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## New lawsuits pose challenge: Are SPACs investment companies?

By *Lene Powell, J.D.*

A fierce new securities law controversy could potentially disrupt a popular way for companies to go public—and threaten accompanying fees for bankers and law firms.

New lawsuits brought by two prominent law professors—one a former SEC commissioner—contend that three special purpose acquisition companies (SPACs) are actually unregistered investment companies that are paying illegal compensation and entering into illegal contracts. The outcome of the broadly drawn claim could potentially affect a broad range of SPACs.

But as of September 5, 63 top law firms have leapt to the defense of SPACs, arguing that SPACs are not investment companies so long as two conditions are met. The firms assert that the lawsuits are “without factual or legal basis” and point out that the SEC has approved over 1,000 SPAC registrations over two decades.

Is the new line of litigation a real threat to SPACs—or a tempest in a teapot?

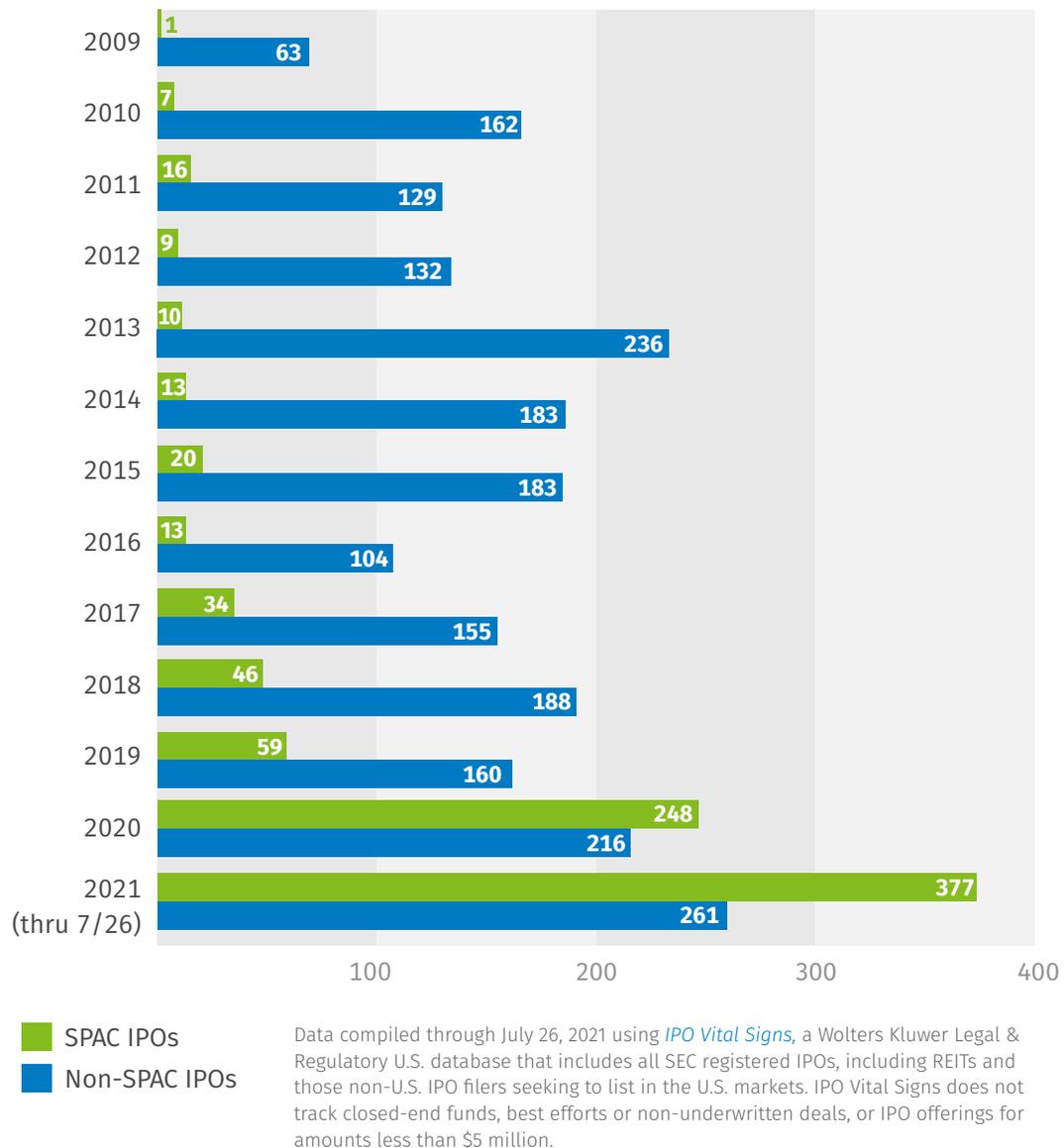
### The SPAC boom

The new lawsuits arrive amid a dramatic increase in SPAC registrations over the past two years. SPAC IPOs have grown in the last decade from a handful to overtaking traditional IPOs.

According to [David Alan Miller](#), partner at Graubard Miller and co-creator of the SPAC structure back in 1993, nobody could have foreseen the 2020 SPAC rush even at the end of 2019. However, he sees several factors driving SPACs’ popularity:

- **High-profile successes.** Some large very well-received business combinations have occurred via SPAC, leading to more SPACs and SPAC buyers.
- **Certainty.** There is a far greater certainty of successfully becoming public at a pre-determined agreed-upon valuation. Unstable market conditions take a toll on traditional IPOs.
- **Speed and expense.** For the most part, SPACs are quicker and less expensive than traditional IPOs.
- **Expertise.** SPAC sponsors offer the target many years of marketplace and industry experience, smoothing the transition to public status and continuing to provide value post-combination.

Figure 1. SPACs vs. Traditional IPOs



The dramatic increase in the number of companies going public via SPAC IPOs has brought a corresponding spike in litigation against SPACs.

According to a recent Wall Street Journal article<sup>1</sup>, 19 class action lawsuits have been filed against SPACs this year through August 25. In all of 2020, there were only five, and in 2019 only two. A number of SEC enforcement actions have also been brought.

## New claim: SPACs as investment companies

Previous SPAC litigation has focused on alleged fraud, inadequate disclosures, conflicts of interest, and other traditional securities claims. However, three new lawsuits add a new element to the mix.

The three actions were brought by Robert Jackson, Jr., former SEC Commissioner and current NYU Law professor, and John Morley, a professor at Yale Law School, in conjunction with several law firms. The lawsuits were all filed by George Assad, a SPAC investor.

The actions, all filed in the Southern District of New York, are:

- [Pershing Square Tontine Holdings, Ltd.](#) (PSTH) (August 17)
- [Go Acquisition Corp.](#) (August 20)
- [E.Merge Technology Acquisition Corp.](#) (August 20)

The Jackson-Morley lawsuits argue that the SPACs are investment companies under the Investment Company Act (ICA). Generally, the three complaints make the same arguments:

- The defendant SPACs are investment companies under the ICA because their primary business is to invest in securities.
- Investing in securities is all the companies have ever done.
- The way the defendants have structured the companies poses the precise dangers the ICA sought to address.
- The defendants have used their dominance over the companies to pay illegal compensation at the expense of public shareholders and in violation of federal law.

Specifically, the claims include:

- **Section 36(b) of the ICA:** the issuance of Class B shares to founder and independent director defendants is a breach of fiduciary duty with respect to compensation for services or payments of a material nature paid by the company or its securityholders.
- **Section 47(b) of the ICA:** the SPAC entered into contracts that were illegal under the ICA.
- **Section 215(b) of the Investment Advisers Act (IAA):** advisor defendants that provided advice to the SPACs entered into contracts that were illegal under the IAA. [PSTH and E.Merge only.]

## Pershing Square Tontine Holdings

The PSTH story is worth particular examination. The company's original business plan was unusual and arguably did resemble an investment company in some ways. Although the original plan was scrapped after objections from the SEC, PSTH may provide additional context for the ICA claims.

As alleged, PSTH's Certificate of Incorporation contemplated that the company would complete an "Initial Business Combination," which it defined quite broadly. In addition to the typical merger, the "business combination" could alternatively involve the acquisition of assets or purchase of stock.

Consistent with this plan, PSTH pursued a deal with Vivendi S.E. to purchase part of the equity securities comprising Vivendi's 80 percent stake in Universal Music Group (UMG), the leading owner of recorded music. On June 4, 2021, PSTH announced that it had entered into a definitive agreement with Vivendi to acquire 10 percent of the outstanding shares of UMG. The next step of the plan envisioned transferring the UMG Shares to a liquidating trust, then performing a distribution from the liquidating trust to holders of the Company's Class A common stock.

After the planned distribution, PSTH would have continued to hold approximately \$1.6 billion in assets. PSTH then would have continued investing those remaining assets in U.S. government securities and shares of money market funds—with no limit on how long it could invest in securities, and no binding legal obligation to use its assets for any purpose other than investing in securities.

However, the plan was scrapped. On July 19, 2021, PSTH CEO Bill Ackman announced in a [letter to shareholders](#) that PSTH would not proceed with the Universal Music Group transaction, and would assign the share purchase agreement to Pershing Square Holdings, Ltd. Ackman stated that the decision “was driven by issues raised by the SEC with several elements of the proposed transaction—in particular, whether the structure of our IBC qualified under the NYSE rules.”

## Top law firms fight back

On August 27, 49 leading law firms issued a [joint statement](#) in response to the Jackson-Morley lawsuits. Additional law firms have since signed onto the statement, bringing the total to 63 as of September 5.

The firms contend that generally, SPACs are not investment companies because they are not “primarily” engaged in investing in securities. Rather, SPACs are primarily engaged in identifying and consummating a business combination with one or more operating companies within a specified time.

The firms note that if the business combination is not consummated by the deadline, investors' money is returned. And while SPACs do typically invest in securities, almost all the SPAC's assets are held in a trust account and limited to short-term treasuries and qualifying money market funds.

Moreover, the firms state that SEC staff has reviewed over 1,000 SPAC IPOs over two decades without deeming those SPACs to be subject to the ICA.

Many of the 49 original firms have “skin in the game,” representing issuers and underwriters in a significant number of SPAC IPOs.

Of a total of 662 SPAC IPOs from January 1, 2020 through August 31, 2021, the 63 firms represented entities as below:

Law Firm	Issuer Reps	Underwriter Reps	Total
Ellenoff Grossman & Schole LLP	98	75	173
Kirkland & Ellis LLP	98	54	152
Skadden, Arps, Slate, Meagher & Flom LLP	41	79	120
White & Case LLP	54	58	112
Ropes & Gray LLP	19	82	101
Davis Polk & Wardwell LLP	24	76	100
Graubard Miller	19	45	64
Loeb & Loeb LLP	39	23	62
Greenberg Traurig, LLP	24	19	43
Weil, Gotshal & Manges LLP	32	8	40
Latham & Watkins LLP	16	20	36
Shearman & Sterling LLP	3	28	31
Paul Hastings LLP	6	24	30
Winston & Strawn LLP	19	6	25
Goodwin Procter LLP	21	1	22
Paul, Weiss, Rifkind, Wharton & Garrison LLP	16	5	21
Vinson & Elkins LLP	14	6	20
Reed Smith LLP	5	8	13
Sidley Austin LLP	4	7	11
Sullivan & Cromwell LLP	7	3	10
Schiff Hardin LLP	4	4	8
DLA Piper LLP (US)	4	3	7
Nelson Mullins Riley & Scarborough LLP	4	2	6
Proskauer Rose LLP	2	4	6
Cadwalader, Wickersham & Taft LLP	5		5
Gibson, Dunn & Crutcher LLP	5		5
Blank Rome LLP	2	2	4
Cooley LLP	3	1	4
Wachtell, Lipton, Rosen & Katz	4		4
Akin Gump Strauss Hauer & Feld LLP	2	1	3
Hughes Hubbard & Reed LLP	3		3
Kramer Levin Naftalis & Frankel LLP		3	3
Milbank LLP	3		3
Simpson Thacher & Bartlett LLP	2	1	3
Willkie Farr & Gallagher LLP	3		3
Cleary Gottlieb Steen & Hamilton LLP	2		2
Hogan Lovells US LLP	1	1	2
King & Spalding LLP	2		2
Mintz, Levin, Cohn, Ferris, Glovsky and Popeo, P.C.	1	1	2
Morrison & Foerster LLP	2		2
Alston & Bird LLP		1	1
Baker & McKenzie LLP	1		1
Crowell & Moring LLP	1		1

Table 1. Law Firm Signatories to Joint Statement

Law Firm	Issuer Reps	Underwriter Reps	Total
Debevoise & Plimpton LLP	1		1
Eversheds Sutherland (US) LLP	1		1
Fried, Frank, Harris, Shriver & Jacobson LLP	1		1
McDermott Will & Emery LLP	1		1
Morgan, Lewis & Bockius LLP	1		1
Orrick, Herrington & Sutcliffe LLP	1		1
Perkins Coie LLP	1		1
Arnold & Porter			0
Baker Botts LLP			0
Clifford Chance US LLP			0
Covington & Burling LLP			0
Cravath, Swaine & Moore LLP			0
Faegre Drinker Biddle & Reath LLP			0
Fenwick & West LLP			0
Freshfields Bruckhaus Deringer US LLP			0
Katten Muchin Rosenman LLP			0
Mayer Brown LLP			0
Nixon Peabody LLP			0
Schulte Roth & Zabel LLP			0
Wilmer Cutler Pickering Hale and Dorr LLP			0

Data compiled through September 6, 2021 using *IPO Vital Signs*, a Wolters Kluwer Legal & Regulatory U.S. database that includes all SEC registered IPOs, including REITs and those non-U.S. IPO filers seeking to list in the U.S. markets. IPO Vital Signs does not track closed-end funds, best efforts or non-underwritten deals, or IPO offerings for amounts less than \$5 million.

## Questions and implications

So where is this all going?

First, the Jackson-Morley lawsuits may have already had a chilling effect. In a [letter to shareholders](#) on August 19, Bill Ackman announced that Pershing Square is working to gain SEC approval of a new entity. If approved, the new entity would receive the PSTH funds and return them to investors.

Ackman stated that the ICA claim could potentially affect all SPACs:

“Because the basic issues raised here apply to every SPAC, a successful claim would imply that every SPAC may also be an illegal investment company,” wrote Ackman. “As a result, the lawsuit may have a chilling effect on the ability of other SPA Cs to consummate merger transactions or to engage in IPOs until the litigation is resolved in PSTH’s favor, as the consequences of being deemed an illegal investment company are extremely onerous.”

However, the formidable united defense of 63 leading law firms has undoubtedly had a strong effect. Since the statement’s release, no additional ICA-based lawsuits have been filed. The statement may well have dammed a potential flood before it started. Reuters<sup>2</sup> recently reported that according to

two sources, the law firms associated with Jackson and Morley planned to file as many as 50 similar lawsuits. (A third source said no new legal action was imminent.)

The ICA-based litigation may take time to provide legal certainty. But with the litigation confined to just three suits in the Southern District of New York, at least so far, there is reason to hope that the question may be settled sooner rather than later.

## Endnotes

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- 1 Jean Eaglesham, SPACs Are Having Their Day—In Court, Wall St. Journal (Aug. 25, 2021), <https://www.wsj.com/articles/spacs-are-having-their-day-in-court-11629889200>.
- 2 Svea Herbst-bayliss, et al., EXCLUSIVE Lawyers behind Ackman's retreat may target more SPACs, Reuters (Aug. 26, 2021), <https://www.reuters.com/business/finance/exclusive-lawyers-behind-ackmans-retreat-target-dozens-more-spacs-2021-08-26/>.