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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.

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 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 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.

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.

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.

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 acontrolling person?.)

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