# SPACS AND THE NEXT WAVE OF SHAREHOLDER LITIGATION

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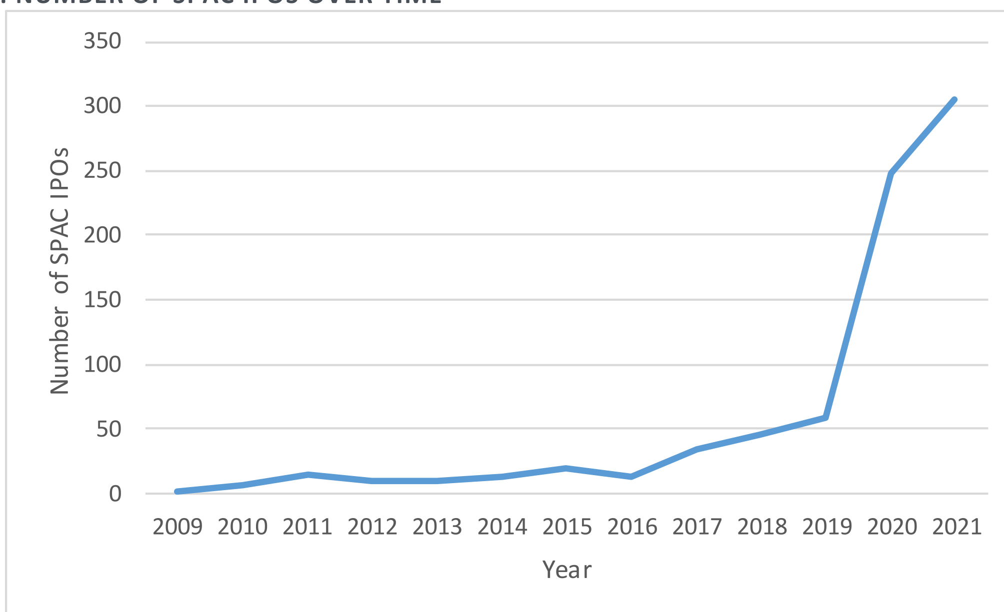
The uptick in initial public offerings (IPOs) for special purpose acquisition companies (SPACs), sometimes referred to as blank check companies, is unprecedented, with over 300 SPACs listing as of April 2021, surpassing 2020's record setting number. The boom has even attracted celebrity sponsors like Serena Williams, Alex Rodriguez, and Shaquille O'Neal. The trend, though, has also raised skeptics, as short interest in SPAC listings more than tripled since the start of 2021.

**FIGURE 1: NUMBER OF SPAC IPOS OVER TIME**




Source: SPACInsider. 2021 number reflects SPAC IPOs as of April 14, 2021

This article discusses how the uptick in SPACs, and the environment it is creating, will likely result in increased shareholder litigation against the vehicles and the companies they eventually merge into. As of March 2021, there were already eight securities class actions filed against SPAC-related companies, according to the Stanford Securities Class Action Clearinghouse.

Three common themes that have emerged thus far as contributing to the expected increase in SPAC securities litigation, include: investors relying on SPAC sponsors to conduct the due diligence of the target company; the ability of SPAC sponsors and the target company's management to "hype" the stock; and the recent trend of SPAC sponsors targeting early-stage

companies with little, if any, revenue or controls in place to comply with Securities and Exchange Commission (SEC) listing requirements.

## SPAC Background

SPACs are a type of blank check company because they do not initially have any operations or business of their own. Rather, they are investment vehicles that raise money from investors in an IPO and then use the proceeds from the offering to acquire a business or operational assets, usually from a private company that does not publicly report financial or operating results. As a result, investors in SPACs entirely rely on the skill, transparency, and ability of the SPAC's sponsor to acquire a fundamentally sound target company.

SPACs are not allowed to have pre-identified target companies, and typically have 18 to 24 months to complete a merger or acquisition, otherwise, they must liquidate and distribute the IPO proceeds plus accrued interest to the investors. Once a SPAC identifies a target company and reaches an agreement for a merger, the public shareholders of the SPAC vote on whether to approve the proposed business combination. Separately, each public shareholder decides whether to redeem their shares or not.

## SPACs vs. Traditional IPOs and Potential Litigation

Some refer to going public via a SPAC as going public "via the back door." In a traditional IPO, underwriters engage in extensive due diligence of the firm, take the offering on a road show where all financials are disclosed to potential investors, and a quiet period is required for the company's management where no forward looking statements can be made. Such rules do not apply for SPACs because SPACs take a company public via a "reverse merger."

As an example, a recent Rule 10b-5 securities class action, against Immunovant, Inc., a biopharmaceutical company that went public via SPAC on Sept. 29, 2019, arose out of allegations that its SPAC, Health Sciences Acquisition Corp., failed to perform adequate due

diligence prior to the merger. The due diligence was related to safety issues associated with Immunovant's drug development and safety processes. The complaint argues that these safety issues diminished the company's prospects for regulatory approval, commercial viability, and profitability.

**FIGURE 2: IMMUNOVANT, INC.—SHARE PRICE FROM SPAC TO POST-MERGER**

Note: Health Sciences Acquisition Corporation (SPAC) acquired Immunovant, Inc. Securities Class Action (SCA) case is ongoing. Data from Capital IQ.

As Figure 2 above indicates, following the securities class action filing, Immunovant's stock price dropped significantly as of April 2021.

Another difference between traditional IPOs and SPACs is that under a traditional IPO, a company goes public after it has the resources, structures, revenue in place, as well as the subsequent SEC reporting requirements for publicly listed companies. The proliferation of SPACs, all of which are searching for target companies to acquire, or complete a reverse merger, are more likely to take early-stage companies public that have little or no revenue, let alone financial systems and internal controls necessary for the mandated SEC reporting requirements.

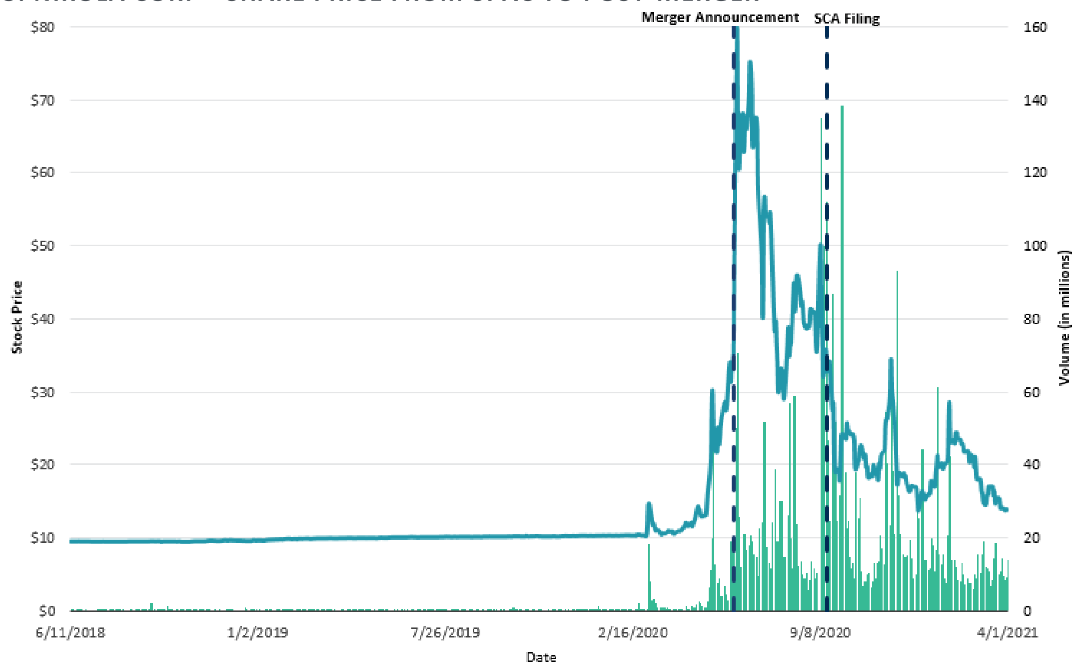
News articles highlight how the wave of SPACs is allowing early-stage startups and fledgling companies with little or no revenue to tap public markets. Another article quoted a founder of a start-up who had been emailed by dozens of SPAC sponsors this year offering to take his company public. Early-stage companies often do not perform well once they go public, and

research finds that on average, one-year post-merger returns for SPACs, sometimes referred to as de-SPAC returns, are negative 15.6%. It is thus unsurprising that companies whose return performance falls below investor expectations often beget securities litigation in the form of shareholder class actions.

Another difference between traditional IPOs and SPACs that we expect to contribute to an increase in securities litigation relates to management's ability to publicize the company. Under a traditional IPO, management must not share any information beyond what is disclosed in the IPO filling from registration of the prospectus until 40 trading days after listing. Neither SPAC sponsors nor the target company's management have no restrictions on the disclosures they can make regarding the merger or the projected target company. This could potentially lead to "hyping" a stock.

One infamous case is Nikola Corp., which is now under SEC and U.S. Department of Justice (DOJ) investigation. Some of the allegations in the securities litigation relate to Nikola's founder and executive chairman, who is alleged to have overstated the company's capabilities, tweeting misleading "test" videos of Nikola's Tre truck, and that Nikola had never even successfully produced its flagship truck. Further, the work experience and background of key Nikola employees had been overstated and obfuscated, the complaint alleges. Figure 3 shows Nikola's stock price performance which has been volatile and declined post-SCA filing.

**FIGURE 3: NIKOLA CORP—SHARE PRICE FROM SPAC TO POST-MERGER**

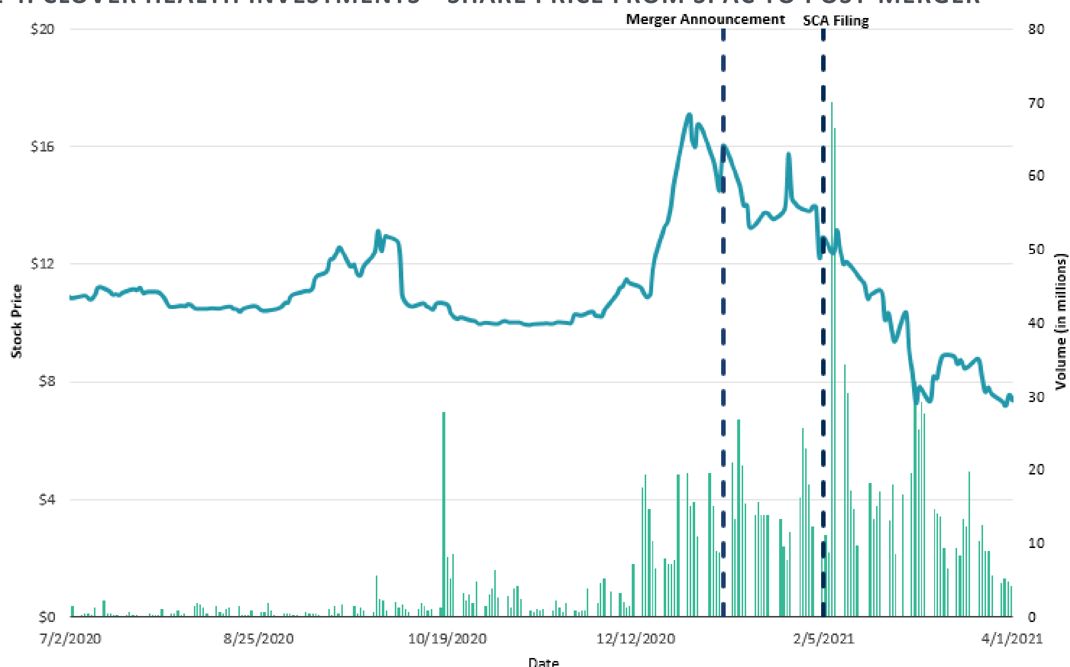



Note: VectoIQ Acquisition Corp (SPAC) acquired Nikola Corp. SCA case is ongoing. Data from Capital IQ.

As mentioned earlier, SPAC investors entirely rely on sponsors to conduct the due diligence of the target's financials and prospective growth. The financials of the post-merger company will not become public until the eventual merger is agreed to and the Form S-1 or S-4 is filed. Once the financials become public, investors might be in for a surprise, particularly if the company is very early stage and making little to no revenue.

Take for example, Clover Health Investments, a recent securities class action that is ongoing. On Feb. 4, 2021, Hindenburg Research, a short selling firm, issued a report stating that prior to the merger Clover was under active investigation by the DOJ for issues ranging from kickbacks to marketing practices to undisclosed third-party deals.

**FIGURE 4: CLOVER HEALTH INVESTMENTS—SHARE PRICE FROM SPAC TO POST-MERGER**




Note: Social Capital Hedosophia Holdings Corp III (SPAC) acquired Clover Health Investments Corp. Securities class action (SCA) case is ongoing. Data from Capital IQ.

The securities litigation arises out of allegations that investors were misled by misrepresentations or omissions made by Clover Health related to the DOJ's investigation, and also that a substantial portion of its sales were driven by one of these third-party deals, of which Clover Health allegedly actively concealed. Had Clover Health gone public via traditional IPO, could it have concealed such allegations and a DOJ investigation? No, and perhaps, might not have gone public at all. As Figure 4 indicates, the share price of Clover Health has declined below its pre-merger announcement value as of April 2021.

# Conclusion

Securities litigation targeting SPAC sponsors and the companies they eventually merge into has already begun. The boom in SPAC IPOs will likely result in even more shareholder litigation, mostly on the dimensions by which SPACs differ from traditional IPOs on how they take companies public.

These differences include investors entirely relying on SPAC sponsors to conduct the due diligence on the target company, as opposed to the more thorough “road show” that traditional IPO underwriters conduct. Further, SPAC sponsors and the companies they target can hype the stock pre-merger as the quiet period restrictions required by a traditional IPO do not apply. Finally, SPACs are targeting early-stage companies with little or no revenue that likely would not be able to go public via traditional IPO.