Professional Perspective

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Special purpose acquisition companies (SPACs) have become an increasingly popular alternative to traditional IPO offerings. As their popularity increases, SPACs are increasingly subject to regulatory scrutiny and litigation challenges.

A SPAC is a publicly traded company formed as an acquisition vehicle for other, to-be-determined, companies. Sometimes referred to as "blank-check" companies, SPACs offer their securities—sometimes just stock and sometimes stock and warrants—for cash and then place that money into a trust account while the SPAC's board identifies suitable acquisition targets subject to a time limitation.

Once the SPAC's target or targets have been identified, shareholders may redeem their shares for the purchase price plus interest that may have accrued or keep the shares and become shareholders of the newly-acquired company or group of companies. The SPAC's eventual merger with its target is often referred to as a "de-SPAC transaction," in which the SPAC transitions into an operating company as opposed to an investment vehicle. In the event that the SPAC fails to close its initial business combination before the SPAC's expiration date or permitted extension, the investors' capital is returned.

This method of taking a company public is often viewed by sponsors as preferable to a traditional IPO. In the de-SPAC transaction, the SPAC and target company agree on a valuation that then is often tested in the PIPE market and with existing investors before the transaction is publicly announced, allowing for early price discovery. That testing in the PIPE market often leads to commitments from investors to provide additional financing. In the regular IPO process, the valuation is only determined at the end of the SEC registration process when the issuer tries to sell its shares on a public exchanges based on a proposed valuation without the committed financing that a PIPE process can bring.

The structuring advantage of testing valuation earlier in the process has made SPACs especially attractive in what has been an unpredictable economic environment. In 2020's turbulent market, the trend toward using SPACs to go public accelerated. While non-SPAC IPO proceeds grew by about 25% in 2020, SPAC IPO proceeds increased by a staggering 425% year-over-year. Early 2021 saw the trend continue, with about 160 SPAC IPOs in January and February alone.

SPACs have generated significant coverage in the media, and with it, increasing attention from the plaintiffs' bar. Most of this increased scrutiny has been on disclosure requirements for SPACs, which is also what plaintiffs frequently target in securities suits in the SPAC context or otherwise.

As is the case with traditional IPOs, SPACs issue registration statements when they offer shares on public exchanges and, later, when they register new shares for the de-SPACed company. Further, as is the case with other public company mergers, SPACs issue proxies to acquire their target companies. While both types of SEC filings are well-worn paths from traditional IPOs, they may present unexpected risk in the SPAC context.

Registration Statements

On formation, SPACs complete their initial registration through Form S-1. Litigation over these statements is rare, because SPACs are limited-purpose shell companies—so there is less to disclose than in a regular IPO for an operating company. Still, SPACs do provide disclosure on their management team and whether they have had substantive conversations about a transaction.

Post-acquisition, the combined business typically files other registration statements to issue new shares upon the exercise of warrants and to register the resale of certain shares issued. In that circumstance, the new company, its officers and directors, and others may be liable for any material deficiencies in the combined business's registration statement under Section 11 of the Securities Act of 1933.

That registration statement reflects the SPAC as an operating enterprise and there is typically information disclosed about the company such that plaintiffs' lawyers may attempt to generate more grist for disclosure-related complaints. Section 11 claims are common vehicles for shareholder litigation, in particular because they can be brought in state courts, which plaintiffs sometimes perceive as favorable venues.

Proxy Statements

After a SPAC raises capital and identifies a target, it needs to obtain approval from a majority of its shareholders to complete the acquisition. Typically, this requires the issuance of a proxy statement that includes necessary disclosures about the target and the proposed transaction. SPAC shareholders possess the same rights as any corporate shareholder to bring an action for fraud or SEC rules violations. This includes suits for material omissions in the proxy statement under Section 14(a) of the Securities Exchange Act of 1934, as well as for material misleading or fraudulent statements under Section 10(b) and Rule 10b-5.

Alleged proxy deficiencies can often be resolved by correcting the alleged omission and filing an amended proxy statement so long as the de-SPACing transaction has not yet occurred. However, plaintiffs might attempt to pursue a damages claim if the SPAC transaction has already occurred. For example, a 2014 settlement in Delaware resulted in a $27 million payment to shareholders for alleged material misrepresentations in a proxy statement with respect to an operating company. *In re Heckmann Corp. Sec. Litig.*, No. 1:10-cv-00378-LPS-MPT (D. Del.).

Many of these suits arise when shareholders are displeased with the financial performance of the acquired target after the de-SPACing transaction has been completed. Plaintiffs will often allege claims against both the SPAC's officers and directors and the acquired target's officers and directors because both sets of individuals were allegedly involved in making the claimed misrepresentations. Courts have allowed such claims to proceed in some instances. In at least one such case, the SEC itself brought actions against a target's managers as well as the business entities. *SEC v. Hurgin*, 484 F. Supp. 3d 98 (MKV) (S.D.N.Y. 2020).

Fraud claims have also been alleged on grounds that sponsors are themselves shareholders in the SPAC and arguably have an incentive to complete an acquisition before the SPAC expires and capital must be returned. At least one court has found that this incentive, while certainly not dispositive, could be probative of scienter. *In re Stillwater Capital Partners Inc. Litig.*, 858 F. Supp. 2d 277 (S.D.N.Y. 2012).

Conclusion

As SPAC transactions increase in frequency, a corresponding increase in scrutiny from regulators and plaintiffs' lawyers is expected.

