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SPACs and speculation: the changing legal liability of forward-looking statements

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Nowadays it's hard to browse any financial news headlines without seeing at least one title referencing the seemingly ubiquitous, buzzy term "SPACs," otherwise known as special purpose acquisition companies. Trendy, hype-laden, and sometimes even celebrity-endorsed, SPACs seem to be popping up in every corner of the market. Despite having been around since the 1990s, SPACs have seen a recent surge in popularity beginning in 2017 and spiking sharply in March of 2020.

According to SPACInsider, a site dedicated to tracking SPAC statistics, 2020 saw a 420% increase in its number of SPAC public offerings as compared to 2019, jumping from 59 to 248. The number in 2021 alone has already exceeded the total number of SPACs in all of 2020, totaling 349 as of June 28, 2021.

These numbers suggest that SPACs are growing exponentially; however, their time in the limelight has also spurred regulatory agencies and legislative bodies to revisit the rules governing these companies.

A Safe Harbor

At its essence, a SPAC is a publicly listed shell company whose goal is to identify and merge with a private target company, usually within two years of listing on a national exchange. This merger (commonly referred to as a *de-SPAC transaction*) effectively functions as a streamlined IPO for the target company, with the post-merger company carrying on the original business operations of the target.

Unlike a company undergoing a traditional IPO, SPACs do not provide services or sell products and therefore have no business operations data to provide to initial investors. When the SPAC identifies a prospective target company to merge with, it sends out a proxy statement to its shareholders, which often includes "forward-looking statements" regarding anticipated performance or financial projections of the post-merger company. A SPAC also typically uses forward-looking statements in its Form 8-K filed with the SEC, which includes details and disclosures regarding the merger agreement.

While this ability to make forward-looking statements is one of the attractive advantages of SPACs compared to traditional IPOs — along with benefits such as a quicker timeline for going public, fewer reporting requirements, and greater certainty as to pricing — SPAC sponsors should be aware of the changing liability landscape. As the SPAC market has exploded in the past few years, regulatory and legislative authorities alike are treating these companies with increasing scrutiny. At present, much of this scrutiny revolves around forward-looking statements and their perceived impact on investor protections.

Under the Private Securities Litigation Reform Act (PSLRA) of 1995, a safe harbor exists that grants protection from liability in private litigation for forward-looking statements made by issuers in certain filings, as long as the projections are made in good faith and are accompanied by meaningful cautionary language. Notably excluded from this safe harbor are forward-looking statements made in connection with initial public offerings or "an offering of securities by a blank check company." It has hitherto been the case that SPACs do not fit the technical definitions for either of these categories, despite the fact that they are often referred to as such.

SPAC sponsors have therefore enjoyed the protections afforded by the safe harbor. However, as the SPAC market has undergone its rapid evolution, several financial authorities have begun to publicly question whether SPACs and their sponsors should be held to a higher degree of scrutiny.

A Regulatory Conundrum

The first substantial guidance on this issue emerged in a public statement by the Acting Director of the SEC Division of Corporation Finance, John Coates, on April 8, 2021. This statement, titled "SPACs, IPOs and Liability Risk under the Securities Laws" questioned the viability of the safe harbor protection for SPACs, voicing concerns that such protection could potentially affect due diligence measures and mislead investors regarding the risk involved in purchasing certain securities.

Coates explained in the statement that the safe harbor was originally created to "permit and even encourage reporting companies to disclose information about future plans and prospects" without fear of frivolous securities lawsuits. He argues that the provision was originally intended only for established, reporting companies and that SPACs should not be considered as such, since they are functionally the same as a company undergoing an IPO. He concludes that, "...the PSLRA safe harbor should not be

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available for any unknown private company introducing itself to the public markets."

Coates also points to several other reasons why SPAC sponsors should not blindly rely on the safe harbor to protect them from liability exposure. He notes that the safe harbor only protects issuers in the case of private litigation and does not exempt them from state and federal securities laws. Furthermore, the safe harbor will not shield issuers against accusations of false or misleading statements if plaintiffs can show that the issuers knew the statements were false or misleading.

The safe harbor is also only applicable to forward-looking statements and is therefore moot when dealing with current valuations. And finally, he adds that forward-looking statements must still be accompanied by meaningful cautionary language if they are to have a chance at being covered by the safe harbor.

While Coates maintains that he is not "pro- or anti-SPAC," he does call for greater clarification of the scope of the safe harbor under the PSLRA. While he acknowledges that forward-looking statements can be valuable for a business looking to entice investors, he warns SPAC sponsors that relying on them too heavily can lead to greater liability exposure.

Legislation on the Horizon

Almost a month and a half later, on May 24, 2021, the U.S. House Committee on Financial Services / 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" to discuss potential legislative changes regarding SPAC disclosures.

The conversation centered largely on the previously mentioned concerns: that freedom from liability for forward-looking statements in the case of SPACs could de-incentivize due diligence into target companies and permit the use of overly optimistic projections, potentially misleading investors.

Along with the testimony from four industry professionals, a brief piece of draft legislation was introduced during the hearing that would amend the language of the PSLRA to exclude SPACs from the safe harbor provision. If passed, the legislation would accomplish this by changing the term "*a blank check company*" to "*a development stage company that has no specific business plan or purpose or has indicated that its business plan is to acquire or merge with an unidentified company, entity, or person*."

This definition change would serve to hold SPACs and their sponsors to a more stringent liability regime outside of the safe harbor, more similar to that of a traditional IPO.

What's Next for SPACs?

While no formal regulations or legislation have been passed as of the time of this writing, sponsors of SPACs and managers of target companies alike would be wise to take steps to further insulate themselves from liability arising from forward-looking statements and SPAC deals in general.

Changes in the SPAC regulatory and legal realms appear imminent, and time will tell the exact form these changes will take. Although substantive action has yet to materialize, the statements issued by the SEC and the Committee on Financial Services have provided a barometer for the prevailing governmental attitudes toward SPACs. Based on these indicators, issuers who depend solely on the safe harbor for protection regarding forward-looking statements could end up facing a host of legal issues in the months to come.

About the authors

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