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How SPACs Should Respond To Increasing Scrutiny

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In the past year, special purpose acquisition companies, or SPACs, have seen enormous growth in use and popularity.

SPACs are shell companies with no operations that proceed in two stages. First, the SPAC raises money through an initial public offering and places the proceeds in trust. Second, the SPAC then has a specified amount of time—usually two years—to find a private operating company to take public through a business combination known as a de-SPAC transaction.

In 2020, there were 248 SPAC IPOs, nearly five times the amount in 2019, and in 2021, there have already been 336 IPOs.[1]

The enormous growth has led to an analogous growth in private litigation with over 100 lawsuits filed against SPACs or former SPACs since the start of the year. Likewise, SPACs have become subject to substantial scrutiny from the U.S. Securities and Exchange Commission and Congress.

The SEC and its personnel have commented on SPACs numerous times, including issuing "CF Disclosure Guidance: Topic No. 11" on Dec. 22, 2020,[2] and through the April 8, 2021, public statement of John Coates, acting director of the SEC's Division of Corporation Finance.[3] Recently, the U.S. House Committee on Financial Services held a hearing on SPACs and issued draft legislation.

The SEC's Dec. 22, 2020, guidance raised potential issues regarding both SPAC IPOs and the de-SPAC business combination.

The SEC's IPO-stage guidance focused on disclosure of conflicts of interests, including circumstances where the SPAC's sponsors', directors' or officers' incentives may not align with public shareholders.

For example, SPACs should clearly disclose that if the SPAC fails to complete a business combination, the sponsors' securities will be worthless, causing the sponsors to take a loss. Likewise, SPACs should fully disclose how the

sponsors, directors and officers are compensated, including if any compensation is contingent on a successful business combination.

The SEC's guidance also discussed sponsors with multiple SPACs or other entities that may compete with the SPAC for business combination opportunities. The guidance noted that these types of arrangements may lead to conflicts of interest and should be fully disclosed.

In private litigation, plaintiffs have already begun basing claims on the issues raised in the SEC's guidance.

For example, in Laidlaw v. Acamar Partners Acquisition Corp.,[4] the plaintiffs alleged that the directors breached their fiduciary duties by rushing into a business combination to meet the de-SPAC deadline, and in Pels v. FinTech Acquisition Corp, IV,[5] the plaintiffs alleged that the directors breached their duties by entering a business combination so the sponsors could move on to their next SPAC.

Given the large number of sponsors with multiple SPACs, we expect to see additional litigation alleging breach of the corporate opportunity doctrine as defined by the Delaware Supreme Court in 1996 in Broz v. Cellular Information Systems.[6] Specifically, Broz held that:

> a corporate officer or director may not take a business opportunity for his own if: (1) the corporation is financially able to exploit the opportunity; (2) the opportunity is within the corporation's line of business; (3) the corporation has an interest or expectancy in the opportunity; and (4) by taking the opportunity for his own, the corporate fiduciary will thereby be placed in a position inimical to his duties to the corporation.

Accordingly, to limit potential exposure, SPACs should consider putting a corporate opportunity waiver into their incorporation documents as authorized by Section 122(17) of the Delaware General Corporation Law.[7]

One interesting example involving two related SPACs is the business combination of Social Capital Hedosophia Holdings Corp. V—which is listed as "IPOE" on the New York Stock Exchange—with Social Finance Inc. When the de-SPAC was announced, IPOE's share price significantly increased and SoFi now trades at over $20 per share, more than double the SPACs net asset value of about $10 per share.

In IPOE's proxy statement, the company revealed that a related SPAC, Social Capital Hedosophia Holdings IV—listed as "IPOD" on the New York Stock Exchange—was initially in discussions to acquire SoFi. IPOD currently trades at just over $10 per share and has yet to announce a target. If IPOD announces a business combination that the market does not view as favorably as the SoFi deal, IPOD's shareholders may sue its directors for passing the good target, SoFi, to one of their related entities.

With respect to the business combination stage, the SEC's guidance focused on many of the same disclosure considerations including conflicts of interest.

SPACs should clearly disclose how the sponsors will benefit from the transaction, any interest they have in the target and the total ownership interest they will have in the combined company including through the exercise of warrants and conversion of debt. In addition, SPACs should disclose how any additional financing or share issuances needed to complete the business combination will impact public shareholders.

The SPAC should disclose if the sponsors, directors or officers are participating in the additional financing and on what terms. Likewise, SPACs should also disclose their advisers' financial interests such as how and when their financial advisers are compensated, and any connection between the sponsors and the financial adviser.

More recently, Coates' April 8 public statement highlighted additional de-SPAC litigation risks.

First, Coates pointed out that in addition to liability under Section 10(b) and Rule 10(b)-5, any material misstatement or omission in a registration statement as part of a de-SPAC business combination may give rise to strict liability under Section 11 of the Securities Act. Private plaintiffs have already begun bringing Section 11 claims, in addition to 10b-5 claims, against SPACs such as in Kaul v. Clover Health Invs. Corp.[8]

Coates further noted that de-SPAC transactions are subject to liability under Exchange Act Section 14(a) and Rule 14a-9 because these transactions require proxy solicitation. Unlike Section 10(b) and Rule 10b-5, Section 14 claims are subject to a negligence standard.

For example, in 2009 the U.S. Court of Appeals for the Seventh Circuit in Beck v. Dobrowski held that:

> There is no required state of mind for a violation of section 14(a); a proxy solicitation that contains a misleading misrepresentation or omission violates the section even if the issuer believed in perfect good faith that there was nothing misleading in the proxy materials.[9]

Not only have plaintiffs used Section 14(a) in strike suits seeking to enjoin de-SPAC transactions such as in Ryan v. GigCapital3 Inc.[10] but plaintiffs have also begun suing under Section 14(a) for post-closing damages such as in Srock v. Multiplan.[11]

Plaintiffs have also begun amending previously filed lawsuits to add causes of action under Section 14. For example, in In re: Akazoo,[12] the plaintiffs amended the complaint nearly five months after filing the lawsuit to add a post-closing Section 14 cause of action.

The public comment also notes that de-SPAC transactions may give rise to liability under state law, and plaintiffs have filed numerous lawsuits challenging such transactions alleging breach of fiduciary duties.

In one recent lawsuit, AMO v. Multiplan Corp.,[13] the plaintiffs attack the entire SPAC business model, alleging that the sponsors receiving founders shares—which sponsors acquire at a great discount but are worthless if the SPAC fails to complete a business combination—creates an inherent conflict of interest between the sponsors and the public shareholders.

Therefore, the plaintiffs argue that de-SPAC transactions should be subject to Delaware's exacting entire fairness review, which requires the sponsors to prove fair price and fair process.[14] If the plaintiffs are successful in invoking entire fairness review, sponsors should consider changing the structure of their founders shares so that their value is based on the continuing success of the combined entity, rather than the combination itself.

Finally, the Coates statement also discussed the application, or potential lack thereof, of the Private Securities Litigation Reform Act's, or PSLRA's, safe harbor provision to de-SPAC transactions. The PSLRA's safe harbor provision provides protection to issuers for forward-looking statements, such as financial projections, accompanied by meaningful cautionary statements.[15]

However, the safe harbor provision does not apply to forward-looking statements "made in connection with an initial public offering."[16] The PSLRA does not define initial public offering, and the SEC has not defined it for the purposes of the safe harbor provision.

While it is generally understood that a SPAC's initial public offering occurs when it offers its units for sale to the public, the Coates statement notes that the de-SPAC transaction "is the transaction in which a private operating company itself goes public, i.e., engages in its initial public offering."

The comment further explains that the safe harbor provision was meant to apply to established companies, not unknown private companies introducing themselves to the public markets for the first time. Therefore, it is possible that the IPO exception to the safe harbor provision may apply to de-SPAC transactions.

Moreover, the comment notes that the SEC could use its rule-making process to define "initial public offering" under the PSLRA, or provide further guidance explaining its views on how, or if at all, the PSRLA's safe harbor applies to de-SPAC transactions. The comment also cautions that the safe harbor provision only applies to private securities actions and does not limit SEC enforcement.

Congress has also begun scrutinizing SPACs, including the PSLRA issue. On May 24, the Congressional Subcommittee on Investor Protection, Entrepreneurship and Capital Markets held a hearing titled "Going Public: SPACs, Direct Listings, Public Offerings, and the Need for Investor Protections," which focused mainly on SPACs.[17]

In advance of that hearing, the committee issued proposed legislation that would amend the PSLRA to expressly exclude SPACs, and therefore de-SPAC transactions, from the safe harbor provision.[18]

If Congress adopts the proposed legislation or the SEC uses its rule-making authority to include de-SPAC transactions in the definition of initial public offering, the safe harbor provision of the PSLRA will not protect forward-looking statements such as financial projections included in proxy statements and public filings.

Absent safe harbor protection, SPACs and their sponsors may be subject to greater liability, including for the de-SPACed company missing financial targets presented in public filings. Lack of PSLRA protection would place even greater importance on directors' diligence, vetting of financial projections, and the due diligence defense to Section 11 claims. Even without a legislative change, SPACs should still proceed cautiously, and directors should perform thorough due diligence.

In sum, SPAC litigation, SEC guidance and congressional inquiry are rapidly evolving. Sponsors and their counsel should continue to closely monitor the legal landscape.

In the interim, SPACs should ensure they fully disclose all potential conflicts of interest at both the IPO and business combination stages. SPACs should also take precautions such as incorporating a waiver of the corporate opportunity doctrine in their incorporation documents and consider structuring their founders shares to align with the interests of public shareholders.

Given the increase in litigation, SPACs should also ensure they have sufficient director and officer liability insurance coverage that extends through the de-SPAC transaction and protects the surviving entity after the business combination.

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[1] SPACInsider, SPAC Statistics available at https://spacinsider.com/stats/ (updated June 10, 2021).

[2] SEC's Division of Corporate Finance, CF Disclosure Guidance: Topic No. 11, Special Purpose Acquisition Companies (Dec. 22, 2020), available at:https://www.sec.gov/corpfin/disclosure-special-purpose-acquisition-companies#_ednref2.

[3] John Coates, acting director of the SEC's Division of Corporation Finance, Public Statement, SPACs, IPOs and Liability Risk under the Securities Laws (April 8, 2020), available at https://www.sec.gov/news/public-statement/spacs-ipos-liability-risk-under-securities-laws?utm_medium=email&utm_source=govdelivery.

[4] Laidlaw v. Acamar Partners Acquisition Corp. et al., Case No. 2021-0016-SG (Del. Ch. Jan. 7, 2021).

[5] Pels, et al. v. FinTech Acquisition Corp, IV, et al., Case No. 2021-0184 (Del. Ch. Mar 02, 2021).

[6] Broz v. Cellular Info. Sys., 673 A.2d 148 (Del. 1996).

[7] Section 122(17) provides that a corporation may "[r]enounce, in its certificate of incorporation or by action of its board of directors, any interest or expectancy of the corporation in, or in being offered an opportunity to participate in, specified business opportunities or specified classes or categories of business opportunities that are presented to the corporation or one or more officers, directors or stockholders." 8Del. C.§ 122(17).

[8] Kaul v. Clover Health Invs. Corp., Case No. 3:21-cv-00101 (M.D. Tenn. Feb. 5, 2021).

[9] Beck v. Dobrowski, 559 F.3d 680, 682 (7th Cir. 2009); see also Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 and Commission Statement on Potential Exchange Act Section 10(b) and Section 14(a) Liability,Exchange Act Release No. 51283 (Mar. 1, 2005) ("Where the failure to make such disclosure is negligent, an issuer would violate Section 14(a) of the Exchange Act and Rule 14a-9 thereunder….").

[10] Ryan v. GigCapital3, Inc. et al, Case No. 5:21-cv-00969 (N.D. Cal. Feb. 8, 2021).

[11] Srock v. Multiplan, et. al., Case No. 1:21-cv-01640 (S.D.N.Y. Feb. 24, 2021).

[12] In re: Akazoo, et. al., Case No. 1:20-cv-01900 (E.D.N.Y. April 24, 2020).

[13] AMO v. Multiplan Corp., Case No. 2021-0258 (Del. Ch. March 25, 2021).

[14] Id.

[15] 15 U.S.C. § 77z.

[16] 15 U.S.C. § 77z(b)(2)(D).

[17] Virtual Hearing - Going Public: SPACs, Direct Listings, Public Offerings, and the Need for Investor Protections available at https://financialservices.house.gov/calendar/eventsingle.aspx?EventID=407753.

[18] H.R. _____, to amend the Private Securities Litigation Reform Act by redefining the phrase "blank check company" in a manner that would include special purpose acquisition companies (Committee Discussion Draft) available at https://financialservices.house.gov/uploadedfiles/5.24_bills-117pih-hr_____.pdf.

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