ALERT MEMORANDUM

SPAC Sponsors Beware: The Rising Threat of Securities Liability

October 21, 2020

Special purpose acquisition companies or "SPACs" are an increasingly popular way for an existing private company to become publicly traded without undergoing a traditional initial public offering, and for investors in public markets to invest in growth-stage companies. There can be generous returns for SPAC sponsors, but they should be aware of the liability risk in connection with their role. Indeed, litigation arising from several recent SPAC acquisitions, most prominently against Nikola Corporation, underscores the risks for SPAC sponsors. They therefore should be mindful of steps they can take to mitigate these risks in the reverse merger process.

If you have any questions concerning this memorandum, please reach out to your regular firm contact or the following authors

NEW YORK

Nicolas Grabar
+ 1 212 225 2414
ngrabar@cgsh.com

Adam Brenneman
+ 1 212 225 2704
abrenneman@cgsh.com

Jared Gerber
+1 212 225 2507
jgerber@cgsh.com

One Liberty Plaza
New York, NY 10006-1470
T: +1 212 225 2000
F: +1 212 225 3999

Key Takeaways

— In the "de-SPAC" transaction, when a SPAC acquires its target, the SPAC and its sponsors are potentially liable under Sections 10(b) and 14(a) of the Securities Exchange Act of 1934 for misleading statements included in a proxy statement or in other public statements. The SPAC and its sponsors may also be liable under Section 11 of the Securities Act of 1933 if that de-SPAC transaction includes a registered offering.

— Investors have sought to hold SPACs and their sponsors liable for a variety of alleged misstatements, including about the financial outlook of the target companies and the level of due diligence performed by the SPAC.

— The best ways for a SPAC sponsor to mitigate these risks are to perform sufficient due diligence on the target and to be cautious with language in the proxy statement.

Risks for SPAC Sponsors in Connection with a De-SPAC

When a SPAC has found its target, it makes filings under the federal securities laws in connection with the completion of the acquisition—what lawyers call the "initial business combination" and everyone else calls the "de-SPAC." In the typical case, the principal filing is a proxy statement, which is often combined with a prospectus. It typically provides detailed disclosure about the target, including several years of financial statements. Many SPACs also include statements concerning the outlook for future business or market growth.

If there is a material misstatement or omission in those materials, the SPAC or its sponsor could be held liable under Section 14(a) of the Securities Exchange Act of 1934 (the "Exchange Act") and Rule 14a–9 thereunder. Such claims would require a plaintiff to prove that the misstatement or omission was an "essential link" in the consummation of the transaction, and that the SPAC or its sponsor was at least negligent in making the misstatement or omission.[1]

Liability could also arise under Section 10(b) of the Exchange Act and Rule 10b–5 thereunder, which prohibit intentional or reckless material misstatements or omissions in connection with the purchase or sale of a security.[2] For example, any material misstatements or omissions concerning the target company could serve as the basis for lawsuits filed on behalf of investors who traded in the SPAC's securities. Indeed, in the wake of the 2008 financial crisis, similar claims were asserted against companies that became listed on U.S. stock exchanges through reverse mergers.

The de-SPAC also often involves a registered offering of the SPAC's shares, so there could also be claims under Section 11 of the Securities Act of 1933 (the "Securities Act") against the issuer and its officers and directors, and under Section 12(a)(2) of the Securities Act against any other sellers (like PIPEs investors reselling pursuant to registration rights).

Recent Litigation Against SPAC Sponsors

The risks are not just theoretical: claims have been asserted against earlier SPACs and there is now an increasing number of examples of securities litigation against recent SPAC sponsors. Three ongoing lawsuits illustrate the litigation risks that SPACs can face.[3]

VectoIQ/Nikola. VectoIQ, a SPAC led by former General Motors executives and focused on the smart transportation industry, merged with hydrogen-powered electric truck startup Nikola Corp. in June 2020. On September 10, 2020, a short seller issued a report stating that it "believe[s] Nikola is an intricate fraud built on dozens of lies over the course of its Founder and Executive Chairman Trevor Milton's career." Multiple law firms subsequently announced that they were investigating claims for violations of the securities laws by Nikola and filed lawsuits against the newly-merged company and its officers, alleging violations of Section 10(b) of the Exchange Act for alleged misstatements and omissions made concerning the merger. One of the lawsuits names the former CEO of VectoIQ (the pre-merger SPAC) as an individual defendant, and the suit alleges that he made misstatements during and subsequent to the announcement of the partnership with Nikola in his capacity as the CEO of VectoIQ. These alleged misstatements include that VectoIQ had been on a "two-year quest to find a partner that was a proven

[1] A SPAC that is a "foreign private issuer" is not subject to the SEC's proxy rules and therefore could not be liable under Rule 14a–9 for any misstatements or omissions in the materials it sends to shareholders, although it could have Rule 10b–5 liability with respect to those materials.

[2] To prove a Rule 10b–5 claim, an investor would have to show, among other things, loss causation, which is generally shown by pointing to a stock price decline following the revelation of the "truth" concerning an alleged misstatement or omission, based on the assumption that the decline in price following that revelation reflects the dissipation of prior inflation caused by the alleged misstatement or omission.

[3] These examples discuss allegations against SPAC sponsors arising from their conduct in that capacity. Claims can also be brought against the same individuals based on their conduct in subsequent roles with the newly merged company.

technology leader" and that "Nikola's vision of a zero-emission future and ability to execute were key drivers in our decision," which are alleged to be false and misleading because Nikola allegedly overstated its "in-house" design, manufacturing, and testing capabilities and its hydrogen production capabilities. The suit also alleges that VectoIQ's statement that it had performed extensive due diligence in selecting Nikola was false and misleading because it had not actually performed such diligence.

Landcadia/Waitr. Another ongoing lawsuit arises out of the November 2018 acquisition of Waitr, a food-delivery service, by a SPAC called Landcadia Holdings, Inc. The lawsuit alleges that with mere weeks to go before the SPAC's deadline to acquire a target (or to liquidate), the SPAC's founders hastily acquired a target to preserve their reputation as dealmakers,[4] and made false and misleading statements in the proxy statement in an effort to quickly close the transaction, giving rise to claims under Sections 10(b) and 14(a) of the Exchange Act and the rules thereunder. For example, the lawsuit alleges that optimistic statements about Waitr's financial condition and projections, including statements made by Landcadia's co-chairman (in his capacity as co-chairman of Landcadia) were misleading, because at the time of the merger, Waitr's existing contracts were not profitable for Waitr, and the fee structures that it planned to use in the future would be "draconian" and unsustainable for restaurants—as evidenced by certain restaurants' calls for a boycott of Waitr after the price changes were put in place.

MMAC/Akazoo. Another ongoing lawsuit was brought against Akazoo S.A.—which is the product of a September 2019 merger between Modern Media Acquisition Corp. ("MMAC"), a SPAC, and Akazoo Limited, a music streaming service—and various individual defendants, including officers and directors of MMAC pre-merger. The complaint alleges that the defendants made misstatements about the strength of Akazoo, including in the proxy statement, giving rise to claims under Sections 10(b) and 14(a) of the Exchange Act and the related rules. For example, the complaint alleges that upon the announcement that MMAC had reached a merger agreement with Akazoo, the chairman of MMAC (in his capacity as chairman of MMAC) made misstatements regarding the number of Akazoo's users, the number of countries it operates in, and its "profitable business model with a strong competitive moat in emerging markets." Similarly, the complaint alleges that the proxy statement contained misstatements about the level of diligence that MMAC had undertaken in evaluating Akazoo as a potential target. Notably, the complaint also brings a claim under Section 11 of the Securities Act, including against the chairman of MMAC, alleging that the company's registration statement for common stock issued in connection with the de-SPAC contained misstatements concerning similar topics. On September 30, 2020, the Securities and Exchange Commission ("SEC") also filed a lawsuit against Akazoo, alleging that it "grossly misrepresent[ed] the nature and success of its music streaming business" and that it "continued to mislead the public" while its shares were publicly traded, although the SEC does not allege misconduct by MMAC or its directors and officers.[5]

---

[4] Courts may consider allegations that SPAC sponsors hastily finalized a deal to be relevant to the scienter inquiry. For example, in one 2012 decision, a court found that "[t]he desire to avoid impending liquidation," as pleaded by the plaintiffs, was a "motivating factor," among others, for the SPAC's officers to commit fraud, and accordingly found that the plaintiffs had properly pleaded scienter.

[5] Another example of a de-SPAC leading to SEC enforcement actions, including against an individual from a SPAC sponsor, is Cambridge Capital Acquisition Corporation's December 2015 acquisition of an Israel-based intelligence communications company called Ability Computer & Software Industries, Ltd. The SEC settled an enforcement action against the SPAC's former CEO, in which it brought Section 14(a) and Rule 14a–9 claims alleging that the former CEO failed to take reasonable steps and conduct appropriate due diligence to ensure that the SPAC's shareholders were provided with material and accurate information regarding the target's business prospects. An enforcement action against individuals associated with the target company is ongoing.

Conclusion

Those looking to create SPACs and acquire companies through them should carefully consider the accompanying legal risks and the ways to potentially mitigate them. Because of the current wave of securities litigation against SPACs, sponsors may wish to approach the de-SPAC process as akin to a traditional IPO from a liability management and risk mitigation perspective, even if the process otherwise resembles a merger transaction. If sponsors choose to do so, they may consider the following steps:

First, SPAC sponsors may consider performing the type of diligence associated with a traditional IPO, in addition to the valuation-focused due diligence typical of the merger context. As discussed above, many of the potential securities claims that could be brought against a SPAC sponsor require a showing of negligent, reckless, or knowing wrongdoing, while others provide a due diligence defense. Thus, a SPAC sponsor can attempt to mitigate its potential litigation exposure by performing robust due diligence on the target, which would allow it to subsequently argue that it did not act negligently, recklessly, or knowingly in making any alleged misstatements or omissions. This would also help defend against claims that challenge statements about the level of diligence conducted.

Second, in regulatory filings and public statements, SPAC sponsors should include appropriate caveats concerning the sources of the information they disclose regarding the target company, as well as disclaimers for forward-looking statements and opinions. For example, where disclosures are made based on information provided by a target, it may be advisable to explicitly say so. Similarly, where disclosures are forward-looking or reflect opinions, sponsors should identify the statements as such and describe the basis for them. By carefully crafting the disclosures in their filings and other public statements, SPAC sponsors may strengthen future arguments against liability for alleged misstatements or omissions.

Finally, SPAC sponsors should fully disclose any potential conflicts of interest, and be aware that the SEC is increasing its focus on this topic with respect to SPACs. In particular, SEC Chairman Jay Clayton recently made comments regarding SPACs, suggesting that the SEC may be taking a closer look at their filings. Specifically, Chairman Clayton stated in a recent interview: "One of the areas in the SPAC space I'm particularly focused on, and my colleagues are particularly focused on, is the incentives and compensation to the SPAC sponsors. How much of the equity do they have now? How much of the equity do they have at the time of the IPO-like transaction? What are their incentives?" With respect to both the IPO and the de-SPAC process, he said that "we expect the disclosure to be such that an investor can understand all of those motivations." Such concerns echo claims about potential conflicts of interest that gave rise to claims pursued by CDO and RMBS investors in the wake of the 2008 financial crisis. Especially in light of these comments, we can expect an increased focus by both regulators and private litigants on the incentives and motivations of a SPAC's sponsors in seeking out and consummating a merger. Full disclosures of those incentives and motivations are therefore critical to mitigating the risks from such claims.

…

CLEARY GOTTLIEB