SPACs and the PSLRA Safe Harbor

By: Frederic Fox and Arielle Frank

Special Purpose Acquisition Companies, or SPACs, as they are called, have been a part of the public markets for some time now. Over the past few years, SPAC offerings have dramatically increased in both number and capital raised, before seeing a more recent decline.[1] In this article, I will address some of the basic attributes of the SPAC and discuss how they are different from traditional public stock offerings. As discussed below, one of those differences has driven debate among commentators concerning the applicability of the PSLRA's safe harbor to forward-looking statements made in a de-SPAC transaction and has led the SEC to propose new rules concerning SPACs.

SPACs have a number of attributes that make them markedly different from traditional public offerings.

SPACs Versus Traditional IPOs

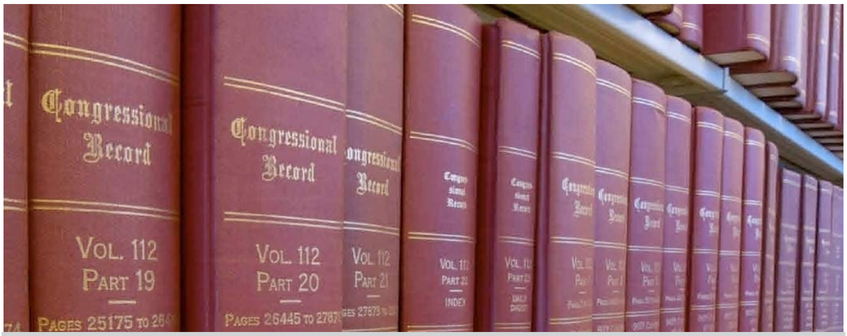
SPACs have a number of attributes that make them markedly different from traditional public offerings. In a traditional public offering of securities, a company which has an operating business and is seeking to raise money for that business by selling securities to the public, must set forth in a Registration Statement and Prospectus the information required by the SEC to be disclosed to potential investors. The Registration Statement must clearly describe important information about the Company's business operations, financial condition, results of operations, risk factors, and management. The prospectus must also include audited financial statements.[2]

Perhaps the most important distinguishing feature of a SPAC, compared to a traditional initial public offering (IPO), is that when the SPAC first offers its securities to the public, the SPAC has no business or business history. Instead, the SPAC offering is to raise money by selling stock to the public to later acquire an operating company.

There are usually two separate and distinct transactions in the life of a SPAC. These two separate transactions consist of: a) the initial SPAC offering through which the SPAC raises money from investors to use to acquire an operating business; and b) the de-SPAC in which the funds raised in the initial SPAC transaction are used to acquire, through a merger, a company which has an operating business.

SPACs almost universally have a time limit, usually two years, within which to utilize the funds raised by the SPAC to merge with or acquire another company that does have an operating business. If the SPAC is unable to achieve an acquisition or merger, absent an extension of time, it must then return the funds raised to the investors.[3]

Another distinguishing feature of a SPAC is that unlike in a traditional public offering, when SPACs sell stock to the public there is not usually an underwriter involved. The absence of an underwriter may as a practical matter remove a layer of investor protection. This is because in a traditional public offering an underwriter will almost always perform due diligence on the issuer. They will closely examine the issuers business and any projections or representations made by the issuer. Such due diligence not only benefits investors, it benefits the underwriter as well because if the prospectus contains a material misstatement or omission the underwriter may avoid liability by establishing that it conducted a reasonable investigation and did not learn of the false statement or omission.[4]



The Private Securities Litigation Reform Act of 1995 provides a "safe harbor" for forward-looking statements so long as those statements are identified as forward-looking and are accompanied by meaningful cautionary statements...

Additionally, when a SPAC finds a company to acquire or merge with, the SPAC must file a proxy statement on SEC Form 14a soliciting the votes of holders of the SPACs shares on whether to proceed with the acquisition of the target company.[5] Typically shareholders of the SPAC also have the right to redeem their shares for their initial purchase price.[6]

Should Forward-Looking Statements in a De-SPAC be Afforded Safe Harbor Protection Under the PSLRA?

A subject of some debate in the legal community is whether SPAC transactions face less or lower legal liability under the Private Securities Litigation Reform Act (PSLRA) of 1995, than do traditional IPO transactions. Some practitioners and commentators believe that unlike in the traditional IPO context, forward-looking statements made in connection with SPAC transactions are protected by the PSLRA safe harbor provisions for forward-looking statements. Others do not agree and, as set forth below, the SEC recently published a proposed rule which through a change in the definition of "blank check company," indicates that the PSLRA safe harbor for forward-looking statements does not apply to de-SPAC transactions.

The Private Securities Litigation Reform Act of 1995 provides a "safe harbor" for forward-looking statements so long as those statements are identified as forward-looking and are accompanied by meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those disclosed in the statement.[7] However, the PSLRA safe harbor for forward-looking statements does not apply to statements made in connection with an initial public offering or by a blank check company.[8]

Some practitioners and commentators have asserted that the PSLRA safe harbor does apply to the de-SPAC transaction because the de-SPAC transaction is not an initial public offering and often do not fall into the definition of a blank check company.[9] Following this line of reasoning, when the de-SPAC occurs it is through a Proxy Statement under the Exchange Act and if there are projections in the Proxy Statement those projections are protected by the PSLRA safe harbor since the de-SPAC merger transaction is not, they say, an initial public offering, nor does a SPAC fall within the definition of a blank check company.

However, others have advanced the argument that there should not be safe harbor protection for forward-looking statements in SPAC transactions. For example, John Coates, Acting Director of the Division of Corporate Finance at the SEC published an article on April 8, 2021, titled “SPACs, IPOs, and Liability Risk Under the Securities Law."[10]

In that article, Mr. Coates states that the de-SPAC may be considered as an initial public offering since that term is not defined in the PSLRA and as a matter of substance the de-SPAC has features that resemble an IPO and it is the first time the acquired company, which was previously private, is disclosing detailed information to investors. In that sense it is in substance very similar to an IPO.

However, others have advanced the argument that there should not be safe harbor protection for forward-looking statements in SPAC transactions.

In cases involving SPACs, courts so far seem to have largely avoided the issue of whether the PSLRA safe harbor applies to SPAC transactions. Instead, it appears that courts have analyzed the issue assuming the PSLRA safe harbor does apply and then deciding whether any statement meets the various requirements for safe harbor protection. For example, in *In re Romeo Power Inc. Securities Litigation*, the court does not analyze whether the PSLRA safe harbor for forward-looking statements applies to de-SPAC transactions. Instead, it analyzed whether the statements at issue were forward-looking and were accompanied by meaningful cautionary language.[11]

The SEC Weighs In – SEC Proposed Rule as it Relates to SPACs and the PSLRA Safe Harbor

Given the uncertainty over the applicability of certain provisions of the securities laws to SPACs, including whether the PSLRA safe harbor for forward-looking statements applies to SPACs, in March 2022, the SEC proposed several new rules for public comment.[12] Through an amendment to the definition of the term “blank check company” the SEC’s proposed rule would, if adopted as proposed, not provide safe harbor protection for forward-looking statements made by SPACs in connection with a de-SPAC transaction.[13]

As stated by the SEC in its proposed rule, while the PSLRA provides a safe harbor for forward-looking statements under the Securities Act and the Exchange Act, the “safe harbor is not available, however, when a forward-looking statement is made in connection with an offering by a blank check company or an initial public offering.”[14]

The proposed rule states that prior to the proposed amendments the Commission has defined the term “blank check company” as a “development stage company that is issuing a ‘penny stock’…and that has no specific business plan or purpose or has indicated that its business plan is to merge with or acquire an unidentified company…”.[15] The SEC further explained that, “SPACs that raise more than $5 million in a firm commitment underwritten initial public offering are excluded from this definition of ‘blank check company’ because they are not selling a ‘penny stock.”[16]

The proposed rule further provides that because projections of a private company’s performance are typically prepared and disclosed in a de-SPAC transaction and some market participants believe that the PSLRA safe harbor for forward-looking statements is available in de-SPAC transactions when the SPAC is not a “blank check company” the SEC has now proposed to amend the definition of “blank check company” for purposes of the PSLRA, by removing the “penny stock” condition and defining the term as “a company that has no specific business plan or purpose or has indicated that its business plan is to engage in a merger or acquisition with an unidentified company or companies, other entity or person."[17] This change then would cover SPACs and exclude safe harbor protection for forward-looking statements.

The SEC further states that since private companies are increasingly using de-SPAC transactions as a mechanism to become public companies, there seems to be no reason to treat de-SPAC transactions differently than forward-looking statements made in traditional IPOs in the PSLRA context.[18] The proposed rule also states that traditional IPOs are like de-SPACs in the way that both involve private issuers entering the public U.S. securities markets for the first time and involve similar informational asymmetries between users and public investors.[19]

As one might expect, some commentators are strongly in favor of the SEC's proposed rule not extending safe harbor protection to SPACs while others urge the SEC to allow safe harbor protection to de-SPAC transactions.[21]

The SEC requested comments on the proposed rule to get a better understanding of how participants in the securities markets and practitioners would view these changes. There have already been more than 80 comments,[20] several of which relate to the issues discussed here. As one might expect, some commentators are strongly in favor of the SEC's proposed rule not extending safe harbor protection to SPACs while others urge the SEC to allow safe harbor protection to de-SPAC transactions.[21] However, it is likely that forward-looking projections made in connection with a de-SPAC transaction will not be afforded safe harbor protection under the PSLRA.

Frederic Fox ***is a senior partner and*** *Arielle Frank* ***is a law clerk with Kaplan Fox & Kilsheimer.***

Endnotes

[1] The first SPAC IPO came out in 2003. Each year, until 2007, the number of SPAC IPOs would rise gradually, starting at 1 in 2003 to 66 in 2007. The number of SPAC IPOs stayed under 20 until 2017, when there was another gradual increase in SPACs. In 2017 there were 34 and by 2021 there were 613. Throughout 2019 SPACs were a quarter of the market, exploding to 53% in 2020, and 61% in 2021. At their height, there were 109 new SPAC IPOs in March 2021. Immediately this all-time high declined to a total of new 10 SPAC IPOs in April 2021. (Yun Li, SPAC Transactions Come to a Halt Amid SEC Crackdown, Cooling Retail Investor Interest, CNBC (Apr. 22, 2021, 9:35 AM), https://www.cnbc.com/2021/04/21/spac-transactions-come-to-a-halt-amid-sec-crackdown-cooling-retail-investor-interest.html.)

[2] 17 C.F.R. § 210.2-02.

[3] SEC's Office of Investor Education and Advocacy, What You Need to Know About SPACs – Updated Investor Bulletin (May 25, 2021) https://www.sec.gov/oiea/investor-alerts-and-bulletins/what-you-need-know-about-SPACs-investor-bulletin.

[4] 15 U.S.C.A. § 77k.

[5] 15 U.S.C.A. § 78n.

[6] Feldman, *supra* note 10, at 181. SPAC investors essentially have three options once an acquisition is proposed: (1) they can reaffirm their investment position, in which case they will own stock in the newly public target company; (2) they can exercise their

right of rescission, in which case they will be refunded their initial investment; or (3) they can elect to sell their SPAC shares on the open market. ICR Conference Call, *supra* note 91, at 5.

[7] 15 U.S.C.A. § 78u-5.

[8] Special Acquisition Companies, Shell Companies, and Projections, 87 Fed. Reg. 29458 (proposed Mar. 30, 2022) (to be codified at 17 C.F.R. pt. 230.419) (can be found on page 82-83 of the proposal).

[9] *See* e.g., Matt Levine, Money Stuff: Maybe SPACs Are Really IPOs, Bloomberg, Apr. 12, 2021; Eliot Brown, Electric-Vehicle Startups Promise Record-Setting Revenue Growth, The Wall Street Journal, Mar. 15, 2021; Public Statement on SPACs, IPOs and Liability Risk under the Securities Laws (Division of Corporation Finance, Apr. 8, 2021).

[10] John Coates, Acting Director, Division of Corporate Finance, SEC, SPACs, IPOs and Liability Risk under the Securities Laws (Apr. 8, 2021), available at https://www.sec.gov/news/public-statement/SPACs-ipos-liability-risk-under-securities-laws.

[11] In re Romeo Power Inc. Sec. Litig., No. 21 CIV. 3362 (LGS), 2022 WL 1806303, at *4 (S.D.N.Y. June 2, 2022), reconsideration denied, No. 21 CIV. 3362 (LGS), 2022 WL 3701095 (S.D.N.Y. Aug. 25, 2022).

[12] Special Acquisition Companies, Shell Companies, and Projections, 87 Fed. Reg. 29458 (proposed Mar. 30, 2022) (to be codified at 17 C.F.R. pt. 230.419). *See*, https://www.sec.gov/oig/reportspubs/aboutoigaudit347finhtm.html for comments.

[13] The SEC's rulemaking process usually begins with a proposed rule, and as here, seek out public input and comment. The Commission may also, have a roundtable discussion or hold hearings and will consider the public's feedback. (https://www.sec.gov/oig/reportspubs/aboutoigaudit347finhtm.html).

[14] Special Acquisition Companies, Shell Companies, and Projections, 87 Fed. Reg. 29458 (proposed Mar. 30, 2022) (to be codified at 17 C.F.R. pt. 230.419) (can be found on page 82 of the proposal).

[15] *Id.* (can be found on page 83 of the proposal).

[16] *Id.*

[17] *Id.*

[18] *Id.*

[19] *Id.*

[20] *See* https://www.sec.gov/oig/reportspubs/aboutoigaudit347finhtm.html for comments.

[21] *See* https://www.sec.gov/comments/s7-13-22/s71322-20135105-306088.pdf (SEC proposal comments by Kerrie Waring, Chief Executive Officer); https://www.sec.gov/comments/s7-13-22/s71322-20130943-300070.pdf (comments by the Council of Institutional Investors); https://www.sec.gov/comments/s7-13-22/s71322-20129959-296347.pdf (comments by CFA Institute).