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Insights

AS SPACS' POPULARITY EXPLODES, LIABILITY RISKS RISE AS WELL

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SUMMARY

Special purpose acquisition companies ("SPACs"), it seems, are everywhere. SPACs have been around for decades, but use of a SPAC to take a company public without a traditional initial public offering ("IPO") has recently exploded in popularity, especially in the first few months of 2021.

One driver of the popularity of SPACs is the perception that they have lower liability risks than a traditional IPO. But a closer look at SPAC transactions suggests that the liability risks are not as low as some believe, and SPAC sponsors and directors and officers of SPAC companies should act to protect themselves against potential claims from both the private plaintiffs' bar and the government.

In recent days, the SEC has made clear that it is intensely focused on SPACs. Further, in an April 8 speech, John Coates, the acting director of the SEC's Division of Corporate Finance, challenged the view that SPAC liability risks are lower than IPO liability risks, stating: "Any simple claim about reduced liability exposure for SPAC participants is overstated at best, and potentially seriously misleading at worst. Indeed, in some ways, liability risks for those involved are higher, not lower, than in conventional IPOs, due in particular to potential conflicts of interest in the SPAC structure."

Some market participants believe the SEC is trying to slow the frenzied SPAC market. And a recent report noted early signs of a slowdown in formation of new SPACs in the past three weeks, when twelve new SPACs became public, in contrast to approximately five SPACs each day during the first three months of 2021. Regardless of whether the slow-down continues, though, with more than 400 already-formed SPACs on the market and looking to acquire operating businesses, SPAC liability concerns will remain a critical issue for market participants.

When SPACs combine with an operating business, they are required to make disclosures to shareholders and file with the SEC a proxy statement, a "Super Form 8-K", and also often a registration statement. All of these disclosures can give rise to potential liability under federal securities law and state law. Plaintiffs and their lawyers are closely scrutinizing SPAC-related filings. For example, a federal class action complaint filed on April 9, 2021 in *Tyler v. Canoo Inc. et al.*, Case No. 21-cv-3080 (C.D.Cal.), alleges that press releases and other statements by an issuer violated securities laws by touting certain business lines as potential revenue streams for the company, while allegedly concealing that those businesses were not viable, as indicated by the company's decision to de-emphasize those businesses three months after its "de-SPAC" transaction was completed.

Similar to other public company transactions, challenges to SPAC transactions may be based on the alleged inadequacy of disclosure, accuracy or completeness of financial projections, and breach of fiduciary duties by the SPAC directors. Critics allege that the structure of SPACs makes them particularly susceptible to such claims. A class action complaint was filed on March 25, 2021 in *Amo v. MultiPlan Corp., et al.*, Case No. 2021-0258 (Del. Ch.), claiming that the typical SPAC structure is "conflict-laden and practically invites fiduciary misconduct" because directors are often given "strong (indeed, overriding) incentives to get a deal done—any deal—without regard to whether it is truly in the best interest of the SPAC's outside investors."

Potential litigation ranges from private actions quickly resolved for a "mootness fee," to more heavily litigated post-closing private actions, as well as SEC enforcement actions. More litigation is expected in the future, especially in light of the SEC's public statements discussing potential claims arising out of SPACs, as well as the dramatic increase in transactions.

Below we take a closer look at how SPACs differ from traditional IPOs, the elements of the de-SPAC transaction, areas of focus in de-SPAC litigation, and key takeaways to avoid de-SPAC litigation.

How SPACs Differ from IPOs

To understand the risks associated with SPAC transactions, it is necessary to consider how such transactions differ from traditional IPOs. A traditional IPO involves an established, privately held business being offered to the public market. For example, consider Facebook going public after years of being operated by Mark Zuckerberg and a small number of other shareholders. In these situations, investors are buying based on the track record of the business as well as its future prospects following the IPO.

In a SPAC transaction, the SPAC goes public before it owns or has any operating business. The SPAC sponsors create a shell company, often referred to as a "blank-check company," and sell it to the public. The SPAC uses the funds raised in the IPO to acquire an operating business within a term of 18 to 24 months. Initial investors in SPAC IPOs purchase units at a fixed price, which consist of a share of common stock and a portion of a warrant exercisable to purchase common stock. SPAC sponsors purchase shares for minimal consideration, known as the "sponsor promote," and also purchase warrants, which are forfeited if the SPAC fails to acquire a target within the SPAC's term.

Because the SPAC's IPO filings do not include disclosure about the company's past operating business or its future prospects and projections that most often create liability under the securities laws in traditional IPOs, the risks of misstatements in a SPAC IPO are thought to be lower than in a typical IPO, although it is conceivable there could be liability for misstatements about the SPAC sponsors' backgrounds or credentials or the SPAC's financial statements.

The de-SPAC Transaction

The real action in a SPAC transaction comes when the SPAC finds its target operating company. Known as the "de-SPAC" transaction, the SPAC acquires the target operating company through a business combination, following which the target operating company becomes a publicly traded company.

Much like any public M&A transaction, the company provides a proxy statement to shareholders and conducts a shareholder vote on the proposed de-SPAC transaction. Both private plaintiffs and the SEC enforcement division could seek to bring actions against the company and its directors under Section 14(a) of the Securities Exchange Act of 1934 for material misstatements or omissions contained in the proxy statement. *See Murdeshwar v. Search Media Holdings, Ltd.*, No. 11-cv-20549, 2011 WL 7704347 (S.D. Fla. Aug. 8, 2011) (denying motion to dismiss private Section 14(a) claims); *SEC v. Hurgin*, 484 F. Supp. 3d 98 (S.D.N.Y. 2020) (denying motion to dismiss SEC action). In addition, the SPAC's directors have fiduciary duties under state law to shareholders in connection with the de-SPAC transaction.

Depending on the structure of the de-SPAC transaction, a registration statement may also be necessary to register shares in the transaction. In that case, purchasers may be able to bring claims under Section 11 of the Securities Act of 1933, which imposes strict liability against the issuer for material misstatements or omissions. And of course, companies and directors face potential liability for claims under Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 where plaintiffs or the government can meet the higher intent requirements of that statute.

Each SPAC shareholder also has the right to redeem their shares prior to closing, even if the shareholder votes in favor of the de-SPAC transaction. Significant redemptions could leave the SPAC without enough money to complete the business combination or to fund business operations going forward and without enough shareholders or market capitalization to satisfy minimum stock exchange listing requirements. In these cases, litigation may result between the SPAC and the target company regarding the terms of the transaction or may be initiated by shareholders claiming the SPAC directors breached their fiduciary duties.

Areas of Focus in de-SPAC Litigation

Areas of focus in de-SPAC litigation are similar to the pressure points in other M&A litigation. Plaintiffs often focus on the financial projections for the business following its acquisition by the SPAC. Here, the liability risk has often been described as lower than in a traditional IPO, since the issuer in a de-SPAC transaction has been thought to be able to claim the protection of the safe harbor for forward-looking statements provided by the Private Securities Litigation Reform Act ("PSLRA"). By contrast, the PSLRA specifically excludes statements made in connection with IPOs from the safe harbor. The safe harbor, however, does not protect against all financial-projection liability. To qualify for the safe harbor, the forward-looking statements must be clearly identified and accompanied by meaningful cautionary language. Issuers are liable for projections they know to be false, and the safe harbor provides a defense only in private litigation, not in SEC enforcement actions, as Coates noted in his April 8 speech.

Moreover, Coates in his speech suggested that it is not clear the safe harbor protections for projections are available in a de-SPAC transaction. He suggested that a de-SPAC offering is similar enough to an IPO that it should be treated like an IPO for purposes of determining whether the safe harbor applies, even though the issuer of the de-SPAC stock often will have already registered stock with the SEC in connection with the SPAC IPO. Regardless of the viability of that potential argument in actual litigation, Coates's speech underscores the extent to which the SEC plans to scrutinize SPACs and also will likely encourage the plaintiffs' bar to pursue more SPAC cases using some of the liability theories articulated in the address.

Key Takeaways to Avoid de-SPAC Litigation

Given these potential risks, it is important that parties to SPAC transactions take measures to reduce litigation risks. Here are some areas of focus.

Accuracy of Disclosures: Thinking Like a Plaintiff. Parties to SPAC transactions should provide enough time for careful and accurate drafting and review of disclosures in the SPAC's IPO registration statement, proxy statement, and Super Form 8-K filing. The review should entail attempting to anticipate how plaintiffs' counsel or government regulators would seek to challenge the disclosures. Special attention should be given to any financial projections: it is important to identify any forward-looking information and include meaningful cautionary language, and it is also critical to review the completeness of the projections disclosed. Regulators, for example, have pointed out potential concerns about selective disclosure of projections where the issuer discloses more favorable projections but not less favorable projections. Any such disclosures need to be carefully reviewed with counsel. This review process is especially important for pre-revenue and early-stage revenue target companies engaging in SPAC transactions.

Careful Target Company Selection. As a SPAC nears the end of its term, the SPAC sponsors have a large financial incentive to complete a business combination. The SPAC's early identification of a target operating company that is within the stated industry focus of the SPAC and is financially ready to be a public company will help reduce the risk that plaintiffs could portray a transaction as being driven by directors' desire to get a deal done rather than the merits of the deal.

Negotiation of de-SPAC Transaction Terms. In negotiating the de-SPAC business combination, the parties should ensure that the transaction is structured in a way to reduce the risk of certain contingencies that could lead to litigation. For example, to reduce the risk that SPAC shareholders redeem their shares and leave the de-SPAC company without sufficient cash or enough shareholders or market capitalization to satisfy stock exchange listing conditions, many transactions are structured to include minimum cash closing conditions and use non-public-market financing (known as private investment in public equity, or "PIPE" financing) or forward purchase agreements to offset redemptions. These and other structuring considerations can have the effect of better positioning the de-SPAC company for post-transaction success.

For more information on these topics, please contact Eric Rieder or Amy Wilson.

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