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SPAC-Related Litigation Risks and Mitigation Strategies

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Special Purpose Acquisition Companies (SPACs) have been gaining traction during the past 18 months, although more recently they have come under the spotlight for more negative reasons. Following high-profile litigation associated with certain de-SPAC deals and statements from the Securities and Exchange Commission (SEC), many investors are now starting to question SPACs as an investment vehicle of choice.

At a recent event hosted by Latham & Watkins and FTI Consulting, panelists took a deep dive into the potential litigation risks associated with SPACs, and explored the mitigation measures investors and target companies should consider before pursuing a SPAC or de-SPAC deal.

This post offers five key takeaways from the panelists' discussion:

1. Beware SPAC Litigation is On the Rise

There has been a surge in SPAC litigation since 2020. According to recent data, the number of SPAC class actions has doubled from seven filings throughout 2020, to 14 filings from January 2021 through May 2021[1]— and the trend continues.

The risks vary throughout the stages of the SPAC lifecycle, with common litigation scrutiny focused around breach of fiduciary duty, claims of material misstatements or omissions in proxy statements, and disclosure shortcomings, particularly in de-SPAC transactions.

There is also increased regulatory scrutiny, with the SEC averaging approximately 480 enforcement actions per year during the past five years.

[1] The statistics are based on data from Cornerstone Research and Stanford Law School Securities Class Action Clearinghouse as of May 2021.

2. Avoid Rushing Due Diligence

The key to mitigating these potential litigation risks is ensuring appropriate due diligence. The parties involved in a SPAC merger often face pressure to expedite the process, but this can lead to shortfalls that may cause issues further down the line.

To help prevent such risks it is important for SPAC sponsors to seek professional legal and financial advisors to conduct proper due diligence and ensure sufficient time is given for Public Company Accounting Oversight Board (PCAOB) audits, as this is a common cause for delayed mergers. For target companies, public company readiness is critical and in particular, bolstering the finance and accounting team to be able to meet the strict financial reporting requirements of a public company.

3. Disclose Potential Conflicts

Many of the SPAC litigation claims to date have focused around allegations of potential or actual undisclosed conflicts. In fact, the SEC's John Coates (former Acting Director, Division of Corporate Finance, and now General Counsel) noted, "In some ways, liability risks for those involved [in SPACs] are higher, not lower, than in conventional IPOs, due in particular to the potential conflicts of interest in the SPAC structure."

Directors involved in SPACs therefore must carefully consider conflicts in the context of their fiduciary duties, and whether their actions adhere to the essence of the "business judgement" rule.

To mitigate potential conflicts liability, companies may consider forming a special committee composed solely of disinterested and independent directors who serve as the principal negotiators in the transaction, and recusing any affiliated directors from board deliberations.

4. Do Not Take Safe Harbor as Guaranteed

The general view that de-SPAC transactions would be shielded by the protections of safe harbor has been called into question following statements from SEC's John Coates that de-SPAC transactions are effectively IPOs, which are excluded from safe harbor.

Currently there is litigation sponsored in the US to formalize Coates' view, but regardless of the SEC's ultimate position, target companies and SPACs should nevertheless consider the risk of post-close litigation in connection with de-SPACs projections. A focus on well considered assumptions and risk disclosure is also advisable.

This poses questions for parties involved in a de-SPAC transaction around how forward-looking statements should be constructed, including whether they wish to consider mitigation measures such as the use of cautionary language and clearly presented base case projections, rather than only bullish financials.

5. Pay Careful Attention to Cross-Border SPACs

While some Asian exchanges are considering allowing SPAC listings, only South Korea and Malaysia currently allow them, with Singapore likely to be hot on their heels. Meanwhile, many US SPACs are increasingly looking to Asia for targets.

However there are many issues to consider in such cross-border transactions, including potential delays in filings due to PCAOB audits, differences in reporting standards between the US and Asia (e.g., Generally Accepted Accounting Principles vs. International Financial Reporting Standards), and misalignment in terms of auditing approaches.

In these instances, internal controls and financial and legal due diligence become even more critical to mitigate the risk of litigation later on.

In conclusion, despite heightened scrutiny and the various litigation risks that SPACs and de-SPACs present, they will likely continue to be valued as investment vehicles and remain an option for certain target companies considering a US listing, provided they undertake appropriate due diligence and use clear and cautionary language in any disclosures.