Portfolio Media. Inc. | 111 West 19th Street, 5th Floor | New York, NY 10011 | www.law360.com
Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

How SPACs Can Avoid Failed China Reverse Mergers 2.0

By **Perrie Weiner, Jerome Tomas and Derek Liu** (April 27, 2021, 5:21 PM EDT)

Perrie Weiner

Jerome Tomas

Derek Liu

Since the start of the pandemic, the exponential growth of special purpose acquisition companies has only continued as SPACs begin to broaden their horizons to foreign markets.

This trend is most notable in Asia, which is proving to be fertile hunting grounds for viable target companies for de-SPAC M&A transactions given the crowded market in the U.S.

2020, properly dubbed the year of the SPAC, represented one of the most dramatic changes in the securities market to date, with SPAC revenue dramatically increasing from a record-setting $13.6 billion in 2019 to more than $82 billion in 2020 — a 462% year-over-year increase.

This trend has only continued since the beginning of 2021, where more than 200 SPACs have raised $87 billion to date, breaking 2020's already impressive record. Due to this growth, SPAC revenue now accounts for nearly half of initial public offering funding.

While this trend signals more SPAC IPOs and de-SPAC mergers, it also signals the likelihood of more securities class actions, as well as U.S. Securities and Exchange Commission enforcement actions.

As such, SPACs hoping to merge with foreign companies should learn from the failed Chinese reverse mergers of the early 2000s, and should keep the two-year de-SPAC timeline, adequate disclosures and due diligence, and disclosure of conflicts of interest at the forefront of their minds in order to mitigate the risk of litigation and SEC enforcement actions.

In connection with de-SPAC transactions, companies will also need to take a closer look at their global compliance procedures — such as insider trading, anti-bribery and third-party due diligence, sanctions and whistleblower helplines — and ensure that the appropriate corporate governance mechanisms are in place to ensure that these procedures meet the relevant exchange listing standards.

Oversaturation and the Trend Toward Asia Markets

A common theme we hear is that the exponential growth of SPACs over the past year and a half has left the U.S. market oversaturated and picked over, with more than 400 SPACs currently searching for target companies to bring public. With timeframes nearing their expirations — particularly with regards to the 2020 vintage SPACs — SPACs are now looking to foreign companies and markets in the hopes of completing their de-SPAC transactions. In fact, more than 20 Asia-based companies have gone public through de-SPAC mergers since 2020.

Southeast Asia, in particular, is home to many highly valued tech companies and health care startups and, as such, a likely forum for the next wave of SPAC acquisitions. For example, the largest de-SPAC merger to date — a nearly $40 billion deal — involved Grab Holdings Inc., a Singapore-based digital mogul in the Asian ride-hailing and food delivery market, and Altimeter Growth Corp., a U.S. SPAC.

Asian investors are also beginning to participate in the SPAC frenzy. SoftBank Group Corp., a Japanese tech giant that has invested in companies like Uber Technologies Inc. and WeWork Co. Inc., invested in multiple SPACs for the purpose of bringing Asian tech companies public.

A number of Chinese investment companies have also raised significant revenue through SPACs, and a former Hong Kong finance secretary launched his own $1.5 billion SPAC in 2018.

Similarities to Chinese Reverse Mergers

With SPACs attracting new issuers from Asia, U.S. capital markets may see renewed interest as well from Chinese companies.

And for many investors and regulators, the potential proliferation of Chinese-based SPACs may bear some parallels to the Chinese reverse merger spate of the early 2000s. That period saw a wave of Chinese corporations enter U.S. capital markets via reverse mergers.

Reverse mergers carry many of the same advantages of SPACs. In a traditional reverse merger, a successful private company combines with a publicly traded shell company, and like a SPAC, the issuer undergoes an expedited SEC review process, as compared to a traditional IPO. Not only is the process much faster than a traditional IPO, it is also quicker and less expensive.

This streamlined process, and the ability to access U.S. capital markets, attracted more than 150 Chinese companies to pursue reverse merger transactions in the U.S. from Jan. 1, 2007 to March 31, 2010.[1]

A more lax regulatory environment, however, makes it easier for certain issuers to commit fraud. In early 2010, reports began to arise of accounting fraud or related irregularities by some Chinese issuers.[2] Prominent plaintiff-side class action securities firms moved into overdrive, filing a bevy of lawsuits alleging that issuers had overstated revenues and profits, and that small auditing firms or Chinese affiliates of the so-called Big Four accounting firms failed to conduct adequate due diligence.[3]

Securities class action plaintiffs would attempt to portray the issue as widespread and common among Chinese issuers. As in In re: China Valves Technology Securities Litigation in the U.S. District Court for the Southern District of New York sought to frame it in 2012, the market was purportedly plagued by "the implosion and massive securities fraud prevalent among Chinese-reverse merger companies."[4] In certain instances, some Chinese companies were alleged to have fabricated their operations and business contracts.[5]

As the fraud grew more rampant and brazen, the SEC and even the FBI eventually stepped in.[6]

The SEC commenced enforcement actions and suspended trading of several Chinese issuers, revoked the securities registration of several reverse merger companies, and suspended trading for many others. Other companies were delisted. Billions of dollars in stock market value was wiped out as the fraud or aggressive accounting techniques came to light.

The booming SPAC industry, even among U.S. issuers, has already begun to attract SEC scrutiny. Just last month, SEC acting Chair Allison Herren Lee warned, during an online meeting of the SEC Investor Advisory Committee, "As the volume of SPACs reaches unprecedented levels, the staff is taking a close look at the structural and disclosure issues surrounding these business combinations."

Given the number of incidents of fraud among dozens of Chinese companies during the early 2000s reverse-merger craze, investors should expect even more intense scrutiny, now that Chinese operating companies are becoming the target acquisitions of U.S. SPACs.

Although the Chinese reverse merger boom ultimately came to end, in part due to these scandals, legal scholars have suggested that the negative publicity may have been an overreaction.

A study led by Charles Lee, an accounting professor at Stanford University, suggests that Chinese reverse mergers actually outperformed, on numerous metrics including post-listing stock return, peer companies of similar market size and in the same industry. This remained the case even after including most of the issuers accused of fraud.

Chinese issuers that conducted private investment in public equity financings along with the reverse mergers performed even better.[7] And in at least one instance, the SEC and Nasdaq reversed themselves, concluding that Chinese company CleanTech should not have been delisted.

Given the strong performance and success by the majority of Chinese reverse mergers, it would come as little surprise if more Chinese companies join the flood of Asian companies entering the U.S. capital markets via SPACs. While many Chinese companies may expect to perform well in SPAC transactions, they may be understandably wary from the fallout of the early 2000's reverse merger boom.

Chinese companies considering access to the U.S. markets via de-SPAC mergers can mitigate those concerns by taking careful measures and conducting particularly thorough due diligence before proceeding. This includes a serious evaluation of the SPAC itself, their history and track record with de-SPAC transactions. Chinese companies should also consider implementing more stringent disclosure and auditing processes that closely map U.S. processes.

Risks Associated With SPACs

While SPAC growth in Asia presents a promising new market, investors and SPAC management teams hoping to de-SPAC in Asia should be aware of the nuances associated with going public through a de-SPAC acquisition, especially in light of increased SEC investigations and securities lawsuits.

As an initial matter, Section 11 lawsuits against SPACs relating to IPOs are extremely rare. Unlike traditional IPOs, SPACs are shell companies without operations that function as cash deposits to finance mergers for the purpose of bringing a company public. Moreover, investors enjoy the freedom to vote against proposed acquisitions or redeem their shares and opt out of the SPAC. Therefore, Section 11 lawsuits against the SPAC and its officers and directors are unlikely to occur absent purposeful fraud.

SPACs have historically enjoyed the protection of the Private Securities Litigation Reform Act, or PSLRA, safe harbor, which allowed SPACs to make forward-looking statements so long as they were accompanied by meaningful cautionary language. Under the safe harbor, SPACs and/or target companies were liable only for knowingly making false and misleading forward-looking projections. However, recent SEC guidance questions the applicability of PSLRA's safe harbor to de-SPAC transactions.

Importantly, the PSLRA's safe harbor only applies in private litigation, and does not prevent the SEC from filing an enforcement action in federal court or before an administrative law judge for violations of the federal securities laws. The acting director of the SEC's Division of Enforcement, John Coates, made this clear in a speech on April 8.[8]

And to this end, SPACs and de-SPAC transactions have led to a number of SEC investigations and securities lawsuits against the SPAC's sponsors and newly public companies. In fact, in the April 8 comments, Coates articulated his position that the PSLRA's safe harbor does not protect against false or misleading statements made with actual knowledge of their false or misleading nature or where the statements in question are not forward-looking, but rather about current valuation or operations.[9]

Moreover, recent SEC guidance potentially subjects SPACs to stricter financial reporting and disclosure requirements.[10] The guidance asks registrants and their independent auditors to evaluate any error in previously filed financial statements, assess the materiality of the error, and, if required, amend and correct any materially misstated financial statements.[11] Registrants should also consider the adequacy of their internal controls over financial reporting and determine whether any deficiencies could lead to actual or potential financial misstatements.

Due to the short timeframe to bring a company public, SPACs often find themselves racing against the clock to de-SPAC. Also at play are the competing interests of the SPAC and its sponsors and the shareholders, where sponsors are incentivized to complete an acquisition even when doing so might harm shareholders.

Oftentimes, litigation involves whether such conflicts were sufficiently disclosed and whether rushing into an acquisition constituted a breach of fiduciary duty. Finally, litigation has also stemmed from the target company's subsequent failure after the acquisition, causing shareholders and investors to lose money despite projections of the company's success.

For example, in June 2020, Nikola Corp. went public through a de-SPAC merger with VetcoIQ Acquisition, an American SPAC. Shortly after the merger, Nikola's stock price dropped by more than 30%. The SEC subsequently subpoenaed officers and directors of Nikola and investors filed a federal securities class action later in 2020 in the U.S. District Court for the District of Arizona alleging violations of the Securities Act based on inadequate disclosures and false representations.[12]

Similarly, in August, 2020, in Welch v. Meaux, investors brought a suit in the U.S. District Court for the Western District of Louisiana against the officers and directors of Waitr Holdings Inc., a publicly traded company, in relation to its de-SPAC merger.[13] There, the SPAC agreed to merge with Waitr only two weeks before the SPAC was set to expire.

Shortly after the merger, Waitr's stock price plummeted, causing shareholders to lose significant revenue. Investors brought a class action alleging Section 11 and 10(b) claims against Waitr's officers and directors, and also alleged that material deficiencies within the proxy statements misled and deceived investors about the company's profitability, leaving investors in the dark about the associated risks.

In addition to securities lawsuits, SPAC mergers can also expose officers, directors and sponsors to lawsuits arising from breaches of fiduciary duties. In March 2021, investors brought a suit against a SPAC after the target company's stock price dropped to nearly 40% of the IPO price. The complaint alleged that the company's board forced the merger to completion despite evidence of weaknesses in the target company's business plan, thereby prioritizing closing the deal in order to avoid dissolution at the expense of outside investors.

Guidance Moving Forward

In light of the recent increase in SPAC litigation, SPACs, their sponsors and target companies can implement certain practices and procedures to reduce and avoid the risk of SEC investigations and securities lawsuits.

First, SPACs should consider retaining an independent financial adviser to provide a fairness opinion regarding the proposed merger. Fairness opinions, though not required by law, are a prevalent feature of most corporate transactions, and provide value to both management and boards to mitigate litigation risk and as evidence of proper due diligence.

They also provide value to shareholders, as an indication regarding the quality of the proposed transaction. Fairness opinions are less common in SPACs, however, except in situations in which the target company has some affiliation to the sponsor.

Nonetheless, with SPAC litigation on the rise, a diligently prepared fairness opinion may offer value to the SPAC's board, who may then rely on them in an any effort to demonstrate they complied with their duty of care.

Significantly, in many suits brought by SPAC shareholders, the business judgment rule is unavailable because the sponsor typically receives part of the target company if the merger goes through. Under the more exacting "entire fairness" standard, a fairness opinion may serve as an effective risk management tool.

Second, use of a reputable accounting firm is critical for conducting due diligence on the target company. Indeed, even if a SPAC sponsor is unaware of false statements by the target company, the sponsor may still be required in litigation to demonstrate that it conducted its own due diligence.[14]

A reputable accounting firm may also provide value by addressing concerns from both the market and regulators regarding accounting integrity and governance weaknesses for target companies. There is a growing perception, fueled by short sellers and press reports on SEC investigations, that some fledgling companies may be abusing the SPAC process.

Investors who recall the high incidence of accounting problems during the Chinese reverse merger craze may, perhaps unfairly, draw comparisons as the number of Chinese firms tapping the U.S. markets via

SPACs increases. An accounting firm with a strong track record and experience auditing Chinese companies thus offers significant utility.

The accounting firm can also assist the company in testing its internal accounting controls, including payment processes, delegation of authority, separation of duties to ensure that transactions are recorded accurately and in conformity with management authorization, which are key considerations in SEC enforcement investigations.

Third, operating companies and SPACs should use extreme care when making and relying on financial earning projections, especially in light of the SEC's guidance foreshadowing stricter financial reporting and disclosure requirements. SPACs should only rely on financial projections to the extent necessary, and if a target company's current revenue can justify the de-SPAC merger, financial projections are best left out altogether.

If a company must provide financial projections, however, sponsors should engage in a documented, critical review and ensure that such projections are based on reasonable grounds and not unsupported opinions. Sponsors might also consider hiring outside financial advisers to determine whether such projections are sound.

Finally, while the SEC's recent guidance challenges the applicability of the PSLRA's safe harbor to forward-looking statements and projections, any forward-looking statements or financial projections should always be accompanied by meaningful cautionary language.

Fourth, SPACs should consider including releases in shareholder support agreements to avoid future liability relating to de-SPAC mergers.

After a de-SPAC merger is signed, target companies often wait to enter into their first shareholder agreement until the registration and/or proxy statement becomes effective.

In response, a SPAC should require officers, directors and shareholders to enter into a shareholder support agreement whereby the signatories pledge to vote their shares in favor of the transaction. By including a release or waiver of liability, SPACs can significantly reduce any liability arising from the de-SPAC merger should anything go awry.

Fifth, as a part of any de-SPAC transactions, SPACs should conduct a robust global compliance gap assessment in light of the fact that the target company will now be subject to SEC jurisdiction, including Exchange Act Section 13(b)'s internal accounting controls and books and records provisions, the Sarbanes-Oxley Act and the Dodd-Frank Act.

In reality, a company going public through a de-SPAC may already have sufficient compliance policies and procedures in place in many areas, but certain other areas, such as procedures around insider trading, anonymous whistleblowing and audit committee oversight of the compliance function, may be new to the company.

In light of the SEC's focus on SPACs, it is critical for a company to make sure that its compliance house is in order on day one or as soon as practicably possible, as SEC enforcement staff will certainly make requests relating to a company's compliance procedures as a part of any investigation.

While the failure to maintain adequate policies and procedures may not always result in liability, their absence is more likely to cause the SEC to further scrutinize the underlying business practices and culture at the company. As the old saying goes, an ounce of prevention is worth a pound of cure.

Finally, there is a plethora of general guidance to keep in mind during the SPAC and de-SPAC process. To the extent possible, SPACs should be cautious of completing a de-SPAC transaction too near to the SPAC's expiration date. A rushed merger and subsequent failure of a target company have often given rise to shareholder claims for breach of fiduciary duty. Additionally, SPACs should identify any potential conflicts between SPAC sponsors, directors, officers and shareholders.

While directors and officers are generally protected from liability by the business judgment rule, the rule might not apply if the directors and officers had a conflict of interest in coming to their decision.

Thus, should any conflicts exist, it is in the sponsors' best interests to promptly and honestly disclose such conflicts to shareholders. Lastly, SPACs should always maintain directors and officers insurance to protect high-level sponsors should any issues arise.

By implementing these safeguards, SPACs and their sponsors are less likely to become the target of an SEC investigation or securities lawsuits, and are more likely to be successful de-SPAC acquisitions in Asia.

Perrie Weiner is a partner and chairman of the North American securities group at Baker McKenzie.

Jerome Tomas is a partner and chairman of the enforcement group at the firm.

Derek Liu is a partner at the firm.

Baker McKenzie associate Desiree Hunter-Reay and counsel Ben Turner contributed to this article.

[1] Jason Williams et al., Activity Summary and Audit Complications for Reverse Mergers Involving Companies from the China Region: January 2007 through March 31, 2010, available at https://pcaobus.org/Research/documents/Chinese_Reverse_Merger_Research_Note.pdf.

[2] See David N. Feldman, Comments On Seasoning Of Reverse Merger Companies Before Uplisting To National Securities Exchanges, 2 Harv. Bus. L.R. Online, available at https://www.hblr.org/wp-content/uploads/sites/18/2012/03/Feldman-Reverse-Mergers.pdf.

[3] See, e.g., Special Situations Fund III QP, L.P. v. Deloitte Touche Tohmatsu CPA, Ltd., 33 F. Supp. 3d 401, 411 (S.D.N.Y. 2014).

[4] In re China Valves Tech. Sec. Litig., No. 11 CIV. 0796 LAK, 2012 WL 4039852, at *9 n.99 (S.D.N.Y. Sept. 12, 2012).

[5] See, e.g., David Barboza and Azam Ahmed, China to Wall Street: The Side-Door Shuffle, New York Times (July 23, 2011).

[6] See, e.g., David Barboza, F.B.I. Looks Into Adviser on Chinese Reverse Mergers, New York Times (Jan. 27, 2012).

[7] See Charles M. C. Lee, Kevin K. Li, and Ran Zhang, Shell Games: Are Chinese Reverse Merger Firms Inherently Toxic?, available at https://www.gsb.stanford.edu/faculty-research/working-papers/shell-games-are-chinese-reverse-merger-firms-inherently-toxic.

[8] John Coates, SPACs, IPOs and Liability Risk under the Securities Laws, U.S. Securities and Exchange Commission, available at https://www.sec.gov/news/public-statement/spacs-ipos-liability-risk-under-securities-laws.

[9] Id.

[10] John Coates and Paul Munter, Staff Statement on Accounting and Reporting Consideration for Warrants Issued by Special Purpose Acquisiton Companies ("SPACs"), U.S. Securities and Exchange Commission, available at https://www.sec.gov/news/public-statement/accounting-reporting-warrants-issued-spacs.

[11] Id.

[12] Complaint, Borteanu v. Nikola Corporation et al., 2:20-cv-01797-SPL (D. Ariz., Sept. 15, 2020).

[13] Welch v. Meaux, No. 2:19-cv-01260-TAD-KK (W.D. La. Oct. 16, 2020).

[14] See Murdeshwar v. Search Media Holdings Ltd., No. 11-CIV-20549, 2011 WL 7704347, at *20 (S.D. Fla. Aug. 8, 2011) (evaluating claims that sponsor failed to "conduct sufficient due diligence leading up to the Merger" and failed to notice "red flags" regarding accounting irregularities).