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Client Alert

Lawsuits Challenge SPACs as Unregistered Investment Companies

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On August 17, 2021, a shareholder of Pershing Square Tontine Holdings, Ltd. (**PSTH**), the $4 billion special purpose acquisition company (or **SPAC**) led by William Ackman, filed a derivative action alleging (among other claims) that PSTH is an illegally unregistered "investment company" as defined in the Investment Company Act of 1940 (the **ICA**).[1] Later that week, the same plaintiff, represented by the same legal team, filed suits against two additional SPACs similarly claiming that the SPACs are investment companies operating in violation of the ICA requirement to register.[2] Press reports suggest the plaintiff team contemplates litigation against as many as 50 other SPACs.[3]

The wave of lawsuits prompted speculation that SPACs as a group may be at risk of being required to register as investment companies, a result that would likely be the death knell of the conventional SPAC model, whose principal features would be prohibited for companies registered under the ICA.[4] By the end of the week following the filing of the three lawsuits, a group of 49 law firms, including Milbank LLP, issued a joint statement asserting their belief that a SPAC is not an investment company if it follows its stated

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1 Assad v. Pershing Square Tontine Holdings, Ltd., No. 21-cv-6907 (S.D.N.Y). The complaint and the two that followed also allege violations of the Investment Advisers Act of 1940 (the IAA). While discussion of the merits of the plaintiff's IAA claims is beyond the scope of this client alert, we note that both the ICA and IAA claims face similar procedural obstacles, as discussed below.

2 Assad v. E.Merge Technology Acquisition Corp., No. 21-cv-7072 (S.D.N.Y.); Assad v. GO Acquisition Corp., No. 21-cv-7076 (S.D.N.Y.).

3 See, e.g., https://www.reuters.com/business/finance/exclusive-lawyers-behind-ackmans-retreat-target-dozens-more-spacs-2021-08-26/.

4 Most notably, the warrants and founder shares commonly issued to SPAC sponsors would generally be prohibited for registered closed-end investment companies under ICA §§ 18(d) and 23.

business plan to engage in a business combination with one or more operating companies within a specified time frame and holds short-term treasuries and shares of money market mutual funds in trust pending completion of its initial business combination.[5]

This Client Alert considers the ICA claims made in the recent lawsuits in the light of the elements of the investment company definition as historically interpreted and the ICA provisions governing investor claims for relief.

The Pershing Square SPAC – Unconventional Facts and a Complex ICA Profile

The PSTH SPAC had singular facts and a more complicated ICA profile than typical SPACs. Its IPO registration included all the elements that have enabled SPACs to go public for decades without being required to register as investment companies: a commitment to invest IPO proceeds only in treasuries and shares of money market mutual funds while seeking an initial business combination; a limited time frame in which to complete an initial business combination or return investors' money; and, critically, a business strategy to acquire a wholly owned or controlled business and operate it over the long term. The PSTH prospectus included the following disclosure (boldface added):

> [W]e anticipate [we] will own or acquire 100% of the equity interests or assets of the target business or businesses. We may, however, structure our initial business combination such that the post-combination business owns or acquires less than 100% of such interests or assets of the target business for the post-combination business to meet certain objectives of the target management team or stockholders or for other reasons, **but we will only complete such business combination if the post-combination business owns or acquires 50% or more of the outstanding voting securities of the target or otherwise acquires an interest in the target or assets sufficient for it not to be required to register as an investment company under the Investment Company Act of 1940, as amended, or the Investment Company Act**.

Nearly all registration statements for SPAC IPOs include the same or similar disclosure.

Generally, a SPAC needs to acquire at least 50% of a target's voting securities to avoid becoming a prima facie investment company.[6] An exception may apply if the SPAC acquires and engages in business through a target it "controls primarily," a standard that generally requires owning more than 25% of the target's voting securities and having a greater degree of control over the target than any other person.[7]

Despite its IPO disclosure, PSTH stated in its first 10-K annual report that it was willing to acquire a minority stake in a target company, and in June 2021, approximately 11 months after completing its IPO, PSTH

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5 The statement is published on the SPACInsider website at https://spacinsider.com/2021/08/27/49-law-firms-unite-push-back-on-spac-litigation/. A number of additional law firms have reportedly joined the statement since its initial release.

6 Under ICA Section 3(a)(1)(C), sometimes referred to as the "40% test," an investment company includes "any issuer which … is engaged or proposes to engage in the business of investing, reinvesting, owning, holding, or trading in securities, and owns or proposes to acquire investment securities having a value exceeding 40 per centum of the value of such issuer's total assets (exclusive of Government securities and cash items) on an unconsolidated basis." "Investment securities" for this purpose do not include securities of majority-owned subsidiaries that themselves pass the 40% test. ICA § 3(a)(2). (As discussed below, investment securities also do not include U.S. government securities and, under SEC staff interpretations, certain "cash items" such as shares of money market mutual funds.)

7 Under Rule 3a-1 under the ICA, an issuer that would otherwise be an investment company under the 40% test does not fall within that definition if, generally, no more than 45% of its assets and income are attributable to securities. Securities of certain companies that are "controlled primarily" by the issuer do not count toward the 45% threshold; the "controlled primarily" standard generally requires over 25% voting security ownership and a greater degree of control over the company than any other person. See, e.g., ICA § 2(a)(9); SEC Release IC-26077 (Jun. 17, 2003), text preceding note 57.

announced that it had entered into an agreement to complete its initial business combination – the purchase of a 10% stake in Universal Music Group B.V. (**UMG**). PSTH told shareholders it planned to distribute the UMG shares to them later in the year, following SEC registration permitting the shares to be publicly traded.[8]

In SEC filings related to the proposed transaction, PSTH acknowledged that the UMG share purchase would result in it "temporarily becoming an investment company within the meaning of [the ICA] because we will own investment securities (*i.e.*, the UMG Shares) the value of which exceeds 40% of our total assets, exclusive of government securities and cash items."[9] However, PSTH stated, it did not believe it was required to register as an investment company, because it could rely on the "transient investment company" safe harbor, ICA Rule 3a-2, which excepts an issuer from the investment company definition for up to one year if it satisfies the rule's conditions.[10] The main condition for reliance on the safe harbor is a "bona fide intent" on the issuer's part to be primarily engaged in an operating business as soon as reasonably possible.

In a July 16, 2021 letter commenting on PSTH's filings, the SEC staff questioned PSTH's ICA position.[11] The staff noted that "PSTH intends to purchase a minority interest in UMG with no future plan or intention to purchase additional shares of UMG, merge with UMG, or otherwise acquire a majority of UMG's voting securities" and that its business activities to date consisted primarily of "pursuing the acquisition of a minority equity interest in a business solely for the purpose of distributing such interests to PSTH shareholders with no intention of operating or controlling such business." The staff stated that these activities cast doubt on whether PSTH had the requisite bona fide intent to rely on the one-year safe harbor. The staff also noted the inconsistency of PSTH's actions with its prospectus disclosure stating a business strategy to seek a 50% or otherwise controlling interest in a target.[12]

Had the correspondence continued, PSTH might have succeeded in demonstrating to the staff that its proposed purchase of UMG shares did not cause it to be an investment company.[13] Two days after the receiving the staff's letter, however, the PSTH board unanimously determined not to proceed with the UMG transaction. In a letter to shareholders, CEO William Ackman said the decision "was driven by issues raised by the SEC with several elements of the proposed transaction – in particular, whether the structure of our [initial business combination] qualified under the NYSE rules,"[14] but did not reference ICA issues specifically.

Subsequent Lawsuits Target Conventional SPACs in their Second Year

Given PSTH's history – its departure from standard SPAC strategy by pursuing a minority interest, the SEC staff's challenge to its ICA status, and its high profile as the largest SPAC raised to date – the PSTH lawsuit initially seemed unlikely to affect SPACs at large. The complaint, however, did not focus on PSTH's

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8 PSTH Press Release dated June 20, 2021, filed as Ex. 99.1 to PSTH Current Report on Form 8-K dated June 20, 2021.

9 PSTH Offer to Redeem dated July 8, 2021, p. 87, filed as Ex. (a)(1)(k) to Schedule to PSTH Tender Offer Statement dated July 8, 2021.

10 Id. at 87-88.

11 Letter dated July 16, 2021 from C. Chalk, Senior Special Counsel, SEC Div. of Corp. Fin. Office of Mergers and Acquisitions, available at https://www.sec.gov/Archives/edgar/data/0001811882/000000000021008861/filename1.pdf

12 Id. at 2-3, 7.

13 While an ICA analysis of the effect of the proposed PSTH-UMG transaction is beyond the scope of this client alert, we note that, as conceived by PSTH, the UMG purchase would have resulted in the SPAC investors holding shares of an operating company, whether by way of the merger of UMG into PSTH (as originally contemplated by PSTH) or the distribution to the SPAC shareholders of the acquired UMG shares. This is the same result achieved by SPACs that follow the conventional route of acquiring all or a majority of the shares of a target operating company.

14 PSTH Letter to Shareholders dated July 19, 2021, filed as Ex. 99.1 to PSTH Current Report on 8-K dated July 19, 2021.

deviation from the standard SPAC strategy or even note the inconsistency identified by the SEC staff between its disclosures and its actions. The plaintiff's ICA claim rested largely on facts that are common to nearly all SPACs.

With the filing of plaintiff's second and third complaints, it became clearer that the plaintiff group's broader agenda was to attack the mainstream SPAC model. The two SPACs sued after PSTH – E-Merge Technology Acquisition Corp. (**E-Merge**) and GO Acquisition Corp. (**GO Acquisition**) – had no history of seeking a minority stake or any apparent material differences from scores of SPACs that have gone public in recent years. Each of the three complaints alleges that the SPAC in question is an investment company because it has done nothing with its assets since its IPO other than to invest them in securities – specifically, U.S. government securities and shares of money market mutual funds, the forms in which virtually all SPACs commit to hold their IPO proceeds while they seek an initial business combination. [15]

The plaintiff bases its claim on Section 3(a)(1)(A), the first prong of the investment company definition, which requires a determination that, based on all the facts and circumstances, investing in securities is an issuer's area of primary business engagement.[16] In contrast, Section 3(a)(1)(C), the other main prong of the investment company definition, provides a bright line test that generally captures any issuer whose assets consist over 40% of "investment securities." SPACs avoid triggering the 40% test by holding their IPO proceeds in U.S. government securities and shares of money market mutual funds, investments that are not "investment securities" for purposes of Section 3(a)(1)(C).[17] U.S. government securities and shares of money market mutual funds are "securities," however, and Section 3(a)(1)(A) applies to an issuer engaged primarily in the business of investing in *any* securities, whether or not they are investment securities.

While correct in asserting that the SPACs' investments are securities, the complaints fall short in alleging facts that would plausibly support a conclusion that the companies are *engaged primarily in the business of* investing in securities as Section 3(a)(1)(A) requires and has been interpreted. In determining a company's area of primary business engagement, the SEC staff has said that the primary consideration is "the area of business in which the entity anticipates realization of the greatest gains and exposure to the largest risks of loss." [18] Under SEC and court interpretations, an issuer has not been considered to be "in the business" of investing in securities, let alone "engaged primarily" in that business, where it invests in securities for a temporary period to preserve their value pending investment in a non-investment company business.[19] The SEC and its staff have said that whether a period is "temporary" in this context is a fact-specific determination hinging largely on intent – specifically, whether the issuer demonstrates the bona fide intent to engage primarily in a non-investment business as soon as reasonably possible – but that a

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15 E-Merge Complaint ¶¶ 70-73; GO Acquisition Complaint ¶¶ 72-75; PSTH Complaint ¶¶ 102-106. The PSTH Complaint also alleges that PSTH "proposes to" invest in securities as contemplated by Section 3(a)(1)(A) because of its efforts to acquire the securities of UMG and/or another initial business combination target. PSTH Complaint, ¶¶ 107-108.

16 An investment company under ICA Section 3(a)(1)(A) includes "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 in securities."

17 See note 6 above.

18 See Hallwood Industries, Inc., SEC No-Action Letter (Jun. 19, 1991), in which the SEC staff notes in its response that, in determining a company's area of primary business engagement, it "would consider of first importance the area of business in which the entity anticipates realization of the greatest gains and exposure to the largest risks of loss," citing its response in Peavey Commodity Futures Fund, SEC No-Action Letter (Jun. 2, 1983).

19 See, e.g., SEC v. Fifth Ave. Coach Lines, 289 F. Supp. 3, 9 (S.D.N.Y. 1968), aff'd, 435 F.2d 510 (2d Cir. 1970); First Florida Equities Corp., SEC No-Action Letter (Sept. 11, 1980).

period of up to one year would generally be considered "temporary,"[20] a position codified in the Rule 3a-2 safe harbor noted earlier.

We note that the E-Merge and GO Acquisition lawsuits were each filed just over one year after the defendant company's IPO.[21] Given the SEC position underlying Rule 3a-2,[22] it would be particularly difficult for a plaintiff to argue that a SPAC in its first year is "in the business" of investing in securities. But the SEC and its staff have repeatedly made clear that Rule 3a-2 is only a safe harbor and that an issuer does not become an investment company after one year so long as it possesses the requisite bona fide intent.[23] And SPACs are structured to fall squarely within SEC staff interpretations of bona fide intent, by holding their liquid assets in conservative investments intended to preserve their value rather than achieve investment gain; pursuing a legitimate non-investment company objective, a business combination with a non-investment company business; holding themselves out to investors as pursuing that objective exclusively; and committing to liquidate if that objective is not achieved within a finite period, commonly 24 months.[24] The staff has made clear that it believes it has issued adequate guidance on questions of bona fide intent for companies in transition and will not accept further no-action or interpretive requests unless novel issues are presented.[25] The fact that the SEC staff has reviewed hundreds of SPAC IPO registration statements and declared them effective without requiring ICA registration strongly demonstrates that it considers the SPAC model to fall within its longstanding interpretations of companies that are not in the business of investing in securities and therefore are not investment companies.

Procedural Hurdles

The plaintiff in the recent lawsuits asserts several causes of action. The plaintiff claims that the defendants breached fiduciary duties under Section 36(b) of the ICA based on the alleged receipt of excessive compensation by sponsors, advisers, officers, or directors of the SPACs. The plaintiff also seeks rescission of certain contracts governing the SPACs under Section 47(b) of the ICA, as well as under Section 215(b) of the IAA. Finally, the plaintiff seeks a declaration that the SPAC is an investment company within the meaning of the ICA

However, there are limited avenues available to enforce provisions of the ICA and IAA in federal court and various hurdles exist for the plaintiff and other investors to succeed in these claims for relief. Although Section 36(b) of the ICA contains an express private right of action permitting fund shareholders to sue for breaches of fiduciary duty involving excessive fees, under the terms of the statute, actions under Section

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20 See, e.g., Medidentic Mtge. Investors, SEC No-Action Letter (May 23, 1984); First Florida Equities Corp., SEC No-Action Letter (Sept. 11, 1980).

21 Both complaints were filed Aug. 20, 2021; the E-Merge IPO closed on Aug. 4, 2021 and the GO Acquisition IPO on Aug. 7, 2020.

22 In general, SPACs do not formally invoke Rule 3a-2, which requires a board resolution and a one-year time frame, as opposed to the two-year time frame typical of SPACs. However, the positions expressed by the SEC in proposing and adopting the rule, and by the SEC staff in no-action letters before and after adoption of the rule, are relevant to fact patterns that fall outside the safe harbor, as discussed below.

23 See, e.g., Transamerican Venture Corp., SEC No-Action Letter (Sept. 23, 1985); Medidentic Mtge. Investors, SEC No-Action Letter (May 23, 1984).

24 See, e.g., Transamerican Venture Corp., SEC No-Action Letter (Sept. 23, 1985) (staff would not recommend enforcement action against an issuer formed solely to acquire or merge with an operating company; issuer had diligently pursued a combination but was unable to complete one within the Rule 3a-2 one-year period; the staff's no-action position may be viewed as a recognition (years before SPAC IPOs became common) that seeking a combination with an operating company, albeit through an acquisition of its securities, represents a non-investment company objective distinguishable from the business of investing in securities); Medidentic Mtge. Investors, SEC No-Action Letter (May 23, 1984) (whether a period of longer than one year would be "temporary" would depend on, among other factors, whether a company invests in securities solely to preserve the value of its assets).

25 See, e.g., Medidentic Mtge. Investors, SEC No-Action Letter (May 23, 1984).

36(b) may only be brought by shareholders of *registered* investment companies.[26] Without having registered a SPAC with the SEC as an investment company, managers of SPACs may not be liable under the provision. In addition, the alleged excessive payments are not traditional management fees paid to an investment adviser that are typically the subject of Section 36(b) lawsuits, but more indirect forms of compensation, such as shares of convertible common stock or warrants that are purchased by the SPAC's sponsor. Section 36(b)'s express limitations on the availability of damages may impede a recovery of such compensation under the provision, as a plaintiff can only bring suit against the "recipients" of the compensation, may only seek damages beginning one year before the action is instituted and may only recover "actual damages" that may not exceed the amount of compensation received from the investment company.[27]

Plaintiff's claims for rescission under Section 47(b) of the ICA and Section 215 of the IAA also face procedural difficulties. Although the Supreme Court has recognized that an implied private right of action exists under Section 215 for rescission of contracts in violation of the IAA,[28] courts are split as to the existence of an implied private right of action under Section 47(b). The Court of Appeals for the Second Circuit has held that Section 47(b) confers an implied private right of action, while the Third Circuit and other lower courts have found that no such implied private right exists.[29] And even if an implied right of action under Section 47(b) exists, the ICA limits the remedy of rescission to the parties to the contract.[30] Here, the plaintiff is not a party to the relevant contracts that he seeks to rescind, such as subscription agreements for the purchase of equity between the SPAC and its sponsor. The rescission claims would therefore need to be brought derivatively on behalf of the SPAC, triggering pre-suit demand requirements on the board of directors under Federal Rule of Civil Procedure 23.1. The plaintiff has not made such demand, but has alleged that the requirement should be excused as futile. Courts determining demand futility apply the law of the state of incorporation, and have often dismissed Section 215 claims under Delaware and other state laws upon finding that demand futility was not alleged with sufficient particularity.[31] Finally, although plaintiff alleges various other violations of the ICA and IAA, courts have not recognized the existence of implied private rights of action under those statutory provisions.

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26 ICA § 36(b) ("An action may be brought . . . by a security holder of such registered investment company on behalf of such company . . . .").

27 ICA § 36(b)(3).

28 See Transamerica Mortg. Advisors, Inc. v. Lewis, 444 U.S. 11, 24 (1979).

*29 Compare Oxford Univ. Bank v. Lansuppe Feeder, LLC, 933 F.3d 99, 109 (2d Cir. 2019) (finding that "ICA § 47(b)(2) creates an implied private right of action for a party to a contract that violates the ICA to seek rescission of that violative contract"), with Santomenno ex rel. John Hancock Trust v. John Hancock Life Ins. Co., 677 F.3d 178, 187 (3d Cir. 2012) (dismissing Section 47(b) claim upon finding no private right of action), and Wiener v. Eaton Vance Distribs., Inc., No. 10-10515-DPW, 2011 WL 1233131, at *12 (D. Mass Mar. 30, 2011) (finding that the "text and structure of the Investment Company Act preclude a private right of action in this case under [Section] 47(b)").*

30 See ICA § 47(b)(1) ("A contract that is made, or whose performance involves, a violation of [the ICA] . . . is unenforceable by either party."); ICA § 47(b)(2) (referring to "rescission at the insistence of any party" to the contract").

31 See In re Evergreen Mut. Funds Fee Litig., 423 F. Supp. 2d 249, 263 (S.D.N.Y. 2006) (dismissing Section 215 claim where "Plaintiffs have failed to state particularized facts demonstrating that the [defendants] were incapable of properly exercising their business judgment with respect to claims at issue" under Delaware law); In re Mut. Funds Inv. Litig., 384 F. Supp. 2d 873, 875, 877-80 (D. Md. 2005) (dismissing Section 215, Section 47(b) and other claims where "plaintiffs have not alleged sufficient facts to excuse demand" under Delaware and Massachusetts law); In re Merrill Lynch Inv. Mgmt. Funds Secs. Litig., 434 F. Supp. 2d 233, 241 (S.D.N.Y. 2006) (dismissing derivative Section 215 claim where plaintiffs did "not allege particularized facts that would show how a given director was unable to respond to a demand in good faith").

Conclusion

The theory of the recent complaints – that temporary investment in short-term treasuries and money market funds is the business in which the defendant SPACs are primarily engaged and requires them to register as investment companies – asks the courts to reject longstanding interpretations of the investment company definition and the principle that companies in a legitimate transition to a non-investment business should not be required to register under the ICA. Even if the courts were to accept the plaintiff's view of the SPACs' ICA status, the plaintiff would likely face an uphill battle in seeking recovery under the ICA or IAA, given the procedural hurdles built into the claims asserted.

Milbank

Milbank advises on special purpose acquisition company (SPAC) transactions. Our team represents SPAC sponsors and underwriters in structuring SPACs and completing their IPOs; SPACs and target companies in SPAC business combination transactions; and investors considering investments in SPACs. We also help clients navigate SPAC litigation and enforcement matters, and claims brought under the ICA. Our attorneys have a deep understanding of not only the legal issues impacting SPACs, but also the business, marketing, and industry issues that affect the success of SPACs.

For further information, or if you have questions, please contact the authors or your usual Milbank attorney. We are happy to schedule a time to connect at your convenience.

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