IPO 2.0: Emerging Enforcement Trends for SPACs

January 5, 2021

Edward Kim
vCard

Henry Ross
vCard

Special purpose acquisition companies ("SPACs") have become a vehicle of choice for investors looking for investment opportunities in disruptive technologies. 2020 was a record-breaking year for SPACs, with 248 SPACs raising over $83 billion through IPOs. But as the popularity of SPACs has increased, so has enforcement scrutiny of SPACs and their acquisition targets. With both trends likely to continue, industry players should be alert to the potential litigation and enforcement risks posed by SPAC transactions.

SPACs at a Glance

A SPAC is a "blank check" company that raises funds from investors via an IPO prior to identifying a "target company" for acquisition. To attract investors, a SPAC typically relies on the reputation of its "sponsor," the person or group that forms and manages the SPAC. The SPAC has a set time, often 18 or 24 months from the date of the IPO, to either acquire a target company via a reverse merger, or liquidate. Reverse mergers, often known as "de-SPAC transactions," are sometimes facilitated by additional financing via private investment in public equity ("PIPE"). After a reverse merger is consummated, the combined operating company begins trading on the public market.

This mechanism provides target companies a potentially less burdensome alternative to the traditional IPO process and is one of the reasons for the growing popularity of SPACs. Sponsors stand to benefit as well, with extremely

limited downside—most SPACs are structured to provide the sponsor a "promote," usually 20% of post-IPO shares, in exchange for a relatively small upfront expenditure. Finally, investors are drawn to SPACs for the access they offer to companies that might otherwise be the exclusive domain of VC funds and other traditional growth-stage investors.

Enforcement Focus

However, SPACs also may create powerful incentives that, if mismanaged, could invite regulatory and criminal scrutiny. For example, as total SPAC capital increases more rapidly than the supply of available target companies, sponsors may face pressure to cut corners on due diligence and enter into ill-advised acquisitions prior to the close of the acquisition window, in order to trigger their promote. There is also a risk that target companies will provide less accurate or fulsome disclosures to their acquirers than they would to the SEC in a traditional IPO.

As former SEC Chairman Jay Clayton made clear in multiple interviews prior to his resignation, regulators are already focused on the adequacy of disclosures made in connection with SPAC transactions, including information about the ownership and compensation of sponsors. Investors and regulators will scrutinize disclosures made at several stages, including in connection with the initial SPAC registration, the de-SPAC transaction, PIPE financing and follow-on stock issuances, and subsequent SEC filings made by the combined company.

Statements made in connection with a de-SPAC transaction likely present the greatest risk of liability under the securities laws. Knowing misrepresentations in public statements related to a de-SPAC transaction, including on special Form 8-Ks ("Super 8-Ks"), can give rise to actions under Section 10(b) of the Securities Exchange Act of 1934 (the "Exchange Act") and Rule 10b-5. In addition, negligently false statements made in connection with a de-SPAC transaction can give rise to actions under Section 14(a) of the Exchange Act and Rule 14a-9, and under Section 17(a) of the Securities Act of 1933, among other provisions.

Recent Enforcement Activity

Nikola, an electric truck company, went public through a SPAC in June 2020. After an initial spike, Nikola's stock price has dropped precipitously amid accusations of fraud by a short-seller and various private plaintiffs, and ongoing investigations by the SEC and the U.S. Attorney's Office for the Southern District of New York. The accusations against Nikola center around alleged misrepresentations regarding the adequacy of the due diligence performed by its SPAC; Nikola's vehicle design, testing, and production capabilities;

and the backgrounds of certain Nikola employees.

Nikola is not the only SPAC transaction to fall into regulators' crosshairs. In September 2020, the SEC brought a civil enforcement action against Akazoo, S.A., a music streaming service that went public in 2019 through a merger with the SPAC Modern Media Acquisition Corp ("MMAC"). The SEC alleged that Akazoo made a number of false statements to investors regarding its finances, operations, and subscriber base, as part of its merger with MMAC, a related PIPE offering, and its subsequent public trading.

In 2019, the SEC brought enforcement actions alleging false statements relating to the reverse merger of Florida-based SPAC Cambridge Capital Acquisitions Corporation ("CCAC") and its Israeli target company, Ability Computer & Software Industries ("Ability"). According to the SEC, proxy statements and roadshow materials included misrepresentations regarding Ability's ownership of certain cellular technology, backlog of purchase orders from its largest customer, and pipeline of possible future orders. In September 2019, Ability announced that undisclosed employees had been arrested by Israeli authorities.

Although no SPAC-related criminal charges have been publicly filed in the U.S. to date, future enforcement activity also could include criminal charges in the U.S. against individuals who participate in making misrepresentations. For instance, U.S. authorities could explore charges against SPAC participants under the federal statutes commonly used to prosecute wire fraud and securities fraud.

***

Given the litigation and enforcement risks outlined above, individuals and entities engaging in SPAC-related transactions should take special care to avoid triggering regulatory scrutiny. Target companies should ensure that they are providing accurate materials to SPACs in connection with the diligence process. SPACs, in turn, should assume that any disclosures made in proxy statements, Form 8-Ks, and other public statements may be subject to heightened scrutiny. In particular, SPACs should ensure that disclosures related to their diligence process, sponsor ownership, and compensation structures are vetted carefully.

About KKL

KKL is a boutique firm with a global practice. KKL represents clients – domestically and abroad – in high-stakes U.S. and cross-border matters involving civil and criminal disputes and investigations. We provide exceptional advocacy and counselling – from the courtroom to the boardroom.

Our founding partners – graduates of Harvard and Yale Law Schools – are veteran federal prosecutors who served for years in senior roles at the Justice Department and FBI. We have conducted and supervised dozens of federal criminal investigations and trials involving some of the highest profile and most sensitive matters prosecuted by the United States government. We have personally led and overseen numerous cutting-edge investigations, involving complex criminal, cyber, and cross-border matters. And we have directly counseled Cabinet-level officials regarding issues of national importance.

We leverage these experiences in order to offer advocacy of the highest quality and innovative solutions to the most challenging issues our clients face.

Visit our website

The content of this email provides information about legal issues and developments of interest to our clients and friends. It should not be construed as legal advice regarding any matter, specific facts, or circumstances. The distribution of this content is not intended to create, and receipt of it does not create, an attorney-client relationship.

© 2021 Krieger Kim & Lewin LLP. Attorney Advertising. Prior results do not guarantee a similar outcome.

Krieger Kim & Lewin LLP | 500 5th Avenue, 34th Floor, New York, NY 10110
212.390.9550 | **Info@KKLllp.com**