

Recent SPAC Surge May Portend Increased Litigation

By James Heyworth and Julia Bensur (October 15, 2020)

Special purpose acquisition companies, or SPACs, are an increasingly attractive option for raising funds apart from the traditional initial public offering. But despite the growing popularity of SPACs over the past several years, SPAC-related litigation has been relatively infrequent. This is unlikely to remain the case.

In this article, we identify potential litigation risks for those sponsoring or participating in SPACs, and offer some practical guidance for avoiding litigation and defending against it once initiated.

Although SPACs have been a prevalent alternative to the traditional IPO for some time, due to recent market uncertainty and other factors, SPAC IPOs are rapidly gaining popularity. Indeed, the number of SPAC IPOs and capital raised in the first eight months of 2020 far overshadows preceding four years:

- 2016: \$3.5 billion across 13 IPOs
- 2017: \$10 billion across 34 IPOs
- 2018: \$10.8 billion across 46 IPOs
- 2019: \$13.6 billion across 59 IPOs
- 2020 through Sept. 1: \$33.9 billion across 84 IPOs[1]



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Despite this surge, there has not been a corresponding increase in litigation. In fact, there have been noticeably few lawsuits aimed at SPACs, ever. One explanation is that the trajectory of the SPAC, from the IPO to the de-SPACing transaction and beyond, is a relatively transparent process, with boilerplate disclosures at every stage, leaving less room for potential litigants to bring suit.

As SPACs become an even more widespread IPO alternative, however, plaintiffs firms inevitably will consider ways to bring suits. Securities litigators should become familiar with the features and lifecycle of the SPAC in order to predict and understand potential litigation risk.

Lifespan of the SPAC

A SPAC is a company formed for the specific purpose of raising capital through an IPO with the goal of acquiring an existing company, to be identified after the completion of the IPO.

Because SPACs are new companies, the required disclosure process pre-IPO is limited and SPACs can go public more easily and quickly than companies embarking on traditional IPOs.[2] The funds raised from the SPAC IPO are held in an interest-bearing trust account, only to be withdrawn to fund the "de-SPACing" acquisition or merger transaction with the identified target company, or to pay out the redemption of common stock prior to the transaction.[3]

Once the IPO is complete, the SPAC typically has 24 to 36 months to find a suitable target company for a business transaction.[4] If the SPAC does not complete a transaction within

the designated period, the trust containing the IPO proceeds typically is liquidated and the funds returned to investors.

Alternatively, the SPAC sponsors can ask the investors to approve an extension of time.[5] After the SPAC sponsors identify a target and begin to negotiate the transaction, the sponsors must obtain approval from the shareholders in accordance with U.S. Securities and Exchange Commission proxy rules — by issuing a proxy statement making any necessary disclosures regarding the transaction and the target company. The sponsors must secure majority approval from the shareholders to move forward with the transaction.

Finally, in the course of the de-SPACing process, SPACs offer the holders of shares the right to redeem their shares in advance of the business transaction. Shareholders opting out of the transaction typically receive a pro rata portion of the proceeds held in the trust account, approximately equal to the investment amount.

Once holders of public shares approve the transaction, the SPAC is required to file a special "Super 8-K" with the SEC, which contains all of the information that would be required in a Form 10 registration statement in a registered IPO.[6]

Potential Litigation Risks

With a few exceptions, there has been a genuine dearth of lawsuits challenging SPACs in the past decade and prior. Given the recent volume of SPAC IPOs, there are a number of issues that could become the subject of future litigations, a few that are unique to SPACs, and many to which any publicly traded company is ultimately subject.

We discuss here a few of which securities litigators should be aware.

Redemption of Public Shares

One area of potential litigation risk is share redemption. SPACs allow shareholders to redeem their shares pre-transaction as an alternative to rolling their shares into the post-acquisition company. As a result, the amount of capital the SPAC brings to a potential deal sometimes is less than was originally anticipated, which could potentially cause last minute re-negotiation of the deal.[7]

A very high redemption amount and corresponding drop in SPAC funds available for the business combination transaction could lead to litigation initiated by the target company. So long as the SPAC sponsors are diligent in negotiating the terms of the agreement, this type of litigation generally can be avoided.

If the deal falls apart and the SPAC sponsors are forced to pursue a less lucrative deal to comply with the 24-month deadline, this also could cause holders of public shares to sue the SPAC sponsors post-transaction concerning the share price. SPAC sponsors should avoid rushing into transactions and seek an extension of the de-SPACing deadline from the shareholders to mitigate the risk of a shareholder suit.

Additionally, a large stock redemption by public investors voting against the de-SPACing transaction could cause the SPAC to face involuntary de-listing from the Nasdaq Stock Market or the New York Stock Exchange.

For instance, Nasdaq-listed companies must have at least 450 unrestricted round-lot shareholders — i.e., shareholders who own 100 or more unrestricted securities — and at

least half of the minimum required number of round-lot holders must each hold unrestricted securities with a minimum value of \$2,500.

Redemption may reduce the number of round-lot shareholders, requiring de-listing either prior to the business transaction or after the transaction. This may lead to shareholder suits against the sponsors of the SPAC, alleging breach of fiduciary duty.

However, the SPAC sponsors can ward off, and subsequently defend against, this type of litigation by following corporate procedures in the SPAC charter, avoiding any appearance of self-dealing, and asserting the business judgment rule as a defense.[8]

De-SPACing Transaction

SPAC sponsors must follow the SEC proxy process for soliciting a shareholder vote on the proposed de-SPACing transaction. Part of this process involves issuing a proxy statement in connection with the transaction with the target company.

Shareholders may sue based on alleged deficiencies in a proxy statement in violation of Section 14(a) of the Securities Exchange Act, arguing that because of inadequate disclosure, they lack the ability to make a fully informed decision on the proposed transaction.

Careful drafting of a complete and accurate proxy statement can help ward off these suits, and they typically can be resolved relatively easily by amending the proxy statement.

A recent example is a class action complaint filed against Greenland Acquisition Corp. and its sponsors in September 2019, alleging a number of omissions, including of financial projections for the post-acquisition company and details about Greenland's negotiations with target companies.[9]

The court entered a stipulation and order of dismissal approximately a month later, noting that Greenland had filed an amended proxy statement with the SEC, mooted the plaintiff's claims a week after the complaint was filed.[10]

Shareholders also may sue for alleged misleading disclosures or fraudulent statements made in the proxy statement, in violation of Section 10(b) of the Securities Exchange Act and Rule 10b-5. These lawsuits might arise after the de-SPACing transaction, if shareholders are unhappy with the financial performance of the newly formed entity.

For instance, shareholders may sue if the sponsors inflated the target's financials or failed to disclose known financial risks, and the share price drops as a result. An example of this is a class action complaint filed in 2010 against SPAC Heckmann Corp. — now known as Nuverra Environmental Solutions Inc. — its sponsors and post-merger company China Water and Drinks Inc., alleging violations of Sections 14(a) and 20(a) of the Exchange Act.

The complaint stated that the proxy documents issued to solicit shareholder approval of the merger contained material misstatements, inflating China Water's operations, financial condition, prospects and revenues.[11] The case settled in 2014.

Another potential risk is lawsuits against SPAC board members for alleged breaches of fiduciary duties. A holding by the New York Supreme Court in *AP Services LLP v. Lobell* suggests that the business judgment rule — under which courts typically defer to the business judgments of directors when made on an informed, good faith basis — may not

always apply to decisions by SPAC directors.[12]

In that case, a year and a half after SPAC Paramount Acquisition Corp. acquired Chem Rx, the post-acquisition company publicly announced that it was unable to file its annual report, which forced the company's admission that its pre-SPAC audited financial statements were false. Chem Rx went into Chapter 11 liquidation and the litigation trust sued Paramount's directors for breach of fiduciary duty of loyalty and care to Paramount, alleging that they allowed Paramount to enter into the business transaction out of self-interest and ignored red flags in the financial statements.

The directors moved to dismiss, arguing that the business judgment rule protected their decision to consummate the transaction, but the court denied that motion because the plaintiffs had sufficiently alleged that the directors stood to receive a material benefit from the transaction.

While the court made no blanket statements regarding the applicability of the business judgment rule in the SPAC context, the court held that the directors in this case were potentially self-interested, and therefore the burden shifted to the directors to establish their good faith and the fairness of the transaction.

To avoid such suits, directors of SPACs should note the holding of the Delaware Chancery Court in *In re: KKR Financial Holdings LLC Shareholder Litigation*, which found that if shareholders are fully informed at the time of a shareholder vote on a transaction, the business judgment rule applies and insulates the transaction from breach of fiduciary duty claims. This holding is one of many that counsels in favor of robust and accurate proxy statement disclosures.

One final note: Once the de-SPACing is complete, the business acquired becomes a publicly traded operating company, which is vulnerable to the same securities litigation risks as any publicly traded company, including shareholder suits alleging false and misleading statements in SEC filings or other public disclosures regarding undisclosed risks, operations, revenues and company goals.

Conclusion

Securities litigators should expect that SPACs will continue to gain popularity, largely as a result of the limited risks SPACs pose for investors and the swiftness with which SPAC IPOs are executed. While SPACs offer a unique investment proposition for investors and an alluring business opportunity for SPAC sponsors, all involved parties, and securities litigators in particular, should be aware of the possibility of an increase in litigation.

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[1] US SPAC IPO Issuance, SPAC Research (last visited Sept. 8, 2020), <https://spacresearch.com>.

[2] Jeffrey Smith and Michael Heinz, INSIGHT: Private Equity and SPACs – A Mutually Beneficial Relationship, Bloomberg Law (Aug. 12, 2020), <https://news.bloomberglaw.com/securities-law/insight-private-equity-and-spacs-a-mutually-beneficial-relationship>.

[3] Ramey Layne and Brenda Lenahan, Special Purpose Acquisition Companies: An Introduction, Harvard Law School Forum on Corporate Governance (July 6, 2018), <https://corpgov.law.harvard.edu/2018/07/06/special-purpose-acquisition-companies-an-introduction/>.

[4] Preston Brewer, Analysis: SPACs – Back & On Track to Challenge Traditional IPOs, Bloomberg Law (Feb. 11, 2020), <https://news.bloomberglaw.com/bloomberg-law-analysis/analysis-spacs-back-on-track-to-challenge-traditional-ipos>.

[5] John Jannarone, Sidley Austin Attorneys: SPAC Extensions Hit Record After Coronavirus Freeze, IPO Edge (June 5, 2020), <http://ipo-edge.com/2020/06/05/sidley-austin-attorneys-spac-extensions-hit-record-after-coronavirus-freeze/>.

[6] Id.

[7] This was an issue that arose in a recent lawsuit, *Manichaeen Cap., LLC v. SourceHOV Holdings, Inc.*, 2020 WL 496606, at *4-5 (Del. Ch. Jan. 30, 2020).

[8] Sara Jane Shanahan, Warding Off Shareholder Derivative Suits: Diligence and Faithfulness Are the Keys, Corporate Counsel (Aug. 25, 2010), https://www.sherin.com/wp-content/uploads/sh_files/News/SJS%20Warding%20off%20shareholder%20Corporate%20Counsel.pdf.

[9] See Complaint, *Wheby v. Greenland Acquisition Corp.* (D. Del. Sept. 19, 2019) (No. 1:19-cv-01758-UNA).

[10] See Stipulation and Order of Dismissal, *Wheby* (D. Del. Oct. 14, 2019) (No. 1:19-cv-01758-MN).

[11] See Complaint, *In re Heckmann Corp. Sec. Litig.* (D. Del. Oct. 8, 2010) (No. 1:10-cv-00378-LPS-MPT).

[12] Michael J. Dillon, United States: SPAC Directors Cannot Take the Protection of the Business Judgment Rule for Granted, Mondaq (October 23, 2015), <https://www.mondaq.com/unitedstates/directors-and-officers/437590/spac-directors-cannot-take-the-protection-of-the-business-judgment-rule-for-granted>.