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New Lawsuits Alleging That SPACs Are Unregistered Investment Companies Face Significant Hurdles

Two law professors—one a former SEC commissioner—have opened a new litigation front against Special Purpose Acquisition Companies ("SPACs").[1] They have spearheaded the filing of what so far are three complaints alleging that the SPACs at issue qualify as investment companies under the Investment Company Act of 1940 (the "ICA") because the SPACs have invested in short-term government securities and money market funds for over a year. The complaints allege that the SPACs are therefore subject to the ICA's stringent requirements, including registration as investment companies, and that the basic structure and compensation arrangements of the SPACs are in violation of the ICA. According to published reports, similar complaints against dozens of other SPACs are in the works. If credited, these allegations could potentially disrupt the SPAC market. However, there is reason to question the viability of these claims, at least in regard to typical SPACs. As discussed below, SPACs will have strong defenses to these and the similar claims that will soon be filed.

What Are SPACs?

SPACs are publicly listed so-called "blank check" companies. They do not themselves operate a business, at least not initially. Instead, after they raise funds, they seek to acquire privately held target companies in what has been referred to as a "de-SPAC" transaction. The SPAC has a set period of time—typically two years—in which to identify a target company and consummate a de-SPAC transaction with the target. If it fails to do so, the SPAC is typically unwound, and the initial investment is then returned to shareholders. If, on the other hand, the SPAC completes an acquisition, the SPAC's investors will be offered the opportunity to either redeem their investment or own stock of the combined company. Investors enjoy the opportunity to acquire an ownership stake in a company that would not previously be available to the investing public. And, merging with a SPAC provides the acquired company with an alternative to the ordinarily complex and lengthy IPO process required by the Securities Act of 1933 ("the Securities Act").[2]

New Complaints Alleging That SPACs Are Investment Companies

As we have previously reported, the explosive growth in SPACs has generated significant amounts of litigation. In the last few days, NYU Law Professor Robert J. Jackson Jr., a former SEC commissioner, and Yale Law Professor John Morley, together with three plaintiffs' firms, have filed actions in the United States District Court for the Southern District of New York—each on behalf

[1] We have reported on these types of SPAC-related litigations in a recent client alert. *See* Paul, Weiss, *What SPAC Sponsors, Directors and Officers Can Do to Mitigate Their Litigation Exposure* (March 17, 2021), https://www.paulweiss.com/media/3980948/what_spac_sponsors_directors_and_officers_can_do_to_mitigate_their_litigation_exposure.pdf.

[2] For an overview of the structure and operation of SPACs, see generally Lamey Layne & Brenda Lenahan, *Special Purpose Acquisition Companies: An Introduction*, Harv. L. Sch. F. on Corp. Governance (July 6, 2018).

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of the same plaintiff who claims to be a shareholder in each such SPAC—challenging the structure of three separate SPACs, including Bill Ackman's $4 billion Pershing Square Tontine Holdings, Ltd., the largest SPAC in history to date.[3]

The theory of each of the complaints is largely the same. They allege that the defendant SPACs are investment companies under the ICA, because, to date, they have invested only in securities—specifically, short-term U.S. government securities or money market funds.[4] The IPO for each of the SPACs was therefore illegal, the complaints allege, because the SPACs did not register with the SEC as investment companies. The Pershing Square and E.Merge Technology complaints also allege that the managers of the sponsors of each of those SPACs are investment advisers under the Investment Advisers Act of 1940 (the "IAA"), but, in supposed violation of the IAA, failed to register as such. The Pershing Square and GO Acquisition complaints further allege that the directors of those SPACs, who were selected by the SPAC sponsor, are serving in violation of the ICA, because the ICA requires that directors of investment companies be elected by the holders of the voting securities of such companies.

The complaints further allege that the compensation arrangements for the sponsors and directors of the SPACs—which are typical in the SPAC industry—also violate the ICA. For example, the Pershing Square complaint alleges that warrants issued to the SPAC sponsor and SPAC directors violate Section 18(d) of the ICA because they expire later than 120 days after issuance and were not issued exclusively and ratably to a class of the SPAC's security holders. The complaint also alleges that the sponsor's compensation violates Section 205(a)(1) of the IAA because it includes warrants to purchase shares that will provide the sponsor with a share of capital gains or capital appreciation of the funds of the SPAC. It further alleges that the contracts providing for compensation to the sponsor violate the ICA because they were not approved by a shareholder vote.

The complaints further allege that the SPAC sponsors and directors breached their fiduciary duties with respect to the compensation arrangements and payments they received from the SPACs. For example, the Pershing Square complaint alleges that the payments "bear no reasonable relationship to the services rendered and could not have been the product of arm's length bargaining." It alleges that the sponsor received payments worth more than $800 million in exchange for a payment of just $65 million and two to two and a half years of work, and that the directors received payments of about $36.8 million in exchange for just two to two and a half years of work and investments of just over $2.8 million.

Each of the complaints seeks rescission of the transactional arrangements underlying the SPACs[5] and damages from the sponsor and the SPAC directors for compensation paid purportedly in breach of their fiduciary duties to the SPACs.

SPAC's Defenses to Claims under the ICA and IAA

The defendants in these cases, which were filed only very recently, have not yet filed responses to the complaints. There are, however, several arguments they could make that the plaintiff will have to overcome.

A critical threshold issue is whether the SPACs are investment companies under the ICA, which courts do not appear to have addressed.

In general, an issuer is an "investment company" under the ICA if it is "primarily engaged" in investing securities.[6] On the other hand, an issuer is *not* an investment company if it is "primarily engaged . . . in a business or businesses *other* than that of

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[3] The three actions are: *Assad* v. *Pershing Square Tontine Holdings, Ltd.*, Case No. 21-cv-6907 (S.D.N.Y); *Assad* v. *E.Merge Technology Acquisition Corp.*, Case No. 21-cv-7072 (S.D.N.Y.); *Assad* v. *GO Acquisition Corp.*, Case No. 21-cv-7076 (S.D.N.Y.).

[4] Under the ICA, "investment company" is defined as including any issuer that "is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities." 15 U.S.C. § 803a-3(a)(1).

[5] The complaints seek rescission under the ICA on the basis of the Second Circuit's decision in *Oxford Univ. Bank* v. *Lansuppe Feeder, LLC*, 933 F.3d 99, 102 (2d Cir. 2019), which found that the ICA provides a private right of action.

[6] 15 U.S.C. § 803a-3(a)(1).

investing, reinvesting, owning, holding or trading in securities."[7] To decide whether an issuer is an investment company, courts and the SEC look to the company's historical development, its representations of policy, the activities of its officers and directors, the nature of its assets, and the sources of its income.[8] Some courts have identified the latter two factors as the most important, which the plaintiff in these actions will no doubt emphasize because, to date, each of the defendant SPACs has allegedly invested only in government securities and money market funds that invest in such securities.

Courts may approach the plaintiff's ICA allegations with some skepticism in view of the fact that it is a longstanding view of practitioners and the SEC that temporarily investing in treasuries and qualified money market funds does not turn an entity into an investment company under the ICA. In fact, in response to these lawsuits and threatened lawsuits, on August 30, 2021, a group of over 55 leading law firms (including Paul, Weiss) issued a statement asserting that SPACs are not investment companies under the ICA.[9] In addition, like many other SPACs, the SPACs in these cases discussed potential issues relating to the ICA and disclosed steps they had taken to address those issues. Thus, acknowledging that, to avoid being deemed an investment company, they had to avoid being engaged primarily in a business other than investing, reinvesting or trading of securities, they each disclosed that "[o]ur business will be to identify and complete a business combination and thereafter to operate the post-transaction business or assets for the long term." In other words, while each may currently be invested in government securities or money market funds, their ultimate goal is to identify and complete a suitable business combination, and not to invest in such securities. The Pershing Square SPAC is somewhat atypical in this regard, in that its initial proposed investment was not the acquisition of another company, but rather a purchase of 10% of the ordinary shares of Universal Music Group ("UMG")—a fact that the Pershing Square complaint emphasizes. But Pershing Square already abandoned that plan and did not in fact make that investment.

The prospectuses identified in the complaints also state—as do the prospectuses of most SPACS—that the SPACs are "not intended for persons who are seeking a return on investments in government securities or investment securities"; that the initial investment in government securities and money market funds is intended only as "a holding place" for funds pending completion of a primary business combination; and that, absent completion of such an investment within 24 months, the funds will be returned to investors.

Another hurdle such complaints may face is the SEC's transient investment companies rule.[10] Under this rule, an issuer is deemed not to be engaged in the business of investing, reinvesting, owning, holding or trading in securities during a period of time not to exceed one year, provided that the issuer "has a bona fide intent to be engaged primarily, as soon as is reasonably possible (in any event by the termination of such period of time), in a business other than that of investing, reinvesting, owning, holding or trading in securities, such intent to be evidenced by: (1) the issuer's business activities; and (2) an appropriate resolution of the issuer's board of directors[.]" Although each of the SPACs in the three lawsuits to date appear to have been invested in government securities and money market funds for more than a year, other SPACs may be able to avoid liability if they consummate an acquisition within one year. And even SPACs that do not complete an acquisition within one year may be able to argue that they do not qualify as investment companies because, if they do not complete an acquisition within the following year, their formational documents require them to liquidate and return their funds to investors.

As a procedural matter, the SPAC-as-investment-company lawsuits are each asserted as a derivative action—that is, they are asserted purportedly on behalf of the SPAC itself against the sponsor and director defendants. But in none of the actions did the plaintiff make a demand on the SPAC board of directors for the SPAC to assert the claims itself, as is typically required before a derivative action may be brought. In such cases, the plaintiff must establish "demand futility." While the plaintiff asserts demand

[7] 15 U.S.C. § 803a-3(b)(1) (emphasis added).

[8] For example, see *SEC* v. *Fiore*, 416 F. Supp. 3d 306, 328 (S.D.N.Y. 2019).

[9] *Over 55 of the Nation's Leading Law Firms Respond to Investment Company Act Lawsuits Targeting the SPAC Industry* (Aug. 30, 2021), https://www.paulweiss.com/media/3981368/spac_joint_statement_8302021.pdf.

[10] 17 C.F.R. § 270.3a-2.

futility in each of these three complaints, it is typically a difficult standard to meet, and generally depends upon the unique facts and allegations of each case.

Conclusion

This new front of litigation challenges the fundamental structure of SPACs. By characterizing SPACs as investment companies, these lawsuits seek to impose the strictures of an until-now entirely separate regulatory regime. However, strong defenses against such claims exist and may help SPACs ward off the expected wave of similar lawsuits.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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