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"SPAC" Clients Pose Unique Risks for Law Firms: Lessons Learned from Defending Lawyers in Malpractice Cases

It is an unfortunate reality that all law firms—including those that represent investment fund sponsors—may be named in malpractice and other legal claims when a loss is suffered and the claimant is seeking a "deep pocket" to blame. To state the obvious, law firms should wish to avoid the burdens, costs, and reputational harm that result from such claims.

Representing the sponsor of a "Special Purpose Acquisition Company" or "SPAC" poses unique risks to law firms. SPACs have been around for decades but recently have become an increasingly popular investment vehicle, leading some to call 2021 "the year of the SPAC."[1] Earlier this year, the *Wall Street Journal* discussed "the boom in special-purpose acquisition companies," and asserted that "SPACs are cool."[2] Quarterback Peyton Manning, pop star Jay-Z, politician Paul Ryan, and many other celebrities have been listed in regulatory documents as associated with SPACs.[3]

In this article, we explain what SPACs are and why representing their sponsors may pose risks for law firms and lawyers. We also offer suggestions—based upon experience defending law firms against malpractice and other claims after investments have gone bad—for reducing risks to law firms representing SPAC sponsors. Whether firms represent SPACs or other investment sponsors, these suggestions may make claims less likely. They also may reduce the disruption, expense, and embarrassment if claims arise.[4]

SPACs and the Year of the SPAC

SPACs—sometimes called "blank check companies"—are investment vehicles that use a corporate merger to take a private company "public" without a traditional IPO. Here's the framework: The sponsor of a SPAC—which is a corporate entity with no operations—raises seed money from investors via an IPO. The SPAC's stated purpose is to merge with a private company in a particular industry within a certain time period. The SPAC typically does not select its merger target before its public offering. After going public, the SPAC selects a private company and merges with it in what is known as a "de-SPAC transaction." If no merger occurs, then investors are supposed to receive a *pro rata* share of the remaining aggregate amount retained from the SPAC's IPO fundraising.

1 Renaissance Capital, *Year of the SPAC: Blank check IPOs are on track to complete more than 1,000 offerings in 2021*, Nasdaq (Feb. 25, 2021).
2 Amrith Ramkumar, *The Celebrities From Serena Williams to A-Rod Fueling the SPAC Boom*, Wall St. J. (Mar. 17, 2021).
3 *Id.*

4 In the event of a potential or actual claim, early consultation with experienced outside counsel can minimize problems. Firms and lawyers should also consider the notification requirements in their insurance policies.

Although all representations pose litigation risks, the sources of litigation risks for lawyers representing SPAC sponsors can differ from other types of investment-fund representations.

First, whereas typically only "accredited investors" would be able to purchase securities through a private offering in a private company, *anyone* can invest in SPACs and thereby effectively become an equity-holder in a formerly private company after a de-SPAC transaction occurs. De-SPAC transactions also are not subject to the same disclosure requirements and restrictions as traditional IPOs. The combination of reduced investor sophistication, reduced investor wherewithal (and ability to sustain losses), and less rigid disclosure rules can increase the potential that investors may not fully appreciate the risks (or later may *claim* that they did not fully appreciate the risks) of a SPAC investment.

Second, in a SPAC, investors are giving money to a sponsor to spend in the manner the sponsor elects, which is the reason SPACs are described as "blank check companies." Although investors will have the opportunity to redeem their shares at the time of a merger, they nonetheless may be dissatisfied with the sponsor's performance.

Third, many SPACs are new ventures, so investors may argue (rightly or wrongly) that intangible factors, such as the sponsor's identity and management history, were important to their decision to invest.

Fourth, de-SPAC transactions can result in a private company going public before it otherwise would have done so on its own, a feature that may be used to assert that the target company was not ready to go public.[5]

Fifth, SPAC sponsors often receive up to 20% of the shares in the SPAC for a nominal fee. This fee structure can dilute the value of the shares owned by retail investors, who later may claim to be aggrieved.[6]

Sixth, it has been argued that the incentives in SPAC transactions are misaligned. Sponsors make money at the merger, which must occur in a matter of months. As such, sponsors can be accused, rightly or wrongly, of cutting corners to find a quick deal and to expedite due diligence.[7]

Seventh, pending a de-SPAC transaction, sponsors may have the flexibility to invest funds in instruments other than safe, interest-bearing instruments, and investors may be unhappy with the performance of these alternative investments.[8]

Eighth, because of SPACs' recent popularity, some argue that attractive merger targets are becoming rare, leading to fewer, riskier deals and poorer investment performance.[9]

These risks have done little to dampen SPACs' appeal. In 2020, "237 SPACs went public, raising nearly $80 billion in gross proceeds—the biggest year on record for SPACs. *Indeed, more money was raised in 2020 by SPACs than in the 10 prior years.*"[10] That "momentum appears to have continued into 2021."[11]

In view of SPACs' sudden popularity, the SEC and lawmakers are taking a more critical look at SPAC transactions.[12] Plaintiffs' lawyers with experience suing law firms are sure to follow. The conscientious law firm will consider the unique risks that SPACs pose before and during the representation of a SPAC sponsor. Such consideration is prudent irrespective of whether the law firm is involved on the front end of a SPAC transaction (advising sponsors), in the middle of that transaction (answering client questions about potential merger issues), or on the back-end of that transaction (answering client questions about seeking merger approval from investors).

5 *See* Alexander Osipovich & Dave Michaels, *Investors Flock to SPACs, Where Risks Lurk and Track Records Are Poor*, Wall St. J. (Nov. 13, 2020).

6 *See* Michael Klausner et al., *A Sober Look at SPACs*, Harv. L. F. on Corp. Gov. (Nov. 19, 2020). Relatedly, in several recently filed cases, SPAC investors are seeking to challenge sponsor compensation by arguing that SPACs must be registered under the Investment Company Act and that SPAC sponsors constitute investment advisors under the Investment Advisers Act. *See, e.g., Assad v. Pershing Square Tontine Holdings, Ltd.*, No. 21-CV-06907 (S.D.N.Y.); *Assad v. E.Merge Tech. Acquisition Corp.*, No. 21-CV-07072 (S.D.N.Y.); *Assad v. Go Acquisition Corp.*, No. 21-CV-07076 (S.D.N.Y.).

7 *See* Letter from Elizabeth Warren, Senator, to Michael Klein, M. Klein & Associates, Inc. (Sep. 22, 2021) [hereinafter *Warren Letter*] (describing three recent class actions targeting SPACs, one of which is alleging that "the SPAC's board misled the SPAC's investors into approving a badly underpriced deal … by concealing that it was about to crater when … its top customer … not only withdrew from their relationship but created a competing business unit" (cleaned up) (citation omitted)).

8 *See What You Need to Know About SPACs – Updated Investor Bulletin*, SEC (May 25, 2021).

9 To be clear, we are not criticizing SPACs or their sponsors, we are not implying that the disadvantages of SPACs outweigh the advantages, and we are not suggesting that law firms should not represent SPAC sponsors. Every type of legal representation poses risks. Prudent law firms consider steps to mitigate the various risks presented by different kinds of representations.

10 *SPACs Explained*, Fidelity, (last visited Nov. 5, 2021) (emphasis added).

11. *Id*

12 *See Warren Letter, supra* note 8; *see also* Press Release, SEC, SEC Charges SPAC, Sponsor, Merger Target, and CEOs for Misleading Disclosures Ahead of Proposed Business Combination (Jul. 13, 2021), (discussing recent enforcement action and alleging it "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").

Risks to Law Firms Representing SPAC Clients

We have reviewed the types of malpractice and other claims that have been instituted against law firms in connection with SPACs and the types of transactions in which SPACs ordinarily are involved. These claims suggest that over the course of a SPAC's "life cycle," law firms are exposed to various types of risks. At the formation/IPO stage, the greatest risks involve regulatory compliance and the accuracy of prospectus disclosures regarding the sponsor and its plans. After the SPAC raises money, the risk of alleged conflicts-of-interests among the sponsor, the sponsor's principals, and the SPAC becomes more prominent. With the benefit of hindsight, disgruntled individuals or entities also may criticize the adequacy of the law firm's advice or other legal services in connection with merger target selection and vetting.[13] In the final stages of the SPAC life cycle—negotiation with the target, shareholder approval, and merger—the law firm's exposure can include the adequacy of disclosures regarding the target, as well as the risk of mistakes in merger-related documents (essentially, the ordinary risk of negligence that accompanies the drafting of any legal document). In addition, if the SPAC fails to merge with a target and dissolves, disgruntled stakeholders may try to sue the law firm over the SPAC's management and use of investor money during the preceding stages. These risks can lead to claims by different constituencies. For example:

- **Claims by the sponsor or the SPAC.** SPAC representation exposes a law firm to potential professional negligence and breach of fiduciary duty claims by the sponsor and/or the SPAC. A receiver or bankruptcy trustee for a failed SPAC, for example, may view a malpractice claim as a means to recoup investor losses. In addition, even if the sponsor and the SPAC elect not to sue the law firm, it is conceivable that the law firm may encounter a derivative claim brought by disgruntled SPAC shareholders alleging a conflict between their interests and those of the sponsor. *See Padgett v. Mitchell*, 2002 WL 991022, at *9 (Cal. Ct. App. May 15, 2002) (fiduciary duty claim in shareholder derivative suit targeting outside counsel for the corporation), *as modified on denial of reh'g* (June 12, 2002).
- **Claims by principals or board members of the sponsor or the SPAC.** If a SPAC transaction does not succeed, principals and board members may encounter lawsuits by investors and others targeting them in an individual capacity. These individuals may attempt to pursue malpractice or other claims against the law firm based upon allegations that they were impliedly clients or third-party beneficiaries of the attorney-client relationship.
- **SEC disciplinary and enforcement actions.** Lawyers practicing before the SEC are subject to the SEC's *Rules of Practice*. *See* 15 U.S.C. § 78d-3(a)(2) (permitting disciplinary action if a person "is found … to be lacking in character or integrity, or to have engaged in unethical or improper professional conduct"). The SEC has exercised this power against attorneys. *See, e.g., Altman v. SEC*, 666 F.3d 1322, 1325–26 (D.C. Cir. 2011); *In re Elaine A Dowling*, Release No. 92293 (June 29, 2021) (order instituting administrative proceedings against attorney). The SEC likewise has issued its own *Standards of Professional Conduct for Attorneys Appearing and Practicing Before the Commission in the Representation of an Issuer*, which also may result in penalties if not followed. *See* 17 C.F.R. § 205.6.[14] Finally, notwithstanding recent jurisprudence limiting investors' ability to bring aiding-and-abetting claims (discussed below), the SEC remains empowered to pursue enforcement actions against lawyers for aiding-and-abetting a sponsor's or a SPAC's violations of the federal securities laws. *See, e.g., SEC v. Fehn*, 97 F.3d 1276, 1280 (9th Cir. 1996) (affirming injunction against lawyer who "aided and abetted violations of Section 10(b) and Section 15(d) of the Securities Exchange Act and related regulations").
- **Claims by SPAC investors.** Although federal law restricts private plaintiffs' ability to bring aiding-and-abetting and other secondary liability claims against law firms for securities violations, some avenues remain for disgruntled SPAC investors to pursue claims against a sponsor's law firm. For example, lawyers can be liable under Rule 10b-5 for their own misstatements. *See Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 191 (1994). And in some circumstances, investors may try to sue the law firm on an aiding-and-abetting theory under state "Blue Sky" statutes or common law. *See Houston v. Seward & Kissel, LLP*, 2008 WL 818745, at *8 (S.D.N.Y. Mar. 27, 2008); *see also* Or. Rev. Stat. § 59.115(1)(b).

13 *See, e.g., Rocketfuel Blockchain Company & Rocketfuel Blockchain, Inc. v. Ellenoff Grossman & Schole LLP*, No. 21-cv-01764 (S.D.N.Y. June 18, 2021), ECF 27 (alleging law firm hired in connection with due diligence on de-SPAC target failed to detect that patents, which had made the target valuable, had been abandoned).

14 Although the SEC historically has invoked its disciplinary procedures "only after a district court entered an injunction or conviction against [an] attorney," it has previously made *de novo* determinations of attorney misconduct and could do so in the future. John K. Villa, 2 Corporate Counsel Guidelines § 8:7 (2020).

Suggestions for Reducing Risks When Representing SPAC Clients

The risks of representing SPAC sponsors can be reduced by adhering to certain principles that apply not only to SPAC-related representations, but also to representations of fund sponsors more generally.[15]

1. Assess the Potential Client Before Agreeing to Represent It. Because the identity, history, capability, and trustworthiness of the SPAC's sponsor are arguably critical to "blank check" companies, carefully vetting the sponsor prior to accepting the representation may mitigate risk to the law firm. Here are some ideas for what a firm may wish to consider before accepting an engagement to represent a SPAC sponsor: whether the sponsor contacted the firm via a cold call or was referred from a reputable source; the sponsor's reputation and internet presence; the sponsor's references; whether this is the sponsor's first attempt at forming a SPAC; whether the sponsor has changed law or accounting firms recently and the reason for such change; whether the sponsor has the resources to pay bills every month (and before raising money from investors); whether the sponsor has sued lawyers in the past; whether the sponsor has sought out your firm due to known expertise in the area or for another reason; whether the sponsor has in-house counsel; the size of the sponsor's staff; the sophistication of the sponsor's management team; any prior bankruptcies; the nature of the contemplated fund; and criminal records of key personnel. Negative information on these points is not necessarily a show-stopper, but may indicate heightened risk to the law firm from the contemplated engagement—if only from plaintiffs' lawyers in the future asserting that the law firm overlooked "red flags." If the law firm proceeds with the engagement, it also should consider whether arguably negative information should be disclosed by the sponsor to potential investors.

2. Rethink Your Firm's Client Retainer Agreement. Even if your law firm never represents a SPAC sponsor, the law firm's retainer agreement should be drafted mindful of the (hopefully unlikely) possibility that your law firm may be embroiled in future litigation. For client engagements governed by versions of the Rules of Professional Conduct that permit such clauses, include a favorable choice-of-law clause, a favorable forum-selection clause for dispute resolution (*e.g.*, arbitration), and a waiver of punitive damages claims.[16] Especially when representing a SPAC or other investment fund sponsor, specifically identifying the entity or entities that the law firm will represent, and making clear that the law firm has not agreed to represent other persons or entities, will make it more difficult for principals and board members, disgruntled investors, and other non-clients to contend that the law firm owed them legal duties. For example, a failed SPAC's bankruptcy trustee may be unable to sue the law firm if it is clear that the firm represented solely the sponsor and not the SPAC itself.

3. Avoid Doing "Favors" For Client Principals. As the engagement proceeds, lawyers will probably develop a rapport with the sponsor's principals. Although such relationships are inevitable, they may result in misunderstandings down the road (real or alleged) regarding whom the lawyer represented. The most cautious lawyers will resist the urge to do "favors" for, or provide one-time advice to, these individuals on matters that do not pertain directly to the engagement (*e.g.*, answering a question about an employment contract). Such conduct frequently surfaces in later litigation as evidence of an implied-in-fact attorney-client relationship between the law firm and the individual, which, in turn, can form the basis of a malpractice claim or allegation of divided loyalties.

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15 We do not suggest that the standard of care or the Rules of Professional Conduct as adopted in any jurisdiction require any of the following practices. Considerable state-to-state variation exists, both with respect to the standard of care and applicable ethics principles.

16 *See* ABA Comm'n on Ethics & Prof'l Responsibility, Formal Op. 02-425 (noting that a punitive damages waiver "would violate [Model] Rule 1.8(h) *unless the client is independently represented in making the agreement*" (emphasis added)).

4. Discourage the Client from Touting Its Counsel's Identity. It is not uncommon for disgruntled investors to allege that they never would have invested but for the fact that a particular law firm was involved, or willing to represent, the sponsor. Some investors try to assert that the law firm impliedly lent its reputation to the sponsor and thereby conferred an implied "stamp of approval" on the investment. Discouraging clients from touting the identity of their lawyers can help protect against plaintiffs' lawyers later contending that the law firm's identity or reputation drove people to invest.

5. Be Wary of Law Firm Communications with Investors. There is nothing wrong with a law firm communicating with its client's investors, and in some cases it may be necessary or desirable. Still, it is more difficult for disgruntled investors and other nonclients to assert or maintain claims against a law firm regarding the performance of their investments if the investors did not communicate directly with firm personnel. *See Rubin v. Schottenstein, Zox & Dunn*, 143 F.3d 263, 268 (6th Cir. 1998) ("[Although] an attorney representing the seller in a securities transaction may not always be under an independent duty to volunteer information about the financial condition of his client, he assumes a duty to provide complete and [non-misleading] information with respect to subjects on which he undertakes to speak."). If an investment goes poorly, disgruntled investors may try to claim that they relied on statements by the lawyers for their decision to invest (or not to sell), or that the lawyers effectively acted as salesmen or promoters. *See Cent. Bank of Denver*, 511 U.S. at 191; *McCartney v. Universal Elec. Power Corp.*, 2005 WL 2020559, at *2 (Ohio App. Ct. Aug. 24, 2005) (attorneys not immune from liability when "acting … as salesmen"). Oral communications with non-client fund investors are especially hazardous because they create no record of what actually was communicated. The easiest cases to defend are the ones in which the lawyers said the least to potential or actual investors. If a lawyer finds him or herself on a telephone call with a non-client, it is best to clarify that the lawyer represents only the sponsor, does not represent investors, cannot advise investors, and that investors should seek their own legal counsel. It also may be appropriate to memorialize the communication in writing as soon as possible and, in some cases, to do so in an email to the non-client. We see malpractice cases in which third parties sue a law firm alleging that a lawyer, years earlier, gave inadequate legal (or investment) advice, or incorrect or misleading information about an investment. Disgruntled investors sometimes "remember" versions of such communications that favor the damages claims they are trying to pursue against the law firm.

6. Beware of Appointments and Titles. To reduce the risk (and riskiness) of future claims, law firms should discourage appointment of firm personnel to serve in a titled position for the SPAC or its sponsor. Some legal defenses available to lawyers may be contingent upon the lawyer's having served solely in a legal capacity. The more closely intertwined the lawyer becomes with investment decisions or fund operations, the easier it becomes for a future plaintiff's lawyer to assert that counsel transitioned from legal advisor to investment promoter. *See McCartney*, 2005 WL 2020559, at *2; *see also Spaude v. Mysyk*, 2017 WL 9485666, at *10 (N.D. Ohio July 14, 2017) (attorneys immune from suit because their alleged conduct did not "fall outside duties incidental to the practice of law").

Representing SPAC sponsors poses special risks to law firms. Many of those risks can be mitigated if they are anticipated and addressed proactively.

7. Consider Whether and How to Withdraw from the Representation, if Appropriate. If, after the representation starts, firm lawyers determine that the risks of continuing the representation outweigh the benefits, the law firm may wish to consider withdrawal. Rule 1.16 of the Model Rules of Professional Conduct—versions of which have been adopted with local variations in all 50 states and the District of Columbia—permits a lawyer to withdraw from a representation if "withdrawal can be accomplished without material adverse effect on the interests of the client." Rule 1.16(b)(1). If circumstances do not permit the lawyer to withdraw under the foregoing provision, the Rule also permits voluntary withdrawal if "the client persists in a course of action involving the lawyer's services that the lawyer reasonably believes is criminal or fraudulent" or if "the client has used the lawyer's services to perpetrate a crime or fraud." Rule 1.16(b)(2)–(3). In addition, the Rule *requires* withdrawal if "the representation will result in violation of the rules of professional conduct or other law." Rule 1.16(a)(1). In extraordinary circumstances, and depending on what jurisdiction's rules control, a law firm may consider the propriety and utility of a so-called "noisy withdrawal," in which the lawyer "reveal[s] information relating to the representation of a client to the extent the lawyer reasonably believes necessary … to prevent the client from committing a crime or fraud that is reasonably certain to result in substantial injury to the financial interests or property of another … in furtherance of which the client has used or is using the lawyer's services," or "to prevent, mitigate or rectify substantial injury to the financial interests or property of another that is reasonably certain to result or has resulted from the client's commission of a crime or fraud in furtherance of which the client has used the lawyer's services." Rule 1.6(b)(2)–(3).

Conclusion

Representing SPAC sponsors poses special risks to law firms. Many of those risks can be mitigated if they are anticipated and addressed proactively. When in doubt, consult with counsel experienced in professional responsibility matters and in defending law firms on how best to address these risks.

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