Professional Perspective

SPAC Procedural Issues & Risks

Proskauer Partners Mike Hackett, Timothy W. Mungovan, Todd Ohlms and Jonathan M. Weiss, and associate David Heck

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SPAC Procedural Issues & Risks

Contributed by Proskauer Partners Mike Hackett, Timothy W. Mungovan, Todd Ohlms and Jonathan M. Weiss, and associate David Heck

Viewed as involving fewer regulatory hurdles than an IPO, SPACs became the most popular way to take a company public in 2020, and deal volume continued to rise in 2021. This increase in popularity brings increased attention from lawmakers and an attendant increase in litigation risk–for sponsors, officers, and directors of the SPAC, sellers in the de-SPAC transaction, and officers and directors of the post-combination entity.

Some of these risks are the same for any company making public disclosures. But others are particular to SPACs, with their unique structure and sometimes-divergent incentives they present for different stakeholders. Treatment of projections and warrants, inducements for deal-making, and deadlines to complete those deals all distinguish SPACs from other public and soon-to-be public companies.

This article discusses the issues and risks that are common to the SPAC process, as well as the specific inflection points where those risks might arise.

Common Issues & Risks

SPACs give rise to a unique set of issues that are important to watch, including issues regarding financial projections, pressure to consummate a transaction, conflicts of interest, material non-public information, and the accounting treatment of warrants. Because of the way SPACs are structured, these issues can expose parties to a SPAC transaction to increased risk and merit close attention.

Financial Projections

SPACs are distinct from traditional IPOs regarding the disclosure of financial projections during the de-SPAC transaction. The consensus view has been that such disclosures, unlike similar disclosures made during an IPO, are subject to a safe harbor provided by the Private Securities Litigation Reform Act (PSLRA). That view has increasingly been coming under question.

The PSLRA provides a safe harbor for forward-looking statements made by an issuer, protecting them in litigations brought under the Securities Act of 1933 or the Securities Exchange Act of 1934. But the safe harbor has limits. A statement must be identified as "forward-looking" and must be "accompanied by meaningful cautionary statements identifying important factors that could cause actual results to differ materially …" Of course, this safe harbor does not apply to a statement that the issuer knows to be false or misleading. And the safe harbor applies only to private litigation, not to SEC actions.

John Coates, the SEC's Acting Director in the Corporation Finance Division, made these points in April 2021. He also noted that the safe harbor might not apply to SPACs at all, because Congress "provided a safe harbor for forward-looking statements made by established, publicly traded, reporting companies." Coates pointed out that the PSLRA safe harbor explicitly excludes statements made by a "blank check company," by a "penny stock issuer," or in connection with an "initial public offering."

The latter term is the only one of the three that is undefined, leading Coates to conclude that "initial public offering" might encompass de-SPAC transactions, particularly in light of Congress's purpose to protect "seasoned issuers" with an "established track record." And obviously, the term "blank check company" applies to SPACs in their formation, meaning SPACs are excluded from safe harbor protections at least at the beginning of their lifecycle. Though there is no case law supporting Coates' interpretation of the PSLRA, his comments serve as a reminder that the risks with SPACs are not always well-defined.

Pressure to Consummate a Transaction

SPACs generally have to consummate a transaction with a target within 18 to 24 months of formation. Otherwise, the SPAC is liquidated and funds are returned to investors, or the SPAC must seek an extension of the time to effect a transaction. And sponsors, who typically invest less on a relative basis upfront in exchange for shares in the post-transaction company, forfeit their initial investment and lose all their upside, which in many cases may be considerable.

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Because of those dynamics, de-SPAC transactions that occur close to the deadline are more susceptible to litigation. Shareholders could allege that SPAC management made misrepresentations or performed insufficient due diligence to avoid liquidation of the SPAC, particularly if the post-transaction entity performs poorly.

That is what the plaintiffs alleged in *Welch v. Meaux*, No. 2:19-cv-01260-TAD-KK, 15-19 (W.D. La. Oct. 16, 2020), which pertains to a SPAC's acquisition of the food ordering and delivery business Waitr. Those plaintiffs alleged that they suffered more than 90% losses because SPAC officers and directors projected unachievable financial results, among other misrepresentations, in connection with a de-SPAC transaction that was announced just two weeks before the deadline.

Similarly, the SEC settled a case with a SPAC chief executive who it claimed had misrepresented the target company's ownership of new "game changing" technology and had made financial projections based on a backlog of customer orders that were not supported by purchase orders. The shareholder vote approving the proposed transaction took place just days before the expiration of a 24-month deadline. The CEO agreed to pay a $100,000 civil penalty, and was subject to a cease-and-desist order and a 12-month associational, penny stock, and investment company suspension. *In the Matter of Benjamin Gordon*, SEC Release No. 33-10651 (June 20, 2019)

Conflicts of Interest

SPACs have more potential for conflict-of-interest claims than traditional IPOs, because SPAC sponsors, officers and directors typically have different incentives than ordinary shareholders. That is why the SEC recommends disclosure of such incentives for sponsors, officers, and directors, as well their control over approval of the de-SPAC transaction; potentially conflicting contractual or fiduciary duties; and any ownership in or affiliation with a target company.

If sponsors, officers or directors have conflicts of interest–even if disclosed–then they may not receive the benefit of the business judgment rule in a shareholder litigation. At least one court has endorsed that theory in the context of SPACs. In AP Services, LLP v. Lobell, No. 651613/12, 2015 BL 215565 (N.Y. Sup. Ct. June 19, 2015), the court declined to dismiss a complaint that alleged that directors entered into a merger despite red flags. The complaint alleged that the directors were motivated by an impending merger deadline and the fact that the directors' securities would become "worthless" if no transaction occurred. Notably, however, the directors did not address potentially extenuating circumstances in their briefing, including the fact that a majority of SPAC shareholders voted to approve the merger. The court noted its expectation that these omissions would be addressed later in the litigation.

Material Non-Public Information

There are many times during the lifecycle of a SPAC that sponsors, directors or officers may be exposed to material, non-public information. For example, they can learn information about a target company, the likelihood of success of a merger, the negotiations with and valuation of a target, and the expected outcome of shareholder votes–including votes not just to effect a merger, but also to extend the time for the SPAC to find a target.

Later, they could learn about the likelihood of a private investment in public equity (PIPE) transaction in the SPAC, and negotiations regarding the same; while PIPE investors could learn information about the company that could be used in hedging or shorting. Individuals who are involved with multiple SPACs, or with multiple targets, could also learn information relevant to other entities.

Accounting Treatment of Warrants

The SEC indicated in a staff statement that the warrants issued in connection with a SPAC's IPO, as well as private placement warrants, may need to be classified on balance sheets as liabilities rather than as equity, depending on the precise facts. In one particular fact pattern referenced in the statement, the SEC determined that the warrants needed to be classified as liabilities because in certain instances all warrant holders would be entitled to cash, while only certain holders of the underlying shares of common stock would be entitled to cash.

If warrants are classified as liabilities rather than as equity, SPACs will have to update their valuation every quarter rather than just at the inception of the SPAC. Because SPAC warrants often have unique or complex features, such as automatic redemption if share price reaches a certain threshold, the valuation calculation can also be complex. The different accounting treatment of warrants may also require the restatement of a SPAC's financial statements.

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SPAC Roadmap

There are several unique events in the lifecycle of a SPAC. The below roadmap highlights some of the important issues related to those events, and the types of litigation risks that arise at each stage.

SPAC IPO Registration Statement

Because SPACs are "blank check" companies without operations, the initial IPO registration statement is generally regarded as low risk. However, it is still possible, at least in theory, for these statements to give rise to litigation. Misrepresentations about the SPAC's targets or target industry could cause issues, as could misrepresentation of management's credentials. Sponsors or board members' experience in the target industry can be relevant, which the SEC noted with respect to celebrity-backed SPACs. It warned: "It 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."

De-SPAC Proxy Statement

As in any other proxy statement, material misstatements or omissions can lead to liability under the Securities Exchange Act of 1934. As discussed above, those misstatements can relate to financials, conflicts of interest, or qualifications of management, among other things. Perhaps the best-known litigation involving a SPAC is *In re Heckmann Corporation Securities Litigation*, 869 F. Supp. 2d 519, 532 (D. Del. 2012) (known as the *China Water* case), which settled for $24 million long before the current SPAC boom.

In the *China Water* case, class action plaintiffs brought claims under Sections 10(b), 14(a), 20(a), and Rule 10b-5 of the Exchange Act against the SPAC, its officers and directors, and the post-merger entity. The plaintiffs alleged misleading statements about the target's past financial results, future growth prospects, and valuation, as well as the qualifications of the target's management and diligence performed by the SPAC.

The court held that the shareholders had sufficiently stated a cause of action at the pleading stage, despite qualifying disclosures in the proxy statement that it was "more than a likelihood" that financials could contain undetected material misstatements, that the target company had deficiencies in internal controls, and that the target's historical operating results might not provide a meaningful basis for evaluating its business, financial performance, and future prospects. This case shows that liability can arise even where the SPAC has made significant disclosures, and that when a lawsuit arises, it is possible that the post-merger entity will be brought in along with the SPAC.

De-SPAC Registration Statement

It is possible that a de-SPAC transaction would require a new registration statement, such as when SPACs register the securities issued as consideration to target company shareholders. A registration statement also would be required if the transaction creates an entirely new company, though that is not often a goal of a de-SPAC transaction. Such a registration statement would come with the same risks as any other registration statement, including strict liability for material misstatements.

De-SPAC Redemption Rights

Shareholders in a SPAC typically must be offered the opportunity to redeem their shares in the SPAC before the de-SPAC transaction is executed. That is an issue separate and apart from the shareholder vote to approve such a transaction. If a significant number of shareholders opted to redeem their shares for cash, that would reduce the funds available to the SPAC and could impact its ability to move forward with the transaction. Even if the transaction were to proceed, significant shareholder redemptions still could lead to litigation.

For example, in *SL Globetrotter, L.P. v. Suvretta Capital Management, LLC*, No. 652769/2020 (N.Y. Sup. Ct. Oct. 22, 2020), the SPAC saw significant redemptions prior to the de-SPAC transaction, likely due to concerns about how the target company's business was performing during the Covid-19 pandemic. The transaction closed, but PIPE investors subsequently declined to move forward with their investment, arguing that conditions precedent to the PIPE agreement had not been satisfied. That led the post-transaction entity to commence the lawsuit.

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Post-SPAC Operations

The experience of SPAC management can be important not only for purposes of disclosure. When those managers stay in high-level roles at the post-transaction entity, that experience can also be integral to the success of the business. But when officers and directors in the post-transaction entity come from the SPAC rather than the target company, they could lack expertise in the relevant industry. That could lead to poor business performance, which in turn could give rise to lawsuits brought by disgruntled shareholders. As discussed above, litigations against SPACs are often commenced after poor performance of the post-transaction entity.

Post-SPAC operational issues could be particularly ripe for *Caremark* claims under Delaware law. The hallmark of such a claim is the allegation that a Board of Directors exercised insufficient oversight and lacked a "system of controls," which can lead to personal liability for directors. Described by the Delaware Chancery Court as "possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment," such claims have gained new footing after the Delaware Supreme Court's decision to deny a motion to dismiss in *Marchand v. Barnhill*, 212 A.3d 805 (Del. 2019) (known as the *Blue Bell* case).

There, a fatal listeria outbreak caused ice cream-maker Blue Bell creameries to recall all its products. The court observed that the directors had an obligation to design "context and industry-specific approaches" to oversight but had failed to put in controls or oversight regarding food safety, which was "mission critical." As such, the court reversed a lower court's dismissal, and the case ultimately settled for $60 million just days before trial.

While the *Blue Bell* Court was clear that the burden for bringing a *Caremark* claim was still very high, numerous complaints have proceeded past a motion to dismiss following the Delaware Supreme Court's decision, opening the door for future *Caremark* challenges.

Additionally, the SEC noted that the post-transaction entity will be subject to certain restrictions on reporting and issuing and will have to adjust to complying with SEC rules and disclosure requirements. If management of the private company stays in place post-transaction, it might not have experience with those obligations.

Conclusion

With the volume of SPAC issuances, and given the many risks highlighted above, an increase in litigation involving SPACs seems almost inevitable. Litigation risk should be top of mind not only for management of current SPACs, but also for sponsors, officers, and directors who have already completed de-SPAC transactions. Parties who have taken or will take their companies public through SPACs should also keep in mind the risks, above, and inflection points, including with respect to post-transaction operations, as the success of the merged company can have a direct impact on litigation risk.

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