ALERTS

SPAC Litigation Alert: SPAC Sponsor and CEO Agree to Pay Civil Penalties and Forfeit Sponsor Shares Following SEC's Charge of Disclosure and Due Diligence Failures

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Throughout much of the COVID-19 pandemic, Special Purpose Acquisition Companies ("SPACs") became an extraordinarily popular alternative to more traditional initial public offerings ("IPOs"). That rapid increase in popularity, with SPACs raising more in 2020 than the preceding decade, and more in the first quarter of 2021 than all of 2020, attracted significant attention from investors, sponsors, and, ultimately, regulators and the plaintiffs' bar. Aggressive actions and statements by the SEC in early 2021, however, appear to have at least temporarily slowed new SPAC offerings.[1] While we expect the SPAC structure to remain attractive to prospective investors and sponsors and to continue to influence how private companies enter the public markets, the SEC's latest warning shot described in this *Alert* illustrates the importance of ensuring that SPAC participants — particularly, SPAC sponsors — devote appropriate attention to legal and compliance matters, with a specific focus on ensuring robust diligence of prospective targets.

On July 13, 2021, the SEC signaled a further escalation of its scrutiny of the SPAC ecosystem by charging Stable Road Acquisition Company ("Stable Road"), a SPAC sponsor, its CEO, the acquisition target and the target's own CEO for making false and materially misleading disclosures[2] in connection with a "de-SPAC transaction."[3] While the SEC has been ramping up its investigations into SPAC participants since

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early 2021, this is only the second complaint it has filed in connection with a SPAC and the first to target liability under Exchange Act Section 14(a) for failing to conduct adequate due diligence of material misstatements incorporated into proxy material.[4] Along the way, however, SEC staff signaled that as part of their holistic scrutiny of each component of the SPAC lifecycle, that they would be carefully evaluating statements contained within proxy solicitations to SPAC investors.[5] Specifically, SEC staff's public statements have made clear that in addition 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, any material misstatement or omission in connection with a proxy solicitation would also be subject to liability under Section 14(a) of the Exchange Act and Rule 14a-9 thereunder.[6]

While aggressive enforcement action by the SEC has been widely anticipated, the breadth and timing of the charges against participants in the Stable Road de-SPAC transaction is notable. The charges against the merger target, nascent space transportation company Momentus, Inc. ("Momentus") and its CEO, Mikhail Kokorich, arise from a series of allegedly false or misleading statements that were communicated to both Stable Road and the associated private investment in public equity ("PIPE") investors. Specifically, Momentus and its CEO allegedly misrepresented to Stable Road and to investors the results of tests performed on its equipment and technology, the national security issues faced by Kokorich, and its prospects of launching future space flights.[7] In addition, the SEC also charged Stable Road and Stable Road's CEO, Brian Kabot, for failing to adequately investigate Momentus' claims, which were incorporated into registration statements and proxy solicitations filed by Stable Road.[8] Without admitting or denying the SEC's allegations, Momentus, Stable Road and Kabot have consented to more than $8 million in civil penalties.[9] Stable Road's sponsor agreed to forfeit its rights to 250,000 founders shares, and Momentus and Stable Road granted a termination right to the investors in the PIPE offering.[10] Kokorich is contesting the SEC's charges against him.

Flawed Due Diligence

As the SEC staff highlighted back in April 2021, liability under Exchange Act Section 14(a) and Rule 14a-9 is subject to a negligence standard.[11] The SEC charged Stable Road and its CEO with, *inter alia*, violating

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Section 14(a) and Rule 14a-9, for negligently soliciting investors with a proxy statement containing false and materially misleading statements.[12] Though the SEC did not allege that Stable Road and its CEO knew that the statements made by Momentus were false or misleading, it determined that Stable Road and its CEO performed inadequate due diligence of Momentus' statements. While the Settlement Order does not specify the level of due diligence required to adequately investigate representations made in connection with registration statements or proxy solicitations, it appears to have premised its Section 14(a) and Rule 14a-9 negligence theory on Stable Road's failure to adequately investigate Momentus' claims. As SEC Chair Gary Gensler stated in connection with the Settlement Order's press release, "the fact that Momentus lied to Stable Road does not absolve Stable Road of its failure to undertake adequate due diligence."[13]

Notably, in assessing Stable Road's due diligence effort, the SEC raised concerns that time pressure and financial incentives may compromise the ability for SPACs, their sponsors and other SPAC participants to conduct reasonable due diligence efforts. In connection with the due diligence performed by Stable Road, the SEC noted that Stable Road's due diligence process was highly compressed due to the liquidation window detailed in its charter, a feature that is common to most SPAC structures. Specifically, Stable Road's charter set an 18-month deadline to complete a merger or dissolve and return assets to shareholders. Due to delays in identifying a target, negotiating a deal and selecting a space technology consulting firm to assist it in conducting due diligence of Momentus' technological claims, approximately 10 months remained before the deadline to consummate a deal.[14] The Settlement Order appears to suggest that this timing pressure resulted in Stable Road limiting its technology consultant to a "rapid technical assessment," initially targeted to take two weeks, that did not include in its scope a number of material issues.

Impact on SPAC Acquisitions

The Stable Road case highlights the need for SPACs and their sponsors to undertake and document a thorough and complete due diligence process in connection with evaluating any prospective target business. Given the outcome in Stable Road, along with recent SEC staff statements focusing on the "de-SPACing" process in general, we expect a renewed focus on both the due diligence process within the SPAC space

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generally, and on disclosure related issues arising from statements pertaining to the performance and prospects of a target business. Notably, the SEC seeking specific protection for SPAC PIPE participants signals that the regulatory focus will not fall exclusively on the retail investor side. As SPAC PIPE arrangements are often crystallized prior to entry into a definitive merger or acquisition agreement — and well in advance of any proxy solicitation — disclosures provided in connection with such PIPE solicitations will likely get enhanced scrutiny from both SPACs and placement agents alike in view of the outcome in Stable Road. In addition to regulatory scrutiny, we expect the plaintiffs' bar to look to Stable Road as a roadmap for future claims, both under federal securities laws and state fiduciary duty requirements. Close coordination between SPACs, their sponsors and deal counsel during both the due diligence and disclosure drafting process will remain imperative in view of the increasing scrutiny on SPAC business combinations generally.

Conclusion

The SEC's flurry of statements and activity regarding SPACs likely portend an environment of further regulatory scrutiny of SPACs, their sponsors, targets, advisors, officers and affiliates. Increased regulatory scrutiny may also lead to follow-on civil litigation. SPACs and their sponsors must ensure that they take all appropriate and necessary steps to properly evaluate their combination targets. In addition, SPACs and their sponsors should perform robust and thorough due diligence, both on prospective targets generally, and to support representations made in connection with any de-SPAC transaction.

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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[1] *See* "SPAC Litigation Alert: SEC Cautions SPAC Participants that Claims of Reduced Liability Exposure Are Overstated," *SRZ Alert* (April 13, 2021), available here.

[2] "*SEC Charges SPAC, Sponsor, Merger Target, and CEOs for Misleading Disclosures Ahead of Proposed Business Combination*," SEC Press Release No. 2021-124 (July 13, 2021), available here ("SEC Press Release").

[3] 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.

[4] In addition to Stable Road, the existence of five active SEC investigations of SPAC participants have been disclosed since the start of 2021: Clover Health, Lordstown Motors Corp., Canoo, MoneyLion and Akazoo SA. Prior to the SEC charging Stable Road, the SEC has so far only reached the complaint stage in Akazoo S.A. Specifically, in September 2020, the SEC filed a complaint against Akazoo S.A. ("SONG"), a post-merger company resulting from a de-SPAC transaction between Modern Media Acquisition Corp. and Akazoo Ltd., a private music streaming platform and technology company. The SEC's charges against SONG 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. Complaint, *Securities and Exchange Commission v. Akazoo S.A.*, Docket No. 1:20-cv-08101 (S.D.N.Y. filed Sept. 30, 2020); Note that shareholders are separately maintaining a class action lawsuit 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. 8, 2020). Notably, in that case, the SEC did not actually allege misconduct by the SPAC itself. *Id.*

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

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[6] *See id.* The proxy solicitation process is regulated by Section 14(a) of the Exchange Act and Rule 14a-9, promulgated thereunder, which "prohibit the solicitation of proxies by means of materially false or misleading statements." *Virginia Bankshares, Inc. v. Sandberg*, 501 U.S. 1083, 1087, 115 L. Ed. 2d 929, 111 S. Ct. 2749 (1991).

[7] *See* SEC Press Release.

[8] *See id.*

[9] *See id.* Note that all parties, including the sponsor, were also charged with violations of the anti-fraud provisions under Section 17(a) of the Securities Act.

[10] *See* SEC Press Release.

[11] In that statement, Director Coates reminded SPAC participants that liability under section 14(a) and Rule 14a-9 are generally subject to a "negligence" standard. "*SPACS, IPOs, and Liability Risk under the Securities Laws,"* Securities and Exchange Commission Public Statement, Acting Director of Division of Corporation Finance, (April 8, 2021), available here. *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 . . .").

[12] *In re Momentus, Inc. et al*, Sec. Act Rel. No. 10955, Exch. Act Rel. No. 92391 (Jul. 13, 2021) at 12.

[13] *See* SEC Press Release.

[14] *See In re Momentus* at 3.

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