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Mitigating SPAC Enforcement and Litigation Risks

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The meteoric rise in the use of special purpose acquisition companies (SPACs)—with more than $98 billion raised in over 300 deals year-to-date alone—has prompted increased government scrutiny of, and civil litigation involving, SPACs and their sponsors, directors, officers, and affiliates. SPAC-related civil litigation is heating up in U.S. state and federal courts, and the Securities and Exchange Commission's (SEC) commencement of an informal investigation into investment banks' SPAC activities portends a more aggressive enforcement posture under incoming SEC leadership. This Legal Update examines the evolving regulatory landscape for SPACs and the potential for SEC enforcement in the SPAC market, details emerging trends and risks posed by SPAC-related litigation in state and federal courts, and offers practical guidance for SPAC market participants to mitigate the regulatory and litigation risk posed by such transactions.

I. Background on SPACs

SPACs are shell (or "blank check") companies formed by a sponsor group to raise capital in an initial public offering (IPO) with the express purpose of using the proceeds to identify and acquire a yet-to-be-identified privately held target company. The sponsor group typically brings expertise and experience in the business or industry sector in which the SPAC will pursue a transaction. After filing a registration statement and navigating the IPO process with the SEC, a publicly traded SPAC has a specific period of time—typically 18 months to two years—to combine with a private company in what is commonly referred to as a "de-SPAC-ing" transaction. If a business combination is not consummated during the designated time period, the public investors' money must be returned. In the event of a business combination with a target company, SPAC investors have the option of redeeming the common stock portion of their investment (they are allowed to keep the warrant portion of their investment) or becoming shareholders of the combined company.

II. SEC Enforcement Risk and the SPAC Regulatory Landscape

The SEC has recently signaled a renewed enforcement interest in SPACs, no doubt in large part due to significant deal volume, intense public interest in such deals, and instances of sharp post-acquisition SPAC share price declines. Last year, then-SEC Chairman Jay Clayton acknowledged that the SEC was examining the "incentives and compensation to the SPAC sponsors." Earlier this year, SEC Commissioner Hester Peirce remarked that "[w]e should ensure SPACs are providing sufficient disclosures to enable informed investment decision-making at

each stage." The SEC's regulatory efforts have also included publishing guidance on disclosure considerations related to conflicts of interest and disseminating investor alerts and bulletins to educate the public on the risks associated with investing in SPACs, particularly given the involvement of celebrities and athletes as SPAC sponsors or anchor investors.

Notably, in March 2021, the SEC's Division of Enforcement reportedly launched an informal investigation into the SPAC dealings of several Wall Street investment banks. According to news reports, the SEC requested information—on a voluntary basis, for now—regarding banks' SPAC deal fees and volumes, as well as their compliance, reporting and internal controls functions related to such deals. In addition, SEC Chairman Gary Gensler reportedly hinted that heightened scrutiny of SPACs would be part of his enforcement agenda.

Another sign of looming enforcement activity (and civil litigation) in the SPAC market came by way of an April 2021 public statement issued by John Coates, the acting director of the SEC's Division of Corporate Finance. In his statement on SPACs, IPOs, and liability risk under the federal securities laws, Coates warned that SEC staff is "continuing to look carefully at filings and disclosures by SPACs and their targets" and cautioned that "[a]ny simple claim about reduced liability exposure for SPAC participants is overstated at best, and potentially seriously misleading at worst." He challenged the prevailing notion that SPAC transactions, as compared with traditional IPOs, lessen securities law liability exposure for targets and the SPACs themselves, suggesting that the de-SPAC-ing transaction could be treated as the "real IPO" and subject to the "full panoply of federal securities law protections." Coates also stressed that any material misstatements in or omissions from registration statements or proxy solicitations disclosed in connection with a SPAC IPO or de-SPAC-ing transaction may give rise to securities law violations.

The SEC has brought SPAC-related enforcement actions in the past, most notably in 2019, when it settled securities fraud allegations that a SPAC CEO negligently failed to conduct appropriate due diligence on the target company, resulting in proxy statements containing false or misleading financial projections about the target company's business prospects. In a related matter, last year, the SEC brought a civil action, now pending in the Southern District of New York, against the managers of the target company, alleging that they misled SPAC shareholders in connection with the merger. The civil action illustrates that the SEC may even seek to hold the target company's management directly liable for securities fraud and proxy statement deficiencies when managers put their "reputation in issue" in proxy materials or other disclosures such that they owe a duty to SPAC shareholders.

In addition, insider trading investigations related to SPAC deals are likely on the horizon. SPAC-related insider trading risk stems from individuals with access to material non-public information, such as the SPAC's likely merger targets, before the de-SPAC-ing transaction occurs. Since SPACs are publicly traded companies prior to the de-SPAC-ing transaction, any trading in SPAC shares on the basis of insider information regarding the proposed target company may violate insider trading laws. It is just a matter of time before the SEC, or even a federal prosecutor's office, takes a crack at bringing an insider trading case related to a SPAC transaction in which insiders trade ahead of a transaction or are the source for a tippee who trades on material non-public information.

III. SPAC-Related Civil Litigation Risk

The recent SPAC boom is also beginning to create a wave of SPAC-related litigation in state and federal courts. Like any IPO, the initial SPAC IPO requires the filing of a registration statement with the SEC, but because SPACs are shell companies with no operations, their registration statements typically contain fewer disclosures than statements of companies going public through traditional IPOs. Thus, while SPAC managers can still be held liable under the Securities Act for any material misstatements or omissions, the disclosures made in connection with an initial SPAC IPO are less likely to be sources of litigation risk.

Rather, most SPAC-related litigation risk stems from the potential for lawsuits filed in connection with the de-SPAC transaction, which generally requires approval of a majority of SPAC shareholders. If SPAC shareholders contend that inadequate disclosures in the proxy statement prevented them from making an informed investment decision regarding the de-SPAC transaction, they can assert disclosure-based claims under Section 14 of the Securities Exchange Act of 1934, as amended (Exchange Act) and SEC Rule 14a-9. When SPAC shareholders challenge proposed mergers before the de-SPAC transaction is completed, a SPAC can typically ward off such nuisance claims by amending the proxy statement and paying a "mootness fee" to plaintiff's counsel. When SPAC shareholders challenge de-SPAC transactions after their completion, however, such actions often result in more protracted litigation. Over the past year, SPAC shareholders have filed several lawsuits alleging material statements in or omissions from proxy statements and other disclosures issued in connection with de-SPAC transactions, with shareholders claiming, for example, that SPACs and their managers fraudulently misrepresented due diligence efforts with respect to target companies and otherwise misled investors regarding the nature of the merged company's business operations and prospects, in violation of Sections 10(b) and 14(a) of the Exchange Act and SEC Rules 10b-5 and 14a-9.

Two recently filed class action lawsuits pending in federal courts in New York and California are illustrative. In a putative class action complaint filed in the Eastern District of New York, the plaintiff alleges, on behalf of himself and similarly situated SPAC investors, that the SPAC and its managers disseminated proxy statements containing materially false and misleading statements regarding the due diligence conducted on the target company, a pharmaceutical company. Specifically, the plaintiff claims that the SPAC ignored or failed to disclose safety issues discovered during the company's clinical trials of the pharmaceutical product in question. Similarly, in a putative class action complaint filed in the Central District of California, the plaintiff, a SPAC shareholder, alleges that the SPAC and its managers violated Section 10(b) and 20(a) of the Exchange Act by failing to disclose that the target company, an electric vehicle developer, among other things, changed its business model and did not maintain a key partnership with an established car manufacturer that was touted in the registration statement.

In addition to cases alleging violations of federal securities laws, de-SPAC transactions may also be the subject of actions brought under state law alleging breaches of fiduciary duties. Since SPAC sponsors typically hold "founder shares" or other equity stakes in the SPAC, plaintiffs frequently argue that such incentives, along with the time restriction for consummating a deal, amount to a conflict of interest. For example, in a recent class action complaint filed in the Delaware Court of Chancery, the plaintiff, a SPAC investor, alleges that the SPAC and its sponsor and directors breached their fiduciary duty by acquiring the target company through a "deeply flawed and unfair process, including severe disclosure defects, [which] led to a grossly

mispriced transaction." Another investor in the same SPAC filed a federal lawsuit in the Southern District of New York alleging violations of Sections 10(b), 14(a) and 20(a) of the Exchange Act, demonstrating that the same de-SPAC transaction may give rise to both fiduciary- and securities law-based claims.

IV. Mitigating Enforcement and Litigation Risk

With the expectation of increased enforcement scrutiny of SPACs on the horizon, and a plaintiffs' bar aggressively monitoring SPAC share prices and exploring novel theories of liability based on the unique characteristics of SPACs, SPAC market participants should consider proactive steps to mitigate the regulatory and litigation risk associated with these investment vehicles, including, where applicable, the following:

- SPACs should seek to include appropriate exculpatory and indemnification provisions in SPAC governing documents (e.g., charter, bylaws) to limit potential civil litigation risk.
- SPAC sponsors, officers and directors, and affiliates should closely examine existing SEC guidance on disclosures, SPAC merger transactions and proxy statements for de-SPAC transactions.
- SPAC sponsors, officers and directors should conduct and document robust due diligence on target companies to reduce the risk of shareholder complaints alleging inadequate due diligence or failure to uncover red flags.
- SPACs should take steps to avoid any conflict of interest or related-party transactions and fully disclose any such conflicts or transactions prior to the de-SPAC transaction.
- SPACs and target companies should carefully draft the proxy statement and all other disclosures to ensure they are materially complete and accurate. SPAC disclosures should also include appropriate cautionary language with respect to any financial projections or other forward-looking statements.
- SPACs and target companies should consider obtaining an amount of director and officer (D&O) liability insurance coverage commensurate with the operations of the combined company.
- All SPAC-related parties should regularly confer with experienced SEC and securities litigation counsel who are closely following developments in the SPAC-related regulatory and civil litigation landscape to ensure that the SPAC is employing best practices to minimize enforcement and litigation risk.

Material drops in SPAC share prices are likely to spur a flood of enforcement activity and private litigation seeking to recover investment losses. Therefore, SPAC market participants are encouraged to consider taking all appropriate measures to mitigate the burgeoning enforcement and litigation risks associated with SPACs.

The complete publication, including footnotes, is available here.