May 27, 2021

The Growth of SPAC-Related Litigation

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The explosive growth of SPACs ("special purpose acquisition companies") as a mechanism for taking private companies public is leading to similar growth in SPAC-related lawsuits. Both trends appear likely to continue. SPACs, a potentially more efficient and quicker process for taking companies public than traditional direct or underwritten initial public offerings, currently represent the substantial majority of IPOs. In any market, as more deals close, a proportion will fail, and litigation will follow. The specific features of SPACs, however, present particular litigation issues that should be minded and managed to reduce the risk of exposure to the SPAC, its sponsors and directors, and its targeted private company and directors. In addition to shareholders' counsel, the SEC is paying particular attention to SPACs. On May 26, 2021, SEC Chair Gary Gensler noted the surge of SPACs and the unique issues they pose in testimony before a House subcommittee, and explained that the SEC is closely monitoring SPACs, and may consider additional rules and guidance to protect investors.

A Primer on SPACs

A SPAC is a public company created for the sole purpose of acquiring a private operating company. A SPAC is a shell company without any operations, formed by its sponsors to raise funds in an initial public offering for the express purpose of acquiring an existing, but as-yet-unidentified, private operating company. The SPAC registers the offer and sale of redeemable securities through a traditional underwriting and places the proceeds in a trust for a future acquisition of a private operating company. The SPAC investors receive shares in the SPAC and also may receive warrants to purchase additional shares. The SPAC sponsors typically are eligible for fees and other consideration, as well as a promote consisting of equity in the SPAC disproportionately greater than their cash contribution or commitment would imply.

Following its IPO, a SPAC typically has up to 24 months to identify and combine with a private operating company. In the event the SPAC fails to complete a combination within 24 months, the sponsors forfeit their promote equity, and the SPAC liquidates and distributes its funds to its shareholders. Since 2009, about ten percent of SPACs have liquidated.[1]

Most SPACs identify and complete a merger with a private operating company. Once the SPAC identifies and negotiates a combination with a target private operating company, the SPAC is merged with the operating company, which results in a publicly-traded successor operating company (the "de-SPAC transaction"). A proposed merger must be approved by a majority of the SPAC shareholders,

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[1] Public Statement of J. Coates, Acting Director, Division of Corporate Finance, "SPACs, IPOs and Liability Risk under the Securities Laws," April 8, 2021, available at https://www.sec.gov/news/public-statement/spacs-ipos-liability-risk-under-securities-laws#_ftn3; SPAC Status by Year of IPO, available at SPACInsider, https://spacinsider.com/stats/.

which requires the SPAC to file and deliver proxy materials to the SPAC shareholders, subject to the SEC's proxy rules. If the proposed merger is approved by a majority of SPAC shareholders, any objecting shareholders have the right to redeem their SPAC shares prior to the merger.

In parallel to the de-SPAC transaction, a SPAC and the target private operating company may arrange for additional financing, *e.g.,* issuing new shares in a private investment in public equity ("PIPE"), to account for SPAC shareholder redemptions and raise additional equity. The issuance of additional shares may require the SPAC to file an SEC business combination share registration statement.

The Growth of SPACs

SPACs have become a significant portion of the IPO market. In 2021, SPACs outpaced traditional IPOs by nearly three to one, though larger offerings still tend to be through traditional IPOs.[2] In 2015, there were just 20 SPAC IPOs, raising aggregate gross proceeds of $3.9 billion.[3] In 2020, the number of SPAC IPOs increased to 248, raising aggregate gross proceeds of $83 billion.[4] For the first four months of 2021 alone, there were 318 SPAC IPOs, which raised aggregate gross proceeds of $102 billion.[5] In comparison, there have been about 118 traditional IPOs so far in 2018.[6]

The success of a SPAC depends in large part on the ability of the SPAC sponsors to successfully identify and negotiate a combination with a promising target private operating company. But SPAC sponsorship is not the exclusive province of sophisticated investment bankers and experienced venture capitalists. An increasing number of SPACs are being led or advised by sports and entertainment celebrities. Over the past couple of years, for example, Colin Kaepernick, former NFL quarterback turned activist, Alex Rodriguez, former Major League Baseball All-Star, and Ciara Wilson, a Grammy-award winning singer, each have sponsored SPACs that have gone public.[7] Indeed, the proliferation of celebrity-branded SPACs caused the SEC to issue an investor alert on March 10, 2021, warning investors that "[i]t is never a good idea to invest in a SPAC just because someone famous sponsors or invests in it or says it is a good investment."[8]

The Corresponding Rise in SPAC-Related Litigation

The growth in SPAC-sponsored IPOs has been matched by a rise in SPAC-related litigation, and the trend is likely to continue. Although these actions generally are in the early stages, they suggest that shareholders and the securities class bar are actively monitoring SPACs. As more de-SPAC transactions are announced, the number of shareholder lawsuits is likely to grow too, raising risks to de-SPAC

[2] S. Kunthara, "The Market Minute: Will SPACs Outpace Traditional IPOs This Year?" Crunchbase News, Feb. 17, 2021.
[3] *See* SPACInsider.com
[4] *Id.*
[5] *Id.*
[6] G. Gensler, Testimony before the House Subcommittee on Financial Services and General Government, May 26, 2021, available at https://www.sec.gov/news/testimony/gensler-2021-05-26.
[7] *See* Mission Advancement Corp. Form S-1, filed February 9, 2021 (Kaepernick); Slam Corp. Form S-1, filed February 4, 2021 (Rodriguez); Bright Lights Acquisition Corp. Form S-1, filed December 18, 2020 (Ciara).
[8] SEC Officer of Investor Education and Advocacy, Celebrity Involvement with SPACs – Investor Alert, March 10, 2021.

transaction closings and the potential exposure of SPACs, their boards and sponsors, and target operating companies.

The Stanford Securities Class Action Clearinghouse has identified 25 SPAC-related federal securities lawsuits filed since 2019. Those federal lawsuits typically allege inadequate disclosures in proxy materials or registration statements in connection with the issuance of new securities.

The number of SPAC-related lawsuits filed in the state courts of California, Delaware and New York is even greater. In New York alone, from October 2020 through April 2021, over 60 SPAC-related lawsuits were filed in state court.[9] The majority of those lawsuits generally allege that SPAC directors breached their fiduciary duties to shareholders by providing allegedly inadequate disclosures regarding proposed de-SPAC mergers. Some also assert claims against the SPAC itself, as well as the target company and its board of directors, for allegedly aiding and abetting the SPAC directors' breaches.

The SEC is also paying close attention to SPACs. On May 26, 2021, SEC Chair Gary Gensler, in testimony before a House subcommittee, explained that the surge of SPACs raises a number of policy questions: "First and foremost, are SPAC investors being appropriately protected? Are retail investors getting the appropriate and accurate information they need at each stage — the first blank-check IPO stage and the second target IPO stage?"[10] He also noted that the interests of SPAC sponsors, advisers, and PIPEs investors may not be completely aligned with the interests of other investors. "SPAC sponsors generally receive 20 percent of shares as a "promote." The first-stage investors can redeem when they find the target, leaving the non-redeeming and later investors to bear the brunt of that dilution. In addition, financial advisors are paid fees for the first-stage blank-check IPO, for the PIPEs, and for the merger with the target. Further, it's often the case that the investors in these PIPEs are buying at a discount to a post-target IPO price. It may be that the retail public is bearing much of these costs." Gensler reported that the SEC is considering additional rules and guidance, and that the Divisions of Corporate Finance, Examinations and Enforcement are closely monitoring the stages of SPACs to ensure the protection of investors.

The Division of Enforcement in fact appears already to have initiated an inquiry into SPACs and their relationships with Wall Street. On March 24, 2021, Reuters reported that the Division of Enforcement had sent letters asking Wall Street banks to voluntarily provide information on their SPAC dealings, including information on SPAC deal fees and volumes and asking questions about compliance, reporting and internal controls.[11] According to Reuters, the SEC may be concerned about the depth of due diligence that SPACs perform before acquisitions and whether SPACs are fully disclosing large payouts to sponsors and affiliates. Shortly afterward, John Coates, the Acting Director of the Division of Corporate Finance, after noting the unprecedented surge of SPACs and consequent alarms raised by shareholder advocates, warned that the SEC staff "are continuing to look carefully at filings and disclosures by SPACs and their

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[9] A. Frankel, "The new 'deal tax': SPAC defendants are paying plaintiffs lawyers to drop N.Y. state suits," Reuters, May 5, 2021, https://www.reuters.com/business/legal/new-deal-tax-spac-defendants-are-paying-plaintiffs-lawyers-drop-ny-state-suits-2021-05-05/

[10] G. Gensler, Testimony before the House Subcommittee on Financial Services and General Government, May 26, 2021, available at https://www.sec.gov/news/testimony/gensler-2021-05-26.

[11] Reuters, "U.S. regulator opens inquiry into Wall Street's blank check IPO frenzy," March 25, 2021, available at https://www.reuters.com/business/exclusive-us-regulator-opens-inquiry-into-wall-streets-blank-check-ipo-frenzy-2021-03-25/.

private targets."[12] When stock prices decline following de-SPAC transactions, litigation is sure to follow, and both SPAC directors and operating company executives should expect ongoing scrutiny from the securities class action bar.

The Litigation Issues Raised by SPACs

IPOs, mergers and acquisitions often lead to shareholder litigation, even if not always meritorious. A de-SPAC transaction poses many of the litigation risks present in traditional public offerings and mergers, so it is not surprising that many de-SPAC transactions lead to litigation. But because of the unique nature of SPACs, they raise particular litigation risks that should be carefully considered and guarded against by SPAC sponsors and directors. These litigation risks, like most deal-related litigation, generally fall into two broad categories: those relating to the SPAC sponsors and directors' fiduciary duties with respect to the negotiation of a combination agreement and those relating to disclosure obligations.

The Fiduciary Duties of SPAC Sponsors and Directors to Identify, Investigate and Negotiate a Business Combination

Potential Conflicts of Interest. A SPAC raises potential conflicts of interest not present in traditional IPOs due to the incentives of SPAC sponsors and directors to secure a deal by a specific deadline, and those potential conflicts may lead to more exacting judicial scrutiny of de-SPAC transactions. The resulting application of the heightened standard of entire fairness may lead not only to more scrutiny and potential liability but also will likely fuel other shareholder litigation. Moreover, allegations of conflicts of interests, even among the outside directors of a SPAC, pose the risk that the claims will be non-exculpated under Delaware and perhaps other state law.

The sponsors, advisers and other entities associated with a SPAC typically stand to earn substantial compensation in the form of promote equity, fees, and other consideration if the SPAC completes a combination with a private operating company within its pre-determined time frame. Their personal interest in the potential benefits that they stand to receive in the event of a combination may pose a conflict of interest with the interests of SPAC shareholders. And that potential conflict of interest may become more acute as the SPAC's deadline for completing a combination draws near. As the SPAC's deadline approaches, the personal interests of a SPAC's sponsors and directors may potentially influence their willingness to recommend target candidates for combination, the extent of due diligence they deem necessary, and the negotiation of merger terms.

The SEC specifically warned about the issues arising from potential conflicts of interests associated with SPACs – and those issues have been echoed in many of the allegations in the class actions filed to date. On December 22, 2020, the SEC Division of Corporate Finance cautioned SPACs and their investors about the risks of potential conflicts of interests associated with SPACs. In particular, it advised that the "economic interests of the entity or management team that forms the SPAC ('sponsor(s)') and the directors, officers and affiliates of a SPAC often differ from the economic interests of public shareholders which may lead to conflicts of interests as they evaluate and decide whether to recommend business

[12] Public Statement of J. Coates, Acting Director, Division of Corporate Finance, "SPACs, IPOs and Liability Risk under the Securities Laws," April 8, 2021, available at https://www.sec.gov/news/public-statement/spacs-ipos-liability-risk-under-securities-laws#_ftn3.

combination transactions to shareholders."[13] It noted that "[a]s a SPAC nears the end of that time frame, its options may narrow, giving acquisition targets significant leverage in negotiating the terms of a business combination transaction."[14] In essence, the economic interests of the sponsor, which could be to close the deal quickly, may be in conflict with the economic interests of the shareholders, which may be better served by waiting to close the right deal at the right price.

Shareholders have commenced litigation asserting breach of fiduciary duty claims against SPAC sponsors and directors based on alleged conflicts between their interests and the interests of SPAC shareholders and seeking to recover investment losses following the de-SPAC transactions. For example, on March 25, 2021, shareholders in Churchill Capital Corp III ("Churchill"), a SPAC, commenced a putative class action in Delaware Chancery Court asserting breach of fiduciary claims against Churchill and its directors, officers and affiliates arising out of Churchill's merger with MultiPlan Corp.[15] The complaint alleges that the SPAC was structured to allocate "founder shares" to the sponsor, giving it the right to obtain 20% of the equity of the SPAC for nominal consideration, but only if an acquisition was completed. The complaint alleges that those shares and other features of the SPAC "gave the Company's board of directors incentives to get a deal done – any deal – without regard to whether it is truly in the best interest of the SPAC's outside investors (*i.e.*, whether the target operating company is actually a good investment)." The complaint further alleges that the defendants failed to disclose serious weaknesses in MultiPlan's business, including that its largest customer was in the process of leaving MultiPlan because it was creating a competing business unit. After the merger closed, a market research report publicly disclosed the loss of that customer's business and its impact on MultiPlan, causing the company's share price to fall 37.3% below the de-SPAC transaction price.

The potential conflicts of interest present in SPACs are a clear source of potential litigation risk, particularly if following the merger, the operating company fails to perform up to expectations – and may lead courts to apply a heightened judicial review of SPAC sponsor and director decision-making, rather than the more deferential business judgment rule. The Churchill/Multiplan complaint, for example, asserts that "the structure at issue in this case requires judicial review for entire fairness." In fact, the complaint asserts that the entire fairness standard is warranted for virtually all similar SPAC mergers: "If and when this Court makes clear that the boards of SPACs like the one at issue here are subject to the same level of fiduciary duty review applicable to any other Delaware corporation, the proponents of future SPACs will surely adapt. Future sponsors of SPACs can easily choose to mitigate avoidable conflicts by structuring entities that better protect public stockholders."

The Risks of Inadequate Due Diligence. SPACs generally target private operating companies that are younger and less developed than the companies that typically go public through traditional underwritten IPOs. The SPAC, after all, initiates the process of taking the target operating company public, as opposed to the operating company preparing for and reaching the decision on its own. At that early stage, the operating company's business may have latent issues or weaknesses that may not be readily discovered, absent careful due diligence.

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[13] SEC Division of Corporate Finance, Special Purpose Acquisition Companies, December 22, 2020, available at https://www.sec.gov/corpfin/disclosure-special-purpose-acquisition-companies.
[14] *Id.*
[15] *See* Complaint, *Amo v. Multiplan Corp. f/k/a Churchill Capital Corp. III, et al.,* Case No. 2021-0258 (Del. Ch. March 25, 2021). *See also Laidlaw v. Acamar Partners Acquisitions Corp.* No. 2021-0016 (Del. Ch. filed Jan. 7, 2021) (alleging that Acamar's board rushed into an agreement with CarLotz to meet the de-SPAC deadline and omitted material information in prospectus).

The issues relating to pre-merger due diligence have been the focus of shareholder actions filed after de-SPAC transactions that have not lived up to expectations. For example, a shareholder action was commenced following a 2019 de-SPAC transaction involving Immunovant, Inc., a clinical-stage biopharmaceutical company that develops monoclonal antibodies.[16] According to the complaint, when the SPAC announced the pending merger, it touted the commercial prospects of IMVT-1401, a novel fully human antibody, in Phase IIa clinical trials. On February 2, 2021, however, Immunovant issued a press release announcing a voluntary pause of dosing in IMVT-1401's clinical trials because of possible safety concerns, leading to a 42% decline in Immunovant's stock price. The complaint alleges, among other things, that the SPAC's sponsors and directors performed inadequate due diligence before the merger and/or ignored or failed to disclose safety issues.

The Obligations of SPAC Sponsors and Directors to Disclose All Material Facts Associated with a De-SPAC Transaction

Shareholder actions concerning proxy and other disclosures are the predominant form of SPAC-related shareholder litigation in both federal and state courts, and they resemble the lawsuits that often proliferate following public mergers. These include actions filed prior to the de-SPAC transaction, many of which are resolved through agreed-upon supplemental disclosure, and actions following the close of the transaction and very often a decline in the public trading price of the stock.

An anticipated de-SPAC transaction must be approved by a majority of the SPAC shareholders, which requires the SPAC to file and disseminate proxy materials consistent with Section 14(a) of the Exchange Act. As is often the case with publicly-announced mergers, shareholder actions have been filed – in both state and federal courts – seeking to enjoin a pending de-SPAC transaction on the ground that the proxy materials misrepresented or omitted material facts.

A substantial proportion of SPAC-related shareholder actions filed in New York State courts, for example, have asserted disclosure-based claims and seek to enjoin the de-SPAC transaction from closing. The majority appear to have been designed, or at least were suited, for disclosure-based settlements. In general, those actions have asserted that the SPAC directors and officers breached their fiduciary duties by mispresenting material facts about the de-SPAC transaction and sought a preliminary injunction to enjoin the transaction. Alison Frankel reports that at least 62 actions filed in New York State courts were filed by just four law firms and – not too dissimilar with general trends of merger objection litigation – generally were not litigated beyond the initial pleadings. Based on her review of the dockets, those actions were settled based on the defendants' agreement to provide supplemental disclosure (and not object to an award of plaintiffs' attorneys' fees).[17]

In federal courts, shareholders have asserted that the SPAC's directors' and officers' statements or the written proxy statements are misleading or fraudulent under Section 14(a) of the Exchange Act and under Sections 10(b) and 20(a) of the Securities Act. In a number of cases, the alleged misstatements involve an alleged failure to disclose the SPAC's sponsors' and directors' conflicts of interest or alleged inadequate due diligence of the target private operating company. A shareholder-plaintiff can establish a claim under Sections 14(a) and Rule 14a-9 merely on the basis of negligence – the plaintiff must show only that the defendant "prepared a proxy statement containing a material misstatement or omission that caused

[16] See Complaint, *Pitman v. Immunivant, Inc.* et al., 1:21-cv-00918-KAM (E.D.N.Y. Feb.19, 2021).
[17] *See* fn 9.

the plaintiff's injury."[18] In contrast, a claim under Section 10(b) and Rule 10b-5 requires, among other things, a showing of scienter.[19]

Moreover, the Private Securities Litigation Reform Act ("PSLRA") safe harbor for forward-looking statements may not be available for de-SPAC transactions. The PSLRA, subject to certain exceptions, precludes private actions based on a false statement or material omission with respect to "forward-looking statements," *e.g.*, statements containing certain financial projections, describing the issuer's future plans and objectives, or predicting the issuer's future economic performance. One of the exceptions to the PSLRA safe-harbor is for statements made in connection with an IPO. A number of commentators suggest that because a de-SPAC transaction is distinguishable from an IPO, de-SPAC transactions are not excepted from the PSLRA safe harbor.

On April 8, the Acting Director of the SEC's Division of Corporate Finance, John Coates, issued a public statement suggesting that SPACs may not qualify for the safe harbor – hence allowing more opportunities for shareholder disclosure actions.[20] Acting Director Coates reasoned that, in its economic substance, a de-SPAC "may" be a type of "initial public offering" for purposes of the PSLRA safe harbor, because "it is also commonly understood that it is the de-SPAC—and not the initial offering by the SPAC—that is the transaction in which a private operating company itself 'goes public,' i.e., engages in its initial public offering."

Moreover, when the SPAC business combination calls for the issuance of new shares by the combined company, shareholders may also assert claims against the newly-public company, its officers and directors for misstatements in the business combination registration statement under Sections 11 and 15 of the Securities Act. Unlike Section 14, Section 11 imposes strict liability for material misstatements in a registration statement. For example, in *Welch v. Meaux,* No. 19-cv-1260, Dkt. No. 1 (W.D. La. Sept. 26, 2019), following a de-SPAC transaction, shareholders alleged that the company and the SPAC had conspired to inflate financials for the local meal delivery app Waitr in order to obscure the fact that it had no meaningful path to profitability. The complaint asserted fraud in the proxy statement that accompanied the merger under Sections 14(a), 10(b), and 20(a). In addition, the shareholders asserted fraud in a subsequent registration statement under Sections 11, 12(a)(2), and 15, asserting strict liability against the post-SPAC company and claims against the company, the investment bank that underwrote the stock offering, and the company and SPAC officers and directors who were responsible for issuance.[21]

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[18] *See, e.g., Sec. & Exch. Comm'n v. Hurgin,* No. 19-CV-5705 (MKV), 2020 WL 5350536 (S.D.N.Y. Sept. 4, 2020) (proxy statement contained misleading financial projections and statements about asset ownership, attached one diligence report commissioned by the SPAC sponsor that contained false statements about the documentary support for the financial projections, and omitted a second report that correctly reported there was no documentary support and noted significant risk).

[19] Some actions have challenged de-SPAC transactions completed near the SPAC's liquidation deadline, which plaintiffs have asserted is indicative of the scienter required to support a claim under Section 10(b) of the Exchange Act and SEC Rule 10b-5.17 *See, e.g.,* Complaint, *Welch v. Meaux*, et al., 19 Civ. 1260 (W.D. La. Sept. 26, 2019) ("For [certain SPAC directors] the failure to find an acquisition target within the two years since they raised money using their blank-check company was especially problematic. . . . It was with 2 weeks left before [the SPAC's] deadline that it announced the last-minute agreement to enter a combination with [the target].").

[20] *See* fn. 12.

[21] *See also In re Akazoo S.A. Securities Litigation*, No. 20-cv-1900, Dkt. No. 15 (E.D.N.Y. 2020) (complaint alleged registration statement issued at the time of the business combination contained much of the same information as the proxy materials, including the same false information, and asserted Section 11 strict liability claims).

How Can SPACs Mitigate Litigation Risk?

Because of the unique characteristics of SPACs, SPAC sponsors, directors, and their advisors should take affirmative steps to mitigate litigation risk, including:

- Adopt Appropriate Exculpatory Charter and By-Law Provisions. SPAC sponsors should consider adopting exculpatory clauses in their charters consistent with relevant state law.
- Bear in Mind Potential Conflicts of Interest in any De-SPAC Transaction. SPAC sponsors and directors may face potential conflicts of interest in connection with de-SPAC transactions, particularly when close to the SPAC's deadline, and should take steps to minimize the risk of allegations that those conflicts improperly influenced actions of the SPAC decision-makers.
- Conduct and Document a Reasonable Search for Targets. SPAC sponsors and directors should conduct the type of broad and considered search for potential targets as is typical in a traditional merger and acquisition context so that they can justify their decision to enter into a combination agreement.
- Conduct and Document Comprehensive Due Diligence of Targets. Many shareholder actions challenge the adequacy of the SPAC's due diligence of targets. SPAC sponsors and directors should ensure that their due diligence is not only robust and thorough but also carefully document the scope of due diligence undertaken, information received, and relevant findings.
- Engage in Rigorous and Well-Documented Negotiations. In order to blunt potential claims that the SPAC's sponsors and directors were influenced by a conflict of interest, they should engage in and document robust negotiation with targets, consistent with the traditional merger and acquisition context.
- Ensure Disclosures are Thorough and Include Cautionary Language. SPAC sponsors and directors should ensure that de-SPAC transaction proxy materials and other disclosures are comprehensive and thorough – and in particular, disclose the scope of potential conflicts of interests – and include appropriate cautionary language regarding the future prospects of the company.
- Monitor SEC Statements on SPACs. The SEC has issued guidance and alerts on SPACs and has specifically noted issues of concern to the SEC, including the matters that should be addressed in SPAC IPO and de-SPAC transaction disclosures – and the SEC likely will continue to issue guidance. SPACs should keep abreast of SEC guidance and ensure their actions and disclosures are consistent with that guidance.

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