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SEC Charges SPAC, Sponsor, Merger Target, and CEOs—Claims SPAC Failed to Conduct Sufficient Due Diligence and Obtains Forfeiture of Founder's Shares

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Last week, the Securities and Exchange Commission (the "SEC") announced a settlement of an enforcement action against a special purpose acquisition company ("SPAC"), its sponsor, its merger target (the "Target"), and the CEO of the SPAC for alleged misleading disclosures regarding the Target's business and the Target's former CEO (the "Target CEO").[1] Separately, the SEC filed a complaint against the Target CEO in federal district court in the District of Columbia. The SEC's Order, which was issued in connection with the announced settlement, is significant for three reasons:

- First, as part of its settlement with the SEC, the SPAC sponsor, which allegedly caused certain securities violations of the SPAC, agreed to forfeit founder shares if the SPAC shareholders ultimately approve the pending business combination.
- Second, the allegations contained in the SEC Order highlight the perceived failure of the SPAC to conduct adequate due diligence regarding certain of the Target's claims about its business and the Target CEO.
- Third, the SEC Order provides considerable insight into the SEC's likely enforcement approach with respect to other SPAC disclosure inquiries.

With regard to the alleged false and misleading statements, the SEC Order states that the Target, a space transportation start-up company, misled private investment in public entity ("PIPE") investors and shareholders regarding (1) the company's prior test of its key technology in space and (2) the U.S. government's concern about national security and ownership risks posed by the Target CEO's association with the Target.

The SEC Order stated that the SPAC allegedly failed to conduct appropriate due diligence regarding both disclosure statements, and that it did not address previously-identified red flags. *Specifically, the Order stated that the SPAC engaged in negligent misconduct by repeating and disseminating the Target's misrepresentation without having a reasonable basis to believe the facts disclosed.* The CEO of the SPAC, who signed the SPAC's corporate filings, allegedly caused certain of the SPAC's violations and directly violated proxy solicitation provisions of the Securities Exchange Act of 1934.

As part of the settled enforcement action, the SEC alleged the SPAC violated Sections 17(a)(2) and (3) of the Securities Act of 1933, Section 14(a) of the Securities Exchange Act of 1934 and Rule 14a-9 thereunder, and certain reporting provisions. The SEC alleged the Target violated the antifraud provisions of the federal securities laws and caused certain of the SPAC's violations. The SPAC sponsor and CEO allegedly violated Section 17(a)(3) of the Securities Act of 1933, and the SPAC CEO allegedly also violated Section 14(a) and Rule 14a-9 thereunder. The SEC Order also required certain "undertakings" by the settling parties, including the appointment of an independent consultant by the Target and the forfeiture of founder shares by the SPAC sponsor, and ordered a total of more than $8 million in penalties from the settling parties.

Below, we summarize the SEC's allegations and provide takeaways with respect to the SEC's enforcement approach in relation to SPACs.

Background and the Alleged Misleading Statements

In November 2019, the SPAC completed its IPO and began trading on Nasdaq. The SPAC sponsor provided $4.625 million in working capital to fund the SPAC through its business combination and received SPAC shares in return for the capital investment. The SPAC CEO was a managing member for the SPAC sponsor, and the SEC specifically alleged that the SPAC CEO's relevant actions were taken "on behalf of and for the benefit of" the SPAC sponsor.

Alleged False Statements Regarding the Target's Propulsion System

The Target's business model, which focuses on the placement of satellites in custom orbits around earth, is allegedly based on the development and testing of the Target's cornerstone propulsion thruster technology. The Target apparently tested that propulsion thruster technology only once in space, in 2019 (the "Propulsion Test"). According to the SEC, the Target made public comments and blog posts in 2019 that the Propulsion Test would give investors "absolute confidence" that the propulsion service would be "on time, safe and reliable." The SEC alleged that the Target's prior statements defined the criteria against which its own test should be measured. Notably, the Target and the Target CEO made these statements *prior to* the start of any negotiations between the SPAC and Target, and during those negotiations, the Target and its CEO told the SPAC and the SPAC CEO that the Propulsion Test was a success.

The SEC alleged that the statements regarding the Target's ability to provide commercial launch services were false because the Propulsion Test did not provide measurable data to suggest that the propulsion thruster would be efficient or large enough to be commercially viable. According to the SEC, the Propulsion Test did not meet the company's internal or publicly disclosed criteria for success. In fact, the SEC cited internal communications among executives at the Target that indicated the Propulsion Test did not obtain "any useful mission results." According to the SEC, the Propulsion Test was plainly not a success.

SPAC Allegedly Failed to Conduct Sufficient Due Diligence

The SEC alleged that, after merger discussions began, the SPAC engaged several firms to assist with due diligence, including a space technology firm capable of investigating the development of the Target's technology. However, the SEC claimed the SPAC did not retain the space technology firm until approximately 30 days prior to the merger announcement in October 2020. The SPAC also allegedly did not specifically ask the space technology firm to review the Propulsion Test. The SEC further noted that the Target informed the space technology firm that the Propulsion Test was conducted at an early stage

and was not relevant to the current technology. As a result, the space technology firm did not conduct a review of the data associated with the Propulsion Test.

The SEC asserted that, despite the fact that the SPAC did not conduct due diligence on the Propulsion Test, the SPAC included false statements in its registration statement (including a number of amendments) about the Target's "successful" Propulsion Test. *The SEC also suggested that the Target's financial projections contained in the SPAC's registration statement were misleading because they were based in part on the misleading claims that the Propulsion Test was a success and the assumption that the technology was approaching viability.* The SEC claimed that the SPAC made similar false statements about the success of prior testing of the Target's technology to PIPE investors.

The SEC noted that the SPAC also claimed in its registration statement that it conducted "extensive due diligence," including with respect to the Target's "technology solutions." Moreover, the SPAC allegedly stated that its consultants reported on the Target's "testing progress." The SEC asserted that these due diligence claims were misleading because the statements suggested that the SPAC independently verified the claim that the Propulsion Test was successful. *Although it appeared to the SEC that the SPAC was simply repeating what it had been told by the Target about its technology and testing, the SEC stated that the SPAC "nevertheless acted unreasonably in adopting and repeating [the Target's] claims that it had successfully tested its technology in space when it had not conducted any specific due diligence to evaluate and verify the accuracy of that material assertion."*

Alleged Inadequate Due Diligence Regarding Misleading Statements about National Security Risks Associated with Target CEO

The SEC also alleged that the Target and its then-CEO made misleading statements about the Target's CEO, a Russian citizen residing in Switzerland. According to the SEC, the U.S. government had expressed national security concerns about the Target CEO's association with the Target, given the nature of the Target's business and that he is a foreign individual. Because he is a foreign individual and owner of the Target, the Target CEO was prohibited from accessing certain technologies of the Target unless he obtained an export license from the U.S. government. Although the Target submitted an application for the license, that application was denied and the Target CEO was deemed not an "acceptable recipient."

The SEC also alleged that, in connection with an unrelated corporate transaction involving a space technology company (the "Unrelated Transaction"), the Committee on Foreign Investment in the United States ("CFIUS") informed the Target CEO that he was viewed as a "threat" to national security. As a result of that determination, the Target CEO was ordered to divest himself from the company involved in the Unrelated Transaction.

Although the SPAC disclosed the fact that the Target CEO was ordered by CFIUS to divest himself of ownership in the Unrelated Transaction, the SEC alleged that the SPAC failed to disclose that CFIUS expressed concern about the Target CEO himself. As a result, the SEC concluded that the statements regarding the Target CEO's prior involvement with CFIUS and national security risk were misleading.

The SEC also claimed that the SPAC failed to conduct adequate due diligence concerning the Target CEO's national security risk. Specifically, the SEC asserted that, although the SPAC asked the Target for the basis of and correspondence relating to CFIUS decision to order the Target CEO to divest himself in the Unrelated Transaction, the Target indicated that it did not have possession over that information. Although the Target CEO had access to that information, the SEC indicated that the SPAC failed to conduct further due diligence and filed its registration statement without obtaining a full understanding of the basis for the CFIUS order. As a result, the SEC claimed that the SPAC failed to take into account

the adverse effects that the national security concerns would have on the Target's corporate projections that the SPAC included in its registration statement.

Takeaways

This SEC enforcement action highlights several issues regarding how the SEC may pursue similar investigations involving SPACs and their targets. We have included below some of the takeaways:

- Expect similar SEC investigations to surface.
- Keep in mind that the SEC staff is aided by the benefit of 20/20 hindsight when it conducts its investigations.
- Consider that the SEC, with the benefit of hindsight, may conclude that a statement was misleading, and that conclusion may differ from what was intended when the statement was made.
- Be aware that if a disclosure issue that concerns a target in a business combination arises, the SEC likely will examine whether the SPAC and its principals conducted adequate due diligence.
- Involve counsel in the process of due diligence, and especially when drawing conclusions regarding critical areas of diligence.
- Remember that, even when a target conceals information from a SPAC, the SEC may not view the SPAC, its sponsors, and its executives as victims of that concealment, and the SEC may expect the SPAC to have a reasonable basis for believing the statements that it simply repeats or disseminates on behalf of a target.
- Keep in mind that the SEC generally views its role as a protector of PIPE investors and public shareholders in a SPAC transaction.
- Consider that the SEC might view general statements about the level of due diligence conducted (e.g., the SPAC conducted "extensive due diligence") as misleading in the event of a disclosure issue.
- Be mindful that the SEC is likely to seek deterrence by pursuing the founders and principals of SPACs and targets personally, to the extent the SEC can demonstrate those individuals played some role in disseminating or repeating an alleged misleading statement.
- The SEC might consider creative forms of relief when pursuing a settlement that involves a SPAC sponsor and others, including the forfeiture of founder shares as a condition of settlement. Although the SEC might seek several forms of equitable relief, including undertakings, in connection with an enforcement action, it does not have an absolute right to the forfeiture of founder shares.

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If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings New York lawyers:

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[1] The SEC Order and other sources indicate that the target CEO left the target around January 2021 (https://www.sec.gov/litigation/admin/2021/33-10955.pdf)