**Westlaw Today**
*powered by Reuters*

# How to avoid SPAC litigation and regulatory enforcement actions

**By Michael J. Dell, Esq., and Tobias B. Jacoby, Esq., Kramer Levin Naftalis & Frankel LLP***

**SEPTEMBER 17, 2021**

Special Purpose Acquisition Companies (SPACs) continue to be popular. The number of SPAC IPOs jumped from 13 in 2016 to 59 in 2019, 248 in 2020, and 407 so far in 2021.[1] There has also been a significant increase in regulatory scrutiny and civil lawsuits concerning SPACs.

In the first half of 2021 alone, the SEC issued several statements on SPACs and signaled a willingness to bring enforcement actions. In that same period, private plaintiffs filed fourteen SPAC-related federal class actions, twice the number filed in 2020.[2]

*SPAC sponsors face the risk that allegations will be made that their registration and proxy statements do not contain sufficient disclosures about the target and their own interests and conflicts.*

Plaintiffs have also brought breach of fiduciary duty and other claims against SPAC sponsors and SPAC-related parties in state courts. Their claims often raise questions about the fundamental soundness of SPACs. But SPACs are not inherently improper, as some have tried to make them out to be. Done right, SPACs are the healthy product of a functioning free enterprise system. They can provide value to investors, sponsors, and businesses.

A SPAC is a company that generally has no operations and raises capital in an initial public offering (IPO) of redeemable securities. Their purpose is to identify and acquire a private operating company within a predetermined period, usually two years.

In the meantime, the capital is placed in a trust fund to pay for the acquisition, which is commonly called a "de-SPAC" transaction. The combined company is then publicly traded and continues the target company's business. If the de-SPAC transaction does not occur within the agreed time, the SPAC liquidates and the funds held in trust are returned to investors.

Some raise questions about the prudence of investing in a SPAC that has not yet identified an acquisition target. But the concept is not at all unusual or untoward and has advantages for the capital markets. For example, companies acquired in de-SPAC transactions can become public more quickly and have more control in arriving at the price of the transaction.

Investors in SPACs rely on the expertise and experience of the SPAC team that locates the target for acquisition. Shareholders who do not like the target can redeem their shares in the SPAC for their share of its funds or sell their shares on the secondary market.

While some SPACs have run into trouble, impugning all SPACs because of those outliers would be like throwing the baby out with the bath water. SPACs can avoid the pitfalls described below that have led to regulatory action or litigation and undermined a small minority of SPACs.

## Disclosures

SPAC sponsors face the risk that allegations will be made that their registration and proxy statements do not contain sufficient disclosures about the target and their own interests and conflicts to enable retail investors to decide whether to invest in the SPAC and to enable SPAC shareholders to decide whether to redeem their shares or support a de-SPAC transaction.

In December 2020, the SEC issued a statement that it is paying particularly close attention to disclosures concerning potential risks and conflicts of interest. The SEC explained that there must be "[c]lear disclosure" concerning, among other things, any interest the SPAC's sponsor, directors, officers, or affiliates may have in the target company, financial incentives for those parties to complete a merger, and any continuing relationship they may have with the combined company.[3]

On August 26, 2021, the SEC's Investor Advisory Committee went further. It issued draft recommendations to be discussed at the Committee's September 9, 2021 meeting, that the SEC "regulate SPACs more intensively by exercising enhanced focus and stricter enforcement of existing disclosure rules under the Securities Exchange Act of 1934."[4]

The draft recommendations suggest that the SEC focus on:

- "Plain English disclosure" in the SPAC registration statement about "the 'promote' (*e.g.* 'founder shares') paid and their impact on dilution sufficient to enable a retail investor to make

Thomson Reuters is a commercial publisher of content that is general and educational in nature, may not reflect all recent legal developments and may not apply to the specific facts and circumstances of individual transactions and cases. Users should consult with qualified legal counsel before acting on any information published by Thomson Reuters online or in print. Thomson Reuters, its affiliates and their editorial staff are not a law firm, do not represent or advise clients in any matter and are not bound by the professional responsibilities and duties of a legal practitioner. Nothing in this publication should be construed as legal advice or creating an attorney-client relationship. The views expressed in this publication by any contributor are not necessarily those of the publisher.

THOMSON REUTERS®

a meaningful comparison of the upside potential and downside risks of a SPAC transaction;"

- A "clear description" in the SPAC registration statement of the "mechanics and timeline of the SPAC process;"
- Disclosure in the SPAC registration statement of
  1. the "boundaries of the search area" for a target company, "attributes of acceptable and unacceptable [target] companies," and "ground rules for any changes to the search area;"
  2. how a sponsor will assess the ability of a potential target to meet the standards of a public company "from a governance and internal control perspective" and whether the sponsor will take steps "to ensure the target company can meet minimum preparedness/quality standards for operating as public company;
  3. the "minimum pre-de-SPAC diligence" the sponsor will commit to conduct regarding "the accounting practices used by the target company";
  4. "the competitive pressure and risks involved in finding appropriate targets and reaching market acceptable prices for those companies;" and
  5. "the acceptable range of terms under which any additional funding (*e.g.* public investment in private equity 'PIPEs') might be sought at the time of acquisition/ redemption."

The draft suggests the SEC require disclosure "of the identity and relationship of PIPE investors, and whether any side payments are to be made to certain shareholders as an inducement not to redeem their shares;" and

- Disclosure of "the role of the SPAC sponsor," including "an overview of any potential conflicts of interest on the part of the sponsor and other insiders or affiliates, and any divergence of the sponsor's financial interest relative to that of the retail investors in the SPAC." The draft suggests "requiring a standardized disclosure of the sponsor's total investment in the transaction; the value of the sponsor's interest if the proposed merger closes including all management and promoter fees; and the break-even post-merger price for the sponsor."

Private plaintiffs are also scrutinizing disclosures. SPAC investors have brought post-merger complaints asserting violations of federal securities laws, typically Sections 14(a), 10(b) and 20(a) of the Securities Exchange Act and Section 11 of the Securities Act. They have alleged that disclosures in proxy solicitations or registration statements in connection with de-SPAC transactions are inaccurate or incomplete, principally concerning conflicts, the target company and the SPAC's due diligence.[5]

Plaintiffs have also filed pre-merger lawsuits in state courts, including actions that seek "disclosure-only" as a remedy, [6] or that assert breach of fiduciary duty claims against SPAC sponsors and directors and aiding and abetting claims against the SPAC and its target.

Such lawsuits sometimes allege the SPAC's sponsors or board members have conflicts of interest, including on the ground that the sponsors and directors are rushing to complete an ill-advised transaction because they would otherwise have to return invested funds to the SPAC's shareholders. SPACs should focus on their disclosures and the target company's disclosures to minimize litigation claims.

## Due diligence

The SEC has asserted that SPACs have an obligation to conduct due diligence on target companies, and that careful attention should be given to the due diligence process. For example, a great deal of attention has been given to the charges the SEC brought against a SPAC (Stable Road), its sponsor and CEO, the SPAC's proposed merger target (Momentus), and its former CEO, for misrepresentations about the target's early-stage space transportation technology.[7]

According to the SEC, Stable Road breached its obligations by repeating statements by Momentus that it "successfully tested" its propulsion technology in space when, in fact, Momentus's "only in-space test failed to achieve its primary objectives or demonstrate the technology's commercial viability," and Stable Road had not conducted adequate due diligence.[8] SEC Chair Gary Gensler cautioned 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."[9]

*The SEC has asserted that SPACs have an obligation to conduct due diligence on target companies, and that careful attention should be given to the due diligence process.*

The consequences of this alleged due diligence failure were significant. Stable Road's sponsor agreed to forfeit shares it would have received from the de-SPAC. And both Stable Road and Momentus "agreed to provide PIPE (private investment in public equity) investors with the right to terminate their subscription agreements prior to the shareholder vote to approve the merger."[10]

PIPE investments often provide critical liquidity to complete a de-SPAC transaction acquisition, particularly when SPAC shareholders redeem their shares before the acquisition. Giving PIPE investors the ability to walk away can doom a de-SPAC, leaving the SPAC no option but to liquidate. SPACs can avoid these problems by conducting adequate due diligence.

## Forward-looking statements

As part of the de-SPAC process, SPACs often distribute proxy statements to shareholders providing financial projections for the post-merger company. Recent commentary from the SEC suggests

that regulators may contend that forward-looking statements in de-SPAC proxy statements are entitled to less protection than previously believed. It is therefore critical that forward-looking statements are adequately vetted.

The Private Securities Litigation Reform Act (PSLRA) provides a safe harbor from liability in private federal securities litigation for forward-looking statements that are made in good faith and couched in cautionary language.[11] Excluded from this safe harbor are forward-looking statements made "in connection with" (i) "an offering of securities by a blank check company" or (ii) an IPO.[12]

Most SPACs do not fit within the PSLRA's definition of "blank check company" (even though they are often referred to colloquially as "blank check companies") because they are not issuers of "penny stock[s]."[13] And commentators have argued that forward-looking statements made by a SPAC and its target in connection with a de-SPAC transaction are not made in connection with an IPO and are therefore protected by the PLSRA's safe harbor provisions.

However, on April 8, 2021, the Acting Director of the SEC's Division of Corporation Finance, John Coates, issued a statement that a de-SPAC is a type of IPO and therefore excluded from the PSLRA's safe harbor. Mr. Coates explained that it is "commonly understood that it is the de-SPAC — and not the initial offering by the SPAC — that is the transaction in which a private operating company itself 'goes public,' i.e., engages in its initial public offering."[14]

More recently, the SEC Investor Advisory Committee's August 26, 2021 draft recommendations state "there is no logical reason for allowing safe harbor for projections for either SPACs or IPOs in a public offering made to retail investors in a regulatory system based on disclosure. If projections are made, issuers must take full responsibility for those projections in both the SPAC and de-SPAC transactions."[15]

The draft therefore "recommends this safe harbor for SPACs be eliminated. The public communications of SPAC promoters should be treated in the same way as public communications for an IPO, particularly for the de-SPAC transaction."[16]

Members of Congress similarly have drafted (but not yet introduced) a law that would amend the PSLRA explicitly to exclude SPACs from the statute's safe harbor provisions.[17]

Even before these developments, the PSLRA never provided a safe harbor from (i) regulatory action, including by the SEC, (ii) common law claims, (iii) statements about present conditions; or (iv) false or misleading statements made with knowledge that they are false and misleading. SPACs can avoid this issue by giving careful attention to forward-looking statements.

## Transition to public accounting

Private companies may spend years preparing to go public in a traditional IPO. A SPAC target, however, may have only months to meet the financial reporting, internal control, corporate governance, and auditing standards that are required of public companies.[18]

The SEC has recently stressed that these standards are not relaxed for companies that become publicly traded as the result of a de-SPAC merger.[19] SPACs must devote attention and resources to ensuring a merger target is ready to meet these standards.

## Accounting for SPAC warrants

Investors in a SPAC IPO generally receive not only equity, but also warrants that give them the option to purchase additional shares. To qualify for treatment as equity instruments, and not liabilities, under U.S. Generally Accepted Accounting Principles, the warrants must be indexed to the SPAC's stock.

On April 12, 2021, the SEC issued a Staff Statement warning that warrants issued by some SPACs should not be accounted for as equity due to "certain terms that may be common in warrants included in SPAC transactions."[20] The Staff identified two such terms:

(1) a warrant provision that potentially changes the settlement amount depending on characteristics of the warrant *holder*, which would preclude the warrant from being indexed to the entity's stock; and

(2) a provision that, in the event of a qualifying cash tender offer, which could be outside the SPAC's control, all warrant holders would be entitled to cash while only certain common stockholders would be entitled to cash.[21]

Proper accounting for warrants is obviously important.

## Investment Company Act of 1940

Plaintiffs continue to search for new claims against SPACs and their sponsors. In August 2021, a plaintiff filed derivative actions against E.Merge Technology Acquisition Corp., GO Acquisition Corp., and Pershing Square Tontine Holdings, Ltd., alleging those SPACs are investment companies under the Investment Company Act of 1940 and that they and their sponsors are violating the statute.[22]

58 U.S. law firms, in a rare showing of unity, responded with a statement that they "view the assertion that SPACs are investment companies as without factual or legal basis."[23] After explaining that "more than 1,000 SPAC IPOs have been reviewed by the staff of the SEC over two decades and have not been deemed to be subject to the 1940 Act," the firms stated their belief that

> a SPAC is not an investment company under the 1940 Act if it (i) follows its stated business plan of seeking to identify and engage in a business combination with one or more operating companies within a specified period of time and (ii) holds short-term treasuries and qualifying money market funds in its trust account pending completion of its initial business combination.[24]

The derivative actions, which remain *sub judice*, are unlikely to be the last attempt to find new ways to test SPACs.

## Conclusion

All IPOs and acquisitions of public companies face the risk of regulatory scrutiny and civil lawsuits.[25] SPACs can mitigate these risks by paying close attention to SEC guidance and by avoiding pitfalls that have ensnared a small minority of SPACs. When SPACs

and de-SPACs are undertaken correctly, they can provide value to everyone involved.

## Notes

[1] SPAC Statistics, https://bit.ly/2SSY817.

[2] Stanford Law School Securities Class Action Clearinghouse & Cornerstone Research, Securities Class Action Filings, 2021 Midyear Assessment, available at https://bit.ly/3zc0dVh.

[3] SEC Division of Corporation Finance, *Special Purpose Acquisition Companies*, CF Disclosure Guidance: Topic No. 11, Dec. 22, 2020, https://bit.ly/3zfWMgz.

[4] *Draft Recommendations of the Investor as Purchaser and Investor as Owner Subcommittees of the SEC Investor Advisory Committee regarding Special Purpose Acquisition Companies*, Aug. 26, 2021, https://bit.ly/3hBwejX ("Aug. 26, 2021 Draft IAC Recommendations").

[5] *See, e.g.*, Complaint, *Kong v. Multi plan Corp.*, 2:21-cv-03186, D.E. 1 (E.D.N.Y. Jun. 4, 2021); Complaint, Pitman v. Immunovant, Inc., 1:21-cv-00918, D.E. 1 (E.D.N.Y. Feb. 19, 2021).

[6] *See, e.g.*, Complaint, *Acker v. Churchill Capital Corp II*, Index No. 650892/2021, D.E. 1 (Sup. Ct. N.Y. Cnty. Feb. 8, 2021).

[7] Press Release, *SEC Charges SPAC, Sponsor, Merger Target, and CEOs for Misleading Disclosures Ahead of Proposed Business Combination*, Securities and Exchange Commission (July 13, 2021), available at https://bit.ly/3hBYt1M.

[8] *Ibid.*

[9] *Ibid.*

[10] *Ibid.*

[11] 15 U.S.C § 78u-5. For common law claims, the "bespeaks caution" doctrine may provide similar protection against liability for forward-looking statements.

[12] *Ibid.*

[13] Securities Act Rule 419, 17 CFR § 230.419.

[14] John Coates, *Public Statement: SPACs, IPOs and Liability Risk under the Securities Laws*, Apr. 8, 2021, available at https://bit.ly/3tRB01C.

[15] Aug. 26, 2021 Draft IAC Recommendations.

[16] *Ibid.*

[17] Discussion Draft H.R. ___, https://bit.ly/2Z5lDr7.

[18] Paul Munter, SEC Acting Chief Accountant, *Financial Reporting and Auditing Considerations of Companies Merging with SPACs*, Mar. 31, 2021, https://bit.ly/3CfUVu1.

[19] *Ibid.*

[20] John Coates, SEC Acting Director, Division of Corporation Finance, & Paul Munter, SEC Acting Chief Accountant, Staff Statement on Accounting and Reporting Considerations for Warrants Issued by Special Purpose Acquisition Companies ("SPACs"), Apr. 21, 2021, https://bit.ly/3tHuQRz.

[21] *Ibid.*

[22] Complaint, *Assad v. E. Merge Technology Acquisition Corp.*, 1:21-cv-07072, D.E. 1 (S.D.N.Y. Aug. 20, 2021); Complaint, *Assad v. GO Acquisition Corp.*, 1:21-cv-07076, D.E. 1 (S.D.N.Y. Aug. 20, 2021); Complaint, *Assad v. Pershing Square Tontine Holdings, Ltd.*, 1:21-cv-06907, D.E. 1 (S.D.N.Y. Aug. 17, 2021).

[23] Over 55 of the Nation's Leading Law Firms Respond to Investment Company Act Lawsuits Targeting the SPAC Industry (Aug. 30. 2021), https://prn.to/3AhcPMe.

[24] *Ibid.*

[25] For example, in 2018, 82% of the deals that were valued at more than $100 million resulted in shareholder litigation. Cornerstone Research, Shareholder Litigation Involving Acquisitions of Public Companies (2019), https://bit.ly/3nCyOtu.

## About the authors

**Michael J. Dell** (L) is a partner at **Kramer Levin Naftalis & Frankel LLP** in New York. He represents corporations and individuals in civil litigation, internal investigations, and investigations and enforcement proceedings before the Securities and Exchange Commission and the Public Company Accounting Oversight Board. He is the chairman of the firm's Accountants and Auditors Defense Practice Group and a member of the firm's Securities and Shareholder Litigation Practice Group. He can be reached at mdell@kramerlevin.com. **Tobias B. Jacoby** (R) is a special counsel in the firm's New York office and a member of its Accountants and Auditors Defense and Securities and Shareholder Litigation practice groups. He represents corporate and individual clients in civil litigation, including cases alleging accounting fraud and merger-related breaches of fiduciary duty, and in SEC investigations and enforcement proceedings. He can be reached at tjacoby@kramerlevin.com

**This article was first published on Westlaw Today on September 17, 2021.**

*** © 2021 Michael J. Dell, Esq., and Tobias B. Jacoby, Esq., Kramer Levin Naftalis & Frankel LLP**

This publication was created to provide you with accurate and authoritative information concerning the subject matter covered, however it may not necessarily have been prepared by persons licensed to practice law in a particular jurisdiction. The publisher is not engaged in rendering legal or other professional advice, and this publication is not a substitute for the advice of an attorney. If you require legal or other expert advice, you should seek the services of a competent attorney or other professional. For subscription information, please visit legalsolutions.thomsonreuters.com.