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PERSPECTIVE

Getting SPACs right

How to build investor trust while mitigating litigation risk

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Blank-check companies, or special purpose acquisition companies, known as SPACs, are thriving in corporate finance. SPACs have rapidly become a popular mechanism to take companies public. SPACs and traditional IPOs each raised about $80 billion in 2020. In January and February of this year, however, SPACs have overtaken IPOs by almost $40 billion. This exciting reemergence into capital markets, from lucrative transactions with popular companies to an array of celebrity endorsements, may be due in part to SPACs' ability to raise capital and bring companies public without some of the uncertainty of the IPO process whereby share prices are set by supply and demand at the time of offering.

Just like any investment vehicle however, SPACs require attention to general and specific guidance promulgated by regulatory agencies like the U.S. Securities and Exchange Commission. Recent SEC actions suggest that it is reviewing disclosures and other potential structural issues related to SPACs. On April 8, 2the acting director of the Division of Corporate Finance predicted increased SEC scrutiny of investor disclosures by SPACs and their private targets. And just like traditional IPOs, as some SPAC transactions miss the mark, shareholder litigation may follow.

SPACs Provide Private Companies a Way to Go Public Without the Same Time, Expense and Regulatory Oversight that Govern Traditional IPOs

In a SPAC merger, a blank-check company is created by industry veteran "sponsors." Its sole purpose is to raise capital from retail and institutional investors to buy and effectively merge with a private company. Funds are raised through the SPAC's own IPO, with buy-in usually priced at $10 per share. That money is held in an interest-bearing trust until the sponsors identify a private company to take public, which typically must occur within two years of the IPO. Depending on the target company's valuation, a private investment in public equity, or PIPE, transaction may simultaneously occur to guarantee the SPAC sufficient funds to effect the merger. Investors approve the transaction via shareholder vote and may keep shares of the resulting company or exercise a redemption right with interest.

SPACs can benefit investors and target companies alike. Because a SPAC is a blank-check company with no existing business, the required disclosures can be less complex and costly than those of an operational company seeking a traditional IPO. A SPAC merger also provides assurances that investors are available, removing the need for rounds of road shows to gauge investor interest. SPACs can also look at future growth and revenue projections when evaluating a target company, which does not occur in a traditional IPO. Thus, SPACs can consider and merge with newer companies that have potential but lack robust history.

SPACs and Their Sponsors Can Use Their Fiduciary Duties of Candor and Disclosure to Build Trust with Investors

The success of a SPAC merger depends heavily on sponsors, binding them to fiduciary duties of candor and disclosure. Sponsors should therefore provide investors material information in a clear and complete manner, thereby building trust. Recent private civil complaints in state and federal courts point specifically to purported misrepresentations in S-4 registration statements filed with the SEC and proxy statements disseminated to investors prior to shareholder authorization of SPAC mergers. Thus, by upholding fiduciary duties, SPACs can also avoid damages and injunctions on proposed mergers.

SPACs should be mindful of certain elements of the process, such as the selection of a target company and communications with investors. When referencing valuation figures, for example, SPACs should disclose the financial modeling used. Based in part on its alleged failure to provide financial models referenced in the proxy statement, investors this February filed suit in the Southern District of New York against a SPAC and its sponsor to enjoin a merger that would have created an $11 billion resulting company.

SPACs can also mitigate litigation risk by disclosing financial advisor compensation for evaluations of and mergers with a particular target company. This information may provide investors with insight into the motivations behind an advisor's analysis and any potential conflicts of interest. In another complaint filed this February in the Southern District of New York against a SPAC and its sponsors, for example, an investor requested disclosure of historical relationships between the hired financial advisors and the SPAC, its sponsors, and the target company. The investor noted that under certain compensation schemes, advisors would obtain a proprietary financial interest in the proposed merger.

SPACs can further build trust by disclosing the future composition of a resulting company's board and the number of designated seats, if any, to be filled by SPAC sponsors or officers. Through this disclosure, SPACs can highlight the control investors will have in the resulting company beyond share percentages, while acknowledging the possibility of divergent interests held by SPAC sponsors or officers in securing a continued role in the resulting company. Indeed, recent complaints filed in federal court have noted that a designated board seat could be a source of conflict of interest that investors needed to consider before voting to approve a proposed merger.

Finally, when SPACs refer to discussions and negotiations with alternative target companies in their statements, they should be prepared to disclose the background processes used to select a target company. Investors may bring suit when offers from or valuations of other target companies are not presented, arguing that their voting rights and ability to evaluate the merger have been hampered.

Clear and Complete Disclosure of Material Information Can Mitigate Litigation Risks Arising from Securities Laws

Even if SPACs lack operations, their shares are nevertheless securities. Thus, SPACs and sponsors should provide investors with clear and complete disclosures to avoid violating securities laws. SPACs should be particularly careful regarding Sections 14(a), 10(b), and 20(a) of the Securities and Exchange Act of 1934 and SEC Rules 14a-9(a)

and 10b-5 promulgated thereunder. SPACs may also face claims brought by the SEC pursuant to Section 17(a) of the Securities and Exchange Act of 1933.

Section 14(a) of the Exchange Act

Liability may arise under Section 14(a) of the Exchange Act and Rule 14a-9, which bars dissemination of a statement that "at the time and in the light of the circumstances under which it is made, is false or misleading with respect to any material fact, or which omits to state any material fact necessary in order to make the statements therein not false or misleading." 17 C.F.R. Section 14a-9(a). Facts alleged as a breach of fiduciary duty, such as misleading and incomplete disclosures, may also be used for Section 14(a) liability. Unlike Section 10(b) claims discussed below, potential plaintiffs need only show negligence. Thus, SPAC sponsors can be held liable if they knew or should have reasonably known that the omitted information was material to the investors yet failed to correct or detect the omissions. Id.

Section 10(b) of the Exchange Act

Once a SPAC merger is complete, investors dissatisfied with the resulting company's performance or revelations of long-standing operations issues are likely to claim that the SPAC's former sponsors violated Section 10(b) of the Exchange Act and Rule 10b-5. These claims do, however, require investors to show the sponsors' scienter rather than mere negligence. For example, plaintiffs may show that sponsors were aware of issues in a target company, yet failed to disclose those issues in registration or proxy statements, and declined to do so even after a merger.

Scienter is difficult but not impossible to show — in a complaint filed against a SPAC and its directors this February in the Middle District of Tennessee, an investor claimed that a post-merger company officer who was the former SPAC's CEO and chairman was liable for violating Section 10(b) and Rule 10b-5. The investor alleged that the officer failed to disclose in a registration statement that the due diligence done for the SPAC merger was insufficient. It allegedly failed to disclose various issues plaguing the target company, including: the proprietary software at the heart of the target's business was rudimentary; a DOJ civil investigation; a major deal with a related party that drove much of the sales; a relationship with a purportedly independent subsidiary; and third-party deals. When these issues came to light and the company's shares fell, scienter was easier to show.

Section 20(a) of the Exchange Act

If a SPAC has committed some securities violation, its sponsors may be found liable under Section 20(a) of the Exchange Act. Indeed, in recent complaints filed in the Southern District of New York, investors have alleged that SPAC sponsors, by virtue of their positions as directors and officers, could and did control the creation and dissemination of faulty proxy statements. Further, as the negotiators and reviewers of the merger agreement at issue, the sponsors were allegedly instrumental in determining what information was included in the proxy statement and what information was left out.

Section 17(a) of the Securities Act

Although unavailable as a cause of action for private litigants, SPACs and their sponsors may also face liability under Section 17(a) of the Securities Act through enforcement actions brought by the SEC. Similar to Section 10(b) of the Exchange Act, this statute prohibits misrepresentations and omissions in the offer or sale of securities. However, the SEC is not required to prove defendants had scienter as to the alleged violations. See 15 U.S.C. Section 77q(a). In an SEC action filed against a resulting company of a SPAC transaction in late 2020, the agency alleged that the company obtained over $50 million in investor and PIPE funds by grossly overestimating the value of the company in violation of Section 17(a).

Growing Pressure on the Government to Address SPAC Disclosures Only Affirms that SPACs Are Here to Stay for the Foreseeable Future

Neither investor nor government interest in SPACs is slowing. The newly appointed chair of the SEC Gary Gensler explained that part of his enforcement agenda will address SPACs. Indeed, Gensler will likely build on the SEC's existing groundwork with regard to SPACs. On Dec. 22, 2020, the SEC's Division of Corporate Finance issued guidance to SPACs on disclosure addressing areas such as sponsor compensation and potential conflicts of interests as SPACs approach their two-year merger deadline. The Division issued additional guidance regarding "accounting, financial reporting and governance issues" concerning SPACs on March 31. This guidance followed an alert to investors explaining the workings of SPAC mergers. Forecasts of increased SEC involvement have done little to slow the SPAC boom however. Just this month, a number of popular companies have gone public through SPAC mergers. With sufficient investor trust and litigation risks mitigated, SPACs can be positioned to reap the full benefits of their unique structure for the foreseeable future. ■

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