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Caution ahead: SPAC litigation trends provide a road map for directors and officers

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For the past several months, many pundits in both the legal industry and securities market have been predicting an uptick in the incidence of litigation related to special purpose acquisition companies or SPACs. Also commonly referred to as "blank check companies," SPACs are shell entities that go public with the intention of identifying and merging with a private operating company, usually within a two-year timeframe. SPACs' recent meteoric rise in popularity has been accompanied by speculation that litigation will soon follow.

According to a variety of mid-year assessments, these predictions have — not surprisingly — come true. According to the "Securities Class Action Filings 2021 Midyear Assessment" conducted by Cornerstone Research, SPAC-related class actions saw a spike in the first half of 2021. In fact, there were twice the number of federal SPAC class action filings in the first half of 2021 as there were in the entirety of 2020.

While this increase in SPAC litigation in and of itself was expected, there are some noteworthy trends regarding the nature of these suits that may prove helpful for directors, officers, and/or sponsors wishing to avoid the same pitfalls as their peers. Being aware of the current litigation market and what disgruntled investors are most likely to seek damages for can provide a road map of areas to avoid and measures to take in order to help minimize claim risk.

Types of claims

The Stanford Law School Securities Class Action Clearinghouse tracks ongoing SPAC-related class action litigation. As of Aug. 31, 2021, there have been 22 total securities class actions brought against SPACs this year, with most of the suits filed in either New York (nine filings) or California (six filings). Of these 22 filings, 21 contained Rule 10b-5 claims. Rule 10b-5 is the catch-all anti-fraud provision that prohibits the making of untrue statements, misleading statements, or omissions regarding material facts connected to the purchase or sale of securities. [*See* SEC (17 C.F.R. § 240.10b-5)]

A separate study conducted by Woodruff Sawyer, titled "2021 Databox Mid-Year Update: Shifts in Securities Litigation Trends Worth Watching," found that 12% of SPACs that have gone public and completed de-SPAC mergers since 2019 have faced 10b-5 claims. There have also been a much smaller number of Rule 14a-9 claims brought against SPACs in the past few years, often in concert with 10b-5 claims. Rule 14a-9 prohibits misleading statements and omissions in proxy statements that are sent to shareholders. [*See* SEC (17 C.F.R. § 240.14a-9).]

While 10b-5 class action claims appear to be spearheading the SPAC litigation push, SPACs are certainly facing other types of suits as well. Hedge fund manager Bill Ackman's $4 billion SPAC, Pershing Square Tontine Holdings (PSTH), was hit with a shareholder derivative lawsuit on Aug. 17, 2021, before it ever underwent a business combination. (*Assad v. Pershing Square Tontine Holdings, Ltd.*)

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This particular complaint focused on the structure of the SPAC and its method of compensating its sponsor. The suit alleged that the SPAC should be registered as an investment company under the Investment Company Act of 1940 and that its hedge fund sponsor, Pershing Square Capital Management (PSCM), should likewise be registered under the Investment Advisor Act of 1940. The plaintiffs argued that since PSTH's primary activity was the investment in securities and because PSCM was essentially operating as the SPAC's investment adviser, the entities should be subject to the compensation restrictions set forth by both acts.

As it stood, PSTH was able to indirectly compensate PSCM advisors through securities offered on sweetened terms, such as warrants that PSTH agreed to repurchase at prices several times higher than their original value. In a nutshell, the suit claimed that "defendants' decision to avoid registering the Company as an investment company has allowed them to use their positions of control to extract compensation from PSTH in forms and amounts that violate federal law" and sponsors had "received securities that under any plausible estimate are worth hundreds of millions of dollars — an unreasonable payment for the work performed."

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According to a letter sent to PSTH shareholders on Aug. 19, Ackman is pursuing the possibility of returning the SPAC's funds to shareholders and shifting to a special purpose acquisition rights company (SPARC) structure.

Types of allegations

While the notion of false or misleading information is broad in general, it may be helpful to look at the kinds of omissions and statements that have repeatedly been the subject of SPAC suits this year, most of which assert that one or a combination of the following issues led to drops in stock prices and/or the overstating of financial prospects:

- **Viability of proprietary technology**. One of the most oft-occurring themes in SPAC class actions suits this year has been the alleged overstatement of companies' commercial technology. In some cases, it was alleged that companies made their technology seem like it worked better than it did, while other suits asserted that the technology didn't work at all, despite being marketed as commercially viable.
- **Histories of misconduct and/or ongoing investigations**. Companies that failed to disclose either internal or external investigations related to the company's actions or the actions of its officers and directors often faced investor retaliation.
- **Business operations**. Supply chain threats, unavailability of raw materials, lack of inventory or suppliers, deficient numbers of personnel, and the inability to scale the business are just some of the business operations-related complications that have spurred claims against SPACs this year.
- **Inflated sales projections or inaccurate production timelines**. For companies that drastically underperformed after announcing or completing their de-SPAC mergers, shareholder litigation seemed almost inevitable. Forecasts that are deemed too speculative or optimistic (and that are not backed by accurate, demonstrable data) have routinely put SPACs at risk.

For any of the above-mentioned issues, SPACs and their sponsors may also be sued for failing to perform due diligence into their target companies. In *Jensen v. Stable Road Acquisition Corp.*, for example, target company Momentus did not divulge the fact that its technology had failed during testing or that its Russian CEO was considered a national security threat by the U.S. government. The original SPAC (Stable Road Acquisition Corp.) was subsequently sued for not performing enough due diligence to uncover these issues.

Why the ramp-up?

So why exactly is SPAC litigation happening so quickly and at such a high rate? The answer is likely a combination of factors.

Some have argued that the SPAC structure is inherently conducive to litigation—that it often puts sponsors' financial interests at odds with retail investors' interests. Sponsors are highly incentivized to complete a business combination within the appointed time period, and some experts worry that this could come at the cost of adequate due diligence and investor protections.

The current state of SPAC litigation does not necessarily need to be a deterrent for directors and officers, just a road map of warning signs.

Another point of view comes from Sasha Aganin, a senior vice president at Cornerstone Research, who was quoted in The Wall Street Journal as saying, "Businesses going public through mergers with SPACs tend to be smaller and potentially riskier than those going public through IPOs. Sometimes those risks materialize and then there's a stock price drop and then a lawsuit. The surge in cases is a feature of these small-company risks, rather than anything specific to SPACs as a class."

It's true that the SPAC structure allows companies to skirt expensive, time-consuming requirements that businesses undergoing a traditional IPO would have to adhere to. This allows for smaller companies, many of which are in "speculative" industries such as electric vehicles or commercial space flight, to go public without necessarily having the same sophisticated business processes as companies using conventional IPOs. Of the 22 suits filed in 2021 so far, most have targeted tech-centric companies, six of which have been associated with the production of electric vehicles. This dovetails with the fact that many of the allegations against SPACs have revolved around inviable technology and problems scaling business operations.

The current state of SPAC litigation does not necessarily need to be a deterrent for directors and officers, just a road map of warning signs. Detailed investor disclosures, robust due diligence into a target company's operations and personnel, substantiated forward-looking statements, directors' and officers' insurance, and the awareness that certain industries are more susceptible to litigation, are all critical factors for SPAC sponsors to take into consideration.

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