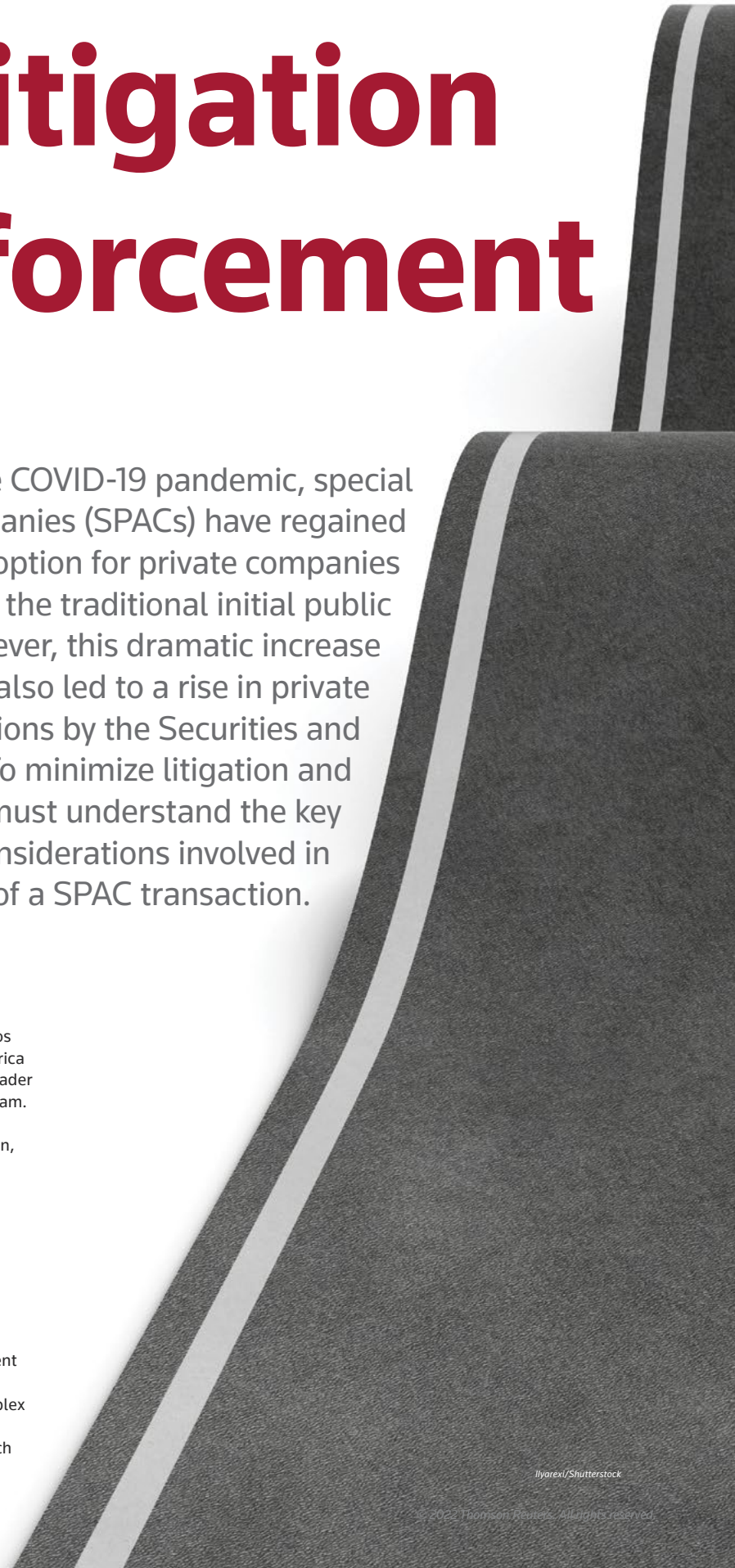
# SPAC Litigation and Enforcement



Since the beginning of the COVID-19 pandemic, special purpose acquisition companies (SPACs) have regained popularity as an attractive option for private companies to go public without using the traditional initial public offering (IPO) process. However, this dramatic increase in SPAC transactions has also led to a rise in private lawsuits and enforcement actions by the Securities and Exchange Commission (SEC). To minimize litigation and enforcement risk, counsel must understand the key legal issues and practical considerations involved in each phase of a SPAC transaction.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SPACs, historically referred to as blank check companies, are vehicles used to transition private companies to public without undergoing a long and expensive IPO process. SPACs are typically corporations, often incorporated in Delaware, formed by sponsors (sometimes called founders), such as private equity firms, venture capital firms, or experienced business executives. Sponsors choose the SPAC's management team, or serve in management roles themselves, and raise funds through an IPO. However, because SPACs have no operations and function solely to raise capital for acquiring a private operating company, the regulatory approval process is faster and cheaper than in a traditional IPO.

Once a SPAC has raised funds through an IPO, it typically has 18 to 24 months to identify a target company and complete the merger (referred to as a de-SPAC transaction). After the merger is complete, the SPAC evolves into the surviving publicly traded company and runs the target company's operations. If, however, a SPAC is unable to identify a target company or complete the de-SPAC transaction within the applicable timeframe, the SPAC liquidates and the proceeds are returned to the public shareholders, with interest.

While SPACs were established in the 1980s, they recently regained popularity during volatile periods in the securities markets because they present a less risky option for companies to access funds despite a lack of fundraising opportunities in the mainstream market. The increase in de-SPAC transactions has led to a rise in related SEC investigations and enforcement actions as well as private lawsuits.

This article provides a primer on SPACs, highlighting important legal issues and recent developments. It examines:

- The advantages of going public through SPACs as compared to traditional IPOs.
- The main phases of a de-SPAC transaction.
- The key legal issues that can arise at each phase of the SPAC process.
- Recent SPAC-related enforcement and litigation trends.
- Best practices to minimize the risk of SPAC-related enforcement actions and litigation.

## SPACs VERSUS IPOs

Benefits to target companies using SPACs to go public include the following:

- De-SPAC transactions are governed by a business combination agreement and therefore provide greater certainty of closing and a speedier process as compared to an uncertain and protracted IPO process.
- De-SPAC transactions provide price certainty because the price is negotiated and agreed to in advance by the SPAC, SPAC investors, and target company, as opposed to it being formed during a roadshow and subject to short-term volatile market conditions.
- The target company has autonomy to select a SPAC that would provide the best business opportunities for that company going forward. In selecting a SPAC, the target company can evaluate:
  - the SPAC sponsors' reputation in relevant communities, for example, the sponsors' success in prior business combinations and de-SPAC transactions;
  - the SPAC management's experience in the relevant industry; and
  - the alignment of interests between the SPAC's and target company's management teams.
- The SPAC process shortens the IPO process, saving target companies time and money.

While SPACs present a host of advantages for target companies, sponsors, and investors, investing in a SPAC also presents inherent risks, including that the emerging company's stock price falls below the $10 stock price at which investors initially purchased the shares (see below *Phase One: The SPAC IPO Process*). This can cause investors to suffer significant losses and put the SPAC, the target company, and their respective management boards at risk of litigation and enforcement actions.

## THREE PHASES OF THE SPAC PROCESS

The SPAC process can be broken down into three distinct phases, each of which carries a risk of resulting in private litigation and SEC enforcement actions:

- The SPAC IPO.
- The target company search and negotiations.
- The de-SPAC transaction.

Search Understanding De-SPAC Transactions for more on the mechanics of de-SPAC transactions.

### PHASE ONE: THE SPAC IPO PROCESS

Before a SPAC's IPO, the SPAC sponsors make nominal capital contributions to the SPAC, typically securing a 20% interest, known as founder shares.

During the IPO, investors purchase the SPAC's remaining shares through "units," typically priced at $10 per unit. Each unit consists of one share of common stock and a fraction of a warrant allowing the investors to purchase a certain amount of common stock post-IPO at a predetermined price, typically $11.50 per share.

The contributions are then deposited in an interest-bearing trust account to be used for the sole purpose of acquiring a target company in the de-SPAC transaction. Warrants usually can be exercised after the later of 30 days after the de-SPAC transaction or 12 months after the IPO closing, and expire five years after the de-SPAC transaction.

Like all other companies going public, SPACs are required to file a registration statement with the SEC setting out the governing parameters of the SPAC in order to register the public units, founder shares,

and warrants offered in the IPO (15 U.S.C. § 77e). In practice, SPAC registration statements are relatively straightforward because SPACs have no operations and present a limited risk. As a result, SPAC registration statements are often declared effective in considerably less time than registration statements for traditional operating companies. Registration statements must:

- Specify the industry or geographic focus of the target business that the SPAC intends to pursue and any experience that the SPAC's sponsors have in the target industry.
- Disclose any conflicts of interest. The SEC has increased scrutiny of conflicts of interest, and a failure to disclose may lead to SEC investigations and private litigation, including derivative lawsuits and securities class actions. To assess whether conflicts of interest exist, the SEC will often inquire into other SPACs that the sponsors have formed and the amount of control and influence the sponsors and other investors will have to vote on the de-SPAC transaction, typically determined by the percentage of shares either party holds in the SPAC. (Draft Recommendations of the Investor as Purchaser and Investor as Owner Subcommittees of the SEC Investor Advisory Committee Regarding SPACs (Aug. 26, 2021); Statement of John Coates, Acting Director, SEC Division of Corporation Finance, SPACs, IPOs and Liability Risk Under the Securities Laws (Apr. 8, 2021); SEC Division of Corporation Finance, CF Disclosure Guidance: Topic No. 11, Special Purpose Acquisition Companies (Dec. 22, 2020).)
- Expressly state that the SPAC has not yet identified a target company. In the registration statement and the prospectus, a SPAC typically identifies an industry or a business that it will target (SEC Investor Alerts and Bulletins, What You Need to Know About SPACs — Updated Investor Bulletin (May 25, 2021)).

Many SPACs file their registration statements as "emerging growth companies" (EGCs) in order to file the registration statement confidentially. Filing as an EGC also reduces the number of disclosures that the SPAC must make to the SEC and eliminates the requirement that the SPAC obtain an auditor attestation of internal control (15 U.S.C. § 7262(b)).

While the registration statement is under SEC review, SPAC sponsors identify the management team and board members, who will control the de-SPAC transaction and make the ultimate decision of which target company to potentially acquire. Following the completion of the IPO, the SPAC then becomes subject to the reporting requirements of the Securities Exchange Act of 1934 (Exchange Act) and must file the requisite reporting documents, such as Forms 10-K, 10-Q, and 8-K.

## PHASE TWO: TARGET COMPANY SEARCH AND NEGOTIATIONS

After the SPAC completes the IPO process, it usually has 18 to 24 months to identify a target company and complete the de-SPAC transaction.

Target companies are often venture capital funded start-up technology companies in the fintech, media, and electric vehicle industry sectors. For these companies, SPACs are appealing because they offer unique fiscal advantages that are not available in other forms of funding, such as easier access to capital, lower fees, and fewer regulatory demands as compared to the traditional IPO process.

To minimize future risks, while searching for a target company, SPACs should look for companies that:

- Are aligned with the industry or geographic focus of the target business identified in the SPAC registration statement.
- Have robust internal financial controls and historical audited financial statements to ensure that the post-merger company is well positioned to comply with the reporting requirements of a public company.

## PHASE THREE: THE DE-SPAC TRANSACTION

Once the SPAC identifies a viable target company, the target and the SPAC begin negotiating a potential de-SPAC transaction, including its terms and the allocation of shares. The SPAC prepares a proxy statement, files it with the SEC for approval, and distributes it to all shareholders. If the SPAC intends to register new securities as part of the de-SPAC transaction, it must file a joint registration and proxy statement on Form S-4.

A proxy statement contains:

- A description of the proposed de-SPAC transaction.
- The governance structure of the post-merger company.
- The target company's:
  - historical financial information;
  - management's discussion and analysis; and
  - pro forma financial statements projecting the effects of the proposed de-SPAC transaction.
- A disclosure of any conflicts of interest and risks associated with the target company and its business.

(17 CFR § 240.14a-101 - Schedule 14A.)

Generally, the SPAC's governing documents require that a majority of shareholders approve the merger to complete the de-SPAC transaction. Even a minority of shareholders may delay the completion of the de-SPAC transaction if they believe the proxy statement lacks adequate disclosures, in which case they can challenge the sufficiency of the proxy statement under Section 14(a) of the Exchange Act (15 U.S.C. § 78n(a); 17 C.F.R. § 240.14a-9(a)).

Shareholders who do not approve of the de-SPAC transaction have the opportunity to opt out of it and redeem their shares in exchange for a pro rata portion of the amount held in the trust plus accrued interest. Shareholders who opt out are usually permitted to keep their warrants. If the SPAC needs additional capital to complete the merger, it may issue debt or raise additional funds, often through a PIPE (private investment in

public equity) transaction (for more information, search Understanding De-SPAC Transactions and PIPE Transactions on Practical Law).

SEC approval of the proxy statement generally takes three to five months from the time the de-SPAC transaction agreement is signed. Once the SEC approves the proxy statement and a majority of shareholders approve the de-SPAC transaction, the merger is completed and equity holders in the target company and the SPAC investors become shareholders in the surviving company.

Post-closing, the emerging public company must comply with applicable securities laws, satisfy financial and reporting requirements, and maintain processes and controls to comply with disclosure obligations and reporting standards. Within four days of the closing, the emerging company must file with the SEC a so-called Super 8-K, which is a Form 8-K containing information equivalent to that required in the target company's Form 10 filing (15 U.S.C. §§ 78m, 78o(d)). This includes any information that was not disclosed in the proxy statement but that is required to allow affiliates to sell their shares under SEC Rule 144.

## LEGAL ISSUES THAT ARISE IN THE SPAC CONTEXT

In general, legal claims arising from SPAC transactions involve claims based on:

- Material misrepresentations and omissions during the IPO process or de-SPAC transaction.
- Breach of contract claims between the SPAC and the target company.
- Conflicts of interest or breach of fiduciary duties owed to investors by SPAC officers, directors, and sponsors.

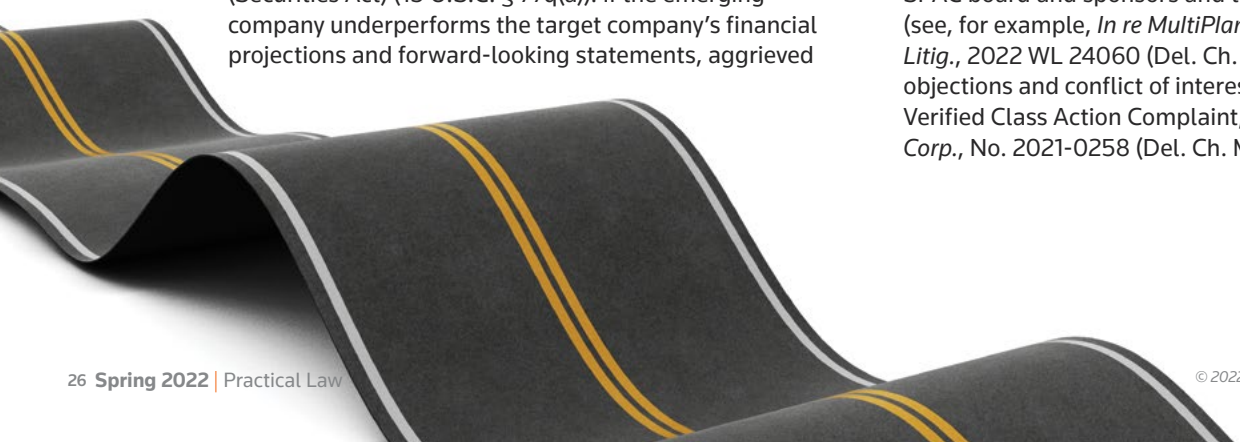
SPAC transactions have been a major focus for the SEC, which has initiated a number of enforcement actions and issued public statements, alerts, and guidance demonstrating its commitment to closely scrutinizing these transactions. After the SEC initiates an enforcement action, it is common for private litigants — often SPAC investors — to file "placeholder" complaints mirroring the allegations in enforcement actions.

Private litigation based on SPAC transactions most commonly involves securities fraud and other claims brought under the Exchange Act, typically Sections 14(a), 10(b), and 20(a) (15 U.S.C. §§ 78j(b), 78n(a), 78t(a)), and under Section 17(a) of the Securities Act of 1933 (Securities Act) (15 U.S.C. § 77q(a)). If the emerging company underperforms the target company's financial projections and forward-looking statements, aggrieved investors often claim that pro forma financials in the proxy statement were misleading (see below *Proxy Statements*) or that the target company was not prepared to operate as a public company and comply with the applicable disclosures.

Search Exchange Act: Section 10(b) Asserting Securities Fraud Toolkit and Exchange Act: Section 10(b) Defense Toolkit for collections of resources to help counsel assert or defend against federal securities fraud claims.

In addition to securities fraud class actions, SPAC investors may file:

- **Shareholder derivative lawsuits against the officers and directors of both the SPAC and the newly public entity.** Derivative suits are often initiated soon after or alongside securities fraud class actions. (For more on litigating a shareholder derivative lawsuit, search Shareholder Derivative Litigation on Practical Law.)
- **Merger objection lawsuits in state courts in opposition to a proposed de-SPAC transaction.** These actions (which are especially common in New York state courts) often allege that directors have omitted material information relating to the target company, the de-SPAC transaction, or both, thereby breaching their fiduciary duties (see, for example, *Truesdale v. Altimar Acquisition Corp.*, No. 650337/2021 (Sup. Ct. N.Y. Cnty. Jan. 18, 2021) (alleging that the directors failed to disclose sale process information, the post-transaction employment of SPAC directors and officers, information relating to financial advisement, and financial projections); see also *Acker v. Churchill Capital Corp II*, No. 650892/2021 (Sup. Ct. N.Y. Cnty. Feb. 8, 2021)). While most SPACs are incorporated in Delaware, plaintiffs bringing these cases in New York state courts assert jurisdiction by alleging that the SPAC is located or based in New York or that its shares are traded on the New York Stock Exchange. Many merger objection lawsuits result in a settlement, typically including the defendants' agreement to provide supplemental disclosures regarding the proposed merger and to pay a "mootness" fee, usually between $50,000 and $300,000.
- **Breach of fiduciary duty lawsuits in state courts.** These lawsuits (which are especially common in Delaware, where most SPACs are incorporated) usually challenge the fairness of the pre-merger consideration process and alleged conflicts of interest between the SPAC board and sponsors and the SPAC investors (see, for example, *In re MultiPlan Corp. Stockholders Litig.*, 2022 WL 24060 (Del. Ch. Jan. 3, 2022) (fairness objections and conflict of interest objections); see also Verified Class Action Complaint, *Amo v. MultiPlan Corp.*, No. 2021-0258 (Del. Ch. Mar. 25, 2021)).



While legal issues can arise from each phase of the SPAC process, most SEC enforcement actions and private securities litigation occur after the completion of the de-SPAC transaction (see below *Legal Issues Arising from the De-SPAC Transaction*).

## LEGAL ISSUES ARISING FROM THE SPAC IPO

The SEC and private litigants often bring enforcement actions and private lawsuits, respectively, under Section 11 of the Securities Act (15 U.S.C. § 77k) based on alleged material misstatements or omissions in disclosures made in the SPAC registration statement during the IPO process. These misstatements and omissions may relate to:

- Sponsors' relationships with SPAC investors and the target company.
- The amount of control and authority that SPAC sponsors, directors, officers, and affiliates have over the approval of a de-SPAC transaction.
- The economic terms of the securities held by SPAC sponsors, directors, officers, and affiliates.

Failure to adequately disclose material information places a SPAC, its sponsors, and the target company at risk of an SEC enforcement action.

## LEGAL ISSUES ARISING FROM THE TARGET COMPANY SEARCH AND NEGOTIATIONS

While the majority of SPAC litigation involves aggrieved shareholders, litigation can also arise between the SPAC and the target company, typically after failed merger negotiations that do not result in a successful de-SPAC transaction. In these circumstances, the SPAC and the target company may sue each other for breach of contract or breach of the duty to negotiate in good faith (see, for example, *Bogart v. Israel Aerospace Indus. Ltd.*, 2010 WL 517582 (S.D.N.Y. Feb. 5, 2010)).

In general, these allegations must be brought on behalf of the SPAC itself as opposed to the individual sponsors. Sponsors may pursue breach of contract or breach of fiduciary duty claims against a SPAC only if the sponsor was a party to the negotiations or written agreements in their individual capacity, that is, if the SPAC had an independent duty to the sponsor to negotiate in good faith. Practically speaking, sponsors often refrain from becoming a party to these negotiations in their individual capacity to limit their potential liability.

## LEGAL ISSUES ARISING FROM THE DE-SPAC TRANSACTION

The majority of SPAC-related private litigation and SEC enforcement actions arise out of conduct taking place during or after the de-SPAC transaction. Commonly asserted claims include:

- Material omissions or misstatements in the proxy statement.
- Conflicts of interest and breach of fiduciary duty.

### Proxy Statements

As part of the de-SPAC transaction, SPACs circulate proxy statements to the SPAC investors, which contain financial projections for the post-merger company (see above *Phase Three: The De-SPAC Transaction*).

The SEC and private litigants often sue SPACs and related industry players in connection with forward-looking statements, misrepresentations, and omissions in proxy statements. Because many de-SPAC transactions involve early-stage target companies, the financial projections in the proxy statements are often based on the target company's early operations and financial earnings, leaving room for errors, omissions, and misstatements.

**After the SEC initiates an enforcement action, it is common for private litigants — often SPAC investors — to file "placeholder" complaints mirroring the allegations in enforcement actions.**

Misleading or incorrect statements in a proxy statement can also result from inadequate due diligence into the target company. When an emerging company's financial performance is lower than that projected in the proxy statement, litigants may bring suit claiming that the SPAC or target company did not adequately perform due diligence into the key players and failed to uncover alleged material misrepresentations or omissions.

In these circumstances, SPAC investors may sue the SPAC under Exchange Act Section 14(a) (15 U.S.C. § 78n(a)), which provides an implied private right of action imposing liability for obtaining shareholder authorization for corporate action through a deceptive or inadequate disclosure in a proxy statement (see, for example, Complaint for Violation of the Securities Exchange Act of 1934, *Wheby v. Greenland Acquisition Corp.*, No. 19-1758 (D. Del. Sept. 19, 2019) (lawsuit by SPAC investor for alleged violations of the Exchange Act based on the proxy statement's lack of disclosures relating to financial statements, financial projections, and affiliations of consultants)).

Shareholders of the emerging company can also bring suit pursuant to Exchange Act Section 14(a), in addition to fraud claims under Securities Act Section 17(a) and Exchange Act Sections 10(b) and 20(a) for material misleading or fraudulent statements in the proxy statement (15 U.S.C. §§ 77q(a), 78j(b), 78n(a), 78t(a); see Class Action Complaint for Violations of Federal Securities Laws, *Welch v. Meaux*, No. 19-1260 (W.D. La. Sept. 26, 2019) (alleging fraud in the proxy statement under Sections 14(a), 10(b), and 20(a))).

**There is an inherent tension concerning the economic incentives of SPAC sponsors and SPAC investors. Accordingly, SPACs present a number of potential legal issues concerning conflicts of interest and breach of fiduciary duty.**

Significantly, the Private Securities Litigation Reform Act (PSLRA) provides a safe harbor that shields SPACs from liability in private litigation arising from most forward-looking statements that are made in good faith and accompanied by cautionary language (15 U.S.C. § 77z-2). However, there are various legislative and regulatory initiatives aimed at excluding SPACs from the PSLRA's safe harbor (H.R. 5910, 117th Cong. (1st Sess. 2021), available at *congress.gov*; Statement of John Coates, Acting Director, SEC Division of Corporation Finance, SPACs, IPOs and Liability Risk Under the Securities Laws (Apr. 8, 2021)).

The PSLRA does not:

- Protect SPACs from liability in private litigation if the false or misleading projections were made knowingly.
- Apply to SEC enforcement actions, making it imperative for SPACs to diligently vet proxy statements before issuing them.

As demonstrated by the SEC's recent enforcement action in connection with Stable Road Acquisition Corp., the SEC has been aggressive in challenging de-SPAC transactions involving alleged misrepresentations (see below *SPAC Enforcement Trends*).

Search Forward-Looking Statements: Securing the Safe Harbor for more on the PSLRA's safe harbor for forward-looking statements.

### Conflicts of Interest and Breach of Fiduciary Duty

Private litigants often pursue claims arising from SPAC sponsors' alleged breach of fiduciary duty. There is an inherent tension concerning the economic incentives of SPAC sponsors and SPAC investors. Sponsors invest only a nominal amount in exchange for founder shares, and their immediate goal is to complete the de-SPAC transaction and avoid having to return the funds before expiration. However, investors have a greater investment at stake on which they wish to realize maximum medium to long-term profit. It is therefore not uncommon for sponsors to advocate for a de-SPAC transaction that might not be in the best interest of the investors. Accordingly, SPACs present a number of potential legal issues concerning conflicts of interest and breach of fiduciary duty.

For example, a recent class action lawsuit filed in the Delaware Chancery Court demonstrates the competing interests between a SPAC and its sponsors. In *Franchi v. MultiPlan Corp.*, the SPAC shareholders brought breach of fiduciary duty claims against a SPAC and the SPAC sponsor for allegedly prioritizing the financial interests of the sponsor at the expense of the SPAC. The plaintiffs alleged that the SPAC sponsor gave the SPAC's board of directors strong incentives to get a deal done without regard to whether it was in the best interest of the SPAC's outside investors. (Verified Class Action Complaint, *Franchi v. MultiPlan Corp.*, No. 2021-300, at 3, 35-38 (Del. Ch. Apr. 9, 2021).)

To support these allegations, the plaintiffs pointed out that even if the post-transaction company's stock fell below $10 per share, completion of the merger would yield massive windfalls to holders of the founder shares because the SPAC sponsor, directors, and officers paid a nominal amount in exchange for a large number of founder shares equaling 20% of the equity of the SPAC on completion of the de-SPAC transaction. Therefore, the financial incentives of the sponsor and board were directly at odds with the shareholders' interests. (Verified Class Action Complaint, *Franchi*, No. 2021-300, at 4.) The defendants subsequently filed a motion to dismiss the complaint, which the Delaware Chancery Court denied except as to two named defendants (*In re MultiPlan Corp. Stockholders Litig.*, 2022 WL 24060, at *2).

## RECENT ENFORCEMENT AND LITIGATION TRENDS

SPACs have received intense scrutiny from Congress, the SEC, and private litigants since regaining popularity in recent years, resulting in numerous SEC enforcement actions and private lawsuits.

## SPAC ENFORCEMENT TRENDS

Since late 2020, the SEC has clearly signaled its intention to closely monitor and scrutinize the SPAC market in a string of statements and actions demonstrating its willingness to bring aggressive enforcement actions against SPACs and other key industry players.

For example, in December 2020, the SEC's Division of Corporation Finance issued guidance on the disclosure of conflicts of interest among SPAC sponsors, directors, officers, underwriters, and public shareholders (SEC Division of Corporation Finance, CF Disclosure Guidance: Topic No. 11, Special Purpose Acquisition Companies (Dec. 22, 2020)). In April 2021, John Coates, the Acting Director of the Division of Corporation Finance, issued a statement expressing the SEC's focus on SPAC transactions and disclosure requirements and bringing into question the applicability of the PSLRA's safe harbor to SPAC transactions (Statement of John Coates, Acting Director, SEC Division of Corporation Finance, SPACs, IPOs and Liability Risk Under the Securities Laws (Apr. 8, 2021)). Additionally, in April 2021, the SEC released a statement on the accounting and reporting considerations for warrants issued by SPACs, outlining circumstances under which registrants must fix errors disclosed in previously filed financial statements (SEC, Staff Statement on Accounting and Reporting Considerations for Warrants Issued by Special Purpose Acquisition Companies (Apr. 12, 2021)). The SEC has followed through on these statements and filed 434 new enforcement actions in fiscal year 2021, a 7% increase over the prior fiscal year (SEC Press Release, SEC Announces Enforcement Results for FY 2021 (Nov. 18, 2021)).

The SEC's investigation and enforcement action involving Stable Road Acquisition Corp., a SPAC, demonstrate that targeting improper de-SPAC transactions remains a high priority for the SEC. In July 2021, the SEC announced charges and a simultaneous settlement with Stable Road, its sponsor, its CEO, and the target company Momentus Inc. relating to Momentus's misrepresentations on the success of its operations. The enforcement action was initiated even before the shareholders voted on the de-SPAC transaction, signaling the SEC's willingness to combat these issues on an expedited basis.

Moreover, in public comments on the action, the SEC Chairman highlighted the "risks inherent to SPAC transactions" and noted that the fact that Momentus lied to Stable Road did "not absolve Stable Road of its failure to undertake adequate due diligence to protect shareholders" (SEC Press Release, SEC Charges SPAC, Sponsor, Merger Target, and CEOs for Misleading Disclosures Ahead of Proposed Business Combination (July 13, 2021)). These statements further reflect the SEC's intention to send a clear message on SPACs.

Additionally, the Financial Industry Regulatory Authority (FINRA) has signaled its increased focus on SPACs. In July 2021, shortly after the SEC's investigation and enforcement action involving Stable Road, FINRA expressed its intention to conduct regulatory "sweeps" into SPAC transactions. FINRA confirmed this plan in October 2021, when it issued a statement advising that it would be examining "firms' offering of, and services provided to, [SPACs] and their affiliates (*e.g.*, sponsors, principal stockholders, board members, and related parties)" (FINRA, Special Purpose Acquisition Companies (Oct. 2021)).

As is typical in securities litigation, the Stable Road enforcement action prompted a parallel civil action initiated by shareholders of Stable Road securities (see below *SPAC Litigation Trends*).

## SPAC LITIGATION TRENDS

In 2021 alone, SPAC investors filed 32 SPAC-related federal securities fraud class actions and 14 derivative actions against directors of SPAC-related entities (Cornerstone Research, Securities Class Action Filings, 2021 Year in Review, at 8; Kevin LaCroix, The D&O Diary, The Top Ten D&O Stories of 2021 (Jan. 3, 2022), available at *dandodiary.com*). SPACs and target companies also have sued each other for breach of contract and failure to negotiate in good faith.

In private litigation brought by SPAC investors, litigants have focused on many of the same issues raised in SEC enforcement actions, such as:

- Inadequate disclosures.
- Poor due diligence.
- Conflicts of interest.

For example, following the SEC's enforcement action in connection with the Stable Road and Momentus transaction, Stable Road shareholders filed a parallel civil proceeding alleging violations of various securities laws (Complaint for Violations of the Federal Securities Laws, *Jensen v. Stable Road Acquisition Corp.*, No. 21-5744 (C.D. Cal. July 15, 2021)). Similar enforcement actions and parallel civil proceedings will likely increase in the future, especially given that, as of the end of 2021, over 500 SPACs are searching for a target company in an increasingly oversaturated market (Yun Li, The SPAC Market Starts 2022 with Abysmal Losses, Abandoned Deals, CNBC (Feb. 2, 2022)).

Moreover, private litigants recently have attempted to find new, creative claims against SPACs and their sponsors. For example, in August 2021, a plaintiff filed a derivative action against three SPACs pursuant to the Investment Company Act of 1940, alleging that SPACs qualified as investors under the Act and that the SPACs and their sponsors were violating the statute (see, for example, Verified Derivative Complaint, *Assad v. Pershing Square Tontine Holdings, Ltd.*, No. 21-6907 (Aug. 17, 2021)). After the suit was filed, nearly 60 law firms published a joint statement stating that the claims were baseless, arguing that in the last two decades, the SEC has never held that SPACs are subject to the Investment Company Act. While these claims are still under review, they indicate plaintiffs' creativity and, if successful, may signal a new wave of litigation and potential liability for SPACs and their sponsors.

## PRACTICAL GUIDANCE

In light of the recent increase in SPAC litigation, SPACs, SPAC sponsors, and target companies can implement certain practices and procedures to minimize the risk of SEC investigations and enforcement actions and private lawsuits, including:

- Retaining an independent financial advisor to provide a fairness opinion regarding a proposed de-SPAC transaction.
- Identifying and disclosing any potential conflicts of interest between SPAC sponsors, directors, and officers.
- Using a reputable accounting firm to conduct due diligence on the target company.
- Exercising caution when making and relying on financial projections in a proxy statement.
- Avoiding, if possible, completion of a de-SPAC transaction too close to the SPAC's expiration date.
- Considering including release of liability provisions in shareholder support agreements.
- Implementing robust compliance policies and procedures as soon as possible.

Additionally, SPACs should always maintain directors and officers insurance to protect high-level sponsors should any issues arise.

### RETAIN AN INDEPENDENT FINANCIAL ADVISOR

Although not required by law, SPACs should consider retaining an independent financial advisor to provide a fairness opinion regarding a proposed de-SPAC transaction.

Fairness opinions provide value to both management and the board by serving as evidence of proper due diligence and mitigating litigation risk. Notably, in many derivative suits brought by SPAC investors, the business judgment rule defense is unavailable to the SPAC board because the sponsors and management typically receive part of the target company if the de-SPAC transaction goes through, and are not considered disinterested as required for the business judgment rule to apply. Instead, the more exacting "entire fairness" standard applies in evaluating the transaction. A fairness opinion may help demonstrate that this standard was met and serve as an effective risk management tool. (See *In re MultiPlan Corp. Stockholder Litig.*, 2022 WL 24060, at *6, *16 (applying the entire fairness standard and noting that the SPAC's proxy statement was not accompanied by an independent third-party valuation or fairness opinion).)

Fairness opinions also provide value to SPAC investors by providing support for the quality of the proposed transaction.

Although fairness opinions are a prevalent feature of most corporate transactions, they are less common in de-SPAC transactions, except in situations in which the target company has some affiliation to the sponsor.

### IDENTIFY AND DISCLOSE POTENTIAL CONFLICTS OF INTEREST

SPACs should identify in the registration statement any potential conflicts of interest between SPAC sponsors, directors, and officers and provide comprehensive disclosures about these potential conflicts. SPACs should also disclose any other issues material to investors, including the financial incentives of the SPAC sponsors, directors, and officers and any prior dealings they had with interested parties.

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 about proceeding with the de-SPAC transaction. Therefore, should any conflicts exist, it is in the sponsors' best interests to promptly and honestly disclose the conflicts to investors.

### USE A REPUTABLE ACCOUNTING FIRM TO CONDUCT DUE DILIGENCE

SPACs should use a reputable accounting firm to conduct due diligence on the target company. Even if a SPAC sponsor is unaware of the target company's false statements, in litigation the sponsor may benefit by being able to demonstrate that it conducted proper due diligence. For example, the Exchange Act provides three affirmative due diligence defenses available to SPACs, each of which requires a reasonableness determination:

- The person reasonably believed that the statements in the registration statement were true at the time the registration statement became effective (15 U.S.C. § 77k(b)(3)(A)).
- The person had no reasonable ground to believe that the statements in the registration statement were not true at the time the registration statement became effective (15 U.S.C. § 77k(b)(3)(C)).
- The person did not know and, exercising reasonable care, could not have known, of a misstatement or omission in the prospectus or oral communication (15 U.S.C. § 77l(a)(2)).

These affirmative defenses are more likely to succeed if a SPAC can assert that it relied on a reputable accounting firm to conduct due diligence.

The accounting firm may provide further value in the due diligence process by addressing concerns from the market and regulators regarding the accounting integrity and governance weaknesses of target companies, helping to combat a growing perception that some fledgling companies may be abusing the SPAC process (US Senate Committee on Banking, Housing, and Urban Affairs, Warren, Brown, Smith, and Van Hollen Request Information from SPAC Creators Amid "Astonishing" Reports of Abuse and Market Dysfunction (Sept. 22, 2021)).

The firm's due diligence on the target company should always be well documented and should:

- Assess the reasonableness of the target company's projections.

- Identify potential risks associated with the de-SPAC transaction (which should be disclosed).
- Clearly state why the potential upside from the de-SPAC transaction outweighs the risks.

The accounting firm can also assist the target company in testing its internal accounting controls, including payment processes, delegation of authority, and separation of duties to ensure that transactions are recorded accurately and in conformity with management authorization, which are key capacities for properly running a public company.

## EXERCISE CAUTION WHEN MAKING AND RELYING ON FINANCIAL PROJECTIONS

Target companies and SPACs should use extreme care when making and relying on financial earnings projections in a proxy statement, especially in light of the SEC's guidance foreshadowing stricter financial reporting and disclosure requirements (SEC, Staff Statement on Accounting and Reporting Considerations for Warrants Issued by Special Purpose Acquisition Companies (Apr. 12, 2021)). SPACs should rely on financial projections only to the extent necessary, and if a target company's current revenue can justify the de-SPAC transaction, the SPAC might leave out financial projections from the proxy statement altogether.

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

Additionally, while the SEC's recent guidance challenges the applicability of the PSLRA's safe harbor for forward-looking statements and projections to SPACs, any forward-looking statements or financial projections should always be accompanied by meaningful cautionary language (Statement of John Coates, Acting Director, SEC Division of Corporation Finance, SPACs, IPOs and Liability Risk Under the Securities Laws (Apr. 8, 2021); see above *Proxy Statements*).

## CONSIDER THE TIMING OF THE DE-SPAC TRANSACTION

To the extent possible, SPACs should be cautious of completing a de-SPAC transaction too near to the SPAC's expiration date. A perception of a rushed merger and subsequent failure of a target company have often given rise to shareholder claims for breach of fiduciary duty and claims under the Exchange Act. For example, in *Welch v. Meaux*, the complaint alleged that the SPAC's founders rushed into a de-SPAC transaction just weeks before the SPAC's deadline to consummate a de-SPAC transaction, providing false and misleading statements about the target's financial conditions in order to quickly complete the transaction and avoid liquidation (No. 19-1260 (W.D. La. Sept. 26, 2019)).

## CONSIDER REQUIRING SHAREHOLDER SUPPORT AGREEMENTS AND RELEASES OF LIABILITY

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

Before a de-SPAC transaction agreement is signed, shareholders often wait to enter into their first shareholder agreement until the registration statement or proxy statement (or both) 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 and include a release or waiver of liability. This way, SPACs can significantly reduce their potential liability arising from the de-SPAC transaction should anything go awry.

## IMPLEMENT ROBUST COMPLIANCE POLICIES AND PROCEDURES

As a part of any de-SPAC transaction, SPACs should conduct a robust global compliance gap assessment given 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 (15 U.S.C. § 78m(b)), the Sarbanes-Oxley Act of 2002, and the Dodd-Frank Wall Street Reform and Consumer Protection Act.

While a company going public through a de-SPAC transaction may already have robust compliance policies and procedures in place in many areas, procedures typical for public companies, such as those pertaining to 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 target company going public through a de-SPAC transaction to make sure that its compliance house is in order on day one or as soon as practicably possible. SEC enforcement staff will make requests relating to a company's compliance procedures as a part of any investigation or compliance examination. In addition to a risk of SEC penalties, an absence of adequate policies and procedures is certain to cause the SEC to further scrutinize the underlying business practices and culture at the company. As the old adage says, "an ounce of prevention is worth a pound of cure." PL