SPACs and Disclosure Liability

By John J. Kenney and Emily Hogan Long

1. What is a Special Purpose Acquisition Company (SPAC)?

Special Purpose Acquisition Companies, commonly called SPACs, are shell companies specifically created to take other companies public. Here, we focus on the extent to which SPACs may give rise to liability for individuals and entities under the Securities Act of 1933 ("the 1933 Act") and the Exchange Act of 1934 ("the 1934 Act") for materially false statements.

SPACs are a type of "blank check company," or a company with no real business purpose other than to merge with another unidentified entity.[1] A SPAC deal begins when the management team, called the sponsor, takes a shell company public. After the IPO, sponsors have a set period (typically two years) to identify a private target company with actual operations. Investors are often allowed to withdraw their money before the acquisition.[2] The SPAC acquires the private target in the "de-SPAC" phase, thereby making the target public.[3]

Sponsors often purchase for a nominal fee a 20% interest in the post-IPO company, called a "promote."[4] Sponsors often also receive warrants to purchase additional shares in the future.[5] If the SPAC acquires a target in the set period, the sponsor forfeits its 20% and the SPAC is liquidated.[6]

The modern SPAC originated in 2003, when Millstream Acquisition Corporation went public. It acquired Nations Health a year later.[7] SPACs gained popularity and legitimacy in 2019 and 2020 when high-profile companies such as Virgin Galactic and Draft Kings went public through de-SPAC mergers.[8] In 2020, half of all IPOs were accomplished through SPACs.[9] The recent proliferation of SPACs has led to increased investor protection concerns from regulators, including the SEC.[10]

2. SEC Regulations & Requirements

a. Forthcoming Regulations

Statements by current SEC Chair Gary Gensler show that the current Commission is not just interested in preventing fraud, but requiring more robust disclosures.

In June, Gensler told Bloomberg News that the agency is focused on "ensuring that the retail investors get the right disclosures and are protected." He also noted concerns with fairness, including that sponsors' equity stake dilutes the value of retail investors shares.[11] He made similar remarks to the House Financial Services Committee, stating that "the surge of SPACs raises a number of policy questions" including whether retain investors are "getting the appropriate and accurate information they need at each stage — the first blank-check IPO stage and the second target IPO stage[,]"[12]

Recently, Gensler publicly made it clear that investors "should benefit [ ] from the protections they would get in traditional IPOs, with respect to disclosure, marketing practices, and gatekeepers."[13] And he notably stated that liability would not be limited to SPACs, but that any "gatekeepers—potentially including directors, officers, SPAC sponsors, financial advisors, and accountants"—could be liable for SPAC disclosure violations.[14]

To further these policy goals, the SEC's Investor Advisory Committee has made eight recommendations for rules that would increase required SPAC disclosures. The recommendations included requiring:

- Plain English disclosures in SPAC registration statements about the compensation various players receive, including the promote and its impact on dilution;

- A clear description of the SPACs mechanics and timeline;
- Disclosures regarding the parameters of the search for a target and the risks involved in finding a target; and
- Disclosures about pre-acquisition due diligence.[15]

Gensler told the advisory committee that he agreed with their assessment that more can be done around SPAC disclosures, "especially around dilution."[16] The SEC's agenda indicates that the Commission will meet to propose a rule next spring.[17] But in the meantime, the Enforcement Division has already brought a proceeding against a SPAC for improper disclosures.

The House Financial Services Committee passed bills earlier this month that would prohibit marketing SPACs absent certain disclosures and exclude SPACs from the safe harbor for forward-looking statements.[18] However, the bills are likely to face political challenges going forward, and regulation by the SEC is much more certain.[19]

b. Enforcement Proceedings

There are currently at least two investigations of SPACs by the SEC that have been disclosed and one settlement by Nikola Corp.[20] Gensler's SEC brought its first enforcement action related to SPACs in July, charging SPAC Stable Road Acquisition Company ("Stable Road"), its sponsor, its target Momentus Inc. ("Momentus"), and Momentus's founder Mikhail Kokorich for making misleading statements about Momentus's technology. Momentus allegedly told investors that its propulsion technology had been tested in space, and Stable Road repeated these statements in public filings. Furthermore, Kokorich allegedly failed to inform investors that national security concerns would likely prevent him from securing required government licenses. Stable Road's registration statements contained projections that failed to account for these national security concerns.[21]

According to the SEC, Momentus violated Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 promulgated thereunder, which prohibit fraudulent conduct statements in the sale of securities. Stable Road violated Sections 17(a)(2) and (3) of the Securities Act, Section 14(a) of the Exchange Act and Rule 14a-9 promulgated thereunder, which materially false statements in proxy statements, and Section 13(a) of the Exchange Act and Rules 12b-20 and 13a-11 promulgated thereunder, which prohibit issuers from making materially false or misleading information in SEC filings. All parties other than Kokorich settled, agreeing to cease and desist from violations and paying penalties totaling over $8 million.[22] The SEC separately sued Kokorich in the U.S. District Court for the District of Columbia for disclosure violations, and that case is still ongoing.[23]

Gensler stated that the case "illustrates risks inherent to SPAC transactions," and that the enforcement action would "help to better align the incentives of parties to a SPAC transaction with those of investors relying on truthful information to make investment decisions."[24]

3. Minimizing Regulatory Risk

SPACs, sponsors, and targets must exercise caution given the scrutiny on SPACS's disclosures. In a tougher regulatory environment, they can minimize their exposure by maintaining sufficient D&O insurance, carefully documenting the due diligence conducted on targets, and ensuring that they have sufficient back-up for statements in filings.[25] The attorneys at Hoguet Newman can help clients navigate the complex legal issues presented by SPAC-related regulatory enforcement and D&O insurance recovery.

About the Authors

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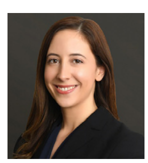

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