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SEC Fires Shot Across the Bow of SPACs

Client Alert | July 14, 2021

On July 13, 2021, the Securities and Exchange Commission ("SEC") announced a partially settled enforcement action against a Special Purpose Acquisition Company ("SPAC"), the SPAC sponsor and the CEO of the SPAC, as well as the proposed merger target and the former CEO of the target for misstatements in a registration statement and amendments concerning the target's technology and business risks.[1] As of the date of the enforcement action, the registration statement had not been declared effective and the proxy statement/prospectus had not been mailed to the SPAC shareholders. This action is notable because the allegations against the SPAC, its sponsor and its CEO are premised on a purported negligent deficiency in their due diligence, which failed to uncover alleged misrepresentations and omissions by the target and its former CEO. This action has important implications for SPACs, their sponsors and executives for their diligence on proposed acquisition targets.

Overview of the Action

In a settled administrative order, in which the respondents neither admit nor deny the allegations, the Commission alleged that disclosures contained in a Form S-4 filed by the SPAC were inaccurate because they both overstated the commercial viability of the target's key product, and understated the risk pertaining to the target's former CEO and a previous regulatory action regarding national security.

The settled administrative action against the target and the civil complaint against its former CEO, who is a Russian national, are premised on allegations of fraud: specifically, that the target and its former CEO (1) misrepresented that the target had "successfully tested" its key technology, when in fact a prior test did not meet criteria for success; and (2) omitted or made misstatements concerning the U.S. government's concerns with national security and foreign ownership risks posed by the target CEO including concerns related to his affiliation with the target.

The target consented to a settlement finding a violation of the anti-fraud provisions of the securities laws, including Section 10(b) of the Securities Exchange Act and agreeing to pay a penalty of $7 million. In the separate civil complaint against the target's former CEO, the Commission alleges violations of the same anti-fraud provisions.

Of greater significance is the settled action against the SPAC, its sponsor and CEO, which is premised on allegations of negligence in the conduct of their due diligence on the target, which failed to uncover the misrepresentations by the target and its former CEO and thus resulted in those misstatements or omissions being repeated in the proxy materials, even though those proxy materials had not yet been mailed to shareholders. The settled order alleges that: (1) although the SPAC engaged a technology consulting firm to conduct diligence on the target's technology, the SPAC did not ask the consulting firm to review the target's prior product test; and (2) although the SPAC was aware that the U.S. government had previously ordered the target CEO to divest from another unrelated technology company, and requested documentation from the target relating to the order, and was falsely told by the target that it did not have such documents, the SPAC nevertheless proceeded with the executing the merger agreement and filing the registration statement.

The SPAC, its sponsor and its CEO consented to violations (or causing violations) of the

Related People

Mark K. Schonfeld

Evan M. D'Amico

Thomas J. Kim

Jonathan Whalen

Tina Samanta

Timothy Zimmerman

negligence-based anti-fraud provisions, including those relating to proxy solicitations – Sections 17(a)(3) of the Securities Act and 14(a) of the Securities Exchange Act and Rule 14a-9. The SPAC agreed to pay a penalty of $1 million and the CEO agreed to pay a penalty of $40,000. The SPAC's sponsor also agreed to forfeit 250,000 of its founder shares in the event the merger receives shareholder approval. The SPAC and the target also agreed to offer PIPE investors in the SPAC the opportunity to terminate their subscription agreement.

Key Takeaways -- Implications for SPAC and Acquiror Diligence

This latest enforcement action comes on the heels of a string of pronouncements by senior SEC officials earlier this year concerning the risks posed by the explosion of SPAC initial public offerings in 2020 and early 2021, including a potential misalignment of interests and incentives between SPAC sponsors and shareholders.[2]

In the press release announcing this enforcement action, SEC Chairman Gary Gensler took the unusual step of providing comments that echoed the concerns of senior officials and sent a clear message that even when the SPAC is "lied to" by the target, the SPAC and its executives are at risk for liability under the securities laws if their diligence fails to uncover misrepresentations or omissions by the target. Chairman Gensler stated, "This case illustrates risks inherent to SPAC transactions, as those who stand to earn significant profits from a SPAC merger may conduct inadequate due diligence and mislead investors. . . . The fact that [the target] lied to [the SPAC] does not absolve [the SPAC] of its failure to undertake adequate due diligence to protect shareholders. Today's actions will prevent the wrongdoers from benefitting at the expense of investors and help to better align the incentives of parties to a SPAC transaction with those of investors relying on truthful information to make investment decisions."

The SEC's action has important implications for SPAC sponsors, as well as any acquiror conducting diligence on a prospective merger target.

- *First*, the SEC took action with respect to the initial Form S-4, filed on November 2, 2020, and two amendments, filed on December 14, 2020 and March 8, 2021, even though the Form S-4 has been subsequently amended (and presumably corrected) and has not yet been declared effective. The combined proxy statement/consent solicitation statement/prospectus contained in the Form S-4 has not yet been mailed to shareholders since it remains in preliminary form.
- *Second*, in view of the unusual posture of this case, it is clear that the SEC intends this to be a message case to SPAC sponsors on the level of scrutiny that will be imposed on their diligence of acquisition targets. Diligence should be reasonable under the circumstances. However, in an investigation, the government reviews the reasonableness of diligence with the dual benefits of hindsight and subpoena power not available to private enterprises engaged in commercial transactions. Moreover, the SEC is well-versed in conducting these types of investigations and the securities law provisions used here are the same well-established provisions used in typical negligent fraud actions filed by the Commission. Thus the lessons of this action are not limited to SPACs, but also apply to diligence conducted by any acquiror on a potential target where the merger will be subject to disclosure and shareholder approval.
- *Third*, when conducting diligence on potential targets, sponsors should keep in mind that, in the event a target's business turns out not to be as represented, the reasonableness of the SPAC's diligence may be reviewed under a harsh government spotlight. This action highlights the need for blank check companies and their founders to conduct and document thorough legal, financial and accounting due diligence review of potential targets, as well as industry-specific due diligence focused on a target's business. Sponsors should also follow up appropriately on potential red flags identified during the due diligence process, including assessing the accuracy of, and basis for, factual statements about the

target in public filings and investor materials and to identify risks related to the target's business to investors. Ultimately, in the event open questions remain, sponsors will need to evaluate the feasibility of proceeding with a transaction or whether adequate disclosures can be made to address the attendant risks.

- *Fourth*, sponsors also may want to consider the inclusion of seller indemnification provisions or the use of representations and warranties insurance to protect the SPAC from losses resulting from the inaccuracy of the target's representations and warranties in the acquisition agreement. Such provisions and the use of insurance are less typical in de-SPAC transactions than in traditional private M&A transactions. In fact, the SPAC in this Enforcement action and the target amended their merger agreement on June 29, 2021, among other things, to add a limited seller indemnity related to untrue statements of a material fact in the information provided by or on behalf of the target for inclusion in the SPAC's SEC filings, or any omission of a material fact therein relating to the target.
- *Fifth*, this action is also notable for the SPAC sponsor's agreement to forfeit a portion of its founder shares and the opportunity given to PIPE investors to terminate their subscription. These remedies may have been driven, in part, by the limited amount of cash working capital at the SPAC available for a settlement and also highlights the SEC's desire to hold founders accountable for the actions of the SPAC, with such founder shares representing a significant value to a SPAC's sponsor. Furthermore, the ability of PIPE investors to terminate their subscription agreements could meaningfully impact the SPAC's ability to close its pending transaction without the additional financing to backstop potential redemptions by the SPAC's public investors.
- *Finally*, this action is also notable because the SEC charged the SPAC, the SPAC sponsor and the CEO of the SPAC with violating the proxy rules, including Rule 14a-9, at the preliminary proxy statement stage. In other words, the SEC could have, but chose not to, simply allowed the SPAC to correct its misstatements and omissions in subsequent filings so that the definitive proxy statement that is mailed to SPAC shareholders is materially accurate.

The SEC's decision to intervene in the middle of the de-SPAC process with an Enforcement action and a suite of remedial actions that includes requiring the target to engage an independent compliance consultant to conduct a comprehensive ethics and compliance program assessment of the target's disclosure practices underscores the priority of the Enforcement Division's continuing focus on SPACs.

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[1] Press Release, Securities and Exchange Commission, SEC Charges SPAC, Sponsor Merger Target, and CEOs for Misleading Disclosures Ahead of Proposed Business Combination (July 13, 2021), available at https://www.sec.gov/news/press-release/2021-124.

[2] March 31, 2021 Staff Statement on Select Issues Pertaining to Special Purpose Acquisition Companies, available at https://www.sec.gov/news/public-statement/division-cf-spac-2021-03-31.

March 31, 2021 Public Statement: Financial Reporting and Auditing Considerations of Companies Merging with SPACs, available at https://www.sec.gov/news/public-statement/munter-spac-20200331.

Apr. 8, 2021 Public Statement: SPACs, IPOs and Liability Risk under the Securities Laws, available at https://www.sec.gov/news/public-statement/spacs-ipos-liability-risk-under-securities-laws

Apr. 12, 2021 Public Statement: Staff Statement on Accounting and Reporting

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Considerations for Warrants Issued by Special Purpose Acquisition Companies (“SPACs”), available at https://www.sec.gov/news/public-statement/accounting-reporting-warrants-issued-spacs.

SEC Official Warns on Growth of Blank-Check Firms, Wall St. Journal (Apr. 7, 2021), available at https://www.wsj.com/articles/sec-official-warns-on-growth-of-blank-check-firms-11617804892.

Gibson, Dunn and Crutcher’s lawyers are available to assist in addressing any questions you may have regarding these developments. Please contact the Gibson Dunn lawyer with whom you usually work, any member of the firm's Securities Enforcement, Securities Regulation and Corporate Governance, Capital Markets, or Mergers and Acquisitions practice groups, or the following authors:

Mark K. Schonfeld – New York (+1 212-351-2433, mschonfeld@gibsondunn.com)
Evan M. D’Amico – Washington, D.C. (+1 202-887-3613, edamico@gibsondunn.com)
Thomas J. Kim – Washington, D.C. (+1 202-887-3550, tkim@gibsondunn.com)
Jonathan M. Whalen – Dallas (+1 214-698-3196, jwhalen@gibsondunn.com)
Tina Samanta – New York (+1 212-351-2469, tsamanta@gibsondunn.com)
Timothy M. Zimmerman – Denver (+1 303-298-5721, tzimmerman@gibsondunn.com)

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