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SPAC Trend Gives Rise to Securities Enforcement and Litigation Risks

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What is a SPAC

Special purpose acquisition companies (SPACs) are on the rise. A SPAC is a publicly traded shell company with no underlying operating business that seeks to merge with a target operating company. According to **Nasdaq**, in 2015, SPACs made up approximately 12% of the IPO market, but by 2020, that number had risen to approximately 53%. SPACs are predicted to be an even higher percentage of the 2021 market share, with SPACs representing 79% of the January IPOs. In light of the trend, the US Securities Exchange Commission's Division of Corporation Finance recently issued **SPAC disclosure guidance**. And as new leadership takes the helm at the SEC, there has been speculation that incoming chairman Gary Gensler's enforcement agenda will include heightened scrutiny of these IPO vehicles.

At a simplified level, typical SPAC transactions work like this: a sponsor group forms a SPAC entity for the purpose of identifying and acquiring an existing private operating company. The SPAC then sells shares of the SPAC company to the public in what is known as a SPAC IPO, and proceeds equal to the amount raised in the SPAC IPO are placed into a trust account. After the IPO, the SPAC sponsors have a finite period of time (typically two years, and no more than three years after the IPO if the SPAC lists securities on an exchange) to identify a private company – the target company – with which the SPAC will enter into a business combination. This combination is commonly referred to as the initial business combination or the de-SPAC transaction. The combined company benefits from the target's operations and the liquidity of the SPAC's publicly traded securities.

If a deal does not materialize, the money held in trust is returned to SPAC shareholders.

Generally, shareholders of the SPAC and the target company must approve the de-SPAC transaction, with SPAC shareholder approval being effectuated through the use of proxy statements. The offer and sale of SPAC securities to the shareholders of the target company in connection with the business combination is often registered on Form S-4 or Form F-4, which is filed with and reviewed by the SEC. SPAC shareholders who do not want to continue to hold shares of the combined entity after the de-SPAC transaction may request a redemption of their shares and exit the venture. Once the deal has been approved, the combined company files an 8-K (known in this context as a Super 8-K) describing the target company's business and including information that would normally have been included in a Form 10 registration statement.

Why it matters

The increase in the number of SPACs in the market, combined with intensified regulatory scrutiny and an active plaintiff's bar, gives rise to securities enforcement and litigation risks. A failure to adequately disclose conflicts of interest and other material information regarding the SPAC transaction creates the risk of SEC enforcement investigations and actions. In addition, any misstatements or omissions in the registration statement filed in connection with the SPAC IPO or in the Form S-4 or F-4 registration statement often filed in connection with the de-SPAC transaction could expose the SPAC entity or its sponsors, as well as the combined company, which ultimately takes on the liability of the SPAC entity after closing, to private securities litigation under Section 11 and other provisions of the Securities Act of 1933.

Close attention should be paid to the information disclosed in the proxy and registration statements often used to obtain shareholder consent to the de-SPAC transaction. In fact, the most recent **SPAC enforcement action**, which settled in June 2019, was focused on issues related to sponsor oversight of proxy materials. In *In re Benjamin H. Gordon*, the SEC found that a SPAC sponsor (who also served as the CEO, secretary, treasurer and board member of the SPAC prior to merger) negligently failed to take reasonable steps and conduct appropriate due diligence to ensure that the SPAC entity shareholders voting on the de-SPAC transaction were provided with material and accurate information concerning the target's business. More specifically, investors were told during meetings and in the proxy materials that the target company could achieve its revenue projections because it had a pipeline of future orders, whereas the SEC found that most of the future orders were only verbal agreements and were not backed by executed purchase orders. Investors were also told that the target company planned to launch a new "game-changing" product but were not told that the target company was obligated to share half the sales revenue from the product with another party.

While acknowledging that the sponsor did not provide this inaccurate information and did not even know about the revenue sharing obligation, the SEC nonetheless held the sponsor liable for his failure to exercise reasonable care in ensuring the accuracy of the proxy materials, which he reviewed and approved for filing, in violation of Section 17(a)(2) of the Securities Act of 1933 and Section 14(a) of the Securities Act of 1934 and Rule 14a-9 thereunder. The SEC focused on the fact that the sponsor did not perform third-party diligence about the target company's pipeline of business or about the game-changing product's revenue structure, despite claims in the proxy statements that the SPAC entity had "conduct[ed] a thorough due diligence review." Without admitting or denying the SEC's findings, the sponsor agreed to pay a $100,000 civil penalty and to be suspended for one year from the securities industry and from participating in any penny stock offering to settle the matter.

In re Benjamin H. Gordon underscores the importance of thoroughly vetting all information provided by the target business before providing that information to SPAC shareholders.

Conclusion

For questions about the litigation and enforcement risks related to SPACs or more information on SEC enforcement matters, please contact a member of Cooley's white collar defense and investigations and securities litigation groups. For more information on the Division of Corporation Finance's new SPAC disclosure guidance, see Cooley's **recent PubCo post** outlining the disclosure considerations in light of this new guidance. For more content on SPACs and the public securities arena generally, please visit Cooley's **SPACtivity page** and Cooley's **PubCo blog**.

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