November 5, 2021

Generations Fall 2021 - SPAC Litigation and Enforcement Boom in Full Swing

In our last newsletter, we asked "Is the SPAC Boom Fading?" Indeed, new special purpose acquisition company (SPAC) registrations have declined. But more than 400 SPACs are still in search of an acquisition target. The litigation and regulatory scrutiny is set to get more intense as SPACs try to find those targets. So far this year, investors have filed more than 20 SPAC-related securities fraud class actions, along with countless merger objection cases and derivative actions against individual directors of SPAC-related entities. The Securities and Exchange Commission (SEC) has issued alerts signaling risks associated with SPAC investments, and it recently charged a SPAC, its sponsor, the target and individual officers with securities violations. Not to be outdone, Congress is going after SPAC creators and considering investor protection legislation concerning SPACs. These developments highlight important risks for those involved in creating, promoting and consummating SPAC and de-SPAC transactions.

Private Litigation: Everything and the Kitchen Sink

SPAC transactions have been the subject of numerous securities fraud claims filed in federal court under the Securities Exchange Act of 1934. Many of these cases have come soon after the SPAC completed its merger with an operating entity, with plaintiffs' lawyers filing claims after these newly public companies announced disappointing financial results. The suits often accuse the SPACs (and their boards) of making overly optimistic financial projections both before and after the merger and of misrepresenting the company's operations. Some of these claims accuse the target companies of being unprepared for their newfound disclosure responsibilities as public companies. A significant number of cases have followed the publication of short-seller reports that have been highly critical of the target companies' operations and financial reporting. It is no secret that short-sellers have SPACs in their sights, and some may be incentivized to publish critical reports to justify—and benefit from—their short positions. Aside from securities class actions, plaintiffs have pursued other types of SPAC-related litigation, including:

- Shareholder derivative lawsuits against the boards of directors of the SPACs and post-merger entities, often filed in parallel to securities class actions against the same entities.
- Merger objection lawsuits filed in New York state court. These are claims filed by shareholders against boards of directors of SPACs that have announced their intention to merge with targets.
- Breach of fiduciary duty actions against Delaware-incorporated SPACs and their sponsors. These suits challenge the fairness of a board's pre-merger consideration process and allege conflicts of interest between the SPACs' boards/sponsors and investors.

SEC Guidance and Enforcement: Putting SPAC Sponsors on Notice

The SEC has published a flurry of alerts and public statements concerning SPACs since late 2020, in some ways providing a road map for the private investor lawsuits. These include:

- December 2020 Investor Bulletin addressing disclosure of SPAC investment terms

- December 2020 guidance from the Division of Corporation Finance discussing the need for SPAC sponsors, directors and officers to disclose their conflicts of interest arising from their other business activities and their financial incentives for completing the de-SPAC transactions
- March 2021 alert warning against investments in SPACs solely on the basis of celebrity endorsements and reminding investors to investigate SPAC sponsors' backgrounds, experience and financial incentives
- March 2021 statement warning target companies to consider important accounting, financial reporting and governance issues before undertaking a combination with a SPAC, including "books and records" and "internal controls" requirements, national securities exchange listing requirements, and corporate governance standards
- April 2021 statement warning that "in some ways, liability risks for those involved [in SPACs] are higher, not lower, than in conventional IPOs, due in particular to the potential conflicts of interest in the SPAC structure" and declaring that SEC staff "will continue to be vigilant about SPAC and private target disclosure so that the public can make informed investment and voting decisions about these transactions"

These releases were precursors to the SEC's loudest statement to date: a July 2021 enforcement action against a SPAC (Stable Road Acquisition Corp.), its sponsor, the SPAC's CEO, the target and the target's former CEO. Stable Road had proposed a merger with the target, an early-stage space transportation company. The proposed target allegedly misrepresented that it had "successfully tested" its propulsion technology in space, when, in fact, the company's only in-space test had failed to achieve its primary objectives or demonstrate the technology's commercial viability. The target also allegedly misrepresented the extent to which national security concerns involving its former CEO undermined the target's ability to secure essential government licenses. Stable Road apparently used a space technology consulting firm to conduct due diligence concerning the target, but it did not review the in-space test results and it did not independently investigate the national security concerns about the target's former CEO. Stable Road included the target's alleged misstatements in public disclosures filed with the SEC ahead of the proposed merger. All parties, except the target's former CEO, settled with the SEC. Stable Road, the CEO of Stable Road and the target agreed to pay penalties. The sponsor, which the SEC had charged with causing Stable Road to violate the Securities Act, agreed to forfeit 250,000 founders' shares and give public investment in private equity investors the opportunity to terminate their subscriptions. This enforcement action is generally viewed as an aggressive step by the SEC: It charged virtually all involved players, and the settlements were substantial despite the parties' cooperation with the SEC investigation and the SEC's acknowledgement that the target may have lied to Stable Road and the sponsor. The SEC seems to have used the case to send a message to SPAC sponsors about their due diligence obligations.

U.S. Congress: Using the Bully Pulpit to Hammer SPAC Disclosures and Marketing

Members of both houses of Congress have been issuing warnings about SPACs. In late September, four Democratic senators sent six serial SPAC creators a letter raising questions about the creators' SPAC-related activities and financial rewards. Sen. Elizabeth Warren, D-Mass., stated in her press release, "We are concerned about the misaligned incentives between SPACs' creators and early investors on the one hand and retail investors on the other." The release warns of "sponsors asserting that SPACs present a faster and cheaper alternative to traditional initial public offerings," and it laments that sponsors have "incentives to quickly strike merger deals, regardless of the quality" and "sponsors and early investors profit from hyperbolic, pre-merger claims about" a target company. The legislators claim SPACs have generated "astonishing reports of abuse and market dysfunction." Some House members also think SPACs spell danger. A recent draft bill, presented to the House Financial Services Committee, would allow brokers and money managers to exclude all SPACs from the safe harbor for forward-looking statements. It is unclear whether there is sufficient support in the House or Senate for any of these proposals.

Looking Ahead

With more than 400 SPACs in search of an acquisition target, it stands to reason that there will be more litigation and enforcement activity. The competition for targets carries risk of corner-cutting to make a deal, just as the SEC and Congress

are getting warmed up over concerns about SPACs. For those reasons, it is as important as ever that SPAC sponsors and boards:

- Consider exculpatory and forum selection provisions in charters and bylaws to try to limit and contain litigation risk
- Pay attention to potential conflicts and conflict disclosures
- Maintain corporate formalities and follow good corporate governance practices from the moment of the SPAC IPO
- Conduct meaningful and robust due diligence on proposed targets, including claims about the viability of their product or technology, and fully document those efforts
- Closely scrutinize any financial projections
- Ensure that the newly combined company will be prepared to meet requisite tax, governance and legal standards

Would you like to receive the *Day Pitney Generations Newsletter*? Sign up here. Day Pitney Generations Newsletter - Fall 2021 (pdf)

Would you like to receive our *Day Pitney Generations Newsletter?* Sign up here.

Authors

R. Scott Beach

Partner

Greenwich, CT | (203) 862-7824

Stamford, CT | (203) 977-7336

rsbeach@daypitney.com