SPAC Litigation Risks: What Happens if the SPAC Bubble Bursts?

Special purpose acquisition companies, or SPACs, took 2020 by storm, with nearly 250 SPACs raising around $83 billion through initial public offerings ("IPOs")—more than the previous five years combined.[1] The SPAC boom has only accelerated in 2021, with over 200 SPACs raising nearly $70 billion by the start of March.[2]

A SPAC is a shell company that raises money through an IPO with the purpose of identifying a private company to merge with and bring public in what is commonly referred to as a "de-SPAC transaction." If the SPAC does not identify a suitable target company within a specified period (typically two years), the SPAC is liquidated and investors get their money back plus interest. SPACs offer potential advantages to companies and investors, such as shortening the time and cost needed to take a private company public, and a substantially reduced cost of capital (vs. an IPO of a private company). These advantages have no doubt contributed to SPACs' soaring popularity.

However, their proliferation has led analysts to caution that the SPAC market is oversaturated, with hundreds of SPACs searching for target companies at the same time. [3] [4] With an imbalance between the number of SPACs and the number of quality targets, time pressure, and strong incentives for SPAC founders ("sponsors") to make a deal, the potential for mergers with underwhelming targets or on terms unsatisfactory to SPAC investors is real. Recent signs of softening in the market have also led some to suggest that an end to the "SPAC bubble" is imminent.[5]

The twin pressures of urgent deal-making and dropping SPAC stock prices create tangible risk of SPAC-related litigation, and indeed recent docket surveys reveal an uptick in SPAC litigation in 2020 and into early 2021.[6] We expect this trend to not only continue, but to increase. This Client Alert focuses on litigation risks that may move to the forefront if these market pressures combine to burst the SPAC bubble.

Inadequate Disclosures and Conflicts of Interest

Disclosures, whether in connection with a SPAC IPO or a de-SPAC transaction, will likely be at the center of future SPAC litigation. The United States Securities and Exchange Commission has focused increasingly on SPACs in recent months, and is particularly concerned with conflicts of interest that incentivize a SPAC's sponsors, directors, officers, and affiliates to close a de-SPAC transaction even when doing so is not in the best interests of SPAC shareholders, and whether those conflicts are sufficiently disclosed.

For instance, in September 2020, SEC Chairman Jay Clayton commented that "One of the areas in the SPAC space I'm particularly focused on, and my colleagues are particularly focused on, is the incentives and compensation to the SPAC sponsors … What are their incentives?"[7] In late December 2020, the SEC released guidance (the "Guidance") discussing a litany of "disclosure considerations" SPACs should take into account while preparing for an IPO or a de-SPAC transaction.[8] The Guidance addresses conflicts that can affect the decision-making of SPAC leadership and highlights potential conflicts, including those related to: (1) deferred IPO fees (which sponsors may be obligated to pay if a de-SPAC transaction is not completed), (2) how the return sponsors, directors, officers and affiliates receive on a de-SPAC transaction differs from

that of public shareholders, and (3) any losses sponsors, directors, officers, and affiliates may take if a de-SPAC transaction is not completed within the required timeframe.[9]

As these comments highlight, disclosures related to conflicts of interest are likely to be prime targets for disgruntled investors looking to assert claims, including because such conflicts are inherent in the SPAC process (*e.g.*, SPAC founders, directors, and officers typically have economic incentives that differ from shareholders). Claims based on these conflicts of interest are also enticing to plaintiff's attorneys because a credibly alleged conflict may allow plaintiffs to avoid the default business judgment rule, which provides directors significant discretion to make business decisions—even if those decisions turn out to be unprofitable.[10] If a conflict is alleged, de-SPAC transactions could be reviewed under the much more stringent "entire fairness" standard, which is a fact-intensive and expensive inquiry into the economic and financial considerations of the proposed transaction, when the transaction was timed, and how it was initiated, negotiated, and approved.[11]

The SEC's focus on these conflicts of interest and their disclosure increases the likelihood that the plaintiffs' bar will do the same. Indeed, the SEC's Guidance is a playbook for attorneys asserting claims based on inadequate conflict of interest disclosures.

The speed at which deals are stuck may also be a source of future SPAC-related disclosure lawsuits. SPACs are generally required to disclose known targets, and their registration statements typically state that they have not identified any target companies. Issues can arise if a deal is made under circumstances suggesting a pre-IPO agreement between a SPAC and a target, such as if a SPAC promptly closes a deal with a company not identified in its registration statement as a potential target. This could result in strict liability claims under Section 11 of the Securities Act of 1933 against SPAC sponsors, directors, and officers for making omissions or false statements in the registration statement by failing to disclose the acquired company as a target.

Inadequate Diligence

Given the time constraints under which SPACs operate, pre-merger diligence will also be a key focus in SPAC litigation. The Nikola Corporation litigation, which we highlighted in a Client Alert titled "Recent SPAC Litigation Tied To Short Seller Scrutiny," demonstrates the importance of adequate diligence. The class action complaint filed in that dispute, *Huhn v. Milton et* al., No. 20-cv-02437, asserts violations of Sections 10(b) and 20(a) of the Securities Exchange Act of 1934 (the "Exchange Act"), and Rule 10b-5 promulgated thereunder, for the SPAC's alleged failure to "engage in proper due diligence" on Nikola before the merger.[12] The complaint excerpts statement from SEC filings discussing due diligence processes and the diligence performed on Nikola, which failed to uncover alleged misrepresentations by Nikola regarding its technology and business model that were exposed by a short seller and sent Nikola's stock plummeting.[13]

And just last month, litigation ensued after Immunovant Inc. ("Immunovant"), which was formed following the merger of a SPAC with Immunovant Sciences, Ltd., announced that it was halting clinical trials of its flagship monoclonal antibody, IMVT-1401, which prompted a 42% reduction in Immunovant's stock price.[14] One of the plaintiff's core allegations is that the SPAC "performed inadequate due diligence into Legacy Immunovant prior to the Merger" in violation of Section 14(a) of the Exchange Act; the complaint cites pre-merger statements by the SPAC's President and CEO touting IMVT-1401's potential.[15]

Importantly, both of these lawsuits involved mergers that took place before or relatively early in the SPAC boom, when fewer SPACs were competing for targets. As more SPACs enter

the market and competition for attractive target companies increases, deals will be made with lower quality targets that go south. And when they do, the diligence performed on the target company will be a focus for disappointed shareholders and their contingent fee lawyers.

Claims Against Investment Banks

Investment banks raked in billions in fees last year for advising SPACs on planned mergers, raising money for mergers, and underwriting SPAC IPOs, secondary offerings, and de-SPAC transactions.[16] [17]While they have largely avoided SPAC-related litigation thus far, their heavy involvement in SPAC transactions and deep pockets make investment banks a rich target for lawsuits if the SPAC bubble bursts.

SEC filings from IPOs and de-SPAC transactions are one potential source for claims against investment banks. For example, in the class action litigation involving the food delivery app Waitr, which went public through a de-SPAC transaction, the plaintiffs asserted a Section 14(a) claim against the investment bank that underwrote the de-SPAC transaction for allegedly making "materially false and/or misleading statements or omissions" in proxy and prospectus materials.[18]

Plaintiffs may also look beyond the SPAC context, where investment banks have been held liable for knowingly aiding and abetting breaches of fiduciary duties in connection with merger transactions.[19] While such claims require a showing that the aider and abettor acted with intent, which is difficult to prove, they have been successfully litigated and their assertion has led to multimillion dollar settlements.[20] Because there appears to be no principled basis to argue that the grounds for liability on such claims – acting with "the knowledge that the conduct advocated or assisted constitutes" a breach of a fiduciary duty – applies to investment banks assisting with mergers, but not de-SPAC transactions, plaintiffs can and likely will rely on aiding and abetting theories as a means to bring investment banks into SPAC-related lawsuits.[21]

Misleading Projections

A critical distinction between a de-SPAC transaction and an IPO is the ability to include forward-looking financial projections in a proxy or registration statement, rather than historical financial results. Unlike a traditional IPO, financial projections made in connection with a de-SPAC transaction fall within Private Securities Litigation Reform Act's ("PSLRA") safe harbor for forward-looking statements. De-SPAC transactions thus offer a unique opportunity to communicate with retail investors about the target company's potential future financial prospects.

However, there is still risk in relying on such projections in a de-SPAC transaction, including because the PSLRA's safe harbor does not apply to knowingly false or misleading projections. The discretion and judgment inherent in such projections makes defending against allegations that projections are knowingly misleading particularly tricky. And lawsuits alleging SPAC investors were provided false and misleading projections are on the rise; disgruntled investors have filed nearly 10 cases that include such allegations in just the last three months.

A recent example is *Jensen v. GigCapital3, Inc. et al.*, where the plaintiff alleges that the SPAC and its board members authorized the filing of a proxy statement containing "materially incomplete and misleading" financial projections and valuations for the planned target company.[22] Among other issues, the plaintiff accused the defendants of selectively revealing certain metrics (such as projected EBITDA) while allegedly concealing more relevant cash flow projections and earlier versions of these figures, which had been revised in anticipation of the de-SPAC transaction.[23]

Similar allegations have been made in the Waitr litigation. The plaintiffs in that case allege that the defendants' financial projections, which in one instance predicted a nearly tenfold net revenue increase over a three year period, were materially false and misleading because "adverse trends," rising cost of revenues relative to growth, and market dynamics made it clear when the projections were made that "Waitr had no viable path to profitability."[24]

Given the growing number of de-SPAC transactions and rising media attention on aggressive forecasts and valuations,[25] we expect more frequent challenges to financial projections. Experienced litigation counsel can help SPACs mitigate and defend against this risk by critically reviewing proposed financial projections before they are disseminated, ensuring they are accompanied by sufficient disclaimers and cautionary statements, and identifying and correcting weaknesses disgruntled investors may try to exploit in the future.

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If you have any questions about the issues addressed in this Client Alert, or if you would like a copy of any of the materials we reference, please do not hesitate to contact us:

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1. Reuters, "Michael Klein-backed SPACs raise $1.68 billion in IPOs," February 12, 2021, available at https://www.reuters.com/article/churchill-capital-corp-vi-ipo/michael-klein-backed-spacs-raise-1-68-billion-in-ipos-idUSL4N2KI1PL.

2. Chris Bryant, "Sorry Folks, the SPAC Party's Over," March 8, 2021, available at https://www.bloombergquint.com/gadfly/spac-party-over-cciv-dive-and-chamath-palihapitiya-spce-sale-say-so.

3. Ivana Naumovska, "The SPAC Bubble is About to Burst," February 18, 2021, available at https://hbr.org/2021/02/the-spac-bubble-is-about-to-burst.

4. Heather Perlberg, "'Hey, Hey, Money Maker': Inside the $156 Billion SPAC Bubble," March 8, 2021, available at https://www.bloomberg.com/news/features/2021-03-08/are-spacs-a-good-investment-inside-the-stock-market-s-looming-spac-bubble.

5. Ivana Naumovska, "The SPAC Bubble is About to Burst," February 18, 2021, available at https://hbr.org/2021/02/the-spac-bubble-is-about-to-burst.

6. Jennifer March and Preston Brewer, "ANALYSIS: SPAC IPOs Boom; Litigation Follows," February 4, 2021, available at https://news.bloomberglaw.com/bloomberg-law-analysis/analysis-spac-ipos-boom-litigation-follows.

7. Dave Michaels and Alexander Osipovich, "Blank-Check Firms Offering IPO Alternative Are Under Regulatory Scrutiny," September 24, 2020, available at https://www.wsj.com/articles/blank-check-firms-offering-ipo-alternative-are-under-regulatory-scrutiny-11600979237.

8. SEC, Division of Corporation Finance, "CF Disclosure Guidance: Topic No. 11," Special Purpose Acquisition Companies, available at https://www.sec.gov/corpfin/disclosure-special-purpose-acquisition-companies.

9. *Id.*

10. *eBay Domestic Holdings, Inc. v. Newmark*, 16 A.3d 1, 36 (Del. Ch. 2010) ("Under the business judgment rule, when a party challenges the decisions of a board of directors, the Court begins with the 'presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company.' The business judgment standard of review is deferential. When applying this standard, the Court 'will not substitute its judgment for that of the board if the [board's] decision can be 'attributed to any rational business purpose.'"); *Lewis v. Aronson*, 466 A.2d 375, 384 (Del. Ch. 1983), *reversed on other grounds by Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984) (a conflict of interest may "remove" a business decision "from the protection of the" business judgment rule); *AP Services, LLP v. Lobell*, No. 651613/12, 2015 WL 3858818, at *6 (N.Y. Sup. Ct. June 19, 2015) (allegations of conflicted directors rebutted presumption of the business judgment rule to a de-SPAC transaction at the motion to dismiss stage).

11. *See eBay*, 16 A.3d at 36. ("If the plaintiff rebuts the business judgment presumption, the Court applies the entire fairness standard of review to the challenged action and places the burden on the directors to prove that the action was entirely fair."); *In re Trados Inc. S'holder Litig.*, 73 A.3d 17, 55 (Del. Ch. 2013) (discussing "entire fairness" factors).

12. *Huhn v. Milton et* al., No. 20-cv-02437, Dkt. 1 (D. Ariz. December 18, 2020).

13. *Id.*

14. *Pitman v. Immunovant, Inc. et al.*, No. 21-cv-00918, Dkt. 1 (E.D.N.Y. February 19, 2021).

15. *Id.*

16. Paul Clarke, "Banks rake in record $3.4bn in fees as Spac frenzy lures Shaquille O'Neal, Playboy," December 9, 2020, available at: https://www.fnlondon.com/articles/banks-rake-in-record-3-4bn-in-fees-as-spac-frenzy-lures-shaquille-oneal-playboy-20201209.

17. Amith Ramkumar, "2020 SPAC Boom Lifted Wall Street's Biggest Banks," January 5, 2021, available at https://www.wsj.com/articles/2020-spac-boom-lifted-wall-streets-biggest-banks-11609842601; *see also* Richard Henderson, Eric Platt, and Ortenca Aliaj, "The SPAC race: Wall St banks jostle to get in on hot new trend," August 11, 2020, available at https://www.ft.com/content/1681c57d-e64d-4f58-b099-8885e85a708e.

18. *Welch v. Meaux et al.*, No. 19-cv-01260, Dkt. 37 (W.D. La. October 16, 2020).

19. *RBC Cap. Markets, LLC v. Jervis*, 129 A.3d 816, 866 (Del. 2015); *see also In re Rural Metro Corp.*, 88 A.3d 54, 99 (Del. Ch.).

20. *RBC*, 129 A.3d at 866 (aiding and abetting claims "among the most difficult to prove"); *see also* Arthur H. Rosenbloom and Gilbert E. Matthews, "Investment Bank Liability for M&A Services," *November 12, 2018*, available at https://corpgov.law.harvard.edu/2018/11/12/investment-bank-liability-for-ma-services/#5.

21. *RBC*, 129 A.3d at 861-62.

22. *Jensen v. GigCapital3, Inc. et al.*, No. 21-CV-00649, Dkt. 1 (S.D.N.Y January 25, 2021).

23. *Id.*

24. *Welch v. Meaux et al.*, No. 19-cv-01260, Dkt. 37 (W.D. La. October 16, 2020).

25. Heather Perlberg, "'Hey, Hey, Money Maker': Inside the $156 Billion SPAC Bubble," March 8, 2021, available at https://www.bloomberg.com/news/features/2021-03-08/are-spacs-a-good-investment-inside-the-stock-market-s-looming-spac-bubble.