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Legal Update

The SEC Pursues Action Against SPAC and Insiders for Misleading Investors

On July 13, 2021, the US Securities and Exchange Commission ("SEC") announced charges against Stable Road Acquisition Corp. ("SRAC"), a special purpose acquisition company ("SPAC"), SRAC's proposed merger target, Momentus Inc., each company's CEO, and the SPAC's sponsor, SRC-NI Holdings, LLC ("Sponsor"), in connection with misleading claims made by SRAC and Momentus about Momentus's propulsion technology and national security concerns associated with Momentus's CEO.

Momentus is an early-stage space transportation company that intends to provide satellite positioning services with in-space propulsion systems powered by proprietary microwave electrothermal thruster ("MET") water plasma thrusters. In October 2020, Momentus and SRAC entered into a merger agreement and SRAC executed subscription agreements in connection with a $175 million private investment in public equity ("PIPE") that is set to close simultaneously with the merger.

In its Order Instituting Cease-And-Desist Proceedings (the "Order"),[1] the SEC states that Momentus and SRAC misled investors regarding:

(1) The extent to which Momentus's propulsion technology had been "successfully tested" in space; and

(2) The extent to which national security concerns involving Momentus's CEO hindered Momentus from obtaining necessary governmental licenses critical to its operations.

As a result of its failure to conduct adequate due diligence, SRAC compounded these disclosure violations by repeating materially false and misleading statements in materials presented to investors.

The SEC claims that these failures amounted to violations of Section 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934 (the "Exchange Act"); Section 14(a) and Rule 14a-9 of the Exchange Act; and Section 17(a) of the Securities Act of 1933 (the "Securities Act").

Without admitting or denying the SEC's findings, all parties, except for Momentus's CEO, have agreed to settle these charges with the SEC, with the following penalties being imposed:

(1) Momentus, SRAC, and SRAC's CEO will pay civil penalties of $7 million, $1 million, and $40,000, respectively;

(2) All subscribers in the PIPE will be given the opportunity to terminate their subscription agreements;

(3) The Sponsor will forfeit 250,000 founder shares in SRAC; and

(4) Momentus will undertake substantial enhancements to its disclosure controls, including the creation of an independent board committee and the retention of an internal compliance consultant for a period of two years.

The SEC has separately filed litigation against the former CEO of Momentus.

Momentus's and SRAC's Statements

PROPULSION TECHNOLOGY FAILURES

In both the investor presentation materials provided to potential PIPE investors and the registration statement on Form S-4 filed in connection with the stockholder vote to approve the merger, Momentus and SRAC repeatedly claimed that Momentus had "successfully tested" its "cornerstone" propulsion technology in space and that the test satellite was "still operational today." In fact, Momentus had conducted only one in-space test of a preliminary version of its technology in 2019, and that test had failed to meet even Momentus's own internal definition of "mission success." Momentus had sought to achieve "100 individual burns of one minute or more." Out of 23 attempts, only three generated plasma, and none generated any measureable thrust. None of the burns lasted a full minute. Momentus was not able to attempt the remaining 77 burns because it lost contact with the satellite part way through the testing. As of July 13, 2021, this test satellite remained in space but was not functional. Even if Momentus had achieved its "mission success" criteria, the preliminary version of the technology was not powerful enough to be commercially viable.

By misleading investors about the results of the in-space test, the SEC found that the registration statement and other public filings falsely assured investors that Momentus was farther along toward commercial deployment of its technology than it actually was.

US NATIONAL SECURITY CONCERNS

Momentus and SRAC also failed to disclose the extent to which the CEO's involvement with Momentus was jeopardizing its chances for success. Because Momentus's former CEO is a foreign national, he requires an export license in order to access parts of Momentus's technology, and he is required to hold a valid visa in order to work in the United States. Over the past few years, various US governmental agencies had not only repeatedly denied the CEO such licenses, but also had revoked his work visa, in each case, because of "national security concerns." The CEO had also previously been required by the US government to divest his holdings in another US-based space technology business, again for "national security reasons." Importantly, these issues were affecting Momentus by slowing down its development process. Following announcement of the merger with SRAC, the US Federal Aviation Administration ("FAA") twice denied approval for scheduled launches of new satellites in 2021 because of the CEO's holdings in Momentus. These launches were critical for Momentus, as they were to be its first commercial flights. The denials by the FAA caused Momentus to reforecast its expected launch dates from 2021 to 2022.

Most of the foregoing information was omitted from SRAC's initial filings of its registration statement. The initial filings failed to disclose that the CEO was considered a national security risk by various US governmental agencies and, thus, was less likely to be granted asylum or an export license. Instead, the disclosure stated that the CEO had not "yet" obtained an export license, even though at the same time it was becoming clear that his application would be denied. Finally and importantly, the registration statement's financial projections for Momentus did not take into account the delays it was experiencing as a result of the FAA's denials.

SRAC's Due Diligence Failings

While the SEC noted most of the omitted information was kept from SRAC by Momentus, the SEC found that SRAC "conducted inadequate due diligence" and adopted Momentus's disclosures when the SPAC included these statements in its PIPE investor presentation and its initial drafts of the registration statement. The SEC found that SRAC's diligence efforts were undertaken in a "compressed timeframe and unreasonably failed both to probe the basis of Momentus's claims that its technology had been 'successfully tested' in space and to follow up on red flags concerning national security and foreign ownership risks." As a result, SRAC's marketing materials and its disclosures caused investors to be misled about material aspects of Momentus's business.

Key Takeaways

- Filings made in the context of business combinations undertaken by SPACs face similar scrutiny from the SEC Staff as do the filings made in connection with traditional initial public offerings ("IPOs") and should be prepared with the same level of rigor. The notion, suggested by some in the popular press that private companies combining with SPACs do not face the same liability as companies that undergo traditional IPOs, should not be relied upon. As emphasized by the SEC Staff,

  > "[a]ny material misstatement in or omission from an effective Securities Act registration statement as part of a de-SPAC business combination is subject to Securities Act Section 11. Equally clear is that any material misstatement or omission in connection with a proxy solicitation is subject to liability under Exchange Act Section 14(a) and Rule 14a-9, under which courts and the Commission have generally applied a "negligence" standard. Any material misstatement or omission in connection with a tender offer is subject to liability under Exchange Act Section 14(e)….Given this legal landscape, SPAC sponsors and targets should already be hearing from their legal, accounting, and financial advisors that a de-SPAC transaction gives no one a free pass for material misstatements or omissions, is not shared by the SEC."

- The SEC expects SPACs and their sponsors to conduct due diligence on the target in connection with an initial business combination. In a traditional IPO, the due diligence undertaken by underwriters serves an important investor protection function, and the SEC Staff has publicly lamented the absence of this structural component in de-SPAC transactions. Indeed, holding the SPAC accountable for its due diligence failures harkens back to statements made by the Staff of the SEC's Division of Corporation Finance asking whether the SEC should "reconsider the concept of 'underwriter' in [de-SPAC] transactional paths."

- Related to the point above, the SEC also is focused on the misalignment of incentives arising from the SPAC structure. SPAC sponsors stand to obtain substantial profit from the completion of a successful business combination, even if the resulting combined company fails to prosper following the business combination. On the other hand, if a SPAC does not complete a business combination within a specified timeframe, SPAC sponsors stand to lose millions of dollars in invested capital. These powerful financial incentives coupled with: (1) the limited time period a SPAC has to complete an initial business combination and (2) the increasingly competitive market for targets have caused the SEC to be concerned that sponsors will conduct cursory due diligence, overlook red flags uncovered during the diligence process, and fail to make the necessary disclosures to their stockholders, all in the interest of getting a favorable stockholder vote.

- The SEC's Order should also be viewed in the wider context of the SEC's heightened scrutiny of SPACs over the past six months, and statements made by SEC Staff, including the following:
    - The SEC's Public Statement on Financial Reporting and Auditing Considerations of Companies Merging with SPACs (March 2021);[2]
    - The SEC Staff's Statement on Select Issues Pertaining to Special Purpose Acquisition Companies (March 2021);[3]
    - The SEC Division of Corporation Finance's Public Statement on SPACs, IPOs and Liability Risk under the Securities Laws (April 2021);[4] and
    - The SEC Staff's Statement on Accounting and Reporting Considerations for Warrants Issued by Special Purpose Acquisition Companies (April 2021).[5]

The SEC's stated regulatory agenda includes addressing rules related to SPACs.[6] Although the agenda does not specify the aspects to be addressed, given statements by the SEC Staff, as well as statements made by SEC Chair Gensler, and areas addressed in proposed SPAC related legislation in Congress, it is likely to address liability issues, whether relating to the use of projections and the availability of the safe harbor for forward-looking statements, or more broadly. In the meantime, we expect additional guidance and additional actions related to SPACs from the SEC in the near future.

See the SEC's announcement and related Order.

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ENDNOTES

[1] See the US Securities and Exchange Commission's Order Instituting Cease-And-Desist Proceedings, Pursuant to Section 8A of The Securities Act of 1933 and Section 21C of The Securities Exchange Act of 1934

[2] See the SEC Staff's statement, Financial Reporting and Auditing Considerations of Companies Merging with SPACs.

[3] See the SEC Staff's statement, Staff Statement on Select Issues Pertaining to Special Purpose Acquisition Companies.

[4] See the SEC Staff's statement, SPACs, IPOs and Liability Risk under the Securities Laws.

[5] See the SEC Staff's statement, Accounting and Reporting Considerations for Warrants Issued by Special Purpose Acquisition Companies ("SPACs").

[6] See the SEC Agency Rule List, Spring 2021, https://www.reginfo.gov/public/do/eAgendaMain?operation=OPERATION_GET_AGENCY_RULE_LIST&currentPub=true&agencyCode=&showStage=active&agencyCd=3235&csrf_token=7CE97CC2D49C9B6B70868F7B2752E582C86F1945A4A46F34426C18AF1ABE101E611318F64B67159C3A36E7556BD0FB872C8F.