WRITING A BLANK CHECK:

REVISITING THE SECOND CIRCUIT'S PLEADING STANDARDS OF SECURITIES EXCHANGE ACT SECTION 20(a) IN THE RISE OF SPAC LITIGATION

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A board of directors of a promising music streaming corporation has decided they want to raise capital publicly quickly and without the regulatory nets of an initial public offering. Instead, the corporation acquires a publicly traded shell company and becomes listed on - secondary markets, including Nasdaq. This process is known as acquiring or merging with a Special Purpose Acquisition Company (SPAC).[2] In doing so, investors continue pouring millions of dollars into the corporation with high hopes of positive returns.[3] However, it turns out that the corporate officers have not been entirely honest about the music corporations' stability and success; they misrepresented financial results by falsifying its number of subscribers to the streaming market. Outraged, the investors decide to file suit against the corporation in the State of New York alleging, among other violations, that the corporate officers are responsible for securities fraud. Will these corporate officers be held liable for their misrepresentations? The answer: it depends.

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[2] Note that a SPAC/de-SPAC process includes a more complex procedure before a final merger. "SPACs exist before a deal; many are actively searching for companies they wish to acquire. When a SPAC identifies a potential match, they'll begin the acquisition process . . . [then,] the SPAC undertakes the due diligence to verify that the company is presenting itself accurately; there are also target valuation considerations from the NASDAQ and NYSE. The de-SPAC transition process officially begins once the formal merger is announced. Once a merger agreement is signed, the deal is announced publicly and investors are notified." After such processes, the business files an S-4 statement with the SEC to trigger the next phases of the de-SPAC transition for the newly created entity. Craig Clay, *What is a De-SPAC Transaction?* DONNELLY FIN. SOLUTIONS (May 3, 2021), https://www.dfinsolutions.com/knowledge-hub/thought-leadership/knowledge-resources/what-de-spac-transaction.

[3] Not all SPAC investors seek positive returns; rather, investors seek "a variety of return and risk profiles and timelines" that they may benefit from a SPAC/de-SPAC transaction. Max H. Bazerman & Paresh Patel, *SPACS: What You Need to Know*, HARV. BUS. REV. (July-Aug. 2021), https://hbr.org/2021/07/spacs-what-you-need-to-know.

This scenario is based on a SPAC litigation in one of the district courts in the Second Circuit, and is one of many that may determine the future of secondary liability in business combination cases.[4] Section 20(a) of Securities Exchange Act of 1934 provides that a person, typically a corporate officer or director, who "controls" another person who is found liable for securities fraud, is jointly and severally liable, "unless the controlling person acted in good faith and did not directly or indirectly induce" the violation.[5] When analyzing Section 20(a) cases, courts across the justice system implement one of two differing tests: the majority's "potential control" test or the minority's "culpable participant" test. Specifically, within the Second Circuit, courts utilize varying interpretations of the minority's culpable participant test, but most importantly, they apply differing pleading standards that may affect the liability of a corporate officer.[6]

The difference between the pleading standards of the culpable participant test within the Second Circuit, while minor, have varying degrees of clarification. Some district courts in the Second Circuit require pleading facts that support an individualized inference of the control person's scienter, whereas others have reasoned that such allegations require a pleading with particularized facts about the control person's actions.[7] For instance, in this scenario with the music streaming corporation, one district court could find the fact that a corporate officer's discussion of false financial profitability is proof of scienter, but another district court may

[4] *See* In re Akazoo S.A. Securities Litigation, No. 20-cv-1900, Dkt. No. 15 (E.D.N.Y. 2020).
[5] Section 20(a) describes joint and several liability as well as the good faith defense of a "control" person. "Every person who, directly or indirectly, controls any person liable under any provision of this chapter or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable (including to the Commission in any action brought under paragraph (1) or (3) of section 78u(d) of this title), unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action." 15 U.S.C. § 78t(a) (1934).
[6] *In re* Tronox, Inc., 2010 U.S. Dist. LEXIS 67664 *63 (S.D.N.Y. 2010); Special Situations Fund III QP, L.P. v. Deloitte Touche Tohmatsu CPA, Ltd., 33 F. Supp. 3d 401, 437 (S.D.N.Y. 2014).
[7] *Id.*

determine that such fact alone is insufficient to determine a "controlling person's" conscious misbehavior to satisfy the scienter requirement.[8] In essence, the competing standards of pleading could determine a corporate officer's freedom or imprisonment, depending on which court he or she sits in.

The pleading standards between the majority and minority tests disrupted uniformity not only across all Circuits, but explicitly, the Second Circuit's contradicting pleading standards resulted in inconsistent liability standards within itself as the Second Circuit battles its own precedent. Again, some district courts within the Second Circuit require pleading facts that support an individualized inference of the control person's scienter, but others reasoned that such allegations require a pleading with particularized facts about the control person's actions instead.[9] Additionally, a minority of district courts in the Second Circuit removed the "culpable participation" prong entirely from the pleading standard requirements, leaning towards the majority's potential control test instead.[10] Thus, courts wrestled the idea of what level of control is required for a corporate officer to be found in violation of Section 20(a).[11]

This Note will analyze the evolution of the tug-of-war between district courts in the Second Circuit that inconsistently apply the varying pleading standards and competing tests to suggest the most effective standard. To illustrate the implications of the varying tests, this note will also address the potential influence of the Second Circuit's inconsistent rulings to secondary

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[8] In Re Tronox, Inc., *supra* note 6 at 63; Special Situations Fund III QP, L.P., *supra* note 6 at 437.
[9] In Re Tronox, Inc., *supra* note 6 at 63; Special Situations Fund III QP, L.P., *supra* note 6 at 437.
[10] In Re Tronox, Inc., *supra* note 6 at 63; Special Situations Fund III QP, L.P., *supra* note 6 at 437.
[11] *See* Laura Greco, *The Buck Stops Where?: Defining Controlling Person Liability*, 73 S. CAL. L. REV. 169, 171-72 (1999) ("By looking at the legislative history of [Section 15 and Section 20(a)], it becomes clear that Congress intentionally omitted fixed criteria for defining a "controlling person." It was thought that by keeping the concept of control flexible, the statute would be applicable to a variety of situations both seen and unforeseen. Absent a bright line rule, however, the courts have been forced to wade through a sea of uncertainty to uncover who qualifies as a controlling person".)

liability exposure under Section 20(a) of the Exchange Act relating to SPAC litigation. First, Part I describes the overall history of secondary liability, including the clarifications sought by courts and the SEC to define what constitutes "control" under Section 20(a).

Next, Part II seeks to uncover the elements of a Section 20(a) claim by providing the distinction in Section 20(a) competing analyses between the test most circuit courts use, the potential control test, against that which a minority uses, the culpable participant test. Furthermore, this part reveals the competing pleading standards faced by the Second Circuit in Section 20(a) allegations. Specifically, this section demonstrates how differing liability can result when some district courts in the Second Circuit continue to require scienter as a pleading requirement element of a culpable participant, and others continue to allow plaintiffs to produce scienter only when the defendant is attempting to show a good faith defense.

Then, Part III delves into the unprecedented rise of SPACs together with the increase in SPAC litigation and legal debates surrounding regulation. This section reflects on how the Second Circuit's split on Section 20(a) will affect the outcome of pending SPAC litigation, using examples to demonstrate varying outcomes based on the competing pleading standards.

Lastly, Part IV concludes the Second Circuit's need for uniformity for the sake of Section 20(a) claims, especially in the face of SPAC litigation, by formally adopting the potential control test. However, if the Second Circuit continues to follow the minority test of a culpable participant test, then this section argues how a pleading standard rejecting the heightened form of scienter would align most with the intent of Section 20(a) and the majority of circuit courts.

I. The History of Secondary Liability

To establish a Section 20(a) claim, all circuits require a showing of primary liability per Rule 10b-5, following Section 10, under the Securities and Exchange Act of 1934.[12] Rule 10b-5 seeks to prevent securities fraud like insider trading by prohibiting deceptive practices, such as false or misleading information.[13] Under Rule 10b-5, plaintiffs must demonstrate a material misrepresentation or omission made with scienter in connection with the purchase or sale of securities that the plaintiff relied upon that proximately caused the injury.[14]

The United States Congress intended Section 20(a) to be supported by an underlying theory of vicarious liability and respondeat superior, as commonly found in actionable conduct against employer-employee relationships.[15] In essence, Congress viewed Section 20(a) as way to "prevent people and entities from using straw parties, subsidiaries, or other agents acting on their behalf to accomplish ends that would be forbidden directly by the securities laws."[16] However,

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[12] Section 10(b) of the Exchange Act makes it unlawful to "use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may proscribe." 15 U.S.C. § 78j(b); Rule 10b-5(b) implemented such practice where "it shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange, (a) To employ any device, scheme, or artifice to defraud, (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security." 17 C.F.R. § 240.10b-5.

[13] Based on Section 10, the Securities and Exchange Commission in 1942 adopted Rule 10b-5, making the fraud provisions applicable to purchases as well as sales of securities. *Timeline: A History of Insider Trading*, N.Y. TIMES (Dec. 6, 2016), https://www.nytimes.com/interactive/2016/12/06/business/dealbook/insider-trading-timeline.html. Notably, Rule 10b-5 is no stranger to proposed amendments due to the [**there was no conclusion to this sentence]. In December 2021, the SEC has proposed amendments to Rule 10b-5, including revised disclosure and affirmative defense requirements. *See* Press Release, SEC, SEC Proposes Amendments Regarding Rule 10b5-1 Insider Trading Plans and Related Disclosures (Dec. 15, 2021) https://www.sec.gov/news/press-release/2021-256.

[14] *See, e.g.*, Private Securities Litigation Reform Act of 1995, § 21D(b)(2), 109 Stat. 737, 747 (1995) (codified as 18 U.S.C. § 1964 (Section 21D(b)(2) of Private Securities Litigation Reform Act (PSLRA) does not specify which state of mind is required; instead, it requires that "the complaint shall, with respect to each act or omission alleged to violate [the Exchange Act], state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.")

[15] Brian A. Melhus, *Control Person Liability: A Repudiation of Culpable Participation*, 37 IOWA J. CORP. L. 929, 932 (2012) [hereinafter Melhus, *Control Person Liability*] ("Control person liability is similar to vicarious liability under respondeat superior in that each holds the superior liable for the acts of those working for them.")

[16] Brianna L. Gates, *The SEC on Forum Shopping Spree: SEC Enforcement Power and Control Person Liability After Dodd-Frank*, 99 IOWA L. REV. 393, 398 (2013) [hereinafter Gates, *Forum Shopping* (quoting Laperriere v. Vesa Ins. Grp., Inc., 526 F.3d 715, 721 (11th Cir. 2008)) (internal quotation marks omitted).

the idea of a culpable participant requirement to the provision's application was introduced in caselaw as being an "obvious" congressional intention to hold individuals liable that are culpable participants to a securities fraud."[17] While some courts, namely the Second Circuit, agree to such congressional intention of culpable participation to be added to a Section 20(a) claim, others do not.

A. The Elements of a Section 20(a) Claim

The purpose of control person liability is to prevent persons, typically corporate officers and directors, from exploiting agents acting on their behalf to conduct illegal activities or unethical business practices prohibited by the securities laws.[18] The term "control" is undefined in the Exchange Act; however, Securities Act Rule 405 and Exchange Act Rule 12b-2 define "control" similarly as "the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise."[19] Additionally, the Dodd–Frank Wall Street Reform and Consumer Protection Act resolved the ambiguity Section 20(a)'s use of the term "any person" to include the SEC, so that both the SEC and private plaintiffs can bring forth Section 20(a) claims.[20] Despite these powerful clarifications, courts throughout the United States, and

[17] SEC v. First Jersey, 101 F.3d. 1450, 1472 (2d. Cir. 1996) (quoting Gordon v. Burr, 506 F.2d 1080, 1085 (2d Cir. 1974)); "[It was the] intent of Congress in adding this section [20(a)], passed at the same time as the amendment to Section 15 of the 1933 Act, was obviously to impose liability only on those directors who fall within its definition of control and who are in some meaningful sense culpable participants in the fraud perpetrated by controlled persons." SEC v. First Jersey, 101 F.3d. 1450, 1472 (2d. Cir. 1996).
[18] *See* 15 U.S.C. § 78t(a) (1934) ; *see also* Jeff G. Hammel and Robert J. Malionek, *Elusive Standard to Plead § 20(a) Control Person Liability*, Vol. 237-No. 42, N.Y. L.J. (2007).
[19] 17 C.F.R. §§ 230.405, 240.12b-2.
[20] "Section 20(a) of the Securities Exchange Act of 1934 (15 U.S.C. 78t(a)) is amended by inserting after 'controlled person is liable' the following: '(including to the Commission in any action brought under paragraph (1) or (3) of section 21(d)).'" Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 929P(c), 124 Stat. 1376, 1865 (2010) (codified at 15 U.S.C. § 78o), https://www.govinfo.gov/content/pkg/PLAW-111publ203/pdf/PLAW-111publ203.pdf. The ambiguity brought on by the term "any person" under the statute actually created a previous circuit split: while "some courts found that the statute's 'context,'" its neighborly relation

specifically within the Second Circuit, have adopted differing standards to what constitutes control through fact-specific inquiries.[21]

A primary violation under Rule 10b-5 is required for a Section 20(a) claim due to courts' history of rejecting secondary liability from an aiding and abetting theory.[22] In 1994, the U.S. Supreme Court decided that "private plaintiff[s] may not maintain an aiding and abetting suit under [Securities Exchange Act Section 10(b)]."[23] Rather, the conduct of a secondary actor must satisfy each of the elements or preconditions for liability as would a primary violator.[24] Plainly, control person liability makes an individual, who exerts control over another person or entity (a "primary violator") that violates the federal securities laws, jointly and severally liable.[25] Due to this extension of liability, Section 20(a) claims are common against SPAC officers once a securities fraud violation like Section 10(b) or Section 14(a) is found against a primary violator.[26]

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to the unequivocal standard for enforcement in Section 20(b), implied Congressional intent to exclude the SEC from the definition of 'person.' Now there is no mistaking the explicit legislative mandate that the SEC be regarded as a person capable of bringing suit under Section 20(a)." *See* Zachary S. Brez, R. Daniel O'Connor, & Joseph G. Cleemann, *Control Person Liability*, 5 BL REP. 17, 1-2 (2011).

[21] *Compare* SEC v. First New Jersey, 101 F.3d 1450 (2d Cir. 1974) with Landa v. Drexel & Co., 479 F.2d 1277 (2d Cir. 1973).

[22] Central Bank of Denver v. First Interstate Bank of Denver, 511 U.S. 164, 191 (1994). *Central Bank* held that aiding and abetting theory is inapplicable to liability in private 10b-5 actions, but the Supreme Court failed to address what acts constitute primary violations of secondary actors. American Bar Association, Section on Business Law, *Aiding and Abetting*, https://www.americanbar.org/groups/business_law/publications/the_business_lawyer/find_by_subject/buslaw_tbl_mci_aidab/ (Jan. 19, 2021).

[23] Central Bank of Denver v. First Interstate Bank of Denver, 511 U.S. 164, 191 (1994).

[24] *See id.* (citing Daniel R. Fischel, *Secondary Liability under Section 10(b) of the Securities Act of 1934*, 69 CALIF. L. REV. 80, 107-108 (1981)) ("Any person or entity, including a lawyer, accountant, or bank, who employs a manipulative device or makes a material misstatement (or omission) on which a purchaser or seller of securities relies may be liable as a primary violator under 1b-5, assuming *all* of the requirements of primary liability under Rule 10b-5 are met."); *see also* Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc., 552 U.S. 148, 164-65 (2008) (establishing secondary liability exists when preconditions of 10b-5 liability, such as reliance, are met).

[25] John Coates, *SPACs, IPOs and Liability Risk under the Securities Law,* SEC (Apr. 8, 2021) https://www.sec.gov/news/public-statement/spacs-ipos-liability-risk-under-securities-laws.

[26] *Id.*

In regard to Section 20(a) procedures in court, control person liability claims contain shifting burdens of proof.[27] After the plaintiff establishes a prima facie case of Section 20(a) liability, the burden shifts to the defendant to show that he acted in good faith by not engaging in the formation of the violative acts.[28] A defendant meets the standard of good faith once she proves that she exercised due care in her supervision by "maintain[ing] and enforc[ing] a reasonable and proper system of supervision and internal controls ."[29] While the rebuttal of good faith is meant to provide a safe haven for innocent defendants, a defendant's evidence of what constitutes control in maintaining such proper due care is at the whim of the particular Circuit's control person liability pleading standard.

B. The Competing Standards

In addition to a showing of primary liability, plaintiffs must indicate how the alleged actor participated as a "control person." However, the circuits split over the requirements to demonstrate a control person under Section 20(a). Two controlling person liability standards exist: the culpable participation and potential control test.

The majority of circuits — the First, Fifth, Sixth, Seventh, Eighth, Ninth, Tenth and Eleventh — follow the potential control test, which requires a showing of a primary violation and control.[30] The majority of circuits hold that the plaintiff is not required to plead the control

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[27] SEC v. First Jersey, 101 F.3d. 1450, 1473 (2d. Cir. 1996).
[28] *Id.*
[29] *Id.* (quoting Marbury Management, Inc. v. Kohn, 629 F.2d 705, 716 (2d Cir. 1980).)
[30] Nuances between tests among the Circuits is demonstrated in this section, but some foundational cases implanting the potential control test are as follows. *See, e.g.,* Metge v. Baehler, 762 F.2d 621, 630-31 (8th Cir. 1985); Harrison v. Dean Witter Reynolds, Inc., 974 F.2d 873, 881 (7th Cir. 1992); Lustgraaf v. Behrens, 619 F.3d 867, 877 (8th Cir. 2010); Abbott v. Equity Grp., Inc., 2 F.3d 613, 619-20 (5th Cir. 1993); Howard v. Everex Sys., Inc., 228 F.3d 1057, 1065 (9th Cir. 2000).

person's culpable participation in the securities violation.[31] Typically, plaintiffs must show that the control person: (1) “actually participated in . . . the operation of the corporation [or person] in general” and (2) “possessed the power to control the specific transaction or activity upon which the primary violation is predicated.”[32] The evidence between concrete participation and actual power to control is fact-intensive.[33]

Each Circuit emphasizes varying degrees of value to either an individual actually exerting control over the firm’s activities versus an individual merely holding the ability to control the firm’s activities. The First Circuit, Seventh Circuit, Eighth Circuit, and Tenth Circuit apply a two-prong potential control test where the control person actually exercises their control, rejecting a “culpable participation” requirement.[34] Notably, the Seventh Circuit more narrowly construes the actual exertion control of an individual over the primary violator.[35] The Fifth, Ninth, and Eleventh Circuits require merely an ability to exercise power, rather than a showing of actual execution of such control.[36]

A depiction of how control is differentiated between officers is demonstrated in the well-known Eighth Circuit case, *Lustgraaf v. Behrens*.[37] The plaintiffs brought Section 20(a) claims against the registered representative for Sunset Financial Services, Inc. (Sunset) and the general

[31] *See, e.g.*, Metge, *supra* note 28, at 630-31; Harrison, *supra* note 28 at 881; Lustgraaf, *supra* note 28 at 877; Abbott, *supra* note 28 at 619-20; Howard, *supra* note 28 at 1065.
[32] Metge, 762 F.2d at 631 (quoting Metge v. Baehler, 577 F. Supp. 810, 817-818 (S.D. Iowa 1984). Additional examples of the potential control test variation across the other circuits is demonstrated in the following. *See e.g.,* G.A. Thompson v. Partridge, 636 F.2d 945, 959-960 (5th Cir. 1981); Christoffel v. E. F. Hutton & Co., 588 F.2d 665, 668 (9th Cir. 1978); Brown v. Enstar Group, Inc., 84 F.3d 393, 396 (11th Cir. 1996).
[33] *See e.g.,* Lustgraaf, 619 F.3d at 884-86; *see also,* Melhus, *Control Person Liability*, *supra* note 15 at 935-37 (emphasizing how the facts of Lustgraaf illustrate the “difficulty [of courts] in defining control”).
[34] Aldridge v. A.T. Cross Corp., 284 F.3d 72, 85 (1st Cir. 2002) ("To meet the control element, the alleged controlling person must not only have the general power to control the company, but must also actually exercise control over the company."); *Metge*, 762 F.2d at 630-31; *Harrison*, 974 F.2d at 880; Maher v. Durango Metals, Inc., 144 F.3d 1302, 1305 (10th Cir. 2000); *see also* Lustgraaf, 619 F.3d at 877.
[35] Harrison, 974 F.2d at 881.
[36] *See* Abbott, 2 F.3d at 619-20; Howard, 228 F.3d at 1065; Brown, 84 F.3d at 396.
[37] Lustgraaf, 619 F.3d at 871.

agent for Sunset's parent company, Kansas City Life (KCL), for operating a ponzi scheme.[38] The Eighth Circuit applied the potential control test and found Sunset, but not KCL, liable as a control person.[39] The court reasoned that Sunset's representative both possessed the power, and actually exercised control over the corporation's activities.[40] The Sunset representative exercised control through his access and exchanges with the markets, which the court determined formed a duty to monitor his activities with respect to his actions as a registered representative.[41] The court then found that while the KCL representative had the ability to control, he did not actually exercise any control.[42] Overall, *Lustgraaf* distinguishes between possession of power and the actual exertion of power.[43]

On the other hand, the Second, Third, and Fourth Circuits use the "culpable participant" test, whereby plaintiffs must show that the alleged violator was a culpable participant in the explicit fraud.[44] Specifically in the Second Circuit, the culpable participation test was established in *SEC v. First Jersey Securities, Inc.*, where the court found that to establish a prima facie case under Section 20(a), a plaintiff must show a primary violation and that the controlling person was "in some meaningful sense [a] culpable participant in the fraud perpetrated by [the] controlled person."[45] Once a plaintiff makes out a prima facie case, the court details that "the burden shifts to the defendant to show that he acted in good faith" by not directly or indirectly inducing the acts in violation of securities laws.[46]

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[38] *Id.* at 871.
[39] *Id*. at 882.
[40] *Id*. at 876-77.
[41] *Id.* at 876.
[42] Lustgraaf, 619 F.3d at 877-78.
[43] *Id*.
[44] *See, e.g.*, SEC v. First Jersey, 101 F.3d. at 1450; Rochez Brothers v. Rhoades, 527 F.2d 880, 889-90 (3d Cir. 1975) (rejecting potential control test by requiring plaintiff prove the controlling person's "culpable participation"); Carpenter v. Harris, Upham & Co., Inc., 594 F.2d 388, 394 (4th Cir. 1979).
[45] SEC v. First Jersey, 101 F.3d at 1450 (quoting Gordon v. Burr, 506 F.2d 1080, 1085 (2d Cir. 1974)).
[46] *Id.* at 1473.

Courts engage in fact-specific inquiries to determine the actions of a firm or individual that may constitute fraudulent control of the market .[47] The circuits are split on the pleading standards for Section 20(a) claims, and courts following the potential control test often only require notice pleading.[48] In contrast, courts following the culpable participant test often require pleading with particularity, though this becomes murky within the Second Circuit.[49] The divergence in rulings is founded on contrasting interpretations of what sort of control is required to constitute a "control person."[50] The following section will delve into how such discrepancies in pleading standards have created inconsistent rulings, specifically across the Second Circuit.

II. The Second Circuit Split

Under the Second Circuit, the manner of control required to constitute a 20(a) violation is undefined.[51] Although the minority of circuits, including the Second Circuit, have required a

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[47] When analyzing Section 10b-5 or Section 20(a) claims, courts view whether a firm is a competitive participant in the market or fraudulently exert control so that it dominates the market. For instance, the Second Circuit held in SEC v. First Jersey that the defendant "dominated and controlled the markets in the six securities at issue" due the findings of First Jersey's behavior of control, such as evidence that First Jersey acted as "the sole underwriter of the initial units of [those securities at issue], the majority of which were sold by the Firm to its own customers." SEC v. First Jersey, 101 F.3d. at 1470-71.

[48] *See, e.g.,* Lustgraaf, 619 F.3d at 877 (describing differences between corporate officer's level of control); *see also In re* EZCorp, Inc. Sec. Litig., 181 F. Supp. 3d 197, 212 (S.D.N.Y. 2016) ("The majority of courts require pleading facts that support an individualized inference of the control person's scienter.").

[49] "[A]llegations of control are not averments of fraud and therefore need not be pleaded with particularity." *In re* Parmalat Sec. Litig., 414 F.Supp. 2d 428, 440 (S.D.N.Y. 2006).

[50] Note that in *Janus Capital Group v. First Derivative*, distinct corporate structures are not liable for securities fraud if it is not the "maker" of a statement. Janus Capital Group v. First Derivative, 564 U.S. 135, 141, 145 (2011) (The maker of a statement is (1) the entity with authority over the content of the statement and (2) control over whether and how to communicate it). As discussed in Part III, SPACs are not considered distinct corporate structures, but rather an acquired company that results in a business combination. *What You Need to Know About SPACs – Updated Investor Bulletin*, SEC (May 25, 2021), https://www.sec.gov/oiea/investor-alerts-and-bulletins/what-you-need-know-about-spacs-investor-bulletin.
https://www.investor.gov/introduction-investing/general-resources/news-alerts/alerts-bulletins/investor-bulletins/what-you

[51] "The Second Circuit has repeatedly stated that 'culpable participation' is the third element of a prima facie control liability case . . . But it has yet to explicitly define the meaning of the term." Boston Ret. Sys. v. Alexion Pharms., Inc., 556 F. Supp. 3d 100, 144 (D. Conn. 2021) (quoting In re EZCorp, Inc. Sec. Litigs., 181 F. Supp. 3d 197, 212 (S.D.N.Y. 2016)).

controlling person be a "culpable participant," the theory behind control is further disputed.[52] Some district courts within the Second Circuit interpret the culpable participation test to signify the pleading standard the same as Section 10(b) scienter.[53] Thus, the inconsistencies within the Second Circuit regarding the definition of "culpable participation" raise two problems: first, which definition of "culpable participant" constitutes an adequate finding of control, and second, whether the Second Circuit should adopt the majority viewpoint and rid the "culpable participation" test altogether.[54]

As per the first inquiry, the culpable participant test is foundationally set out in the Second Circuit by *SEC v. First Jersey*, where the culpable participant prong is required to enforce Section 20(a) liability.[55] Here, the defendant firm, First Jersey, and the firm's president sought review of a decision by the Southern District Court of New York that held them liable for violations in the sale, repurchase, and resale of securities.[56] Facing a Section 20(a) violation by the district court's decision, the firm's president failed to satisfy his burden to show in good faith a "reasonable proper system of supervision and internal control" on appeal.[57] The Second Circuit

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[52] *Id*.

[53] "On one end of the spectrum, most courts have equated it with the scienter requirement of §10(b) claims, requiring a showing of recklessness, conscious misbehavior or either of the two…These district courts generally—but not universally—hold plaintiffs to the heightened pleading requirements of the PSLRA…On the other end of the spectrum are a few courts holding that a plaintiff need only allege a defendant "knew or should have known" about the fraud." Lustgraaf, 619 F.3d at 87 (referencing *In re* Blech Secs. Litig., No. 94 Civ. 7696, 2002 WL 31356498 at *21 (SDNY Oct. 17, 2002); *In re* Marsh & McLennan Cos. Sec. Litig., 501 F. Supp. 2d 452, 458 (S.D.N.Y. 2006) (noting that the pleading required for culpable participation "has been the subject of great debate in this District," and holding that "plaintiffs must, at a minimum, plead recklessness in the same sense required by Section 10(b)").

[54] "Culpable participation fails to distinguish between the separate issues of liability and control." Laura Greco, *The Buck Stops Where? Defining Control Person Liability,* 73 S. CAL. L. REV. at 187.

[55] *Id.* at 61-62.While SEC v. First Jersey is often cited as the foundational case establishing the culpable participant test, the theory stems from *Lanza v. Drexel & Co.* where "it observed that the 'intent of Congress in adding this section, passed at the same time as the amendment to Section 15 of the 1933 Act, was obviously to impose liability only on those directors who fall within its definition of control and who are in some meaningful sense culpable participants in the fraud perpetrated by controlled persons." *Bos. Ret. Sys*., 556 F.Supp.3d at 143 (quoting Lanza v. Drexel & Co., 479 F.2d 1277, 1299 (2d Cir. 1973)).

[56] Resulting in defendants' gaining more than $ 27 million in illegal profits from their fraudulent scheme. SEC v. First Jersey, 101 F.3d. at 1455.

[57] *Id.* at 1473. Recall the shifting burdens as discussed in Part I, Part A.

concluded that the firm officer's conduct during First Jersey's illegal activities, including, but not limited to, the spread of misinformation through questionnaires and censorship of information to sales representative, established the corporate officer as a primary violator and "controlling person" under Section 20(a).[58]

Control, as defined in *SEC v. First Jersey*, suggests that a primary violator is established by showing that the defendant possessed "the power to direct or cause the direction of the management and policies of a person . . ." as demonstrated in Exchange Act Rule 12b-2.[59] However, the definition of control begs the question as to how such control makes an actor a "culpable participant."[60] While some culpable participation tests require a pleading standard containing "particularized facts of the controlling person's conscious misbehavior or recklessness," other Second Circuit decisions have determined that the pleading standard requires particularized facts surrounding the "…control person's actions, [and] it does not necessarily follow that those particularized facts must also establish conscious misbehavior or recklessness on the part of that defendant."[61]

In short, some Second Circuit decisions continue to require scienter, or a showing of the controlling person's conscious misbehavior or recklessness, as an element of a culpable participant, while others choose to allow plaintiffs to produce a knowledge standard only when

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[58] SEC v. First Jersey, 101 F.3d at 1461.
[59] Such power can be "…through the ownership of voting securities, by contract, or otherwise." 17 C.F.R. § 240.12b-2 (2022); *see also* SEC v. First Jersey, 101 F.3d at 1473.
[60] "The Second Circuit has not defined what is meant by the requirement that a controlling entity be a culpable participant." *In re* Tronox, Inc., 2010 U.S. Dist. LEXIS 67664 *63 (S.D.N.Y.); other courts determined differing definitions of control, such as courts under the jurisdiction practicing the majority potential control test: Lustgraaf, 619 F.3d at 873 (defining control as "requir[ing] only some indirect means of discipline or influence short of actual direction").
[61] Bos.Ret. Sys*.*, 556 F. Supp. at 144; Boguslavsky v. Kaplan, 159 F.3d 715, 720 (2d Cir. 1998) (finding pleading with particularity a sufficient standard).

the defendant is attempting to show a good faith defense.[62] Imagine how the differing standards would affect the judicial outcome of *SEC v. First Jersey* between a showing of the firm officer's scienter of misbehavior or recklessness in engaging in securities violations, versus a showing of conduct demonstrating the corporate officer's control.[63] The difference in culpable participation standards for Section 20(a) claims thus have the potential to produce differing results of a corporate director's liability for the same actions.

The Second Circuit debate about Section 20(a) pleading standards is further illustrated in *Boston Ret. Sys. v. Alexion Pharms., Inc.*, where a Chief Financial Officer (CFO) of a pharmaceutical corporation was deemed a culpable participant in violation of Section 20(a).[64] The court established in *Boston* that the CFO was a culpable participant despite not meeting the scienter requirements of misbehavior or recklessness.[65] The plaintiffs pled facts that supported the inference that the corporate officer knew of illegal operations and unethical business practices through evidence of suspicious behavior.[66] Here, the CFO's conduct included his timely resignation after an audit committee investigation and his certifications on the corporation's annual SEC filings, such as Form 10-K and Form 10-Q, that falsified the corporation's growth to increased demand rather than their fraudulent practices.[67] The court

[62] *See In re* Tronox, at *63-64 ("although the meaning of 'culpable participation' is unclear, there is strong reason to believe that it is not the same as scienter…"); *but see Special Situations Fund*, 33 F. Supp.3d at 430 (quoting *Boguslavsky*, 159 F.3d at 720) ("this Court finds more persuasive the line of cases holding that "culpable participation" is an element of a Section 20(a) claim that must be pleaded with the same particularity as scienter. Because Section 20(a) liability requires an "individualized determination ... of the defendant [control person's] particular culpability," it stands to reason that an allegation of "culpable participation" requires "particularized facts of the controlling person's conscious misbehavior or recklessness").
[63] SEC v. First Jersey, 101 F.3d. at 1456.
[64] Bos. Ret. Sys., 556 F. Supp. at 98-99.
[65] "While the Plaintiffs have not stated with particularity facts giving rise to a strong inference that [CFO] Sinha acted with scienter, they have stated with particularity facts that support a conclusion that Sinha was, in some meaningful sense, a culpable participant in a fraud perpetrated by Alexion." *Id.* at 99.
[66] *Id.*
[67] *Id.* at 98.

reasoned that a CFO in his position would not have verified the accuracy of such forms without the requisite knowledge of unethical activities.[68]

Thus, while the court noted that the facts pled were insufficient to successfully demonstrate scienter of a culpable participant, the facts did demonstrate actions that would create an inference of a "culpable" participant due to the particularized facts of the CFO's actions.[69] The CFO's conduct signified that he was "aware of the general nature" of the corporation's illegal operations; thereby, the court followed that a pleading standard did not have to prove the "conscious misbehavior or recklessness" to hold the CFO liable.[70] Notably, as demonstrated previously with the *SEC v. First Jersey* case, the CFO's liability may have differed if the pleading requirements did require scienter, or evidence of his "conscious misbehavior or recklessness" actions.[71]

The power of a differing pleading standard can determine the whole dismissal of a Section 20(a) claim as demonstrated in the Southern District of New York case *Lapin v. Goldman Sachs*.[72] Here, the shareholder alleged that the securities firm and its subsidiary, along with the firm's CEO violated Section 10(b) and Section 20(a) when they misrepresented the firm's research and failed to disclose analysts' conflicts of interest with the investment banking clients.[73] While the control person claims under Section 20(a) asserted against the CEO are

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[68] *Id.* at 98-99.
[69] Bos. Ret. Sys., 566 F. Supp. at 96-97.
[70] *Id.* at 96-99 ("While the Plaintiffs have not stated with particularity facts giving rise to a strong inference that [the CFO] acted with scienter, they have stated with particularity facts that support a conclusion that [CFO] was, in some meaningful sense, a culpable participant in a fraud perpetrated by [the company].").
[71] *Id.*; SEC v. First Jersey, 101 F.3d. at 1456.
[72] Because Section 20(a) liability requires an "individualized determination ... of the defendant [controller's] particular culpability," it stands to reason that an allegation of 'culpable participation' requires "particularized facts of the controlling person's conscious misbehavior or recklessness." Lapin v. Goldman Sachs, 506 F.Supp.2d 221, 245-46 (S.D.N.Y. 2006).
[73] *Id.* at 228.

premised on a primary violation of Section 10(b) by Goldman, the court discussed the nuances between requiring a showing of conscious misbehavior scienter versus a general knowledge through conduct pleading standard.[74] Decidedly, the court found that the culpable participation test required a plaintiff to plead with the same heightened particularity as scienter under Section 10(b) by alleging particularized facts of the controlling person's conscious misbehavior or recklessness.[75] As a result of the plaintiff failing to allege scienter in connection with the CEO's conduct, the court approved the motion to dismiss the Section 20(a) claim.[76] Therefore, the evidence of the CEO's statements, speech and conduct in connection with primary violations of the firm's misrepresentations was insufficient to analyze the Section 20(a) claim.[77] Notably, the Section 20(a) claim may have survived under the standard set forth by other courts that analyze the particularized facts of the CEO's actions of violative conduct to determine culpable participation instead.[78]

As per the second inquiry, district courts in the Second Circuit have debated adopting the majority's potential control test in lieu of the culpable participant test, while others have proposed formally adopting the culpable participant prong as a formal element of a Section 20(a)

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[74] *Id.* at 245-46.

[75] The court here decided to implement a pleading standard with a scienter requirement, rather than allow for an inference of control of knowledge through conduct because "[t]he Court believe[ed] this conclusion [was] most consistent with the decisions of the Second Circuit and the PSLRA." *Id.* ("Since culpable participation is an element, the PSLRA's heightened pleading requirements apply, and plaintiffs must plead with particularity facts giving rise to a strong inference that the controlling person knew or should have known that the primary violator, over whom that person had control, was engaging in fraudulent conduct") Burstyn v. Worldwide Xceed Grp., Inc., 2002 WL 31191741, at *8 (S.D.N.Y. Sep. 30, 2002).

[76] Despite the successful motion to dismiss, the plaintiff was "given an opportunity to seek leave to amend the Complaint to add…any allegations that the [CEO] was a 'culpable participant' in the primary violation." *Lapin*, 506 F. Supp.2d at 249.

[77] *Id.* at 246.

[78] *Id.*; *compare Boston Ret. Sys. v. Alexion Pharms., Inc., 556 F. Supp.* at 143-45 (holding the CFO as a culpable participant in securities fraud though the plaintiffs stated facts of the CFO's general awareness and actions of illegal behavior, and did not state facts that the CFO acted with scienter).

claim.[79] A powerful argument against the culpable participant test, specifically the type requiring scienter, is that the test does not align with the good faith defense built into the statute.[80] Through this perspective, if a defendant is deemed "culpable" due to her knowledge of an illegal practice prohibited by the securities laws, then the good faith defense would be fruitless as an option because she would already be in violation of securities fraud by a sort of strict liability standard.[81]

The argument remains the same against courts using a heightened pleading standard of scienter with the culpable participant test. The court in *Lapin* used a culpable participant test requiring scienter due in part by the Private Securities Litigation Reform Act of 1995 (PSLRA), which was created to limit frivolous securities lawsuits by implementing, among other changes, a more heightened pleading standard.[82] Some argue that courts should apply the PSLRA heightened pleading standard to the primary violation only.[83] However, like the argument against the usage of the culpable participant test altogether, the scienter requirement negates the language of Section 20(a).[84] The implementation of the PSLRA heightened standard conflicts with the need to avoid a trend towards a strict liability standard.[85]

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[79] "Since the Second Circuit's *First Jersey* decision, district courts within the circuit "disagree on the question of whether Section 20(a) plaintiffs must also allege 'culpable participation' as a third element of their claim…"" Hoehl Family Found. v. Roberts, 2020 WL 10790035 at *92 (quoting *Special Situations Fund*, 33 F. Supp.3d at 437.

[80] *See* Carpenter, 594 F.2d at 394 (finding good faith standard requires more than negligence where defendant could be held liable for reckless behavior that led to a fraudulent practice prohibited by the securities laws); Erin L. Massey, *Control Person Liability Under Section 20(A): Striking a Balance of Interests for Plaintiffs and Defendants*, 6 HOUS. BUS. & TAX. L.J. 109, 113 (2005) (arguing the only successful balancing of interests in 20(a) liability centers on the good faith defense under Section 20(a), not by negating such defense through the culpable participant test).

[81] *See* Carpenter, 594 F.2d at 394.

[82] *See* Lapin, 506 F.Supp.2d. at 247-49; *See generally* Private Securities Litigation Reform Act of 1995, Pub. L. No. 104–67, 109 Stat. 737.

[83] *See generally* Melhus, *Control Person Liability*, *supra* note 15, at 947.

[84] "The statute plainly imposes liability on a controlling person for any primary violation, unless the controlling person acted in good faith and did not induce the action." Lapin, 506 F. Supp.2d, at 248.

[85] *Id*.

Above the two questions addressing the combatting interpretations of standards, both point to the same goal: uniformity. The inconsistent pleading standards within one circuit has the potential to create liability for some persons, and not for others in alleged control person violations, solely on the preferred standard of a court. Specifically in the rise of SPAC litigation cases, an adoption of the majority potential control test would be most consistent with the language and congressional intention of Section 20(a) for SPAC litigation; however, a pleading standard without the scienter requirement under a culpable participant test would also provide similar consistency to the majority test as reflected in the comparison between *SEC v. Jersey*, *Boston Ret. Sys. v. Alexion Pharms., Inc*., and *Lapin v. Goldman Sachs.*[86]

III. The Rise of SPACs

The U.S. securities markets have faced an unprecedented surge in the use and popularity of SPACs within the past two years. In 2020, approximately 200 SPACs went public, "raising about $64 billion in total funding, nearly as much as all of last year's IPOs combined."[87] Some prominent SPACs in the course of the unprecedented surge include WeWork, Virgin Galactic, Nikola Motor Company, DraftKings, and Opendoor.[88] In 2021, "330 SPACs have raised nearly $105 billion, according to SPAC Research[,]. . .[a massive] jump from prior years [where] in 2020, 248 SPACs raised more than $83 billion and in 2019, 59 SPACS raised more than $13

[86] *See* SEC v. First Jersey, 101 F.3d. at 1450; Boston Ret. Sys. v. Alexion Pharms., Inc., 556 F. Supp. 3d at 100; Lapin v. Goldman Sachs, 506 F.Supp.2d at 221.

[87] Tom Huddleston Jr., *What is a SPAC? Explaining one of Wall Street's Hottest Trends*, CNBC (Feb. 23, 2021, 11:13 PM), https://www.cnbc.com/2021/01/30/what-is-a-spac.html.

[88] SPAC discussions have spanned across all industries. For instance, "Bill Gates-backed portable ultrasound start-up Butterfly Network (valuing the company at $1.5 billion) and DNA-testing startup 23andMe is reportedly in talks to go public through a $4 billion deal. There is also buzz that digital media companies like BuzzFeed, Vice Media, Bustle Media Group and others could use SPACs to finally bring in money for their investors." *Id*.

billion."[89] Such frenzy with the ups and downs of SPAC shares leads to "riskier deals."[90]

SPACs, also known as "blank check companies" or "shell corporations," are companies that are listed on stock exchanges with the special purpose of acquiring a private corporation, thus becoming public without maneuvering through the regulatory oversight of an initial public offering (IPO).[91] Typically, once a corporation seeks to publicly raise capital through the IPO process, the corporation must abide by SEC reporting requirements to list its securities on an exchange market.[92] Conversely, a SPAC is sponsored by a team of institutional investors and has a specified period of time to merge with a private operating corporation.[93]

The merger process in becoming public through a SPAC is described by the SEC as a "business combination" that have unique risks apart from other public offerings.[94] SPACs generally have two years to search for a private company with which to merge or acquire, bringing it public in the process as it becomes part of the publicly-traded SPAC.[95] For instance, a

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[89] Carmen Reinicke, *A SPAC frenzy earlier this year could lead to riskier deals*, CNBC (June 2, 2021, 3:25 PM), https://www.cnbc.com/2021/06/02/a-spac-frenzy-this-year-could-lead-to-riskier-deals-heres-why.html.
[90] *Id.*
[91] *Id.*; GlobalData Healthcare, *Return of the SPAC?*, PHARM. TECH. (May 25, 2022), https://www.pharmaceutical-technology.com/comment/spac-blank-check-companies/#:~:text=A%20SPAC%20is%20a%20shell,through%20the%20stringent%20IPO%20process.
[92] *See Celebrity Involvement with SPACs – Investor Alert*, SEC (March 10, 2021), https://www.sec.gov/oiea/investor-alerts-and-bulletins/celebrity-involvement-spacs-investor-alert. ("SPAC transactions differ from traditional IPOs and have distinct risks associated with them. For example, sponsors may have conflicts of interest so their economic interests in the SPAC may differ from shareholders. Investors should carefully consider these risks. In addition, while SPACs often are structured similarly, each SPAC may have its own unique features, and it is important for investors to understand the specific features of any SPAC under consideration.")
[93] *What You Need to Know About SPACs – Updated Investor Bulletin*, SEC (May 25, 2021), https://www.sec.gov/oiea/investor-alerts-and-bulletins/what-you-need-know-about-spacs-investor-bulletin.
[94] "Once the SPAC has identified an initial business combination opportunity, its management negotiates with the operating company and, if approved by SPAC shareholders (if a shareholder vote is required), executes the business combination. This transaction is often structured as a reverse merger in which the operating company merges with and into the SPAC or a subsidiary of the SPAC. While there are various ways to structure the initial business combination, the combined company following the transaction is a publicly traded company and carries on the target operating company's business." *Id.*
[95] *Id.*

SPAC does not manufacture or commercially sell any product.[96] Instead, the capital raised is typically vested in a trust account for a SPAC's management to use upon a private company's successful acquisition of a public company.[97] Notably, a SPAC's management team is under pressure to find a deal within a deadline to follow through an acquisition or else the capital raised is liquidated.[98] Then, SPAC's investors can exchange their shares to that of the merged company or convert their shares to their original investment.[99] In short, SPACs are alternative means in which a corporation can be public.[100]

One reason behind the sudden rise behind SPACs has been the increase in high-net-worth individuals and celebrities becoming SPAC sponsors or investors.[101] Although a recognizable face may provide a great marketing strategy for SPAC investments, not all celebrity-backed SPACs automatically result in success.[102] For instance, in 2021, only "21 out of 33 SPACs tied to famous public figures ha[d] posted negative returns."[103] Due to the heightened popularity among high-profile figures, the SEC attempted to warn investors in March 2021 about celebrity-

[96] "In fact, the SPAC's only assets are typically the money raised in its own IPO, according to the SEC." "That's because when a SPAC raises money, the people buying into the IPO do not know what the eventual acquisition target company will be. Institutional investors with track records of success can more easily convince people to invest in the unknown. That's also why a SPAC is also often called a "blank check company." Huddleston Jr., *supra* note 81.
[97] *Id.*
[98] *Id.*
[99] "The SPAC sponsors typically get about a 20% stake in the final, merged company." *Id.*
[100] *What You Need to Know About SPACs – Updated Investor Bulletin*, SEC (May 25, 2021) https://www.investor.gov/introduction-investing/general-resources/news-alerts/alerts-bulletins/investor-bulletins/what-you.
[101] Some examples of high-profile individuals and celebrities include CEOs like Richard Branson; billionaire and television personality, Tillman Ferttita; multiple Grammy award winner, Jay-Z; and former NBA champion, Shaquille O'Neal. Bailey Lipschultz. *Celebrity SPACs Leave Famous Winners Looking More Like Losers*, BLOOMBERG (Dec. 16, 2021) https://www.bloomberg.com/news/articles/2021-12-16/celebrity-spacs-leave-famous-winners-looking-more-like-losers; s*ee also* Huddleston Jr., *supra* note 81.
[102] Lipschultz, *supra* note 95; Note that another reason behind the unprecedented surge in SPACs has become due to the market volatility caused by the global pandemic. Huddleston Jr., *supra* note 81.
[103] Lipschultz, *supra* note 95.

backed SPACs due to the specific risks associated with such investments.[104]

The increase in SPAC mergers has coincided with a rise in litigation specifically, within the New York state courts.[105] The complex structure of SPACs, together with its lack of clarity regarding the governing oversight by the U.S. Securities Exchange Commission, has created concerns as to how effectively SPACs are regulated to prevent securities fraud.[106] Thus, an unprecedented surge, coupled with the unclear regulatory standard of SPACs, led to a widespread question as to the legality of blank check companies.[107] As investors blindly invest in SPAC mergers without knowing the company to be acquired, transparency concerns have persisted regarding a SPACs' parameters.[108] In response, legislative efforts have reflected the need for regulatory bodies to implement supervisory mechanisms tailored around SPAC activities. [109] On November 9, 2021, two pieces of legislation aimed were introduced in Congress

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[104] *Id.*; *See Celebrity Involvement with SPACs – Investor Alert*, SEC (March 10, 2021) https://www.sec.gov/oiea/investor-alerts-and-bulletins/celebrity-involvement-spacs-investor-alert. ("It is never a good idea to invest in a SPAC just because someone famous sponsors or invests in it or says it is a good investment… Celebrities, like anyone else, can be lured into participating in a risky investment or may be better able to sustain the risk of loss").

[105] *See* Alice Hsu et al., *Recent SPAC Shareholder Suits in New York State Courts: The Beginning Wave of SPAC Litigation*, LEXISNEXIS, Practical Guidance, https://www.akingump.com/a/web/grN5LsBcpMNeqqe9FEhk4K/2K8JQZ/recent-spac-shareholder-suits-in-new-york-state-courts_the-beginning-wave-of-spac-litigation_all-authors.pdf ("Between September 2020 and March 2021, at least 35 SPACs have been hit with one or more shareholder lawsuits filed in New York state court"); *see also*, John Coates, *SPACs, IPOs and Liability Risk under the Securities Law*, SEC (April 8, 2021) https://www.sec.gov/news/public-statement/spacs-ipos-liability-risk-under-securities-laws.

[106] The unprecedented surge has brought problems to the forefront of SPAC creation and implementation. *See* John Coates, *SPACs, IPOs and Liability Risk under the Securities Law*, SEC (April 8, 2021) https://www.sec.gov/news/public-statement/spacs-ipos-liability-risk-under-securities-laws ("Concerns include risks from fees, conflicts, and sponsor compensation, from celebrity sponsorship and the potential for retail participation drawn by baseless hype, and the sheer amount of capital pouring into the SPACs, each of which is designed to hunt for a private target to take public").

[107] Andrew Ross Sorkin et al., *A SPAC Counterattack*, NY TIMES (Aug. 30, 2021) https://www.nytimes.com/2021/08/30/business/dealbook/spac-lawsuits.html.

[108] Huddleston Jr., *supra* note 81. ("[…] Former Goldman Sachs CEO Lloyd Blankfein told CNBC recently that the due diligence of the SPAC process is not as rigorous as a traditional IPO. Blankfein also said that SPAC sponsors, who are mostly tasked with finding a workable acquisition within two years and not necessarily the best possible deal, are not incentivized to avoid having the SPAC overpay for the target company").

[109] In addition to Congressional bills, other mediums of addressing additional SPAC regulation have been advocated by politicians. *See SPAC Litigation Outlook: 2021 Trends Lead to 2022 Predictions,* JD SUPRA (Jan. 21, 2022) https://www.jdsupra.com/legalnews/spac-litigation-outlook-2021-trends-9937504/ ("Senator Elizabeth Warren, for

in attempts to promulgate transparency procedures for SPACs: the first, H.R. 5910, the "Holding SPACs Accountable Act of 2021," and the second, H.R. 5913, the "Protecting Investors from Excessive SPACs Fees Act of 2021."[110]

Other concerns include the theory of a *SPAC bubble* that such "proliferation has led analysts to caution that the SPAC market is oversaturated, with hundreds of SPACs searching for target companies at the same time …, [leading] some to suggest that an end to the *SPAC bubble* is imminent."[111] In August 2021, two professors issued a series of lawsuits arguing that SPACs operated principally as investment funds, rather than an alternative method of raising capital publicly.[112] More than 60 law firms replied to the complaints, criticizing the legal merits of the lawsuits.[113]

In March 2022, the SEC responded to concerns of insufficient shareholder protections by issuing a number of amendments to promote transparency of SPAC mergers.[114] The SEC has

example, called on the SEC in November 2021 to investigate the DWAC TMTG deal for possible securities violations. Warren and several other senators also sent letters in September 2021 to six SPAC creators outlining their concerns about potential misaligned incentives between SPACs' creators and investors").

[110] *SPACs Face Legislative Scrutiny: House Financial Services Committee Advances Two SPAC-Related Bills*, JD SUPRA (Nov. 29, 2021) https://www.jdsupra.com/legalnews/spacs-face-legislative-scrutiny-house-7208832 ("110 H.R. 5910 proposes to amend the securities laws to exclude all SPACs from the safe harbor for forward-looking statements (the "Safe Harbor")… H.R. 5913 proposes to amend the Investment Advisers Act of 1940 (the "'40 Act") and the Exchange Act, to prevent investment advisers, as defined by the '40 Act, and brokers and registered representatives of brokers, as defined by Exchange Act, from recommending SPAC securities to a non-accredited investor unless the SPAC's promote or other economic compensation is less than 5% or the SPAC makes certain disclosures mandated by the Securities and Exchange Commission").

[111] Attorneys at Quinn Emanuel Urquhart & Sullivan, LLP, *SPAC Litigation Risks – What Happens if the SPAC Bubble Bursts*, JD SUPRA (March 26, 2021) https://www.jdsupra.com/legalnews/spac-litigation-risks-what-happens-if-3188363/.

[112] *Id. See also*, Memorandum of Law in Opposition to Defendants' Motion to Dismiss, George Assad v. GO Acquisition Founder LLC, Case No. 1:21-cv-07076 (2021 S.D.N.Y.) https://fingfx.thomsonreuters.com/gfx/legaldocs/znvnezwykpl/frankel-spac40Act--goMTDopposition.pdf.

[113] *Over 60 of the Nation's Leading Law Firms Respond to Investment Company Act Lawsuits Targeting the SPAC Industry*, ROPES & GRAY (Aug. 27, 2021), https://www.ropesgray.com/en/newsroom/alerts/2021/August/49-of-the-Nations-Leading-Law-Firms-Respond-to-Investment-Company-Act-Lawsuits.

[114] Special Purpose Acquisition Companies, Shell Companies, and Projections*, Securities Act Release Nos. 33-11048; 34-94546*, U.S. SEC. AND EXCH. COMM'N, https://www.sec.gov/rules/proposed/2022/33-11048.pdf; *see also*

issued *Proposed Subpart 1600 to Regulation S-K,* which includes heightened disclosure requirements to SPACs in connection with "the sponsor, potential conflicts of interest and dilution, and [it] requires certain disclosures on the prospectus cover page and in the prospectus summary."[115] Moreover, the proposed rules require the same level of greater disclosure for de-SPAC transactions, including a "fairness determination requirement" and clearer "financial projections" in such transactions.[116] While the SEC has addressed these concerns with proposals, they serve as a testament to the tensions surrounding the rise of SPACs. Such unprecedented terms have perpetuated debate not only about the structure of the SPAC process themselves, but also about regulatory oversight overall.

A. SPAC Litigation Facing the Second Circuit Split

Beyond the functional inquiries surrounding SPACs, inconsistencies in Section 20(a), pleading requirements, and competing tests within the Second Circuit have the ability to produce differing liability results of control persons when applied to cases of SPAC litigation.[117] Common allegations under Section 20(a) arise when SPAC shareholders sue for fraud in business combination statement or proxy statements.[118] For instance, if shareholders believe a proxy statement contains inadequate disclosures for them to make an informed decision, they can

Breheny, et. al., *SEC Proposes Significant Changes to Rules Affecting SPAC*, SKADDEN (March 31, 2022), https://www.skadden.com/insights/publications/2022/03/sec-proposes-significant-changes-to-rules-affecting-spacs.
[115] Breheny, et. al., *SEC Proposes Significant Changes to Rules Affecting SPAC*, SKADDEN (March 31, 2022), https://www.skadden.com/insights/publications/2022/03/sec-proposes-significant-changes-to-rules-affecting-spacs.
[116] *Id.*
[117] GIBSON DUNN, "2022 Mid-Year Securities Litigation Update," (Sep. 20, 2021), https://www.gibsondunn.com/2022-mid-year-securities-litigation-update/.
[118] *Litigation Risk in the SPAC World*, QUINN EMMANUEL TRIAL LAWYERS (Sep. 30, 2020), https://www.quinnemanuel.com/the-firm/publications/litigation-risk-in-the-spac-world/. ("Shareholders disappointed by the post-SPAC company's performance may claim SPAC managers' statements or written proxy statements are misleading or fraudulent, and may challenge them under Section 14(a) of the Exchange Act, and under Sections 10(b) and 20).

challenge the statement.[119] Such Section 20(a) claims are arising in other circuits as well, which can further disrupt uniformity in the interpretation of control person liability in SPAC-oriented cases, if the Second Circuit does not adjust its requirements.[120]

For example, in the Western District of Louisiana, investors in a post-SPAC company brought a suit alleging that the company and the SPAC had conspired to inflate financials for the local meal delivery app, to obscure the fact that it had no meaningful path to profitability.[121] The complaint asserted fraud in the proxy statement that accompanied the merger, with claims under, among other provisions, Section 20(a) for fraud in the securities registration statement against the investment bank that underwrote the stock offering, the company, the SPAC officers, and the directors who were responsible for issuance.[122]

Furthermore, allegations can affect the merged company itself and its officers and directors, such as in the Eastern District of New York within the Second Circuit.[123] In *Akazoo*, the managers from the target company and SPAC who took leadership roles post-merger contain Section 20(a) allegations against them for numerous false statements regarding the financial results, geographic reach, and number of subscribers to the company's services.[124] The

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[119] *Bruce A. Ericson, Ari M. Berman, Stephen B. Amdur, & Lee Brand, The SPAC Explosion: Beware the Litigation and Enforcement Risk*, PILLSBURY L., (Dec. 15, 2020), https://www.pillsburylaw.com/en/news-and-insights/spac-litigation-enforcement-risk.html.
[120] Priya Cherian Huskins, *As Predicted: More SPACs Are Leading to More Litigation,* WOODRUFF SAWYER (June 22, 2021), https://woodruffsawyer.com/do-notebook/more-spacs-leading-more-litigation/.
[121] Welch v. Meaux, No. CV 19-1260, 2020 WL 4758269, at *1 (W.D. La. Aug. 17, 2020).
[122] *Id.*
[123] *In re* Akazoo S.A. Securities Litigation, No. 20-cv-1900, Dkt. No. 15 (E.D.N.Y. 2020).
[124] "On September 8, 2020, an amended complaint was filed in a consolidated class action in the Eastern District of New York against Akazoo, S.A, the product of a merger between Akazoo Ltd. and a SPAC called Modern Media Acquisition Corp., along with several of its officers and directors.[32] The Complaint alleges liability under 14(a) (on behalf of SPAC shareholders eligible to vote on the merger), 10(b) and 20(a) (as to the control persons) (on behalf of other purchasers of Akazoo shares, including through the SPAC's PIPE offering agreement)… The complaint alleges numerous false statements regarding the financial results, geographic reach, and number of subscribers of Akazoo, an emerging markets music streaming service." *Id.*; *see also* Litigation Risk in the SPAC World, *supra* note 111.

Complaint alleged liability under, among other violations, 10(b) and 20(a) on behalf of a Director by claiming he "knew" about the non-public violative activities and actually exercised control over such activities.[125] In other words, ~~here,~~ the standard was knowledge as opposed to a heightened scienter requirement.[126] While the parties reached a settlement in April 2021, the *Akazoo* case signified an essential potential of SPAC-related transactions being litigated and how complaints must cater to a specific form of control person liability standard.[127]

Despite the trend towards litigation, there are SPAC cases, like *Akazoo* that have not reached a court room due to a settlement, or to successful motions of dismissal across all Circuits. In *Bo Shen v. Exela Techs., Inc.,* a plaintiff alleged violations of Sections 10(b) and 20(a) of the Exchange Act against the company and its directors.[128] The court held that the plaintiff had failed to plead scienter because the plaintiff did not adequately allege that defendants "knew or recklessly did not know" that they were making false statements.[129] However, other cases have been unsuccessful in motions to dismiss, such as *In re QuantumScape Securities Class Action Litigation*, where the plaintiffs advanced claims under Sections 10(b) and 20(a) of the Exchange Act.[130] While the defendants argued that the plaintiffs failed to plead a

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[125] Complaint at 34, *In re* Akazoo S.A. Securities Litigation, No. 20-cv-1900, Dkt. No. 15 (E.D.N.Y. 2020), https://storage.courtlistener.com/recap/gov.uscourts.nyed.447480/gov.uscourts.nyed.447480.1.0.pdf.
[126] *Id.*
[127] Priya Cherian Huskins, *As Predicted: More SPACs Are Leading to More Litigation*, WOODRUFF SAWYER (June 22, 2021), https://woodruffsawyer.com/do-notebook/more-spacs-leading-more-litigation/ ("The parties agreed to mediate all the cases and reached a partial settlement (excluding the terminated CEO and the auditor) for $4.9 million. A much larger settlement, approximately $30 million, was paid to the PIPE investors.").
[128] Shen v. Exela Techs., Inc., et al., No. 3:20-cv-00691-D (N.D. Tex. Aug. 11, 2020); Andrew Hammond, "How to Manage the Risks SPAC Securities Fraud Actions in 2022," *White Case* (March 3, 2022), https://www.whitecase.com/publications/alert/how-manage-the-risks-spac-securities-fraud-actions-2022.
[129] Shen, *supra* note 120 at 25. Additionally, in *Jesus Mendoza v. HF Foods Grp. Inc,* the plaintiff alleged violations of Sections 10(b), 14(a) and 20(a) of the Exchange Act against the company, and officers of the post-de-SPAC company, based upon allegations of fraudulent short selling transactions. Defendants moved to dismiss and a court granted their motion without prejudice in August 2021. Jesus Mendoza v. HF Foods Grp. Inc., et al., No. 2:20-cv-02929-ODW-JPR (C.D. Cal. Dec. 4, 2020).
[130] *In re* QuantumScape Securities Class Action Litigation, No. 3:21-cv-00058-WHO (N.D. Cal. Jun. 21, 2021), ECF No. 131.; Hammond, *supra* note 120.

strong inference of scienter, the court concluded that the short seller reports themselves were reliable to admit into the pleading stage.[131] Notably, a short seller report occurs when a prominent short investor publishes reports on their next targets, and is thereby controversial as reliable evidence.[132] However, this Court acknowledges that a short seller report "may raise credibility issues for a factfinder," but that "the actual 'substance of the report' may be 'sufficient to survive a challenge at the pleadings stage,' where the reporting entity interviewed company 'employees' and 'experts' about its conclusions."[133] Thus, through this level of scienter the court is applying, the court allows the reports themselves into the pleading stage.

The types of lawsuits based on a SPAC procedure differs among litigation, which ultimately affects the type of court procedure a Section 20(a) claim will follow. Six type of lawsuits are the most popular among SPAC litigation: merger objections, shareholder voting, breach of fiduciary duty, investment company, shareholder derivative actions and securities class actions.[134] In the past year, the most common type was a merger objection lawsuit, affecting approximately 30% of SPACs that announced and completed their business combinations.[135]

[131] QuantumScape*, supra* note 122 at 9.
[132] "Short selling occurs when an investor borrows a security and sells it on the open market, planning to buy it back later for less money." Adam Hayes, *Short Selling: What Is Shorting Stocks with Pros, Cons, and Examples*, INVESTOPEDIA (March 1, 2022), https://www.investopedia.com/terms/s/shortselling.asp. "At first blush, litigation based on short seller reports would appear to hold little merit given the inherently self-interested nature of these disclosures. Indeed, courts have stated that short sellers 'operate by speculating that the price of a security will decrease' and that '[a]lthough short sellers can perform a useful function by bringing information that securities are overvalued to the market,' they also 'have an obvious motive to exaggerate the infirmities of the securities in which they speculate." Kennedys, *Short Seller Reports in SPAC Litigation*, JD SUPRA (Apr. 5, 2022), https://www.jdsupra.com/legalnews/short-seller-reports-in-spac-litigation-9839154/ (citing Long Miao v. Fanhua, Inc., 442 F. Supp. 3d 774, 801 (S.D.N.Y. 2020)).
[133] "Plaintiffs in SPAC cases often rely on short seller reports resulting in a stock drop…Securities plaintiffs continue to rely on these short-seller reports to substantiate their claims. For instance, a recent survey published on Law360.com concluded, among other things, that "[a]round 21%, or 27 of 131, of fraud-on-the-market securities class actions rely on short-seller research that affected the price of common stock of the defendant company when the negative information was disseminated to investors." Kennedys, *supra* note 124 (quoting *In re* Quantumscape, *supra* note 122).
[134] Yelena Dunaevsky & Teresa Milano, *SPAC Litigation Outlook:2021 Trends Lead to 2022 Predictions*, WOODRUFF SAWYER (Jan. 20, 2022), https://woodruffsawyer.com/spac-notebook/spac-litigation-2021-trends/.
[135] *Id.*

These lawsuits arise when the share price of the SPAC's shares drop before the merger or the combined company's shares drop after the merger.[136] Predictions set forth by Woodruff Sawyer, an insurance-based company following the SPAC litigation trends, anticipates a proliferation of securities class action cases, namely among SPACs in the specific industry of electric vehicle space.[137] While SPACs are most commonly attributed to technological spaces, it is essential to note that these forms of non-traditional IPOs can occur at any industry, meaning that such litigation can be attributed to various facets of everyday commercial life.

Another factor involving increased litigation includes marketing and diligence efforts by SPACs. For instance, the Securities and Exchange Commission (SEC) has issued statements about such unethical marketing and diligence efforts, in part due to the celebrity prevalence of such transactions.[138] On December 9, 2021, Chair Gary Gensler of the SEC, spoke about strengthening disclosure requirements for SPACs.[139] Moreover, in an April 2021 statement, John Coates of SEC's Division of Corporation Finance "surprisingly questioned SPACs' reliance on the Private Securities Litigation Reform Act (PSLRA) safe harbor for forward-looking statements."[140]

Such questionability surrounding the PSLRA may bring repercussions when deciding on how to look at the control liability standards.[141] The PSLRA provides a safe harbor under which

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[136] *Id.*
[137] *Id.*
[138] U.S. Securities & Exchange Commission, Statement, John Coates, "SPACs, IPOs and Liability Risk under the Securities Laws," (Apr. 8, 2021), https://www.sec.gov/news/public-statement/spacs-ipos-liability-risk-under-securities-laws.
[139] U.S. Securities & Exchange Commission, Statement, Chair Gary Gensler, "Statement on Proposal on Special Purpose Acquisition Companies (SPACs), Shell Companies, and Projections," (Apr. 8, 2021), https://www.sec.gov/news/statement/gensler-spac-20220330.
[140] *Id.*
[141] Carol Anne Huff, et al. *SEC Proposes Sweeping New Regulations of SPAC Transactions*, WINSTON & STRAWN, (Apr. 4, 2022), https://www.winston.com/en/capital-markets-and-securities-law-watch/sec-proposes-sweeping-new-regulations-of-spac-transactions.html.

"a company is protected from liability for forward-looking statements [such as projections] in any private right of action under the Securities Act or the Securities Exchange Act of 1934, when, among other things, the forward-looking statement is identified as such and is accompanied by meaningful cautionary statements."[142] The SEC's proposed rules in March 2022 also provides that the PSLRA's safe harbor for forward-looking statements is not an option for de-SPAC transactions.[143] Because such debate is occurring on the top regulatory fields surrounding securities law, it is no wonder that the adaptation of the control person liability test is continuously changing its definition.

IV. Conclusion

Section 20(a) of Securities Exchange Act of 1934 provides that a person, typically a corporate officer or director, who "controls" another person found liable for securities fraud, is jointly and severally liable, "unless the controlling person acted in good faith and did not directly or indirectly induce" the violation.[144] The circuits are split over the requirements to demonstrate control person liability under Section 20(a) of the Securities Exchange Act of 1934. In addition to a showing of primary liability under Rule 10b-5, plaintiffs must indicate how the alleged actor participated as a "control person." When analyzing Section 20(a) cases, circuit courts implement two differing tests: the majority's potential control test or the minority's culpable participant test.

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[142] The PLSRA does not apply to IPOs. *Id.*; *see also* SEC, Special Purpose Acquisition Companies, Shell Companies, and Projections, Release Nos. 33-11048; 34-94546, https://www.sec.gov/rules/proposed/2022/33-11048.pdf.

[143] Huff, et al., *supra* note 133.

[144] As discussed, Section 20(a) describes joint and several liability as well as the good faith defense of a "control" person. "Every person who, directly or indirectly, controls any person liable under any provision of this chapter or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable (including to the Commission in any action brought under paragraph (1) or (3) of section 78u(d) of this title), unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action." 15 U.S.C. § 78t(a) (1934).

District courts in the Second Circuit either require one of two pleading standards: (1) pleading facts that support an individualized inference of the control person's scienter, which is a heightened standard based from the PSLRA, or (2) pleading with particularized facts about the control person's actions. The Second Circuit's contradicting pleading standards have resulted in inconsistent liability standards. Notably, a minority of district courts in the Second Circuit that have stripped the 'culpable participation prong' entirely from the pleading standard have also broken the precedent of the Second Circuit.

The sudden rise of SPACs is namely a result of the increase in high-net-worth individuals and celebrities becoming SPAC sponsors or investors. The increase in SPAC mergers has coincided with a rise in litigation specifically, within the New York state courts. Due to the history and congressional intent of secondary liability demonstrates, coupled with novel, regulatory gaps, there remains a need for uniformity among control person liability tests. In part, such uniformity relies on the control definition for what makes an individual a "culpable participant" under a control person liability standard. On the other hand, such need also demonstrates the requirement of courts to follow to combat unique challenges that arise with SPAC litigation as well as the need to make courts' control person liability tests parallel to the language of Section 20(a), such as to continue to allow defendants a good faith defense.

Recall the introductory scenario with the music streaming corporation where one district court may find the fact that a corporate officer discussion of false financial profitability was proof of scienter, but another district court could determine that such fact was insufficient to determine a "controlling person's" conscious misbehavior to plead scienter. The competing standards of pleading within the Second Circuit and across others could determine a corporate

officer's liability regarding Section 20(a) across all industries utilizing a SPAC, not just a music company. If the inconsistent rulings persist, the judicial system will continue to write blank checks for control persons hidden behind SPACs.