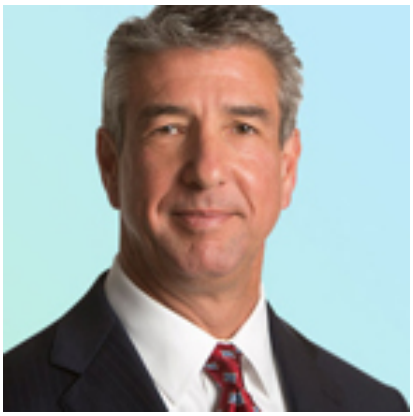
By: **Kevin M. LaCroix**

The D&O Diary

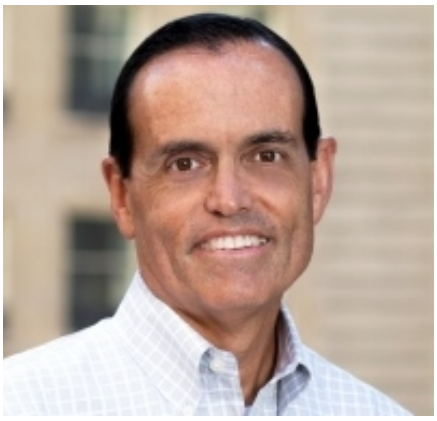
A Periodic Journal Containing Items of Interest From the World of Directors & Officers Liability, With Occasional Commentary

Guest Post: SPACs and SPAC-Related Litigation: A Primer on Reducing Litigation and Enforcement Risk

By Kevin LaCroix on May 23, 2021



Paul R. Bessette



Chris Crawford

As I have documented on this site, along with the rapid rise of SPAC-related transaction activity has come a surge in SPAC-related litigation. In the following guest post, Paul R. Bessette and Chris Crawford consider the likelihood for even further litigation relating to SPAC transactions and review the steps that

well advised companies involved in SPAC transactions can take to try to reduce their litigation risks. Paul is co-chair of the King & Spalding law firm's Corporate & Securities Litigation Practice and Chris is a Senior Vice President and Client Executive with Marsh in Los Angeles. A version of this article was previously published in Westlaw Today, 2021 WL 1990398. I would like to thank Paul and Chris for allowing me to publish their article on this site. I welcome guest post submissions from responsible authors on topics of interest to this blog's readers. Please contact me directly if you would like to submit a guest post. Here is Paul and Chris's article.

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Special Purpose Acquisition Companies "SPACs" are all the rage right now. Hardly a day goes by without a new article appearing in various business or legal forums covering SPACs, including the SPAC IPO, their sponsors, target companies, and so-called de-SPAC transactions, as well as the related litigation and regulatory risks. SPACs are shell companies that raise money, go public, and seek a private company target to acquire. The private company gets a short-cut to a public listing by merging with the SPAC. SPAC IPOs had a record-breaking year in 2020, and 2021 so far has already crushed those record numbers. *SPAC Insider* reports that there were 46 SPAC IPOs in 2018 and 59 in 2019, but the number shot up to 248 in 2020 and over 300 so far this year.

According to the *Stanford Securities Class Action Litigation Database*, there have been 25 Securities Class Action suits brought against SPAC-related entities, all since 2019, and 19 in the past 13 months. Per *SPAC TRACK*, there have been 141 closed de-SPAC transactions since 2015. This leads to a litigation rate of 17% of de-SPAC deals overall and 19.4% of closed transactions since 2019. As a frame of reference, the average publicly traded company had a 5.7% likelihood of class action litigation in 2020 and 7.4% in 2019, two of the five highest years of class action suits in history. Interestingly, the Robbins Geller law firm announced in an April press release that it had formed a "SPAC Task Force." The press release notes that supposed SPAC features, such as "significant conflicts of interest" and "less stringent disclosure requirements," have caused several high-profile SPAC offerings to result in "serious allegations of fraud and misconduct, collectively costing investors billions of dollars of investment losses."

With nearly 550 SPAC IPOs in the past 16 months and an 18 – 24 month investment period during which a transaction needs to occur or the SPAC must return the escrowed capital funds to shareholders, the pressure to consummate deals is moving at a furious pace. Multiple SPACs are bidding against one another for a limited pool of targets, particularly in certain industry segments – driving up multiples and leaving spurned suitors with less time to get a deal done within the ticking time frame. Incredibly, there are more than 400 SPACs still searching for merger targets currently.

Through 2021 and 2022, this increased frenzy for SPACs to close transactions is expected to decrease the diligence and quality of many of the deals. This will likely drive up the potential for securities class action litigation to even higher rates, making it even risker to serve as directors or officers in a SPAC-related transaction, on both the SPAC entity, as well as the privately held target that becomes a public company. Management and Boards on all sides of the SPAC world need to think in terms of how to mitigate their potential liability for the increasing likelihood of having to defend themselves in costly securities litigation.

The SEC has also increased its scrutiny of SPACs. The SEC shocked the soaring SPAC market on April 12 when it announced that SPACs needed to account for warrants as liabilities instead of equity. The announcement paused SPAC IPO offerings and forced SPACs and the companies they are acquiring to determine if the accounting change would require a restatement. The SEC's Enforcement Division has also shown an interest in SPACs and appears to have opened several inquiries/investigations.

Despite the headwinds that are chilling the once red-hot market for SPACs, it is a safe bet that SPAC activity will rebound once the accounting and related issues raised by regulators are resolved. Preparing in advance – and throughout the SPAC transaction cycle – for the prospect of litigation or further regulatory scrutiny is a prudent step in this environment. It could spell the difference between a relatively quick resolution or a prolonged headache. Proactively addressing the following issues will help provide needed protection for SPACs, their Boards, sponsors, and advisors for future litigation and regulatory inquiries.

- **Play Defense in the Governing Documents**. SPACs and private company de-SPAC targets should consider adopting a federal forum provision (FFP) and an intra-corporate forum selection provision. These tools will help control the domicile where any litigation may take place and should provide more certainty around how the applicable law will be applied. SPACs should also consider including exculpatory clauses in the charter and bylaws at the time of formation – this will limit director liability for breach of fiduciary duty claims, a common claim found in SPAC-related litigation.

- **Carefully Review and Comply with SEC Disclosure Guidance.** Pay attention to potential conflicts and the adequacy of conflict disclosures. Conflicts of interest often arise in de-SPAC transactions (the private company merger) and become one of the bases of the de-SPAC litigation – remember, the Robbins Geller law firm, among others, is focused on these conflicts of interest. Employ a process that identifies possible conflicts between SPAC sponsors, directors, officers, and shareholders, and helps prevent the perception of compromising decisions to merge with a target company. Make sure there are private, executive sessions of the independent directors, without the sponsors present, and document these sessions in the board minutes. Be wary of the late-stage deal, when appearances of potential conflicts between SPAC sponsors and ordinary shareholders are the greatest as the deadline for liquidation looms.

- **Keep Contemporaneous Records.** Document in real time all the target searches and ensure that robust due diligence is performed during the entire de-SPAC process. Be sure to document the complete search history, not just the due diligence for the final de-SPAC partner. In light of the SEC's current focus on SPACs, it would be wise for the SPAC to conduct a detailed assessment of the target company's compliance policies and procedures, as it will now be subject to SEC jurisdiction.

- **Be Cautious When Making or Relying on Financial Projections.** The SEC has provided recent guidance indicating it will apply strict financial and disclosure requirements for de-SPAC transactions. SPACs should ensure that any financial projections they rely on have a reasonable basis and are objectively supportable. Make sure to document the process by which the projections are generated, and provide detail on the assumptions that underlie the projections. Keep in mind that the failure to meet financial projections is a major litigation risk, so take advantage of the PSLRA safe harbor provisions for forward looking statements while you can. There is speculation that the SEC may soon issue guidance restricting the availability of the safe harbor for SPACs. To comply with this protective provision, management must provide meaningful cautionary language that goes beyond mere boilerplate verbiage and tailors the disclaimers to identify specific risks relating to the target company, its projections, and industry.

- **Bullet-Proof Your Due Diligence.** It is critical to conduct thorough due diligence on the target company. Consider engaging a reputable accounting firm to scrutinize the target's financials, as well as an independent financial advisor to provide a fairness opinion on the proposed merger. A fairness opinion and/or a formal presentation from a financial advisor will be valuable to both management and Boards to mitigate the impact of litigation risk and as further evidence of proper due diligence.

- **Think Through All of the Potential D&O Insurance Issues.** There is a significant likelihood that multiple D&O insurance policies representing the separate constituents may be involved in litigation. For example, lawsuits can target SPAC directors and officers along with the management and Board of the target or go-forward public company – with each of these three entities having different D&O insurance policies, limits, insurers, and breadth of coverage. Additionally, with the de-SPAC transaction, there is the possibility that common individuals will be on both the SPAC and go-forward public company Boards, implicating

"capacity" related issues as to which role they were serving in during the time of the alleged wrongdoing and which policy(ies) should respond.

Not only will these various D&O insurance programs likely have been constructed independent of one another, unless proper foresight was utilized in negotiating the private company form to contemplate a public transaction, there are many potential coverage limitations that may preclude or reduce the potential protection available. The majority of private company D&O contracts exclude coverage for SEC offerings and have not been amended to include coverage for failed IPO claims, Road Show protection or alleged violations of Section 11, 12 and 15. Additionally, a large percentage of private company D&O insurance is provided on a "duty to defend" basis, meaning that the insurer is in control of defending the claim and selecting Defense Counsel, not the company and its directors and officers.

With roughly 420 SPACs currently targeting private companies for de-SPAC transactions in the next 18 – 24 months (per *SPACInsider*), litigation will almost assuredly continue to rise. The business combination process has driven the bulk of securities class action lawsuits to date against SPACs and related entities and can be expected to do so going-forward, as the M&A transaction and its success or alleged failure is what investors – and, unfortunately, plaintiffs' attorneys – are betting and focusing on. The bulk of SPAC litigation to date in 2021 has related to alleged post-transaction shortfalls in comparison with pre-combination projections. Carefully reviewing and ensuring that financial projections are fully supported is just one area of risk mitigation that directors and officers of SPACs and private company targets need to carefully scrutinize. With great opportunities come great expectations . . . and the possibility for downside risk. Taking the proper measures in advance as suggested above can help mitigate the liability should things go awry down the line.

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