

Professional Perspective

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SPAC Due Diligence & SEC Enforcement

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After a year of watching and commenting on the recent proliferation in special purpose acquisition company (SPAC) IPOs and mergers, the SEC announced its first major enforcement action in the SPAC arena since the beginning of the explosion in mid-2020. The charges—which were accompanied by rare public comments by Chair Gary Gensler—send a clear message to market participants that the SEC will pursue all parties involved in SPAC transactions and will closely scrutinize, with the benefit of hindsight, SPACs' due diligence efforts.

The timing of the action is also particularly notable, as the SEC intervened in the middle of the merger process, after the SPAC corrected the alleged deficiencies in its registration statement, and shortly before the SEC declared the subsequently amended statement to be effective. Following the announcement of the charges, the target company replaced its CEO and the SPAC shareholders voted to approve the transaction on Aug. 11, 2021. By intervening mid de-SPAC process, the SEC clearly intended to send a message that it is closely watching the SPAC marketplace and that its policing efforts will continue.

Nevertheless, the events suggest that even when faced with an SEC enforcement action, a SPAC may still have an opportunity to correct its purported misstatements, enhance its disclosures, and potentially close the planned transaction. This article will review the SEC's action and highlight key takeaways for practitioners.

Overview

On July 13, 2021, the SEC [announced](#) partially settled administrative charges against both sides of a planned SPAC transaction. These charges allege both scienter-based and negligence-based violations of the securities laws.

Fraud Based Charges

The SEC charged the target, Momentus, Inc., an early-stage space transportation company, and its former CEO with scienter-based fraud charges. The foundation for these charges were allegedly false statements that Momentus had “successfully tested” its key technology in space. However, the company's only in-space test had failed.

In addition, the SEC [alleged](#) that the target and former CEO concealed the extent to which the U.S. government has national security concerns involving the CEO. This led to Momentus being unable to obtain certain necessary licenses to operate, and jeopardized the company's ability to generate revenue.

Negligence Based Charges

Of perhaps greater significance are the negligence-based charges announced against the SPAC involved in the transaction, Stable Road Acquisition Corp., and its sponsor and CEO. These charges arose from Stable Road's failure to conduct adequate due diligence of the target and its representations.

Specifically, the SEC alleged that although Stable Road engaged a space technology consulting firm with the necessary expertise to investigate the state of development of Momentus' technology, Stable Road did not ask the consulting firm to review the results of the target's in-space test. Instead, Stable Road relied upon the company's suggestion that the test was not relevant due to the development of the company's technology since the time of the test.

Although the consulting firm did not review the results of the in-space test, Stable Road nevertheless repeatedly included in its public filings Momentus' claim that the company had “successfully tested” its technology in space. Unbeknownst to Stable Road, this claim proved to be false.

In addition, Stable Road publicly stated that it conducted “extensive due diligence” on a number of issues, including Momentus' “technology solutions,” and that its consultants had reported on the company's “testing progress.” Based on these statements, investors “had no way to know that [Stable Road] was merely repeating what it had been told by...Momentus.”

National Security Issues

The SEC further alleged that Stable Road conducted inadequate due diligence into the target CEO's national security issues, notwithstanding that Stable Road was aware that the CEO was ordered by the U.S. government in 2018 to divest his ownership stake in another space technology company. Although Stable Road had requested correspondence and documents concerning the government's 2018 order, it accepted Momentus' response that it did not possess the requested materials. Stable Road went on to file multiple registration statements "without obtaining a full and complete understanding of the basis for the [government's] order or its impact on Momentus' business."

Settlement

Importantly, the SEC settlement contains aggressive remedies that further demonstrate the agency's intense focus on this area and desire to send a message to market participants. Specifically, in addition to civil monetary penalties of \$1 million against the SPAC and \$7 million against the target, the order provides that the SPAC sponsor will forfeit 250,000 of its founder shares in the event the merger receives shareholder approval.

The private investment in public equity investors must also be given the opportunity to terminate their subscription agreements. In addition, the order requires the target company to undertake enhancements to its disclosure controls, including the creation of an independent board committee and retention of an internal compliance consultant for a period of two years.

Key Takeaways

The SEC's enforcement action against Momentus and Stable Road is notable for several key reasons. SPACs, targets, and other market participants should take careful note of the SEC's order and related public statements in conducting themselves moving forward.

Due Diligence Must Be Robust and Thorough

As Gensler stated in his public [remarks](#) accompanying the administrative order, the fact that a target company lies to a SPAC "does not absolve [the SPAC] of its failure to undertake adequate due diligence to protect shareholders." This action is consistent with [statements](#) of John Coates, the acting director of the Division of Corporation Finance, that the SEC views de-SPAC transactions as the economic equivalent of traditional IPOs. This enforcement action makes clear that the agency expects SPACs to conduct robust and thorough due diligence on target companies. This is particularly true in technical areas that are essential to the long-term commercial viability of the target.

More specifically, SPACs should conduct their due diligence with the awareness that such diligence will be scrutinized by the SEC with the benefit of hindsight and through the use of the agency's subpoena power. A SPAC will not be absolved of liability simply by retaining a consultant and relying on its findings. Even where misstatements by a target involve extremely technical matters, it is not a defense for the SPAC—which may be managed by players in the private equity field with no expertise in the target's business—to claim ignorance. The SPAC will be expected to have scrutinized the consultant's findings with a critical eye and run down any red flags identified in the due diligence process.

Further, SPACs should be particularly cautious in repeating or adopting any statements by the target that it did not independently verify.

Diligence Should Not Be Compromised Due to Time Constraints

Although it was not an independent basis for the SEC's charges, it is not coincidental that the SEC noted in its order the condensed time frame in which the deal was negotiated and the diligence was conducted. SPACs are typically required to consummate a business combination within 18-to-24 months of its IPO or risk liquidating, which would result in its sponsors forfeiting millions of dollars in invested capital.

The SEC may thus be skeptical of any transaction that occurs close to the deadline, a circumstance which could motivate the SPAC and its sponsors to cut corners in diligence or to accept a deal that is less favorable to public shareholders. It is notable that the SEC's order states that after identifying the target and beginning negotiations in earnest, the SPAC was left with only about a one-month period to conduct its due diligence before the merger announcement.

Given the skepticism with which the SEC appears to view business combinations negotiated toward the end of the SPAC's lifetime, SPACs that find themselves in that situation should be particularly cautious in their diligence efforts. The SEC will expect robust and thorough diligence, regardless of the time frame under which the SPAC may be realistically operating. Clear and thorough documentation of the SPAC's diligence process, while always advised, may be even more important in these scenarios.

The SEC May Intervene Before a Transaction is Consummated

This action is also notable for the timing of the SEC's enforcement action. The SEC brought charges based on the initial Form S-4 and certain amended registration statements, notwithstanding that the Form S-4 had been subsequently amended to presumably correct the alleged misstatements. It was not declared effective at the time of the enforcement action. In fact, shortly after the announcement of the action, the SEC deemed effective the subsequently amended statement.

In addition, although the preliminary proxy statement contained in the initial Form S-4 had not yet been mailed to shareholders, the SEC charged Stable Road, its sponsor, and Stable Road's CEO with violation of the proxy solicitation rules. This was even though the error could have been corrected prior to dissemination to shareholders.

This enforcement action occurred in the middle of the de-SPAC process and after the alleged material misstatements and omissions appear to have been corrected. The posture of this action suggests that the SEC intended to send a message to market participants as to the standard it intends to apply in these cases, and makes clear that the SEC has no intention of slowing down its policing of the SPAC marketplace.

Because investors in the public market for the SPAC's securities may rely on statements in the initial, pre-effective Form S-4, SPACs should ensure that disclosures in the initial Form S-4 and preliminary proxy statement are sufficiently vetted and materially accurate.

Conclusion

The SEC should be expected to closely monitor the SPAC marketplace following its first major SPAC-related enforcement action. Market participants should be alert to this order as the SEC carefully examines SPAC's due diligence efforts moving forward.