Client Alert:

Three Steps to Consider When Advising SPAC Investors

OCTOBER 2021

by Julie Copeland & Ryan LaRue

In July, the SEC took one of the first enforcement actions ever against a Special Purpose Acquisition Company ("SPAC"), Stable Road Acquisition Company, its sponsor, SRC-NI, its target company, Momentus Inc., and the target company's founder and former CEO. In the SEC's press release, SEC Chair Gary Gensler said, "This case illustrates risks inherent to SPAC transactions, as those who stand to earn significant profits from a SPAC merger may conduct inadequate due diligence and mislead investors."[1] Since then, the SEC has taken additional steps to warn SPAC sponsors and investors to enhance due diligence procedures. During the September 9 meeting of the SEC Investor Advisory Committee (the "Committee"), the Committee made recommendations regarding certain investor protection issues associated with SPACs. The recommendations focused on "the practical challenges SPAC investors face in fully assessing the risks and opportunities" associated with SPACs. According to the recommendations, SPAC sponsors should enhance their disclosures of the due diligence performed on target companies:

- "Disclosure regarding the manner in which the sponsor plans to assess the capability of potential targets to be a "'34 Act company" from a governance and internal control perspective, and whether the sponsor will take any steps to ensure the target company can meet minimum preparedness/quality standards for operating as public company."
- "Disclosure about the minimum pre-de-SPAC diligence the sponsor will commit to regarding the accounting practices used by the target company,

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including audit history, use of GAAP and non-GAAP pro forma numbers, and audit committee (composition; communication between committee, auditor, and management)."[2]

In light of the SEC's recent actions and pronouncement, SPAC investors and their advisors should take the following steps when making investment decisions.

Verify Due Diligence Findings

The Committee recommendations note that while SPAC sponsors perform due diligence it "is not necessarily done with the interests of retail investors in mind." This was highlighted in the Stable Road case where the SEC alleged that the SPAC sponsor's due diligence "was conducted in a compressed timeframe and unreasonably failed both to probe the basis for [the target company's] claims…and to follow-up on red flags concerning…risks."[3] According to the Committee, SPAC investors and their advisors do not have access to the same information as plan sponsors because there is no comfort letter or Section 11 liability in SPAC transactions.[4] This further demonstrates the importance of performing sufficient independent due diligence procedures, including those that assess the financial, operational, and reputational risks associated with target companies and their owners..

Evaluate the Sophistication of the Target Company

The rise in popularity of SPACs has reduced the number of target companies and forced SPAC sponsors to turn to more risky targets. The Committee noted that key market actors are concerned about this, since fewer targets "may incentivize sponsors to take substandard targets to market that are generally unprepared to satisfy legal, regulatory, and overall market expectations." [5] When making investment decisions, investors and their advisors must consider if the target company has the ability to meet its legal and regulatory obligations after the de-SPAC transaction.[6] Investors and their advisors should consider these questions when performing due diligence:

- How much time and resources does the target company devote to legal, regulatory compliance, and risk management? What is the headcount in these functions? What is the expertise of those leading these areas?
- Can the target company meet the internal control responsibilities of a public company? Do accounting personnel have sufficient expertise in Sarbanes-Oxley requirements? Has the company been audited before by a reputable audit firm?
- Is the SPAC sponsor placing significant reliance on target company pro-forma, non-GAAP, or projected financial numbers? Have these amounts been independently reviewed and verified? Do projections make sense given the target company's business model and product/service offerings?
- Does the target company have an appropriate corporate governance structure? Does it have a board of directors? Does the board of directors meet the requirements of the listing exchange (e.g., independent director requirements)? Does the board of directors meet at a sufficient frequency to provide meaningful oversight?

Reconsider Initial Due Diligence Conclusions Post-Acquisition

SPAC investors and their advisors face two important decisions: (1) whether to invest initially in the SPAC; and (2) whether to stay with the company once the acquisition is announced. It is important to reconsider

the results of initial due diligence procedures when deciding whether to maintain your investment post-acquisition. For example, has new information come to light that might help better inform investment decisions? This could include a change in management, significant investments by other parties that may create reputational risk, or changes in board composition or governance processes.

Conclusion

SPAC popularity is unlikely to go away, nor will the scrutiny SPAC sponsors and target companies face. Investors and those advising investors must make careful investment decisions that should be informed by detailed due diligence procedures that include evaluating the sophistication of the target company and reconsidering the results of initial due diligence post-acquisition.

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[1] https://www.sec.gov/news/press-release/2021-124.

[2] Recommendations of the Investor as Purchaser and Investor as Owner Subcommittees of the SEC Investor Advisory Committee regarding Special Purpose Acquisition Companies, page 2. https://www.sec.gov/spotlight/investor-advisory-committee-2012/draft-recommendation-of-the-iap-and-iao-subcommittees-on-spacs-082621.pdf.

[3] In the Matter of Momentus, Inc., Stable Road Acquisition Corp., SRC-NI Holdings, LLC< and Brian Kabot, ¶6.

[4] Section 11 of the Securities Act of 1933 enables investors to sue issuers, officers, underwriters, and others for damages if any part of the registration statement contained an untrue statement of a material fact or omitted a material fact necessary to make the statements not misleading. 15 U.S. Code § 77k. Recommendations of the Investor as Purchaser and Investor as Owner Subcommittees of the SEC Investor Advisory Committee regarding Special Purpose Acquisition Companies, page 7. https://www.sec.gov/spotlight/investor-advisory-committee-2012/draft-recommendation-of-the-iap-and-iao-subcommittees-on-spacs-082621.pdf.

[5] Recommendations of the Investor as Purchaser and Investor as Owner Subcommittees of the SEC Investor Advisory Committee regarding Special Purpose Acquisition Companies, page 5. https://www.sec.gov/spotlight/investor-advisory-committee-2012/draft-recommendation-of-the-iap-and-iao-subcommittees-on-spacs-082621.pdf.

[6] "Assessing SPAC Risk After SEC Pumps Brakes on Market," May 2021.

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