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SPACs Could Face More Litigation Risks Under SEC Proposal

By **Tom Zanki**

Law360 (March 31, 2022, 8:31 PM EDT) -- The U.S. Securities and Exchange Commission's proposed rules governing special-purpose acquisition companies, billed as an effort to harmonize regulations with those for traditional initial public offerings, would add liability risks that some lawyers say may curb the appeal of the alternate funding vehicles.

In a 372-page proposal released for public comment Wednesday, regulators said SPAC transactions could be viewed as a way for market participants to avoid certain safeguards associated with conventional IPOs. If adopted in their current form, the new rules seek to narrow regulatory gaps between these varying ways of taking companies public.

The SEC's proposal would require more disclosures throughout the SPAC process, purportedly enabling investors to make better informed decisions. It would also expand liability and hold more parties accountable for faulty disclosures, including by broadening the statutory definition of an underwriter. Lawyers said the entire proposal, as currently crafted, could diminish the lure of SPACs.

"This has the potential to impose real costs in diligence and potential litigation costs that could slow down SPACs a little bit, though much will depend on definitions I hope will be clarified in the adoption process, such as when one qualifies as an underwriter," said Morrison & Foerster LLP partner Michael Birnbaum, a former SEC senior trial counsel who represents companies and investment banks in regulatory and litigation matters.

SPACs, or blank-check companies, are shells that raise money through IPOs with the intent of acquiring a private business and taking it public, within about two years or less. These alternative vehicles have existed for decades, but exploded around 2020, aided by pandemic-era stimulus, providing many target companies another way to go public.

The SPAC surge has softened since mid-2021, partly due to poor post-merger stock performance of target companies, as well as recent market volatility. Blank-check companies have also attracted more litigation and scrutiny from regulators concerned about investor protection.

Regulators worry SPACs prospered partly because they enjoy certain advantages over traditional IPOs due to "regulatory arbitrage," which the recent SEC proposal seeks to eliminate.

"It certainly may make transactions less attractive, when you look at the whole package of changes in the proposal, combined with the market dynamics that we've seen since the second half of last year,"

said WilmerHale partner Glenn Pollner, who steers both traditional public offerings and SPAC transactions.

The SEC's attempt to bolster SPAC disclosures — which require companies to reveal more information about conflicts of interest, insider compensation, plus equity dilution and related costs that could be borne by investors — were largely expected.

Lawyers are still delving into other aspects of the proposal, which would impose new legal obligations on SPAC offerings and their eventual mergers — known as "de-SPACs" — so they more closely resemble traditional IPOs.

Among potential changes, the SEC would require target companies being acquired by a SPAC to sign as co-registrants when the SPAC files an S-4 document regarding its proposed merger. This would clarify that the target company and its board of directors are subject to strict liability, meaning they could be found liable in a lawsuit or enforcement action even if they did not intend to deceive investors, if disclosures are found to be materially misleading.

The new rules also propose any underwriter that participated in the original blank-check IPO and "takes steps" to arrange a merger, including raising additional financing, would also be considered an underwriter in the "de-SPAC" transaction and thus face the same strict liability as traditional IPO underwriters.

The SEC said imposing liability should motivate parties to ensure accurate disclosures in merger documents.

Republican SEC Commissioner Hester Peirce, who cast the lone dissent in a 3-1 party-line vote to propose the rules on Wednesday, expressed concern the SEC was being overly broad in how it defines an underwriter. She noted any blank-check IPO underwriter that receives deferred compensation pending a subsequent merger would be liable in connection with a "de-SPAC."

Peirce said many underwriters may seek to avoid being captured by the rule, including by demanding more compensation upfront at the IPO stage, which she said does not benefit investors. Lawyers said this topic will be worth watching as the SEC receives comments, noting investment banks may push back on the idea.

"That could have a chilling effect on IPOs currently," said Vinson & Elkins LLP partner Ramey Layne, who advises many SPACs in the energy industry and others. "I wouldn't be surprised if some of the bulge-bracket banks wait a little bit and think hard about that."

The SEC said additional parties, such as financial advisers who guide a SPAC merger, could also be considered underwriters depending on the circumstances.

Moreover, regulators would require SPACs affirm they believe the terms of a merger, and any related financing to complete the deal, are fair to all investors. The SEC said this may address concerns that SPAC mergers have uneven incentives, where insiders can profit even if shares of the target company decline after the acquisition.

The proposal would also clarify that a target company's financial projections, which are sometimes disclosed to investors before they vote on a SPAC merger, would not benefit from liability protection

under the Private Securities Litigation Reform Act of 1995.

Projections have been a sticking point with SPACs as some target companies have seen share prices flop after a merger because their performances fell below forecasts.

Companies typically avoid disclosing projections in traditional IPO filings because underwriters are concerned about liability or reputational risks if rosy predictions flop. The SEC wants to clarify that a securities law "safe harbor" for projections that applies to existing public companies does not apply to target businesses in a SPAC merger.

"The takeaway is the SEC seems much more comfortable with companies going public via the traditional IPO process," said Mark Brod, a Simpson Thacher & Bartlett LLP partner who advises clients on capital markets transactions and blank-check mergers. "From a regulatory perspective, they are trying to make the 'de-SPAC' process look much more like the traditional IPO process, and to impose the same potential securities law liability and the same limitations on making forward-looking statements as in traditional IPOs."

In the meantime, Layne noted some 300 SPACs that completed public offerings are facing deadlines to complete a merger within the next 12 months. He said it will be worth monitoring whether any SPACs close shop given the uncertainty over how rules shake out.

"The interesting question is: Does this slow down 'de-SPACs' for the next four, five or six months as we work through what the rules are really going to be?" Layne said.

The SEC's proposal will be published on the agency's website and in the Federal Register. Regulators will accept public comment for 60 days following publication of the release on the SEC's website or 30 days upon publication in the Federal Register, whichever is longer. Regulators could vote on a final version later this year.

--Editing by Philip Shea and Lakshna Mehta.
