Professional Perspective

Tips for Liability Prevention for SPACs

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Special purpose acquisition companies (SPACs) have continued to proliferate in 2021. Since 2020, over 300 new SPACs have raised more than $100 billion, and SPACs now account for more than a third of initial public offering (IPO) funding.

The SPAC boom of 2020 and early 2021 has drawn attention from investors, U.S. Securities and Exchange Commission regulators, and lawmakers alike, and a recent string of SEC advisory opinions foreshadows a stricter SPAC enforcement regime. Moreover, statements by SEC chair Gary Gensler indicate the agency is prepared to devote significant resources to addressing SPAC-related issues.

In light of the SEC's recent crackdown, as well as congressional attention and the inevitable increase in securities lawsuits and SEC investigations to come, it is crucial that SPACs, their boards, their sponsors, and target companies implement safeguards to protect against securities litigation and SEC enforcement actions.

This article provides an overview of recent regulations and litigation of SPACs, and outlines the best preventative practices to avoid SEC scrutiny and lawsuits.

Recent Regulation & Litigation

Since late 2020, the SEC issued statements indicating the agency's intent to tighten SPAC regulations, potentially altering the ways SPACs operate.

In December 2020, the SEC issued disclosure guidelines on potential conflicts of interest among SPAC sponsors, directors, and public shareholders. In April 2021, the SEC made statements on the adequacy of financial reporting and even suggested the Private Securities Litigation Reform Act's safe harbor—which applies to SPACs but not IPOs—does not protect against false or misleading statements made with actual knowledge of their false or misleading nature or when the statements are not forward-looking but rather about current valuation or operations.

In this most recent guidance, the SEC asserted that SPACs should face stricter financial reporting and disclosure requirements, asking registrants and their independent auditors to evaluate and correct any material misstatements in their financial disclosures. Since then, numerous SPACs filed Form 8-Ks indicating their intent to refile their financial statements.

The concerns expressed in the SEC's advisory opinions generally track with the concerns outlined by private litigants and SEC enforcement actions. Historically, securities litigation and SEC actions against SPACs have focused on false and misleading forward-looking financial projections; conflicts of interest among SPAC sponsors, directors, officers, and public shareholders; inadequate financial disclosures; and inadequate due diligence of the target company. Take the class action lawsuit against the SPAC Immunovant, Pitman v. Immunovant, Inc., 1:21-cv-00918-KAM (E.D.N.Y. Feb. 19, 2021), and a similar case, Jensen v. GigCapital3, Inc., as examples. Jensen v. GigCapital3, Inc. et al., No. 21-CV-00649, Dkt. 1 (S.D.N.Y Jan. 25, 2021).

Best Preventative Practices

SPAC boards, sponsors, and target companies should implement the following practices and procedures to reduce the risk of litigation and avoid SEC scrutiny.

Retain an Independent Financial Adviser for a Fairness Opinion

Fairness opinions, though not required by law, are a feature of most corporate transactions, and they provide value to both management and boards in mitigating litigation risk and as evidence of proper due diligence. They also provide value to shareholders as an indication of the quality of the proposed transaction. Fairness opinions are less common in SPACs, however, except when the target company has some affiliation with the sponsor. Nonetheless, with SPAC litigation on the rise, a diligently prepared fairness opinion may offer value to a SPAC's board, which may then rely on it to demonstrate the board complied with its duty of care.

Use a Reputable Accounting Firm for Due Diligence

Indeed, even if a SPAC sponsor is unaware of false statements made by the target company, the sponsor may still be required in litigation to demonstrate that it conducted its own due diligence. A reputable accounting firm may also provide value by addressing concerns from both the market and regulators on target companies' accounting integrity and governance weaknesses.

There is a growing perception, fueled by short sellers and press reports on SEC investigations, that some fledgling companies may be abusing the SPAC process. The accounting firm can help the target company test its internal accounting controls–including payment processes, delegation of authority, and separation of duties–to ensure that transactions are recorded accurately and conform to management authorization, which are key considerations in SEC enforcement investigations.

Use Extreme Care When Making and Relying on Financial Earnings Projections

Sponsors should engage in a documented, critical review and ensure that such projections are based on reasonable grounds and not unsupported opinions. Sponsors should also consider hiring outside financial advisors to determine whether such projections are sound. Finally, while the SEC's recent guidance challenges the applicability of the Private Securities Litigation Reform Act's safe harbor for forward-looking statements and projections, these statements and projections should always be accompanied by meaningful cautionary language.

Consider Liability Waivers in Shareholder Support Agreements

After a de-SPAC merger is signed, target companies often wait to enter into their first shareholder agreement until the registration or proxy statement becomes effective. In response, a SPAC should require officers, directors, and shareholders to enter into a shareholder support agreement, whereby the signatories pledge to vote their shares in favor of the transaction. By including a release or waiver of liability, SPACs can significantly reduce any liability arising from the de-SPAC merger should anything go awry.

Identify Potential Conflicts Among Sponsors, Directors, Officers, & Shareholders

While directors and officers are generally protected from liability by the business judgment rule, the rule might not apply if the directors and officers had a conflict of interest in coming to their decision. To avoid exposure to conflict of interest claims, SPAC sponsors should consider disclosing their expectations going into the merger and what they expect to take away from it. Should any conflicts exist or arise, it is in the sponsors' best interest to promptly and honestly disclose such conflicts to shareholders. Finally, SPACs should always maintain directors and officers insurance to protect high-level sponsors should any issues arise.

Conduct a Robust Global Compliance Gap Assessment During the de-SPAC

Target companies will now be subject to SEC jurisdiction, including the Securities Exchange Act Section 13(b)'s internal accounting controls and books and records provisions, the Sarbanes-Oxley Act, and the Dodd-Frank Act. While a company going public through a de-SPAC may already have sufficient compliance policies and procedures in place in many areas, certain other areas might be new to the company, such as procedures around insider trading, anonymous whistleblowing, and audit committee oversight of the compliance function.

SEC enforcement staff will certainly make requests relating to a company's compliance procedures part of any investigation. It is, therefore, critical for companies to make sure their compliance is in order on day one, or as soon as practicably possible. While failure to maintain adequate policies and procedures may not always result in liability, their absence is more likely to cause the SEC to further scrutinize the company's underlying business practices and culture. As the old saying goes, an ounce of prevention is worth a pound of cure.

By implementing these safeguards, SPACs, their boards, and their sponsors are less likely to become the target of an SEC investigation or securities lawsuits.