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Top Ten Issues in De-SPAC Securities Litigation

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TOP TEN ISSUES IN DE-SPAC SECURITIES LITIGATION

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I am delighted to contribute to this symposium on special purpose acquisition companies (SPACs).[1] The securities litigation associated with the de-SPAC transaction is at an early stage, but courts are already wrestling with a number of unsettled issues that cast a mirror on SPACs and the securities laws more broadly. As these issues are resolved, they will affect the future of de-SPAC transactions as well as the regulatory environment in which they operate. In this essay, I identify ten such issues, drawing from the pleadings, briefings, and hearings in pending de-SPAC securities cases, with the goal of highlighting the key issues that are currently percolating in federal district courts across the country, from the Middle District of Tennessee to the Southern District of New York. I also include several issues that are not yet ripe, but which I foresee arising as the litigation progresses. The first five issues relate to claims under Section 10(b)[2] and Rule 10b-5;[3] the next four issues relate to claims under Section 14(a)[4] and Rule 14a-9;[5] and the final issue relates to both causes of action.

I. ISSUE ONE: DOES THE "CORE OPERATIONS" INFERENCE APPLY WHEN PLEADING THE SCIENTER OF THE SPAC'S DIRECTORS AND OFFICERS WITH RESPECT TO ALLEGED MISREPRESENTATIONS ABOUT THE TARGET'S OPERATIONS?

The first four issues that I highlight relate to the pleading of the defendants' scienter in securities fraud claims under Section 10(b) and Rule 10b-5. Scienter is an element of securities fraud,[6] and most courts define this element

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1. This essay assumes a basic understanding of SPACs and the de-SPAC transaction. For an excellent overview, see Beau Duty, Note, *Business Judgment Rule or Due Diligence? How to Reduce Vicarious Liability for SPAC Directors and Officers*, 44 U. ARK. LITTLE ROCK L.REV. 251, 255–57 (2021).

2. 15 U.S.C. § 78j(b).

3. 17 C.F.R. § 240.10b-5 (2022).

4. 15 U.S.C. § 78n(a).

5. 17 C.F.R. § 240.14a-9.

6. *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 201 (1976) ("10(b) was addressed to practices that involve some element of scienter and cannot be read to impose liability for negligent conduct alone.").

as requiring at least recklessness with respect to truth or falsity.[7] Under the Private Securities Litigation Reform Act (PSLRA), a complaint must "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind."[8] As interpreted by the Supreme Court, a complaint will survive a motion to dismiss on this basis "only if a reasonable person would deem the inference of scienter cogent and at least as compelling as any opposing inference one could draw from the facts alleged."[9] The failure to plead a strong inference of scienter is the most successful ground on which defendants seek dismissal of securities fraud claims.[10] Notably, because of the PSLRA's discovery stay, plaintiffs are required to meet this stringent pleading standard without the benefit of discovery.[11]

One strategy that plaintiffs often use to attempt to plead the strong inference of scienter is the so-called "core operations" inference. "Under the 'core operations' doctrine, 'a court may infer "that a company and its senior executives have knowledge of information concerning the core operations of a business," such as "events affecting a significant source of income."'"[12] This inference is an extension of the common-sense notion that, if a director or an officer made a materially false representation about something core to the operations of the business, he or she must have acted at least recklessly in so doing.[13] The Supreme Court recognized this common-sense notion in *Merck & Co. v. Reynolds*: "We recognize that certain statements are such that, to show them false is normally to show scienter as well. It is unlikely, for example, that someone would falsely say 'I am not married' without being aware of the fact that his statement is false."[14]

In de-SPAC litigation, plaintiffs are seeking to extend the core operations inference, arguing that alleged misrepresentations about the target's core

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7. Tellabs, Inc. v. Makor Issues & Rts., Ltd., 551 U.S. 308, 319 n.3 (2007) ("Every Court of Appeals that has considered the issue has held that a plaintiff may meet the scienter requirement by showing that the defendant acted intentionally or recklessly, though the Circuits differ on the degree of recklessness required.").

8. 15 U.S.C. § 78u-4(b)(2)(A).

9. *Tellabs, Inc.*, 551 U.S. at 324.

10. Wendy Gerwick Couture, *Around the World of Securities Fraud in Eighty Motions to Dismiss*, 45 LOY. U. CHI. L.J. 553, 558 (2014) ("Failure to plead a strong inference of scienter, as required by the Private Securities Litigation Reform Act ('PSLRA'), is by far and away the most frequently successful ground for dismissal.").

11. 15 U.S.C. § 78u-4(b)(3)(B).

12. Haw. Structural Ironworkers Pension Tr. Fund v. AMC Ent. Holdings, 422 F. Supp. 3d 821, 852 (S.D.N.Y. 2019) (quoting *In re* Supercom Inc. Sec. Litig., No. 15-cv-9650, 2018 WL 4926442, at *31 (S.D.N.Y Oct. 10, 2018)).

13. Wendy Gerwick Couture, *The Falsity-Scienter Inference*, 40 No. 3 SEC. REG. L.J. 303, 308 (2012) ("In essence, the core operations inference is a subset of the falsity-scienter inference proposed in this column. The falsity-scienter inference applies anytime the speaker, by necessity, both knew the truth and noticed the falsity.").

14. Merck & Co. v. Reynolds, 559 U.S. 633, 649–50 (2010).

operations support an inference of the scienter of the SPAC's directors and officers. In other words, plaintiffs are contending that the inference can cross entities. In support, plaintiffs are citing the SPAC's due diligence about the target company's operations, while defendants are arguing that the SPAC's due diligence is insufficient to allow the inference to cross entities, particularly where the alleged misrepresentation relates to a topic covered by the target's representations and warranties in the merger agreement. The following excerpt from the defendants' briefing in the *Clover Health Investments, Corp.* de-SPAC litigation exemplifies this issue:

> Plaintiffs' scienter theory concerning Mr. Palihapitiya is also misplaced. Plaintiffs concede that Mr. Palihapitiya had no role at Legacy Clover [the target], but rather was the head of SCH [the SPAC]. Plaintiffs seek to establish Mr. Palihapitiya's scienter by touting the due diligence performed by SCH, and conclusorily asserting that Mr. Palihapitiya must have known that the statements at issue were false as a result of that due diligence. But nowhere do Plaintiffs identify any information provided to Mr. Palihapitiya that revealed any of the statements at issue were false or misleading. Indeed, the Complaint actually alleges the opposite—that SCH received representations and warranties that there were no legal proceedings or regulatory actions that could have a material impact on the business.[15]

Prior to the recent spike in SPAC transactions, one court specifically rejected plaintiffs' attempts to apply the core operations inference across entities:

> Defendants are correct that allegations of drastic overstatements and flagrant accounting violations are all probative of a strong inference of scienter as to a director or officer of a company. However, in this case, the Ideation Defendants were directors of the acquiring company, not the target company whose financial results were overstated. Plaintiffs claim, without any support, that the Ideation Defendants' "status as directors of the acquirer business and SMIL's status as the target business does not alter the analysis." The Court disagrees. Indeed, each of the cases Plaintiffs cites [sic] concerns an inference of scienter being drawn against an officer of the company with the alleged irregularities.[16]

It remains to be seen whether courts will categorically reject the core operations inference in the de-SPAC context or whether the inference could

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15. Memorandum of Law in Support of Defendants' Motion to Dismiss the First Amended Complaint at 36, Bond v. Clover Health Invs. Corp., No. 3:21-CV-00096 (M.D. Tenn. Aug. 27, 2021), ECF No. 75 (motion denied).

16. Murdeshwar v. Search Media Holdings, Ltd., No. 11-Civ-20549, 2011 WL 7704347, at *18 (S.D. Fla. Aug. 8, 2011).

potentially apply across entities, depending on the SPAC's due diligence and the target's representations and warranties.

II. ISSUE TWO: TO WHAT DEGREE DO THE INCENTIVES FOR THE SPAC'S SPONSOR TO "CLOSE THE DEAL" GIVE RISE TO A STRONG INFERENCE OF SCIENTER?

As Professors Usha Rodrigues and Michael Stegemoller have detailed, the SPAC's sponsors have unique and compelling incentives to complete a de-SPAC transaction: "[F]or the sponsor, merging with a private firm even with relatively poor prospects, and receiving 20% of it, is vastly preferable to the alternative of receiving no payoff at all."[17] Plaintiffs have pleaded these incentives to close the deal "come hell or high water"[18] in support of the SPAC sponsors' scienter. The following excerpt from the plaintiffs' briefing in the *Velodyne Lidar, Inc.* de-SPAC litigation is typical: "Defendants' authorities are distinguishable as *none* involve the unique SPAC structure present here. . . . The de-SPAC process here guaranteed that Defendants Graf and Dee would receive a substantial ownership position at an extreme discount but *only* if the Reverse Merger was timely completed. Otherwise, their founders' shares would be worthless."[19]

In response, defendants have cited lock-up periods to undercut the claim that sponsors are incentivized to close bad deals that would be revealed before they could profit therefrom.[20] Defendants have also argued that the reputational impact of closing a bad deal undercuts any inference of scienter, such as in this excerpt from oral argument in the *Waitr Holdings, Inc.* de-SPAC litigation:

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17. Usha Rodrigues & Michael Stegemoller, *Redeeming SPACs* 8 (Univ. Ga. Sch. L., Rsch. Paper No. 2021-09, 2021), https://ssrn.com/abstract=3906196.

18. Memorandum of Law in Opposition to Defendants' Motion to Dismiss the First Amended Complaint at 2, Bond v. Clover Health Invs. Corp., No. 3:21-CV-00096 (M.D. Tenn. Nov. 11, 2021), ECF No. 80.

19. Lead Plaintiffs' Memorandum of Law in Opposition to Defendants' Motion to Dismiss at 27, Moradpour v. Velodyne Lidar, Inc., No. 3:21-CV-1486-SI (N.D. Cal. Jan. 7, 2022), ECF No. 92.

20. Reply Memorandum of Law in Further Support of Defendants' Motion to Dismiss the First Amended Complaint at 25, Bond v. Clover Health Invs. Corp., No. 3:21-CV-00096 (M.D. Tenn. Dec. 17, 2021), ECF No. 83 ("Plaintiffs' ultimate fallback position is that they have pled scienter because many of the Individual Defendants stood to make significant profits as part of the Business Combination. . . . [T]he Individual Defendants did not gain from a temporary rise in Clover's shares given that their profits from the transaction were (i) almost entirely in Clover stock, (ii) they agreed not to sell their stock for a substantial period after the Business Combination, and (iii) there are no allegations of the sale of a single share of Clover stock during the Class Period.").

> But I think just, again, from the sort of plausibility perspective, when you think about, you know, which would be more attractive, you know, if you didn't believe in the CEO and the target, having the company be a failure, you know, the sponsor is going to own 16 percent of it after the merger, you know. It's their name that would be associated with a failed—with an unsuccessful merger. It's difficult to see, if one is weighing inferences as the Supreme Court's decision in Tellabs says one does in that motion to dismiss and the Section 10(b) case, it's difficult to see the inference for wanting to go out with a bad deal that you thought was bad.[21]

It is unlikely that courts will view the unique incentives associated with de-SPAC transactions as sufficient in and of themselves to plead a strong inference of the sponsors' scienter. However, it remains to be seen how these incentives will play into courts' holistic analyses, particularly if sponsors realized profits from the de-SPAC transaction and if they were not repeat players with compelling potential reputational impacts.

III. ISSUE THREE: TO WHAT DEGREE DOES THE TIMING OF THE DE-SPAC TRANSACTION SUPPORT A STRONG INFERENCE OF SCIENTER?

Related to the unique incentives of the SPAC's sponsors to close the deal, plaintiffs are also highlighting the timing of the de-SPAC transaction as supportive of the strong inference of scienter. As argued by plaintiffs, the closer to the deadline,[22] the stronger the motive for the sponsors to act recklessly in seeking to close the deal. The following excerpt from the plaintiffs' briefing in the *Velodyne Lidar, Inc.* de-SPAC litigation exemplifies this issue:

> Failing to merge meant Graf and Dee's founder's shares would expire worthless, and they would not participate in any liquidating distribution from the trust account. On the other hand, successfully merging with Velodyne meant that Graf and Dee alone would reap, along with their fellow founders, a 20% interest in the combined Company, then valued at $72 million. Further, GIC was in a desperate financial state because its original investors had *already* redeemed approximately 53% of its trust account after the original April 2020 deadline lapsed. Defendant Graf and Dee's desire to avoid an impending liquidation—particularly following a

21. Transcript of Motions Hearing at 38–39, Welch v. Meaux, No. 2:19-CV-1260 (W.D. La. May 28, 2021), ECF No. 81 (motion to dismiss pending).

22. Duty, *supra* note 1, at 251–252 ("SPACs typically have a deadline of about two years to acquire a target company and complete a merger transaction. If the SPAC does not acquire a target within two years, the SPAC dissolves, liquidates the trust fund, and returns the capital to the SPAC's original IPO investors.").

> redemption by its stockholders—provides sufficient motive to raise a strong inference of scienter.[23]

Although defendants have rejected plaintiffs' argument that transactions on the eve of the deadline support a strong inference of scienter, defendants have highlighted the timing of the de-SPAC transaction when the transaction was announced well in advance of the deadline. For example, the defendants in the *Alta Mesa Resources, Inc.* de-SPAC litigation argued as follows in their briefing:

> Plaintiffs allege that "Defendants" were motivated to lie about AMH and Kingfisher before the Business Combination because "Riverstone" would lose its entire investment if Silver Run II did not engage in a transaction by March 2019. The calendar alone eviscerates that inference. The Business Combination was announced in August 2017—over nineteen months before the deadline for Silver Run II to complete a transaction.[24]

The court denied these defendants' motion to dismiss.[25]

IV. ISSUE FOUR: HOW MUCH WEIGHT, IF ANY, SHOULD COURTS AFFORD TO ALLEGATIONS MADE BY ANONYMOUS SOURCES QUOTED IN SHORT SELLERS' REPORTS?

A final scienter pleading issue with which courts are grappling in the pending litigation is how much weight, if any, to afford to allegations made by anonymous sources quoted in short sellers' reports. Short sellers have been particularly interested in de-SPAC entities, and short sellers "may have an incentive to bring to light information that justifies their analysis that a stock is overvalued, and thereby catalyze the very market reactions that will reward their position."[26] In a client alert, Quinn Emanuel noted the potentially symbiotic relationship between short selling and securities litigation:

> [W]hile the examples we cited primarily featured securities plaintiffs borrowing from the publicized work of short sellers, litigation may ultimately prove to be a tool for short sellers. By focusing on the content of the SPAC

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23. Lead Plaintiffs' Memorandum of Law in Opposition to Defendants' Motion to Dismiss, *supra* note 19, at 27.

24. Bd. Defendants' Motion to Dismiss Plaintiffs' Second Corrected Consol. Amended Complaint at 10, *In re* Alta Mesa Res., Inc. Sec. Litig., No. 4:19-CV-00957 (S.D. Tex. June 30, 2020), ECF No. 127.

25. Camelot Event Driven Fund v. Alta Mesa Res., Inc., No. 4:19-CV-957, 2021 WL 1416025, at *1, *12 (S.D. Tex. Apr. 14, 2021).

26. Ellison Ward Merkel et al., *Recent SPAC Litigation Tied to Short Seller Scrutiny,* QUINN EMANUEL TRIAL LAWS (Jan. 12, 2021), https://www.quinnemanuel.com/the-firm/publications/recent-spac-litigation-tied-to-short-seller-scrutiny/.

> transaction proxy statement, for example, a short seller may telegraph potential litigation claims to securities plaintiffs.[27]

In their complaints, plaintiffs have often quoted short sellers' reports, which themselves quote anonymous sources. Defendants have contended that courts should disregard these quoted anonymous sources because they are not subject to plaintiffs' counsel's Rule 11 certifications, unlike the confidential witness statements that are often quoted in securities fraud complaints, and because they are contained in biased and unreliable reports. The following excerpt from the defendants' briefing in the *Clover Health Investments, Corp.* de-SPAC litigation summarizes this argument:

> Plaintiffs' Complaint is premised, in large part, on the Hindenburg Report. As explained below, the Court should disregard those allegations entirely because the Hindenburg Report offers no indicia of reliability: it does not provide any information regarding the sources upon which it claims to rely, was not filed in any court under obligations similar to those imposed by Rule 11, and to top it all, explicitly disclaims reliability.[28]

One court, in the *QuantumScape* de-SPAC litigation, rejected the defendants' argument that these allegations were inherently unreliable:

> [T]hat Scorpion Capital was allegedly short on QuantumScape may raise serious credibility issues for a factfinder. But QuantumScape overstates the caselaw by arguing that it makes the report's conclusions "inherently unreliable." All of its cited cases discuss short-sellers but did so as part of a broader contextual analysis, not as a bright-line rule of exclusion. . . . Those cases, in fact, are concerned with the nature of the revelation more than it coming from a short-seller. . . . The substance of the report shows that it is sufficient to survive a challenge at the pleadings stage. Investors need not only have relied on the say-so of the short seller because the report interviewed nine former QuantumScape employees about QuantumScape's testing and four experts about its conclusion. . . . It is true that most of the experts and all of the former employees are unidentified by name. But they need not be today: "Where a complaint relies on both confidential witnesses and other factual information, such as documentary evidence, the plaintiffs need not name their sources as long as the latter facts provide an adequate basis for believing that the defendants' statements were false."[29]

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27. *Id.*

28. Memorandum of Law in Support of Defendants' Motion to Dismiss the First Amended Complaint, *supra* note 15, at 11.

29. Order on Motion to Dismiss at 14–15, *In re* QuantumScape Sec. Class Action Litig., No. 3:21-CV-00058-WHO (N.D. Cal. Jan. 14, 2022), ECF No. 153 (quoting Zucco Partners, LLC v. Digimarc Corp., 552 F.3d 981, 995 (9th Cir. 2009)) (denying motion to dismiss in part).

V. ISSUE FIVE: CAN THE PLAINTIFFS ESTABLISH THAT THE MARKET WAS EFFICIENT AT THE TIME OF THE ALLEGED MISREPRESENTATIONS?

The next issue also relates to securities fraud claims under Section 10(b) and Rule 10b-5, but it relates to the element of reliance rather than scienter. Although this issue has not yet arisen in pending de-SPAC litigation, which has not yet progressed beyond the motion to dismiss stage, I foresee this issue on the horizon to the extent that cases proceed to motions for class certification.

Reliance is an element of private securities fraud claims.[30] If plaintiffs were required to prove individualized reliance, it would defeat the class certification prerequisite that "the questions of law or fact common to class members predominate over any questions affecting only individual members."[31] In most securities fraud cases, plaintiffs seek to establish class-wide reliance via the fraud-on-the-market presumption of reliance. In order to invoke this presumption of reliance, plaintiffs bear the burden of proving the following prerequisites: "(1) the alleged misrepresentations were publicly known, (2) they were material, (3) the stock traded in an efficient market, and (4) the plaintiff traded the stock between when the misrepresentations were made and when the truth was revealed."[32] If plaintiffs succeed in making these showings so as to invoke the presumption, defendants may "defeat the presumption through evidence that an alleged misrepresentation did not actually affect the market price of the stock."[33]

When courts assess whether the stock traded in an efficient market, they often examine the so-called *Cammer* factors, which are summarized as follows:

> (1) whether "there existed an average weekly trading volume during the class period in excess of a certain number of shares;" (2) whether "a significant number of securities analysts followed and reported on a company's stock during the class period;" (3) whether "it could be alleged the stock had numerous market makers;" (4) whether "the Company was entitled to file an S-3 Registration" and, if not, whether "ineligibility was only because of timing factors rather than because the minimum stock requirements [*i.e.*, public float requirements] . . . were not met;" and (5) whether "empirical facts show[ ] a cause and effect relationship between

30. Halliburton Co. v. Erica P. John Fund, Inc., 573 U.S. 258, 263 (2014) ("Investors can recover damages in a private securities fraud action only if they prove that they relied on the defendant's misrepresentation in deciding to buy or sell a company's stock.").

31. FED. R. CIV. P. 23(b)(3).

32. *Halliburton Co.*, 573 U.S. at 277–78.

33. *Id.* at 284.

> unexpected corporate events or financial releases and an immediate response in the stock price."[34]

In de-SPAC securities litigation, plaintiffs likewise are pleading the fraud-on-the-market presumption of reliance in order to establish class-wide reliance. The following excerpt from the complaint in the *Velodyne Lidar, Inc.* de-SPAC securities litigation is typical:

> At all relevant times, the market for Velodyne securities was an efficient market under *Basic v. Levinson*, 485 U.S. 224 (1988) for the following reasons, among others: (a) Velodyne securities met the requirements for listing, and were listed and actively traded on Nasdaq, a highly efficient, national stock market;
>
> (b) as a regulated issuer, Velodyne filed periodic public reports with the SEC and the Nasdaq . . . .[35]

And plaintiffs are citing the fraud-on-the-market presumption of reliance for class periods that pre-date the merger. For example, the putative class in the *Velodyne Lidar, Inc.* complaint quoted above begins on the date of the press release about the proposed merger.[36]

However, SPACs' trading volume and shareholder base vary throughout their life cycle.[37] Thus, in addition to the usual litigation about price impact at the class certification stage, I foresee litigation about whether plaintiffs can establish that the SPAC stock traded in an efficient market at the time of the alleged misrepresentations, so as to support class-wide reliance, particularly prior to the de-SPAC transaction.

VI. ISSUE SIX: WHICH PARTIES IN THE DE-SPAC TRANSACTION ARE PERMITTING THE USE OF HIS OR HER NAME TO SOLICIT ANY PROXY?

The next four issues arise in claims under Section 14(a) and Rule 14a-9 for alleged misrepresentations in proxy materials against a "person . . . solicit[ing]" or "permit[ting] the use of his [or her] name to solicit any proxy."[38]

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34. Wendy Gerwick Couture, *Professor Alan R. Bromberg and the Scholarly Role of the Treatise*, 68 SMU L. REV. 703, 710 (2015) (quoting Cammer v. Bloom, 711 F. Supp. 1264, 1286–87 (D.N.J. 1989)).

35. Consol. Class Action Complaint for Violations of the Fed. Sec. Laws ¶ 401, Moradpour v. Velodyne Lidar, Inc., No. 3:21-CV-01486-SI (N.D. Cal. Sept. 1, 2021), ECF No. 73.

36. *Id.* ¶¶ 3, 13–14.

37. *See* Phil Mackintosh, *A Record Pace for SPACs*, NASDAQ (Jan. 21, 2021, 2:28 PM), https://www.nasdaq.com/articles/a-record-pace-for-spacs-2021-01-21 ("In our analysis, SPACs that completed the entire cycle from 2018 through 2020 (55 SPACs) show that trading patterns change over the lifespan of a SPAC, and each phase is distinctly different.").

38. 15 U.S.C. § 78n(a)(1).

In the context of de-SPAC transactions, a recurring issue is which parties named in the proxy materials are potential defendants. As explained by the D.C. Circuit, "the simple appearance of one's name in a proxy statement does not trigger liability for any misstatement appearing therein."[39] Rather, there must have been "a substantial connection between the use of the person's name and the solicitation effort."[40]

Plaintiffs have sought to hold a variety of players within the de-SPAC transaction liable under Section 14(a) and Rule 14a-9, including the target's leadership, the SPAC's sponsor, and the SPAC's financial advisor. Defendants have argued that the inclusion of their names in the proxy materials is insufficient to expose them to liability.

With respect to the target's leadership, a court in the Southern District of New York denied a defendant's motion to dismiss an SEC enforcement action on this basis:

> [T]he Commission adequately alleges that Aurovsky put his reputation in issue in the proxy materials such that he owed a duty to the Cambridge shareholders. Aurovsky consented to the use of his name "as a person who would become a director of Ability Inc." to solicit proxies. The Commission alleges that his "qualifications and continued participation in the newly formed public company were essential to soliciting Cambridge shareholders to vote in favor of the merger." It specifically alleges that the proxy materials contained information about his background and assured shareholders that he was a "highly-talented . . . industry professional[]" who would bring his skills to the company after the merger. Indeed, the Commission alleges that the Proxy Statement invoked Aurovsky's name "approximately 29 times."[41]

With respect to the sponsor, in the *Alta Mesa Resources, Inc.* de-SPAC securities litigation, the sponsor Riverstone Holdings LLC moved to dismiss the Section 14(a) claim, arguing as follows:

> The standard emerging from these cases is that a third-party to the proxy solicitation can be liable under Section 14(a) for permitting its name to be used to solicit proxies when that person is the subject of the specific matter to be voted on—e.g., when stockholders are being asked to vote to give the person control over the company. Applying this standard to this case, it is obvious that Plaintiffs cannot establish that Riverstone Holdings is liable under Section 14(a). The stockholders were asked to decide whether they wanted Silver Run II to acquire the AMH and Kingfisher businesses. The reputation of Riverstone Holdings, which simply held an interest in certain investment vehicles who owned stock in Silver Run II, is

39. SEC v. Falstaff Brewing Corp., 629 F.2d 62, 68 (D.C. Cir. 1980).
40. *Id.* (quoting Yamamoto v. Omiya, 564 F.2d 1319, 1323 (9th Cir. 1977)).
41. SEC v. Hurgin, 484 F. Supp. 3d 98, 117 (S.D.N.Y. 2020).

> immaterial to the stockholder's evaluation of those businesses, and an affirmative vote would not give Riverstone Holdings control over Silver Run II.[42]

The court denied Riverstone Holdings LLC's motion to dismiss.[43]

The motion to dismiss filed by sponsor Jefferies Financial Group is still pending in the *Waitr Holdings, Inc.* de-SPAC litigation. At oral argument, the sponsor's counsel argued:

> Yes, Jefferies Financial Group was an investor in Landcadia. It was the sponsoring investor, but that doesn't mean you look through the corporate entity and treat it as a Section 14 defendant. That is essentially piercing the corporate veil. You need more. You need something that would cause you to be deemed a participant which the plaintiffs do not have under this SEC regulation or a clear usage of the name that's clearly, you know, for the purpose of soliciting a proxy.[44]

With respect to the SPAC's financial advisor, defendants have argued that their exposure to liability under Section 14(a) and Rule 14a-9 would undercut the SEC's instructions to Schedule 14A. The instructions explicitly exclude financial advisers from those deemed to be participants in the proxy solicitation: "The terms 'participant' and 'participant in a solicitation' do not include: . . . [a]ny person employed by a participant in the capacity of . . . financial adviser, and whose activities are limited to the duties required to be performed in the course of such employment."[45] Accordingly, defendants contend that, if the naming of the financial adviser were sufficient to expose the financial adviser to liability, it would undercut the instruction:

> [I]f you took the view that mentioning the financial adviser in the proxy statement would be enough to have them be liable under Section 14 because their name was used, that would render this SEC regulation I handed up to you pointless because it always mentions the financial adviser and that it conducted analyses in the proxy statement. And if that were enough to make you a Section 14 defendant, there would be no reason for the SEC to have taken the time to put out a regulation saying that a financial adviser in a merger is not a participant in the proxy solicitation process.[46]

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42. Riverstone Holdings LLC's Motion to Dismiss Plaintiffs' Second Corrected Consol. Amended Complaint at 9, *In re* Alta Mesa Res., Inc., No. 4:19-CV-00957 (S.D. Tex. June 30, 2020), ECF No. 128.

43. Camelot Event Driven Fund v. Alta Mesa Res., Inc., No. 4:19-CV-00957, 2021 WL 1416025, at *1, *12 (S.D. Tex. Apr. 14, 2020).

44. Transcript of Motions Hearing, *supra* note 21, at 57.

45. 17 C.F.R. § 240.14a-101 note (instruction 3(b)(iii)) (2022).

46. Transcript of Motions Hearing, *supra* note 21, at 55.

In response, plaintiffs have argued that, particularly where the SPAC's financial adviser stands to profit from the consummation of the transaction, the financial adviser is appropriately exposed to liability under Section 14(a) and Rule 14a-9:

> The cases cited by Jefferies Defendants for the proposition that financial advisors cannot be liable under 14(a) are inapplicable. In *Mendell v. Greenberg*, 612 F. Supp. 1543, 1552 (S.D.N.Y. 1985), the court found that a financial advisor who merely "permitted the use of its name to solicit proxies" was not liable because . . . it would not "directly benefit by the shareholders' favorable vote." Here, by contrast, Jefferies Defendants stood to (and did) benefit handsomely from the Going Public Transaction.[47]

VII. ISSUE SEVEN: WHEN SEEKING TO HOLD OUTSIDE DIRECTORS AND ACCOUNTANTS LIABLE UNDER § 14(A) AND RULE 14A-9, IS NEGLIGENCE SUFFICIENT, OR IS SCIENTER REQUIRED?

Although most circuits apply a negligence standard in claims under Section 14(a) and Rule 14a-9,[48] the Sixth and Eighth Circuits have held that scienter is required when seeking to hold outside directors and accountants liable.[49] The following excerpt from the Sixth Circuit's opinion in *Adams v. Standard Knitting Mills, Inc.* explains the court's rationale for making this distinction:

> In view of the overall structure and collective legislative histories of the securities laws, as well as important policy considerations, we conclude that scienter should be an element of liability in private suits under the

47. Plaintiffs' Omnibus Opposition to Defendants' Motions to Dismiss the Amended Class Action Complaint at 30–31, Welch v. Meaux, No. 2:19-CV-01260-TAD-KK (W.D. La. Jan. 21, 2021), ECF No. 56.

48. *E.g.*, Kennedy v. Venrock Assocs., 348 F.3d 584, 593 (7th Cir. 2003); Beck v. Dobrowski, 559 F.3d 680, 682 (7th Cir. 2009) ("There is no required state of mind for a violation of section 14(a); a proxy solicitation that contains a misleading misrepresentation or omission violates the section even if the issuer believed in perfect good faith that there was nothing misleading in the proxy materials."); Knollenberg v. Harmonic, Inc., 152 F. App'x 674, 682–83 (9th Cir. 2005) (unpublished) ("[N]egligence is sufficient to support a claim for a violation of Section 14(a) for both forward looking and non-forward looking statements."); Wilson v. Great Am. Indus., Inc., 855 F.2d 987, 995 (2nd Cir. 1988) ("Under Rule 14a–9, plaintiffs need not demonstrate that the omissions and misrepresentations resulted from knowing conduct undertaken by the director defendants with an intent to deceive. Liability can be imposed for negligently drafting a proxy statement.").

49. SEC v. Shanahan, 646 F.3d 536, 546–47 (8th Cir. 2011) ("Neither the Supreme Court nor this court has decided whether scienter is an element of an action brought under § 14(a). . . . We agree with those courts that have concluded that scienter is an element, at least for claims against outside directors and accountants."); Adams v. Standard Knitting Mills, Inc., 623 F.2d 422, 428–29 (6th Cir. 1980).

> proxy provisions as they apply to outside accountants. . . . [W]e are influenced by the fact that the accountant here, unlike the corporate issuer, does not directly benefit from the proxy vote and is not in privity with the stockholder.[50]

In response, plaintiffs have argued: "If Congress had wanted there to be different standards depending on the party's role, it also could have made that explicit, and it didn't."[51] In addition, in light of the unique incentives in de-SPAC transactions, whereby "*all the major players* in the SPAC are deeply incentivized to see the deal pushed forward,"[52] outside directors and accountants arguably do directly benefit from the proxy vote in de-SPAC transactions, undercutting the policy rationale underlying the Sixth Circuit's holding.

VIII. ISSUE EIGHT: IS NEGLIGENCE A "STATE OF MIND," SUCH THAT PLAINTIFFS ARE REQUIRED TO PLEAD A STRONG INFERENCE OF IT?

A related issue is whether negligence—which is an element of Section 14(a) and Rule 14a-9 claims at least against insiders—is a "state of mind" such that the PSLRA's heightened pleading standard applies. Courts are split on this question.[53]

Some courts have agreed with plaintiffs that:

> [N]egligence is *not* a state of mind but a type of culpable conduct, objectively determined. . . . For the purposes of Section 14(a), 'negligence' is the failure to comply with the legal obligation not to solicit a proxy with false or misleading statements or omissions, imposed on an identified category of persons, irrespective of any subjective intent or level of diligence or care.[54]

Other courts have agreed with defendants that the PSLRA's strong inference of scienter pleading requirement applies to the element of negligence.[55] In oral argument on the motion to dismiss in the *Waitr Holdings, Inc.*

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50. *Adams*, 623 F.2d at 428.

51. Transcript of Motions Hearing, *supra* note 21, at 97.

52. Rodrigues & Stegemoller, *supra* note 17, at 5.

53. *In re* Willis Towers Watson Plc Proxy Litig., 439 F. Supp. 3d 704, 712–14 (E.D. Va. 2020) ("The open issue then is whether that negligence is a 'state of mind' triggering the particularization of those facts giving rise to a 'strong inference' that the defendant acted with the 'required state of mind.'").

54. *Id.* at 715; *see also* Camelot Event Driven Fund v. Alta Mesa Res., Inc., No. 4:19-CV-00957, 2021 WL 1416025, at *10 (S.D. Tex. Apr. 14, 2021) ("Plaintiffs in Section 14(a) actions are not required to comply with the PSLRA's scienter pleading requirement, but they must comply with the PSLRA's particularity requirement.").

55. *E.g.*, *In re* McKesson HBOC, Inc. Sec. Litig., 126 F. Supp. 2d 1248, 1267 (N.D. Cal. 2000) ("[A]ny 'required state of mind' is subject to a requirement of pleading of particular

de-SPAC litigation, defendant's counsel argued: "We say negligence is a required state of mind. Plaintiffs say there can be no such required state of mind. I think we're right. I mean, negligence is a mens rea. At least that's what I was taught in law school . . . ."[56]

IX. ISSUE NINE: WHAT WOULD A REASONABLE SHAREHOLDER CONSIDER IMPORTANT IN DECIDING HOW TO VOTE ON A DE-SPAC MERGER?

Section 14(a) and Rule 14a-9 impose liability only for material misrepresentations or omissions in a proxy solicitation. A misrepresented or "omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote."[57] Materiality is a fact-specific, contextual inquiry[58] that includes the overall context of the transaction at issue.

Although this issue has not yet been raised in the de-SPAC litigation, I anticipate litigation about how the unique incentives in de-SPAC transactions affect the materiality analysis. As Professors Rodrigues and Stegemoller have detailed, "SPACs have decoupled voting and economic interest in the de-SPAC. This decoupling renders the SPAC shareholder vote—when it even occurs—a mere fig leaf. A de-SPAC is a *fait accompli*."[59] Accordingly, courts may be inclined to view some alleged misrepresentations about the target's operations as immaterial as a matter of law, even if the same alleged misrepresentations would be material in a non-de-SPAC context.

X. ISSUE TEN: DOES THE PSLRA SAFE HARBOR FOR FORWARD-LOOKING STATEMENTS APPLY TO STATEMENTS MADE IN THE DE-SPAC TRANSACTION?

The PSLRA safe harbor insulates those who make forward-looking statements from liability if (1) the statements were "identified as a forward-looking statement, and . . . accompanied by meaningful cautionary" language, or (2) the plaintiffs fail to establish that the forward-looking statements were "made with actual knowledge" of falsity.[60] The safe harbor does not apply to

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facts giving rise to a strong inference of that state of mind. The text of the statute provides no exception for standards of culpability lower than scienter.").

56. Transcript of Motions Hearing, *supra* note 21, at 61.

57. TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976).

58. Basic Inc. v. Levinson, 485 U.S. 224, 236 (1988) ("Any approach that designates a single fact or occurrence as always determinative of an inherently fact-specific finding such as materiality, must necessarily be overinclusive or underinclusive.").

59. Rodrigues & Stegemoller, *supra* note 17, at 28.

60. 15 U.S.C. § 78u-5(c).

"a forward-looking statement . . . that is . . . made in connection with an initial public offering."[61] "[I]nitial public offering" is not defined.

Infamously, in a statement representing solely his own view, John Coates, then the Acting Director of the SEC's Division of Corporate Finance, suggested that the de-SPAC transaction could be viewed as the target's initial public offering:

> The economic essence of an *initial public offering* is the introduction of a new company to the public. . . . An IPO is where the protections of the federal securities laws are typically most needed to overcome the information asymmetries between a new investment opportunity and investors in the newly public company. . . . If these facts about economic and information substance drive our understanding of what an "IPO" is, they point toward a conclusion that the PSLRA safe harbor should not be available for any unknown private company introducing itself to the public markets. . . . If we do not treat the de-SPAC transaction as the "real IPO," our attention may be focused on the wrong place, and potentially problematic forward-looking information may be disseminated without appropriate safeguards.[62]

Not surprisingly, this issue has made its way into the de-SPAC litigation.[63] For example, the plaintiffs in the *Velodyne Lidar, Inc.* de-SPAC litigation have urged the court to reject the safe harbor's applicability:

> The PSLRA's safe harbor provisions, however, do not apply here. The now General Counsel of the SEC (and then-Acting Director of the Division of Corporate Finance) John Coates has publicly stated that going public *via* a de-SPAC (i.e., reverse merger) has all the hallmarks of a traditional initial public offering for which the safe harbor does *not* apply.[64]

Additionally, a bill has been introduced in Congress to explicitly exclude certain SPACs from the protections of the "safe harbor for forward-looking statements."[65]

In conclusion, although the de-SPAC litigation is at an early stage, it is already highlighting the unique incentives associated with de-SPAC

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61. *Id.* § 78u-5(b).

62. John Coates, *SPACs, IPOs and Liability Risk Under the Securities Laws,* SEC (Apr. 8, 2021), https://www.sec.gov/news/public-statement/spacs-ipos-liability-risk-under-securities-laws.

63. Transcript of Motions Hearing, *supra* note 21, at 75 ("We have submitted an additional statement from Mr. Coates of the SEC, and it's not the position of the SEC. It's just his personal opinion where he raises the question of whether the PSLRA Safe Harbor even applies in a Section 14(a) deSPAC case.").

64. Lead Plaintiffs' Memorandum of Law in Opposition to Defendants' Motion to Dismiss, *supra* note 19, at 13.

65. *See* Holding SPACs Accountable Act of 2021, H.R. 5910, 117th Cong. (2021).

transactions and raising unsettled issues, which—once resolved—may have impacts far beyond the world of SPACs.