Professional Perspective

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Litigation & Enforcement Fallout of the SPAC Boom

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Special purpose acquisition companies (SPACs) were the darling of the financial world at the beginning of the Covid-19 pandemic. These "blank check" companies are publicly traded and are formed by "founders" or "sponsors" to pursue a transaction, sometimes with a focus on a particular industry or sector.

The structure of SPACs has garnered attention because of their limited lifespans. After formation, a SPAC issues a certain amount of equity to the "founders" or "sponsors" through private placements. The shares issued to these individuals often represent approximately 20% of the equity interest of the SPAC post-offering. After securing those initial funds, SPACs register their securities for sale on a stock exchange.

However, unlike traditional IPOs, the proceeds of the IPO are placed in trust accounts that cannot be touched unless the SPAC completes a transaction. If the SPAC does not consummate a deal within a certain amount of time—usually 18-24 months—the funds will be returned to investors unless the shareholders vote to extend the SPAC's lifespan.

Recent months have seen mounting opposition to SPACs, with lawsuits addressing both the fiduciary duties involved and the role of scienter. Class-action litigation has sprung up across the country, with the plaintiffs' bar focusing on disclosure obligations. At the same time, the Securities and Exchange Commission (SEC) rolled out proposed rules to further regulate SPACs. This article focuses on current trends in this emerging area of law that is expected to continue to develop quickly.

Rise in Private Securities Class Actions

SPACs saw an increase in lawsuits in 2022. Recent decisions allowed securities claims to survive motions to dismiss, which is unwelcome news for SPAC officers, directors, sponsors, and targets. But at least one decision in California suggests that plaintiffs still have a significant burden to plead falsity and scienter.

Higher Standards for Evaluating Fairness

Delaware courts have applied a heightened standard to evaluate the acts of SPAC officers, directors, and sponsors because of the inherent conflicts that commonly exist between a SPAC's fiduciaries and public stockholders in the context of a value-decreasing transaction. In *In re MultiPlan Corp. S'holders Litig.*, 268 A.3d 784 (Del. Ch. 2022), the court evaluated a transaction that looked like an ordinary SPAC process: The SPAC listed shares on NASDAQ, identified a target, and closed the transaction within 18- to 24-months of the closing of the initial public offering.

But investors believed that the SPAC breached the fiduciary duty of loyalty because it failed to get an independent evaluation of the target, hired a financial advisor affiliated with the SPAC's sponsor, and failed to disclose that the target's biggest customer was starting a competing venture. The customer's competing venture surfaced after the merger, causing shares to plummet and triggering a class-action lawsuit.

The *MultiPlan* court denied a motion to dismiss because the plaintiff adequately alleged the transaction did not meet the exacting "entire fairness" standard. Ordinarily, transactions are evaluated under the business judgment rule, which defeats stockholder lawsuits if the decision is made in good faith, with reasonable care, and in the best interests of the corporation. But when there is a conflict of interest, courts apply the "entire fairness" standard, which gives no deference and requires defendants to prove that both the price and the process were "entirely fair" to the company's stockholders. The *MultiPlan* court reasoned that the heightened standard applied because of "inherent conflicts between the SPAC's fiduciaries and the public stockholders in the context of a value-decreasing transaction." It therefore denied the motion to dismiss.

While it is not clear how far courts will stretch *MultiPlan*, the "entire fairness" standard makes it more likely that a lawsuit will survive the critical motion to dismiss. SPAC participants should do everything possible to avoid its application. This should include hiring an independent financial advisor to conduct financial due diligence on a target in addition to legal due diligence, hiring a qualified independent accounting firm or a qualified independent investment banking firm to do an independent valuation or render a fairness opinion, and avoiding even the appearance of a conflict of interest when

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negotiating or evaluating a business combination. If the SEC ultimately adopts its proposed rules, these recommendations would become requirements.

Forward-Looking Statements Not Always Protected

SPACs also have failed to find success with the "forward-looking statements" defense. With certain exceptions, the Private Securities Litigation Reform Act of 1995 (PSLRA) provides that no securities lawsuit can turn on forward-looking statements such as financial data projections, plans, objectives of management, or future economic performance information. 15 U.S.C. § 77z-2(i)(1).

This defense has sometimes fallen flat in SPAC litigation. For example, in *In re Romeo Power Inc. Sec. Litig.*, No. 21 Civ. 3362 (LGS), 2022 BL 190788 (S.D.N.Y. June 02, 2022), the target company was involved in the development of batteries and battery packs for electric vehicles. Both before and after the transaction, the defendants allegedly misstated the number and extent of the target's battery-cell suppliers.

Specifically, in proxy statements, Romeo touted its "close relationships with vendors of key components of [Romeo's] battery products, in particular battery cells." It also listed several suppliers, only two of which were actual suppliers. The defendants argued that later statements corrected those misstatements by only listing the actual suppliers, but the court decided that was not enough to cure the former misstatements because the complaint sufficiently alleged Romeo's executive directors knew their repeated misstatements were not accurate.

The court also found the statements were not forward-looking because they were made in the present tense, included no projections, and were not statements of assumptions underlying a projection. The court found that this evidence, if true, was strong circumstantial evidence of scienter to support a securities fraud claim. But the court dismissed claims based on the proxy rules—Section 14(a)—because those were derivate claims and the plaintiff failed to plead demand or demand futility.

In *In re Stable Rd. Acquisition Corp. Sec. Litig.*, No. CV 21-5744-JFW (SHKx), 2022 BL 248999 (C.D. Cal. July 13, 2022), the court refused to dismiss a class action against a SPAC, its executives, the sponsor, and the target. The target, a space industry startup, allegedly misrepresented the immigration status of its Russian CEO and his potential removal from the US as a national security risk, the success of the targets' single in-space test of its technology, and made misleading revenue projections resulting from the undisclosed concerns about the CEO and the problems with the targets' technology. In July 2021, the SEC issued a cease-and-desist order against all the defendants and filed a civil complaint based on those misrepresentations, which settled with the SPAC paying a fine of $1 million, the CEO paying a fine of $40,000, and the target paying a fine of $7 million.

The lawsuit followed, and the defendants moved to dismiss. Among other things, they argued that many of the alleged misstatements were forward-looking statements that were protected under the safe harbor for the PSLRA. The court disagreed, reasoning that the defendants "knew that many of those risks had already materialized or very likely would materialize." The court, however, dismissed claims against certain SPAC executives because there was no alleged scienter or control-person liability.

Plaintiffs Still Must Plead Falsity & Scienter

It is not all doom-and-gloom for SPAC litigants. In *Jedrzejczyk v. Skillz Inc.*, No. 21-cv-03450-RS, 2022 BL 231688 (N.D. Cal. July 5, 2022), the plaintiffs sued a mobile-gaming company over misstatements about the company's financial condition, technical capabilities, and business prospects. The court dismissed most securities-fraud claims because the plaintiffs failed to allege falsity or the intent to deceive.

The court explained, "[a]t worst, the statements appear[ed] to be poorly worded explanations of what games the company offered, rather than a statement made with" an intent to deceive, manipulate, or defraud investors. Because the Northern District of California is influential with respect to securities litigation, it is likely other courts will adopt its reasoning and require investors to satisfy a significant pleading burden to prove falsity and scienter in order to succeed in a securities class action lawsuit.

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Increased Scrutiny of SPACs

No discussion of SPACs would be complete without a mention of the SEC's new proposed rules. In March 2022, the SEC proposed rules for SPACs that would, among other things, impose stricter disclosure requirements, enhance liability for underwriters, make the protection of the PLSRA safe-harbor unavailable for projections used in the de-SPAC transaction, and clarify the circumstances under which a SPAC would have to register as an "investment company" under the Investment Company Act of 1940.

The comment period closed in June 2022, and the industry submitted voluminous and strident critiques of the proposed rules. The SEC has therefore postponed implementation of the rules and is reviewing the comments.

Conclusion

SPACs remain a critical tool for private companies that want to go public through a business combination. But as private securities lawsuits proliferate, those engaged in the de-SPAC transaction should remain vigilant about the litigation risks and take preventive measures.

Among other things, it is important to engage in heightened due diligence before announcement of a de-SPAC transaction, give increased attention to disclosures, and perform a thorough vetting of the target's management team—such efforts should mitigate the risk of private or regulatory enforcement actions. As the SPAC market continues to experience volatility, companies may continue to see increased litigation and regulatory action. As with any arena, an ounce of prevention is worth a pound of cure.

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