - (1) D&O policies will generally be interpreted under the law of Delaware; and
    - (2) the interaction between language in a fraud exclusion requiring a "final adjudication" and the fact of a settlement.
- RSUI Indemnity Company ("RSUI") provided Dole's eighth layer of D&O coverage, providing $10,000,000 that was "payable upon the exhaustion of the $75,000,000 coverage from the underlying policies and the payment of a $500,000 retention by Dole."

D&O Insurance – Fraud, cont.

The Court of Chancery Litigation

- In November 2013, David Murdock took Dole Food Company ("Dole") private. Murdock was Dole's CEO and a member of its board of directors. Before the transaction, Murdock owned about 40% of Dole's stock. Through the transaction, Murdock acquired the rest of the stock through a company.
- Dole stockholders brought suit in the Court of Chancery, alleging breach of fiduciary duty claims against Murdock and a Dole officer, C. Michael Carter. That lawsuit was consolidated with an appraisal action addressing the same transaction.
- After a nine-day trial, the Court of Chancery held that Murdock and Carter breached their duty of loyalty "though a series of intentional, unfair, and fraudulent actions" that drove down Dole's pre-merger stock price. The Court found the conduct was "not innocent or inadvertent, but rather intentional and in bad faith," and found that both Carter and Murdock had "engaged in fraud."
- The Court of Chancery found that this misconduct "reduced the ultimate deal price" and imposed a $148 million damages award. After that decision was issued, Dole settled both the fiduciary duty and appraisal actions for that amount.
- The Court of Chancery's decision led to a federal securities claim premised on the fraud ruling. Dole settled that action for $74 million plus interest.

D&O Insurance – Fraud, cont.

The Superior Court Insurance Coverage Action

- After the settlements, Dole sought coverage under its D&O policy for the settlement amounts. RSUI, which as a reminder provided the eighth layer of coverage, refused, along with other excess insurers.
- RSUI and other excess insurers sought a declaratory judgment in the Delaware Superior Court that they had no obligation to fund the settlement. Murdock and Dole filed counterclaims.
- Of interest here, RSUI argued that fraudulent conduct should be uninsurable under Delaware law.
- By the time the Superior Court ruled on RSUI's coverage issues, every other insurer had settled or paid the full amounts of its layer. The Superior Court issued judgment requiring RSUI to pay its policy limits plus interest.

D&O Insurance – Fraud, cont.

The Delaware Supreme Court Holds Fraudulent Conduct is Insurable

- "We start our analysis by reaffirming our respect for the right of sophisticated parties to enter into insurance contracts as they deem fit 'in the absence of clear indicia that … [a countervailing public] policy exists.'"
- "[T]he Policy has an expansive definition of covered losses …."
  - RSUI agreed to pay for "all Loss … arising from any Claim for a Wrongful Act …."
  - "Wrongful Act" includes "actual or alleged error, misstatement, misleading statement, act, omission, neglect, or breach of duty."
  - The Fraud Exclusion illustrates that claims based on fraud were covered.
- "The question here then is: does our State have a public policy against the insurability of losses occasioned by fraud so strong as to vitiate the parties' freedom of contract? We hold that it does not."
  - Freedom of contract is wealth-maximizing and not lightly ignored.
  - The DGCL grants corporations power to purchase D&O insurance that covers non-indemnifiable behavior. Bad-faith behavior is non-indemnifiable.
  - Without insurance in stockholder litigation, injured parties may have no remedy.

D&O Insurance – Practical Steps

- Consider this decision when renewing D&O policies.
- Freedom of contract remains the driving principle.
- Insurers may attempt to contract around the result in this decision.

Sources

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