LAW360

Portfolio Media. Inc. | 111 West 19th Street, 5th Floor | New York, NY 10011 | www.law360.com
Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

# Damage Calculations And Other Trends In SPAC Litigation

By **Amit Bubna and An Wang** (March 22, 2022, 1:07 PM EDT)

Amit Bubna

An Wang

The special purpose acquisition company, or SPAC, market has been phenomenally busy in 2020 and 2021, going from a niche market to a household term in a few short years.

This conspicuous increase in SPAC activity brings with it heightened scrutiny by federal prosecutors and regulatory bodies. December 2021 saw Lucid Group Inc., the electric vehicle maker that went public through a SPAC merger in July, announce a U.S. Securities and Exchange Commission investigation. A shareholder suit — Williams-Spinks v. Rawlinson — was filed on Feb. 23, against Lucid in the U.S. District Court for the Northern District of California.[1]

A recent academic study suggests that, while investors who buy SPAC shares in initial public offerings generally profit from selling or redeeming their shares prior to the merger, the structure of SPAC deals "creates substantial costs, misaligned incentives, and on the whole, losses for investors who own shares at the time of SPAC mergers."[2]

While the SEC is considering increasing disclosure requirements, which may potentially slow the pace of SPAC activity in the future, SPAC-associated litigation can be expected to continue for some time, both on the basis of the already-completed de-SPAC transactions as well as the need for deploying the large amount of dry powder currently available with SPACs.[3]

**Key Potential Issues in SPAC-Related Litigation and Examples**

Greater scrutiny typically increases the risk of litigation when privately held companies go public. However, the structure of SPACs and subsequent de-SPAC transactions provide additional grounds for litigation.

In this section, we discuss a number of potential issues in SPAC-related litigation, several of which arise from the unique structure of SPACs. We also provide evidence from recent litigation.

***Conflicts of Interest***

SPAC deals could potentially generate high returns for sponsors even if they do not deliver the same

returns for public investors. Sponsors receive promotes for a nominal contribution and may also obtain warrants at more favorable terms than public investors.[4]

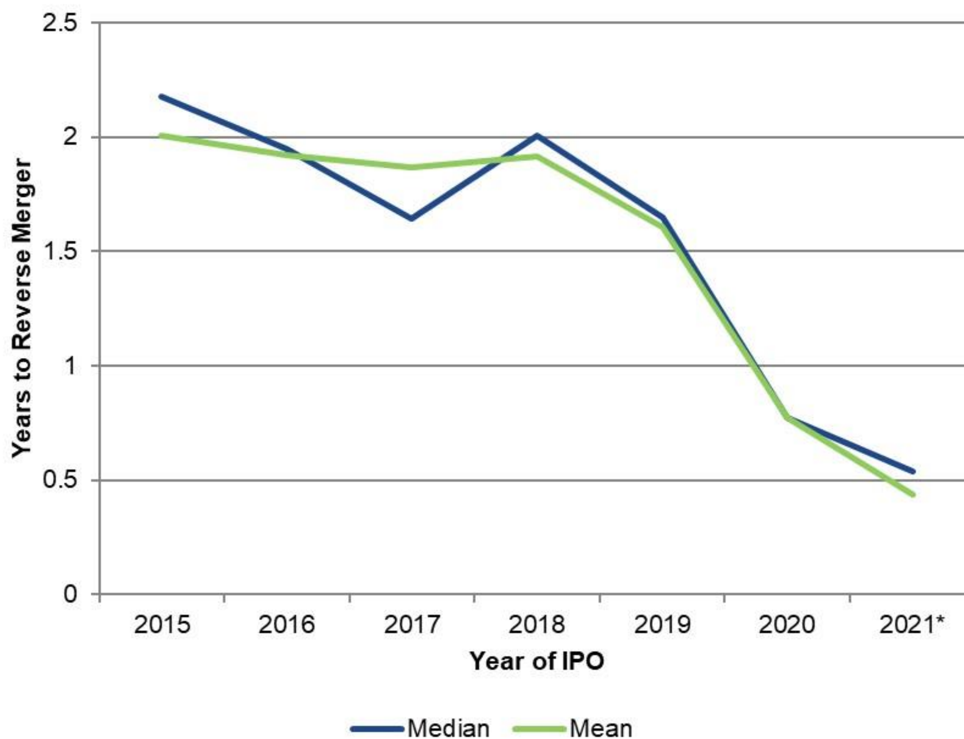
Sponsors' returns are conditional on the SPAC consummating a merger within a limited time frame. This can create conflicts of interest between sponsors, who are at the helm of decision making and public investors. Additionally, sponsors may have obligations to other business entities, which may exacerbate such conflicts.

While the necessity of a merger may create an incentive for a sponsor to push through a merger, such concern could be ameliorated under certain situations. SPAC IPO investors' redemption option may serve as a disciplining tool.

Investors may prefer to vote down a bad merger proposal and redeem their shares prior to the merger, leaving the sponsor with the risk of inadequate funds for the SPAC to fulfill the merger agreement requirements. Furthermore, sponsors could have more skin in the game by buying more private placement warrants or units at the time of the IPO and putting the money into a trust.

Concerns about conflicts of interest have grown as de-SPAC transactions have become quicker. Figure 1 indicates that the length of time SPACs used to identify a merger target has fallen substantially, from two years on average to just half a year.

*Figure 1: Years from SPAC IPO to reverse merger deal by year of IPO*




*Source: PitchBook. *Note: the 2021 data is as of Sept. 28, 2021.*

In Laidlaw v. Ledecky, a class action in the Delaware Chancery Court against Pivotal Investment Holdings II LLC for its acquisition of XL Hybrids Inc., the plaintiffs allege that both the sponsors and Pivotal's board

had a conflict of interest.

Besides their own promote as a source of conflict of interest, the sponsors allegedly transferred some of the sponsors' founder shares to the board members, thereby aligning the board's incentives with those of the sponsors.[5]

***Material Misrepresentation and Omission***

Allegations of misrepresentations and omission often accompany conflict of interest claims in SPAC-related litigation. The incentive to consummate a deal increases the likelihood of securities litigation alleging inadequate or inaccurate statements in the company's disclosures and SEC filings.[6]

Several cases have been filed with respect to disclosures in SPAC IPO registration statements, as well as when new securities were to be issued as part of de-SPAC transactions.

John Erlandson v. Triterras Inc., a 2021 class action in the U.S. District Court for the Southern District of New York with the SPAC Netfin Acquisition Corp. as one of the defendants, over its acquisition of Fintech, a blockchain enabled platform facilitating commodities trading, trade finance and logistics solutions, provides an example of this kind of litigation.[7]

The case includes Section 11 claims, accusing the SPAC of making material misrepresentations and omitting material facts associated with the SPAC and de-SPAC transactions, including the background and relationships between officers of Netfin and Fintech, as well as the "prearranged or preconceived nature of the transaction."[8]

Another class action, Rose v. Butterfly Network Inc., was recently filed in the U.S. District Court for the District of New Jersey on Feb. 16, against a digital health company, Butterfly Network Inc.[9] Butterfly merged with Longview Acquisition Corp. through a de-SPAC transaction on Feb. 16, 2021.[10]

The complaint alleges that Butterfly made false or misleading statements or failed to disclose relevant information in the proxy statement, thereby precluding SPAC investors from making an informed decision about the merger.[11] The complaint seeks remedies under both Rules 10b-5 and 14a-9.[12]

***Forward-Looking Statements in Proxy Statements***

Besides the issue of disclosures in proxy statements discussed above, another basis of litigation may be the nature of forward-looking statements in proxy statements associated with de-SPAC transactions. The Private Securities Litigation Reform Act, or PSLRA, offers safe harbor for forward-looking statements for mergers but not for such statements made during a traditional IPO.

Therefore, the ability to make forward-looking statements has been considered a key advantage of going public through a reverse merger with a publicly traded SPAC. There is increased scrutiny of the connection between ambitious forecasts and stock performance of companies that use SPACs to go public.[13] The SEC suggested caution and proposed that companies consider the "limits of the safe harbor" provisions in the PSLRA.[14]

Relatedly, in May 2021, the U.S. House Committee on Financial Services prepared draft legislation amending the Securities Act of 1933 and the Securities Exchange Act of 1934 to exclude SPACs from the safe harbor for forward-looking statements.[15]

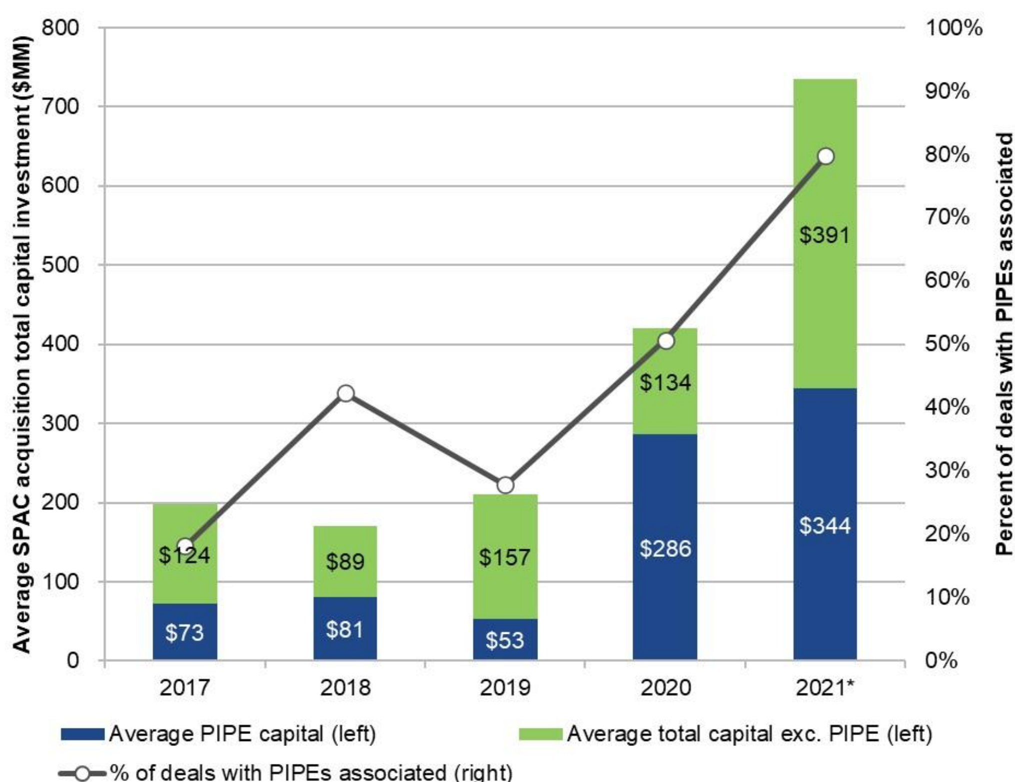
While there isn't yet an official position on the applicability of the PSLRA safe harbor for SPACs, the potential removal of its protections for a de-SPAC transaction would draw closer scrutiny to disclosures and potentially increase litigation.

***Breach of Contract***

SPAC disputes may sometimes arise not from SEC rule or statutory violations but from breaches of contracts between parties. The success of a SPAC and associated de-SPAC transaction depends on a number of participants. Private investment in public equity, or PIPE, investors are increasingly common in de-SPAC transactions.

Figure 2 shows a steady increase in PIPEs' involvement in SPAC deals.

*Figure 2: Involvement of PIPE in SPAC acquisition*




*Source: PitchBook. *Note: the 2021 data is as of Sept. 28, 2021*.

SPACs may have a forward purchase agreement with PIPE investors, who may choose to not go through with the investment. Sustainable Opportunities Acquisition Corporation, a SPAC, filed two lawsuits in September 2021 against multiple PIPE investors, for allegedly breaching subscription agreements obligating the defendants to invest in the de-SPAC transaction. The cases are Sustainable Opportunities Acquisition Corp. v. Ramas Capital Management LLC and Sustainable Opportunities Acquisition Corp. v. Ethos Fund I LP in the Southern District of New York.[16]

Though these PIPE investors failed to follow through on their commitment to invest, the de-SPAC

transaction took place anyway. The cases were voluntarily dismissed a week after filing.

***Fair Market Value of Targets***

As in any proposed merger or consolidation, shareholders of the proposed target may seek the court's intervention in determining the fair value of the shares.

Some statutes, like Section 262 of the Delaware General Corporation Law, explicitly provide this right.[17] The SPAC sponsors' incentive to complete a merger could potentially lead to stakeholders' claims of inaccurate valuation.

Something like this occurred in Pivotal Holdings' de-SPAC transaction with XL Hybrids Inc. Based on the Pivotal board's alleged conflict of interest as discussed above, the plaintiffs asserted that the merger with XL Hybrids was based on an "excessive valuation" and thus required a "judicial review for entire fairness."[18]

So long as SPACs have such incentives to execute a merger and shareholders have rights to a fair valuation, these claims could continue to surface.

***SEC-Driven Litigation***

The rapid rise in SPAC transactions has also attracted scrutiny from the SEC. As discussed above, the SEC has offered guidance and even proposed draft legislation on the topic, pointing to concerns associated with SPACs' structure and SPACs as a route for enabling private companies to become publicly traded.

For instance, on April 12, 2021, the SEC offered guidance on the accounting of warrants issued by SPACs.[19] Restatements made in response to such guidance could prompt litigation against SPACs. Separately, the SEC may also bring rules-based enforcement actions against entities associated with SPAC and de-SPAC transactions.[20]

Take, for example, SEC actions against Stable Road Acquisition Corp, or SRAC. In July 2021, the SEC filed a cease-and-desist motion against SRAC. In its filing, the commission asserts that SRAC and its officers made false statements to justify a combination with Momentus, a privately held space company.

Such a move by the SEC reflects the potential of the commission to act directly against SPACs, as opposed to waiting for plaintiff classes to form and make claims using SEC rules. This was also a preemptive move, wherein the SPAC transaction was prevented altogether, instead of a retrospective suit to recoup damages.

In light of $8 million in potential fines spread across several parties, the defendants opted to settle these claims by allowing private investors to redeem their cash before the merger was executed.

**Common Methodologies and Considerations in Calculating Damages**

Each litigation has its own special characteristics, and so does damage estimation. There is no one-size-fits-all damages methodology, but some approaches may be more commonly adopted than others in the context of SPAC litigation.

Stock price drop is a common trigger for SPAC-related litigation. Event studies are a tried and tested

method for economists in many legal settings, such as anti-competitiveness evaluations and analyses of material impact of company news or events on stock prices. Using historical data, the court establishes a baseline competitive market, undisturbed by the conduct in question.

Once such a baseline is established, economists can use regressions to quantify market price fluctuations associated with a certain well-defined event. In SPAC-related price drop cases, this could be the stock price pre- or post-revelation of previously undisclosed information.

Admittedly, certain traditional assumptions of event studies may need to be tweaked to fit the SPAC litigation specifics, one of them being the benchmark window for news shortly after the SPAC IPO or the de-SPAC acquisition. If the shareholder litigation materializes shortly after these events, the lack of historical data on the security as an efficiently traded public instrument can make event studies harder to implement.

Another statistical technique may be a candidate method to single out the impact of long-lasting change — e.g., SPAC leadership change — through comparing to a control group during the same period of time.[21] The identification of a control group may be challenging particularly when observations for similarly situated companies are thin for startups.

Moreover, even the most similar startups have distinct strategies and market images, making it hard to satisfy parallel-trend assumption — the assumption that underlies the ability of the method to attribute the difference causally to the conduct.

In many cases, there is a clear need for analyses regarding the value of the SPAC or post-merger entity. For public companies, such as the SPAC itself and the post-merger company, multiples analysis may be used to determine the fair value of the at-issue entity.

Alternatively, it may be appropriate to perform a comparable analysis to value the target firm based on the value of companies that are similarly situated.

In other cases, damages may arise from unjust enrichment or loss of profits or value due to a material adverse effect from certain actions of an involved party of SPAC deals, and estimating such damages would require careful evaluation of the transactions.

---

*Amit Bubna is a principal and An Wang is a manager at Bates White LLC.*

*The opinions expressed are those of the author(s) and do not necessarily reflect the views of the organization, its clients, or Portfolio Media Inc., or any of its or their respective affiliates. This article is for general information purposes and is not intended to be and should not be taken as legal advice.*

[1] Complaint, Zsata Williams-Spinks v. Peter Rawlinson et al., No. 3:22-cv-01115-VC (Northern District Court of California, February 23, 2022) ["Lucid Complaint"].

[2] Michael Klausner, Michael Ohlrogge, and Emily Ruan, A Sober Look at SPACs, April 2021, Finance Working Paper N. 746/2021, European Corporate Governance Institute.

[3] See, e.g., Heather Somerville and Eliot Brown, SPAC Startups Made Lofty Promises. They Aren't Working Out, February 25, 2022, Wall Street Journal.

[4] Michael Klausner, Michael Ohlrogge, and Emily Ruan, A Sober Look at SPACs, April 2021, Finance Working Paper N. 746/2021, European Corporate Governance Institute.

[5] Verified Class Action Complaint, Cody Laidlaw et al., v. Jonathan J. Ledecky et al., No. 2021-0808 (Chancery Court of Delaware, September 20, 2021) ["Pivotal Complaint"], paras. 4, 9-10.

[6] Reflecting on the important role of disclosures in potential litigation, the SEC provided disclosure guidance for SPACs. See CF Disclosure Guidance: Topic No. 11, Division of Corporate Finance, Securities and Exchange Commission, December 22, 2020, available at https://www.sec.gov/corpfin/disclosure-special-purpose-acquisition-companies.

[7] Amended Class Action Complaint, John A. Erlandson et al., v. Triterras, Inc. et al., No. 7:20-cv-10795-CS (Southern District Court of New York, July 6, 2021) ["Netfin Complaint"], paras. 23, 24.

[8] Netfin Complaint, Section VI.

[9] Class Action Complaint, Craig M. Rose et al., v. Butterfly Network, Inc. et al., No. 2:22-cv-00854 (District Court of New Jersey, February 16, 2022) ["Butterfly Complaint"].

[10] Butterfly Complaint, para. 1.

[11] Butterfly Complaint, para. 83.

[12] Butterfly Complaint, para. 1.

[13] See, e.g., Heather Somerville and Eliot Brown, SPAC Startups Made Lofty Promises. They Aren't Working Out, February 25, 2022, Wall Street Journal.

[14] See "SPACs, IPOs and Liability Risk under the Securities Laws," Statement from John Coates, Acting Director, Division of Corporate Finance, Securities and Exchange Commission, April 8, 2021, available at https://www.sec.gov/news/public-statement/spacs-ipos-liability-risk-under-securities-laws.

[15] See https://financialservices.house.gov/uploadedfiles/5.24_bills-117pih-hr____.pdf.

[16] Complaint, Sustainable Opportunities Acquisition Corp. v. Ramas Capital Management, LLC, et al., No. 1:21-cv-07642 (Southern District Court of New York, September 13, 2021); Complaint, Sustainable Opportunities Acquisition Corp. v. Ethos Fund I, LP, et al., No. 1:21-cv-07640 (Southern District Court of New York, September 13, 2021).

[17] Section 262 of the DGCL is available at http://delcode.delaware.gov/title8/c001/sc09/.

[18] Pivotal Complaint, paras. 20, 56.

[19] See John Coates and Paul Munter, "Staff Statement on Accounting and Reporting Considerations for Warrants Issued by Special Purpose Acquisition Companies ("SPACs")," April 12, 2021, available at https://www.sec.gov/news/public-statement/accounting-reporting-warrants-issued-spacs. Also see Paul Munter, "Financial Reporting and Auditing Considerations of Companies Merging with SPACs," March 31, 2021, available at https://www.sec.gov/news/public-statement/munter-spac-20200331.

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

[21] This approach is referred to as "difference-in-difference" methodology. See Bruce Meyer, Natural and Quasi-Experiments in Economics, April 1995, Journal of Business and Statistics 13(2), available at http://unionstats.gsu.edu/9220/Meyer_JBES_1995.pdf.