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SECURITIES LITIGATION AND CAPITAL MARKETS

Recent Lawsuits Challenging SPACs Under the ICA Miss the Mark

A new trend in special purpose acquisition company ("SPAC") litigation has emerged: shareholder derivative actions seeking to declare SPACs "investment companies" under the Investment Company Act of 1940 (the "ICA").[1] Despite powerful backing, these lawsuits miss the mark.

For the reasons described herein, SPACs are not investment companies for the purposes of the ICA. Under prevailing case law and common sense, investors are not likely to believe that a SPAC's principal activity is trading and investing in securities.

A group led by two prominent plaintiffs' firms, and including a former SEC commissioner and a Yale law professor, recently filed a series of actions against SPACs and their directors and sponsors seeking declaratory judgments that the SPACs are investment companies under the ICA and thus subject, en masse, to a host of additional regulatory obligations. The suits also seek rescission of the contracts under which the SPACs' sponsors and directors acquired SPAC shares and/or warrants.

The suits, whose claims and allegations largely mirror each other (with a few differences discussed below), were separately filed in the Southern District of New York against SPACs that included E. Merge Technology Acquisition Corp. ("ETAC")[2] and Pershing Square Tontine Holdings ("PSTH"), Bill Ackman's SPAC.[3] In essence, they allege that the SPACs are investment companies under section 3(a)(1)(A) of the ICA and failed to register as such. Section 3(a)(1)(A) of the ICA provides that an "investment company" is "any issuer which … is or holds itself out as being engaged primarily, or proposes to engage primarily in the business of investing, reinvesting, or trading securities."[4] Excluded from the definition is any issuer that is "primarily engaged" in a business "other than that of investing, reinvesting, owning, holding, or trading

1. The authors of this article previously wrote about the trends and increase in litigation against special purpose acquisition companies. *See How SPACs Should Respond to Increasing Scrutiny,* Law360 (June 22, 2021), available at www.law360.com/articles/1396165.
2. *Assad v. E. Merge Technology Acquisition Corp. et. al.,* Case No. 1:21-cv-07072 (S.D.N.Y. Aug. 20, 2021).
3. *Assad v. Pershing Square Tontine Holdings, LTD. et. al.,* Case No. 1:21-cv-06907 (S.D.N.Y. Aug. 27, 2021).
4. 15 U.S.C. § 80a-3(a)(1)(A).

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in securities."[5] Accordingly, the key question in each case is whether the SPAC's primary business is investing in securities.

Each complaint alleges that "investing in securities is the [SPAC's] primary business because that is all the [SPAC] has ever done with its assets," and since their IPOs, each SPAC has "invested nearly all of its assets in securities of the U.S. government and securities of money market mutual funds."[6] For example, Plaintiffs allege that PSTH has invested $4.02 billion of its $4.03 billion, and that ETAC has invested $600 million of its $601 million.[7] The complaints further allege that the securities "are the only source from which the [SPAC] has ever received any income."[8]

The lawsuit against PSTH also focuses on a now-defunct deal in which PSTH had agreed to acquire 10% of the outstanding shares of Universal Music Group (UMG) in a "Share Purchase Agreement."[9] Plaintiffs contend that PSTH "focused almost exclusively on trying to complete" the UMG deal, which would have been "an investment in securities."[10] As such, according to the complaint, PSTH has focused its efforts "primarily on investing the Company's assets in securities."[11]

PSTH is unique in that (i) its structure is different from all other SPACs,[12] and (ii) it proposed to purchase stock in a soon-to-be-public company (UMG) rather than take a private company public (a traditional de-SPAC transaction).[13] By contrast, the other SPAC targets appear to have standard structures and neither has announced a proposed business combination. Therefore, plaintiffs' contention that the SPACs are "primarily engaged" in the business of investing in securities is based predominantly on the SPACs' investment of investment proceeds in government securities and mutual funds while they search for a suitable business combination. Such claims could seemingly be brought against every SPAC currently in the "hunt" phase and should fail under prevailing law.

In determining whether an issuer is "primarily engaged" in a non-investment company business, the SEC and courts look to the following factors: (a) the company's historical development, (b) its public representations of policy, (c) the activities of its officers and directors, (d) the nature of its present assets, and (e) the sources of its present income (the "*Tonopah* factors"). *Lyft, Inc.,* Release No. 33399 (Mar. 14, 2019) (citing *In the Matter of the Tonopah Mining Co. of Nev.,* 26 S.E.C. 426 (July 21, 1947)); see *S.E.C. v. Nat'l Presto Indus., Inc.,* 486 F.3d 305, 313 (7th Cir. 2007).

Applying the *Tonopah* factors to SPACs pursing a traditional de-SPAC transaction makes clear that such SPACs are not investment companies. In the

5. 15 U.S.C. § 80a-3(b)(1).
6. PSTH Compl. ¶ 103; ETAC Compl. ¶ 71.
7. PSTH Compl. ¶ 103; ETAC Compl. ¶ 71.
8. PSTH Compl. ¶ 103; ETAC Compl. ¶ 71.
9. PSTH Compl. ¶ 66.
10. *Id.* ¶¶ 107–108.
11. *Id.* ¶ 108.
12. PSTH differs from the traditional SPAC in that it did not provide founders shares to its sponsor and directors. Rather, the sponsor entered into forward purchase agreements, including optional agreements, under which it could purchase additional shares of the SPAC at the time of its initial business combination. PSTH also sold sponsor and director warrants that do not expire until 10 years after the consummation of PSTH's initial business combination. *See* July 23, 2020 PSTH prospectus available at www.sec.gov/Archives/edgar/data/0001811882/000119312520197776/d930055d424b4.htm.
13. After the PSTH action was filed, PSTH issued a letter to stockholders stating that the lawsuit was "meritless" but also stating that the company had decided to seek shareholder approval to return the money held in trust. Aug. 19, 2021 PSTH Letter to Shareholders, available at www.businesswire.com/news/home/20210819005824/en/Pershing-Square-Tontine-Holdings-Ltd.-Releases-Letter-to-Shareholders.

leading case interpreting the factors – *S.E.C. v. National Presto Industries, Inc.,* 486 F.3d 305 (7th Cir. 2007) – the Seventh Circuit held that "what principally matters is the beliefs the company is likely to induce in investors. Will its portfolio and activities lead investors to treat a firm as an investment vehicle or as an operating enterprise?" 486 F.3d at 315. That is, will the disclosures in SEC filings and reports to stockholders likely "lead investors to believe that the principal activity of the company was trading and investing in securities?" *See id.* (quoting *Tonopah,* 26 S.E.C. at 430). In the context of SPACs, the answer is clearly "no."

1
A SPAC'S PUBLIC REPRESENTATIONS OF POLICY

SPACs present themselves to the public as non-investment companies. In *National Presto Industries, Inc.,* the Seventh Circuit looked to the company's website, public filings, and publicity to determine how the company presents itself to the public. 486 F.3d at 313. SPACs' registration statements usually state that their "business will be to identify and complete a business combination and thereafter to operate the post-transaction business or assets for the long term."[14] Likewise, SPACs' websites and press releases tell the public that they are in the business of identifying a target business and pursuing a business combination.

In determining how investors view a company, the Seventh Circuit also looked at whether the company's stock moves in response to changes in investment income. *See id.* The price of a SPAC's stock moves in response to the selected target and progress toward a completed transaction "rather than the slight annual changes in its investment income." *Id.*

2
THE ACTIVITIES OF A SPAC'S OFFICERS AND DIRECTORS

The activities of SPACs' officers and directors also demonstrate that SPACs are not investment companies. Investment companies' officers and directors spend "most of their time managing the firms' investment portfolios." *Id.* On the other hand, SPACs' officers and directors spend nearly all their time seeking out a business combination, evaluating targets, conducting diligence, and negotiating deal terms. Additionally, the money raised in a SPAC's IPO is placed in trust and then managed by a third-party trustee and third-party investment advisors, not the SPAC's directors and officers.

3
THE NATURE OF A SPAC'S PRESENT ASSETS

The nature of a SPAC's present assets also favors the SPAC. Even though nearly all of a SPAC's balance sheet assets are securities similar to those referenced in the lawsuits, the Seventh Circuit has held that "looking primarily at accounting assets has a potential to mislead." *Id.* at 314. The Seventh Circuit pointed out that accounting assets do not show many intangible assets, which in the case of a SPAC may include the management's teams experience and expertise. Moreover, the two assets SPACs invest in are not "investment securities." Section 3(a)(2) of the ICA exempts "Government securities" from the definition of "investment securities."[15]

14. See, *e.g.*, ETAC July 13, 2021 S-1, available at www.sec.gov/Archives/edgar/data/0001814728/000121390020017364/fs12020_emergetech.htm.
15. 15 U.S.C. § 80a-3(a)(2).

4
THE SOURCES OF A SPAC'S PRESENT INCOME

The source of a SPAC's present income does not weigh in favor of declaring a SPAC an investment company. While it is true that SPACs initially have no income other than interest from investments, this is true only during the limited period prior to a business combination. In *Tonopah Mining Co.,* the Commission found that the company was an investment company because its "only source of net income consists of interest, dividends and profits on the sale of securities" and because there was "*nothing to indicate that this situation will be changed substantially in the foreseeable future*." 26 S.E.C. 426 (July 21, 1947) (emphasis added). With SPACs, it is not just foreseeable but guaranteed that the situation will change. And as previously noted, a SPAC's stock price does not "move in response to … the slight annual changes in its investment income." *Nat'l Presto Indus., Inc.,* 486 F.3d at 313.

5
A SPAC'S HISTORICAL DEVELOPMENT

Unlike former operating companies that have been deemed investment companies, SPACs have not sold off all their assets and do not "purport to be looking for acquisitions" for an indefinite amount of time. *See id.* Rather, SPACs are "newly organized blank check compan[ies] formed for the purpose of effecting a merger"[16] and have a limited time period to complete an initial business combination, usually 18 to 24 months.

Additionally, the history of SPACs and other blank check companies further militates against an investment company designation. The SEC adopted Rule 419 in 1992, which governs certain blank check companies. Rule 419 requires that blank check companies: (1) deposit their assets in a trust account; (2) the trust funds be invested only in U.S. treasuries or certain money market funds; and (3) the trust fund be returned to investors if the company fails to complete a business combination within a certain period of time.[17] While Rule 419, does not directly apply to SPACs, all three of the above stated requirements do, and in adopting Rule 419 the SEC stated that "in light of the purposes served by the regulatory requirement to establish such an account, the limited nature of the investments, and the limited duration of the account, such an account will neither be required to register as an investment company nor regulated as an investment company as long as it meets the requirements."[18] Accordingly, the regulatory history demonstrates that, from inception, blank check companies have not been considered investment companies by the agency tasked with enforcement of the Investment Company Act. Courts should defer to the long established regulatory view.

SUMMARY

For the reasons described above, among others, **SPACs are not investment companies for purposes of the ICA** – under prevailing case law standards or common sense – and investors are not likely "to believe that the principal activity of the company was trading and investing in securities." *Nat'l Presto Indus., Inc.,* 486 F.3d at 315.

Winston & Strawn will continue to track the law and provide further updates as the law progresses.

16. See, *e.g.*, *supra* note 14.

17. 17 C.F.R. § 230.419.

18. SEC Release Nos. 33-6932; 34-30577; IC-18651, available at www.govinfo.gov/content/pkg/FR-1992-04-28/pdf/FR-1992-04-28.pdf#page=206.

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