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Alert

SPAC Litigation Alert: SEC Cautions SPAC Participants that Claims of Reduced Liability Exposure Are Overstated

April 13, 2021

Since the start of the COVID-19 pandemic, the U.S. securities markets have seen an exponential rise in the use of Special Purpose Acquisition Companies ("SPACs") as an alternative to more traditional initial public offering ("IPOs") and direct listings. SPACs raised over $80 billion in 2020, exceeding the total capital raised by these vehicles during the preceding decade. The number of SPACs going public has continued to accelerate in 2021, with approximately $100 billion raised so far this year. The growth has been fueled by significant interest and demand from investors and, in many cases, an influx of high-profile sponsors. However, the SPAC ecosystem is facing myriad headwinds including increased scrutiny from regulators and the plaintiffs' bar. While we expect SPACs to remain a popular vehicle with enormous potential to reshape the way private companies enter the public markets, the importance of ensuring that SPAC deals are properly structured and that participants have adequate legal and compliance resources has never been greater.

Specifically, on April 8, 2021, John Coates, Acting Director of the SEC Division of Corporation Finance,[1] signaled in the most direct terms yet that the SEC intends to apply an unprecedented level of scrutiny to disclosures accompanying either the initial issuance of the SPAC securities or a follow-on transaction funded — at least in part — by a SPAC structure. Director Coates' statement came on the coattails of a near-constant stream of investor alerts, bulletins and other warnings that began in late 2020.

Earlier SEC Guidance

On Dec. 10, 2020, the SECs Office of Investor Education and Advocacy ("OIEA") issued a bulletin for retail investors that explained the basic mechanics and key risks of SPACs.[2] Shortly thereafter, the SEC's Division of Corporation Finance warned participants in SPAC transactions about the importance of complete, clear and accurate disclosures regarding potential conflicts of interest between SPAC investors and, among others, sponsors, targets, advisors and their affiliates.[3]

On March 10, 2021, the OIEA issued an investor alert highlighting the unique risks that SPACs pose to investors, including how they differ from traditional IPOs, and expressing caution about the increasing

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[1] Securities and Exchange Commission, Acting Director of Division of Corporation Finance, *SPACS, IPOs, and Liability Risk under the Securities Laws* (April 8, 2021), available here.

[2] *See* Securities and Exchange Commission, Office of Investor Education and Advocacy, *SPACs – What You Need To Know* (Dec. 10, 2020), available here.

[3] Securities and Exchange Commission, Division of Corporation Finance, *CF Disclosure Guidance: Topic No. 11: Special Purpose Acquisition Companies* (Dec. 22, 2020), available here.

prevalence of celebrity SPAC sponsors.[4] A few weeks later, on March 31, 2021, the SEC's Division of Corporation Finance and the Office of the Chief Accountant issued separate statements reminding SPAC targets and their officers and directors about the importance of regulatory and financial reporting requirements associated with becoming a public company.[5] The Division of Corporation Finance's statement noted that, as shell companies, SPACs are subject to certain limitations, including that the combined company will not be eligible to incorporate by reference information in Exchange Act reports on Form S-1 until three years after the completion of a merger.[6] It also detailed books and records and internal control requirements, as well as exchange listing standards that private target companies need to understand before merging with a shell company (commonly referred to as a "de-SPAC transaction").[7] The Chief Accountant's statement addressed the enhanced timing, financial reporting and governance issues inherent in a "de-SPAC" transaction, in which the SPAC puts its funds to work in an acquisition, and reminded auditors and audit committee members of their oversight responsibilities.

Director Coates' Warning Regarding Potential Regulatory Enforcement

It was therefore no surprise that, in a statement released on April 8, 2021 by the SEC's Acting Director of Corporation Finance ("SEC Director's Statement"), the SEC strongly affirmed that it intends to use every tool in its arsenal to apply the protections of the federal securities laws to SPACs, and, in particular, the process by which a SPAC merges with a target to take a private company public. Regardless of whether in the context of registration statements,[8] proxy solicitations[9] or tender offers,[10] the SEC Director's Statement signaled that the SEC will be carefully evaluating participants' statements and disclosures at all stages of the SPAC lifecycle for potential violations of the federal securities laws.

Director Coates made clear that material misstatements or omissions relating to any de-SPAC transaction will be subject to liability under Sections 11 and 14(e) of the Exchange Act, respectively. Similarly, any material misstatement or omission in connection with a proxy solicitation would also be

[4] Securities and Exchange Commission, Office of Investor Education and Advocacy, *Celebrity Involvement with SPACs — Investor Alert* (Mar. 10, 2021), available here; Note that the SEC has issued similar warnings focused on celebrity promotions associated with cryptocurrency offerings, resulting in enforcement actions being brought against certain celebrity promoters. *See,* e.g., Securities and Exchange Commission, Division of Enforcement and Office of Compliance Inspections and Examinations, *SEC Statement Urging Caution Around Celebrity Backed ICOs* (Nov. 1, 2017) available here; *Two Celebrities Charged With Unlawfully Touting Coin Offerings*, SEC Press Release 2018-268 (Nov. 29, 2018), available here.

[5] Securities and Exchange Commission, Division of Corporation Finance, *Staff Statement on Select Issues Pertaining to Special Purpose Acquisition Companies* (March 31, 2021), available here; Securities and Exchange Commission, Office of the Chief Accountant, *Financial Reporting and Auditing Considerations of Companies Merging with SPACs* (March 31, 2021), available here.

[6] *See* General Instruction VII.D.1(b) to Form S-1.

[7] Note that the SPAC lifecycle consists of two distinct phases. First, a shell company is formed (the SPAC), which registers a securities offering and sells shares to investors to fund the future acquisition of one or more private companies. The proceeds from that sale are held in a trust until the eventual acquisition. In the second stage, the SPAC combines with a private company (i.e., the "de-SPAC" transaction), upon which the target, in effect, becomes a public company.

[8] Subject to liability under Securities Exchange Act Section 11.

[9] Director Coates also reminded participants that liability under section 14(a) and Rule 14a-9 are generally subject to a "negligence" standard. *See, e.g.*, *Beck v. Dobrowski*, 559 F.3d 680, 682 (7th Cir. 2009) ("There is no required state of mind for a violation of section 14(a); a proxy solicitation that contains a misleading misrepresentation or omission violates the section even if the issuer believed in perfect good faith that there was nothing misleading in the proxy materials"); Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 and Commission Statement on Potential Exchange Act Section 10(b) and Section 14(a) Liability, Exchange Act Release No. 51283 (Mar. 1, 2005) ("Where the failure to make such disclosure is negligent, an issuer would violate Section 14(a) of the Exchange Act and Rule 14a-9 thereunder…").

[10] Subject to liability under Securities Exchange Act Section 14(e).

subject to liability under Section 14(a) of the Exchange Act and Rule 14a-9 thereunder. Additionally, any material misstatement or omission about the target company could give rise to liability under Section 10(b) and Rule 10b-5 based on trading in securities of the pre-merger SPAC and/or the post-merger company. For example, in September 2020, the SEC filed a complaint against Akazoo S.A. that included Section 10(b) and Rule 10b-5 claims based on false statements that were allegedly made in public reports while its shares traded publicly on the Nasdaq.[11]

Civil Liability and the Private Securities Litigation Reform Act ("PSLRA")

The SEC Director's Statement challenges the assumption that the SPAC process offers protection from civil liability for forward-looking proxy statements under the Private Securities Litigation Reform Act's ("PSLRA") safe harbor.[12] By way of background, the PSLRA includes a safe-harbor for certain forward-looking statements[13] that are identified as such and "accompanied by meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those in the forward-looking statement; or immaterial ... "[14] The PSLRA, however, contains three enumerated exclusions from the statutory safe harbor for statements made in connection with (i) offerings by "blank check companies," (ii) offerings made by "penny stock" issuers and (iii) IPOs. The SEC Director's Statement notes that the PSLRA references the SEC's rules defining blank check companies and the Exchange Act's definition of penny stock, but does not refer to any definition of "initial public offering," and therefore posits a theory that all de-SPAC transactions may be excluded from the PSLRA safe harbor under the IPO exception.[15]

Accordingly, participants in SPAC and de-SPAC transactions should carefully consider the limitations of any perceived liability differences afforded to this structure. Following Director Coates' comments, the plaintiffs' bar will almost certainly take the position that de-SPAC transactions are not subject to the PSLRA safe-harbor. Moreover, even if de-SPAC transactions fall within the protections of the PSLRA safe-harbor, Director Coates reminds targets, and by extension the plaintiffs' bar, that the PSLRA does not protect against false or misleading statements made with actual knowledge that the statement was false or misleading.[16] Finally, Director Coates points out that there are additional causes of action that can be

[11] Complaint, *Securities and Exchange Commission v. Akazoo S.A.*, Docket No. 1:20-cv-08101 (S.D.N.Y. filed Sep. 30, 2020); In September 2020, shareholders also filed suit against Akazoo S.A., Modern Media Acquisition Corp. ("MMAC"), a SPAC, and its directors and officers alleging material misstatements about Akazoo's user base and competitive advantages in Akazoo's registration and proxy statements. *See* Amended Complaint, *In re Akazoo S.A. Securities Litigation*, Docket No. 1:20-cv-01900 (E.D.N.Y. filed Sept. 08, 2020).

[12] Note, that the SEC Director's Statement emphasizes that the safe-harbor applies only to private litigation and does not thwart SEC prosecution.

[13] Note that the First, Second, Third, Fifth, Seventh and Ninth Circuits have all held that PSLRA's safe harbor does not apply to non-forward-looking statements, even when contained within mixed statements made by defendants that contain both forward looking and non-forward-looking statements. *See In re Stone & Webster, Inc., Securities Litigation*, 414 F.3d 187, 211-13 (1st Circ. 2005); *In re Vivendi, S.A., Securities Litigation*, 838 F.3d 223, 246 (2d Cir. 2016); *Institutional Investors Group v. Avaya, Inc.*, 564 F.3d 242, 255 (3d. 2009); *Spitzberg v. Houston American Energy Corp.*, 758 F.3d 676, 691-92 (5th Cir. 2014); *Makor Issues & Rights, Ltd. v. Tellabs Inc.* (*Tellabs II*), 513 F.3d 702, 705 (7th Cir. 2008); *City of Miami Fire Fighters' & Police Officers' Ret. Tr. v. Quality Sys., Inc. (In re Quality Sys., Inc.)*, 865 F.3d 1130, 1142 (9th Cir. 2017).

[14] 15 U.S.C. § 78u-5(c)(1)(A)(i)-(ii).

[15] The Director suggests that given the PSLRA's legislative history, and that the result of a de-SPAC transaction is the public offering of a private company, de-SPAC transactions may be excluded from the safe harbor by the PSLRA's IPO exclusion.

[16] *See* 15 U.S.C. § 78u-5(c)(1)(B)(i)-(ii) (the safe harbor does not apply where a plaintiff proves that the forward looking statement "was made with actual knowledge [by the maker or approver] that the statement was false or misleading"). The SEC Director's Statement provides an example where, assuming arguendo that the PSLRA safe harbor applies, a target that possesses multiple sets of projections and only presents the most favorable one and omitting the less favorable ones would still be subject to civil liability for a knowing misstatement. Additionally, the Supreme Court has held that while Section 11 liability does not apply in the case of "a sincere statement of pure opinion … regardless of whether an investor can ultimately prove the belief wrong," liability will attach where the speaker does not actually hold the stated opinion, if

brought under state law and could subject issuers, targets and their investors and directors to civil liability in connection with de-SPAC transactions.

Consistent with Director Coates' warning, we are already seeing civil suits alleging both perceived misstatements by parties under the federal securities laws and breaches of fiduciary duties by sponsors and directors in connection with de-SPAC transactions. As an example, in *Zuod v. Lordstown Motors*,[17] plaintiffs alleged that a SPAC target company, Lordstown Motors, misled SPAC investors into approving a combination by, among other things, including fictitious pre-orders, making false claims concerning time-to-market and failing to disclose the CEO's termination for misconduct and mismanagement from the separate company developing Lordstown's electric truck.[18] While the plaintiff's civil allegations against Lordstown have yet to be adjudicated, Lordstown disclosed during a March 17, 2021 conference call that the company had also received a request for information from the SEC.[19]

In addition to claims of misrepresentation, plaintiffs are also using state corporate governance law to bring actions against officers, directors and sponsors for breaching their fiduciary duties in connection with de-SPAC transactions. Specifically, on March 25, 2021, in *Kwame Amo v. MultiPlan Corp.*,[20] plaintiff brought a putative class action under Delaware state law alleging that MultiPlan's directors and sponsors breached their fiduciary duties by failing to adequately mitigate certain inherent conflicts of interest.[21] The MultiPlan plaintiff alleged that the "entire fairness" standard, which is onerous and would require the defendants to demonstrate that the transaction was both procedurally and substantively fair, should apply to the de-SPAC acquisition, as the directors and sponsors approved the consolidated transaction through "a deeply flawed and unfair process."[22]

Given the flurry of new SPACs and the recent comments from Director Coates, we expect to see many more civil suits filed against sponsors and directors. Indeed, on April 9, 2021, a second and substantially-similar class-action complaint was filed against MultiPlan in the Delaware Court of Chancery on behalf of a second class of plaintiffs.[23]

Conclusion

Traditionally, emerging market trends have resulted in enhanced regulatory scrutiny and a flurry of civil litigation. While the recent unprecedented interest by investors in SPACs provides enormous potential to capital market participants, the structure can present complicated conflicts and other novel issues and has become an attractive target for securities regulators and the plaintiffs' bar. Recent developments reflecting aggressive enforcement by the SEC and securities industry SROs, likely suggests

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the opinion contains "embedded statements of untrue facts," or if an excluded fact "shows that the [Defendant] lacked the basis" for the stated opinion that a reasonable investor would expect. *See Omnicare, Inc. v. Laborers Dist. Council Const. Indus. Pension Fund,* 135 S. Ct. 1318, 1326, 1333 (2015); s*ee also Tongue v. Sanofi*, 816 F.3d 199, 214 (2d Cir. 2016) (holding that so long as an issuer has conducted a "meaningful inquiry" into and sincerely believed the stated opinion in question, the statement is not actionable under Section 11).

[17] Complaint, *Zuod v. Lordstown Motors Corp. et al*, Docket No. 4:21-cv-00720 (N.D. Ohio filed Apr. 02, 2021).

[18] *Id.* at 2-3.

[19] *Id.* at 3.

[20] Complaint, *Kwame Amo v. MultiPlan Corp.*, C.A. No. 2021-0258 (Del. Ch. filed Mar. 25, 2021).

[21] *Id.* at 1-2.

[22] *Id.* ¶ 3.

[23] Complaint, *Anthony Franchi v. MultiPlan Corp.*, C.A. No. 2021-0300 (Del. Ch. filed Apr. 09, 2021).

that if 2020 was the "Year of the SPAC," then 2021 may well be a year of unprecedented regulatory scrutiny and private securities litigation against SPAC sponsors, targets, advisors and their affiliates for deals that are improperly structured or where the participants fail to adequately address the legal and compliance issues inherent in the structure.

This is part of a series of SRZ Alerts regarding SPAC litigation. In addition to our robust SPAC transactions practice, which advises clients on SPAC IPOs and business combination transactions, SPAC sponsor investments, SPAC PIPEs and trading in SPACs generally, SRZ has a SPAC litigation task force advising, monitoring and advocating on SPAC litigation and regulatory developments. If you have any questions, please contact your attorney at Schulte Roth & Zabel or one of the authors.

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