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PERSPECTIVES

# THE SPAC EXPLOSION POSES LITIGATION RISK

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Special purpose acquisition companies (SPACs) have rapidly gained popularity as a flexible alternative to initial public offerings (IPOs). SPACs raised over $70bn in 2020, a five-fold increase from 2019. That growth has continued into 2021, with SPACs raising $100bn in the first quarter alone. But the very features of SPACs that create additional flexibility raise new questions that could result in litigation.

## What is a SPAC?

A SPAC is a mechanism for facilitating public investment in a private company. The process typically involves two steps. First, a SPAC is registered as a shell company with no operations. The SPAC's registration statement declares that the entity's sole purpose will be to identify and then merge with a privately held company. The SPAC solicits investment capital for that purpose, and investors hope to profit from the growth of the company the SPAC will acquire. Generally, the SPAC must identify a target acquisition within a specified time, often two years, or the SPAC is liquidated, and money is returned to investors.

After a SPAC identifies an acquisition target, it enters a 'de-SPAC' transaction in which publicly traded shares of the SPAC are exchanged for private shares of the target. SPAC shareholders usually must vote to approve the de-SPAC transaction. Following the transaction, the combined entity operates as a

publicly traded company. SPACs thus enable private companies to go public without holding an IPO.

The SPAC is generally managed by a team of sponsors comprised of business managers and investors. These sponsors frequently invest in the SPAC themselves and often receive additional incentive compensation upon completion of the de-SPAC transaction. That additional compensation encourages SPAC sponsors to identify a suitable target and consummate an acquisition, but creates a risk that sponsors will receive nothing, or even lose money, in the event of liquidation.

“SPACs reduce some types of litigation risk, but their novel structure also permits investors and regulators to raise different claims not typically associated with IPOs.”

## Potential for litigation involving the SPAC

SPACs reduce some types of litigation risk, but their novel structure also permits investors and regulators to raise different claims not typically associated with IPOs.

A private company undertaking a traditional IPO must file a detailed registration statement that describes its operations and history. The level of detail required creates litigation risk under Section 11 of the Securities Act, which imposes strict liability on the company and its officers, among others, for any material misstatement or omission in the registration statement.

A SPAC’s registration statement, by contrast, requires less detail because the company has no ongoing operations. The description of its plan for acquiring an unspecified private company should also pose less risk under Section 11 because it is an inherently uncertain prediction about the future. Congress has recognised the uncertainty of such “forward-looking statements” by creating a safe harbour in the Private Securities Litigation Reform Act (PSLRA) that shields them from liability.

But SPACs cannot eliminate the risk of litigation under Section 11 altogether. As a threshold matter, the safe-harbour for forward-looking statements does not apply to statements “made in connection with an initial public offering”. That safe harbour therefore may not apply to de-SPAC transactions. A SPAC must therefore carefully evaluate the description of its plans to ensure accuracy and completeness. For example, if a SPAC is already considering a potential target, it must disclose all relevant information.

The de-SPAC transaction also creates risk under Section 14 of the Exchange Act. To obtain shareholder approval for the de-SPAC transaction, SPAC sponsors must issue proxy statements with information about the acquisition target and the merged entity's business plan. Officers of the target company may issue proxy statements as well. Shareholders can challenge any misstatement or omission in those proxy statements under Section 14(a) and Rule 14a-9, which set a lower pleading bar than Section10(b) and Rule 10b-5.

A recent enforcement action by the SEC highlights the risks. In 2019, the Securities and Exchange Commission (SEC) sued a target company and two of its officers under Section 14(a) and Rule 14a-9 to recover money on behalf of SPAC investors. The SPAC at issue, Cambridge Capital Acquisition Corp., needed to consummate a merger by December 2015 or return money to its investors. Shortly before that deadline, Cambridge proposed to acquire Ability Computer & Software Industries, Ltd., an Israeli tech company.

To persuade Cambridge Shareholders to approve the merger, Ability issued a proxy statement in which it falsely claimed to own new "game-changing" cellular interception technology and also that it had a "backlog" of orders from a Latin American police agency. Those lies allegedly cost Cambridge shareholders $60m. The SEC also brought a separate administrative charge against Cambridge's chief executive under Rule 14a-9 based on his alleged negligence. The chief executive ultimately entered a settlement that required him to pay a $100,000 civil penalty and suspended him from operating an investment company for a year.

SPACs may also face litigation under state law. For example, if investors in a target company believe that a de-SPAC transaction undervalues their shares, they may invoke statutory appraisal rights. Shareholders successfully invoked such rights in a recent case before the Delaware Court of Chancery, thereby forcing the SPAC to either pay more or abandon the transaction. Such suits, like suits under the securities laws, threaten to upend the transactions through which SPACs try to generate value.

## Potential for litigation involving the SPAC's sponsors

SPAC transactions also create litigation risk for the officers and directors of both the SPAC and the target company. The claims described above can be brought not only against the SPAC and the target company, but also the officers and directors who serve them. For example, Section 14(a) imposes liability on "any person" who violates the proxy rules, and the SEC's actions against the officers of Cambridge and Ability show the risks a de-SPAC transaction can create for the individuals involved.

But officers and directors may face additional risks. Under Delaware law, a company's officers and directors have fiduciary duties to shareholders.

Those duties include a "duty of disclosure" that requires them to provide shareholders with accurate and complete information material to a corporate transaction, as well as a duty of loyalty that requires them to act in good faith for shareholders' best interest.

Ordinarily, the business judgment rule acts as a check on suits alleging breach of fiduciary duty, foreclosing liability whenever a decision can be attributed to a rational business purpose. The structure of SPAC transactions, however, may allow plaintiffs to avoid the business judgment rule and instead invoke the exacting entire fairness test.

Specifically, where a SPAC's officers receive incentive compensation upon the completion of a de-SPAC transaction, they have an interest in consummating a merger that is distinct from shareholders' interests. The appearance of a conflict of interest may be compounded when a de-SPAC transaction occurs shortly before the SPAC's liquidation date, as it could raise potential questions about whether officers rushed a deal to increase their own compensation.

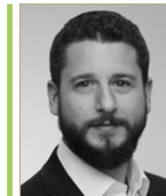
Recently filed suits advance these exact allegations. For example, the complaint in *Amo v. Multiplan*, a recent shareholder class-action in the Delaware Court of Chancery, raised breach of fiduciary duty claims against a SPAC's officers, directors and controlling shareholders. The complaint invokes the entire fairness standard based primarily on allegations that the officers and directors received "founder shares" for little consideration that allowed them, following a de-SPAC transaction, to obtain up to 20 percent of the merged entity's equity. Such shares allegedly resulted in a windfall of up to \$300m for the SPAC's sponsors, even if the deal they closed was bad for investors. The defendants have

moved to dismiss, but the complaint highlights the potential risk.

Finally, officers and directors of a SPAC or a target corporation face a risk that they may be perceived to have traded based on material non-public information. Insiders will receive a variety of non-public information throughout the different phases of a SPAC transaction, and any trading in the SPAC's shares or a related security needs to be carefully vetted for regulatory compliance. The benefits of hindsight can make information seem more important than it appeared earlier, triggering increased scrutiny.

## Conclusion

SPACs have already produced litigation and their exponential growth suggests that more litigation lies ahead. The sheer number of SPACs will likely create competition over acquisition targets and may increase pressure to close deals quickly. Parties to SPAC transactions would be well-advised to anticipate the risk of increased litigation risk and consult with counsel about how best to manage it. At each phase of a SPAC transaction, parties can take measures to mitigate risks, document their actions, and position themselves to respond effectively if risk materialises and litigation becomes necessary. CD



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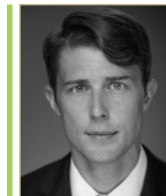

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