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SEC Brings Enforcement Action Against Space SPAC for Alleged Misleading Disclosure and Due Diligence Failures

July 22, 2021

The U.S. Securities and Exchange Commission ("**SEC**") has brought an enforcement action against a special purpose acquisition company ("**SPAC**") and its major participants, highlighting enhanced regulatory scrutiny of SPACs and underscoring the importance of following appropriate diligence and other practices in the de-SPAC process.

On July 13, 2021, the U.S. Securities and Exchange Commission announced that it had brought an enforcement action against Stable Road Acquisition Company ("**Stable Road**"), its sponsor, SRC-NI ("**SPAC Sponsor**"), its CEO Brian Kabot, Stable Road's proposed merger target, Momentus Inc., and Momentus' founder and former CEO Mikhail Kokorich for their involvement in a SPAC business combination. Stable Road is a SPAC that completed its initial public offering of 17,250,000 units at a price of $10.00 per unit, generating gross proceeds of $172.5 million, on November 13, 2019. Momentus, a Delaware corporation, is a privately-held space transportation company that plans to offer in-space infrastructure services. The two companies announced a business combination in October 2020 that would result in Momentus becoming a public company.

The SEC alleged that, ahead of a proposed business combination, (i) the respondents made materially misleading statements in their public disclosures surrounding (a) Momentus' technology and (b) national security risks associated with Kokorich; and that (ii) Stable Road and the SPAC Sponsor made misleading disclosures compounded by the SPAC Sponsor's insufficient due diligence. All parties except Kokorich settled with the SEC, with total penalties of over $8 million, the SPAC Sponsor's forfeiture of its founder shares, an undertaking to give PIPE investors the ability to terminate their subscription agreements prior to the shareholder vote to approve the merger, and tailored investor protection undertakings. The SEC has filed a complaint against Kokorich in federal court based on related conduct.

The SEC further alleged that Momentus and Kokorich repeatedly told public investors that they had "successfully tested" Momentus' key technology in space when, in fact, the test had failed to achieve its primary mission and did not even meet Momentus' own public and internal pre-launch criteria for success. In addition, the SEC claimed that Momentus and Kokorich made false claims regarding U.S. government concerns about national security and foreign ownership risks posed by Kokorich, a Russian citizen residing in Switzerland, and that they concealed doubts about Momentus' ability to secure essential governmental licenses.

Stable Road, the SPAC Sponsor and Kabot are accused of repeating these alleged material misrepresentations in their own public filings while also failing to review the in-space test and to follow up on red flags concerning the national security risks raised during their due diligence. SEC Chair Gary Gensler stated in his remarks that: "The fact that Momentus lied to Stable Road does not absolve Stable Road of its failure to undertake adequate due diligence."

The SEC's order asserts violations of antifraud provisions of the federal securities laws, including scienter-based charges against Momentus for fraud under the Securities Act and Exchange Act. It asserts negligence-based charges of fraud and violations of reporting and proxy solicitation provisions by the SPAC itself (Stable Road), and that Kabot and the SPAC Sponsor caused Stable Road's violation of the antifraud "scheme" liability provision (Section 17(a)(3) of the Securities Act). The complaint filed against Kokorich asserts that he violated the antifraud provisions with scienter, among other claims.

As noted above, this action is one of the first of an expected series of potential enforcement actions related to SPACs. Given the rapid growth in this sector over the past few years, the SEC's Enforcement Division has a working group focused on SPACs, and we expect more actions to come. Activity from the Enforcement Division follows staff guidance and remarks earlier this year on SPACs relating to the use of projections, accounting methodologies and celebrity involvement with SPACs. Future enforcement actions may focus on disclosures in public filings, including those relating to risks regarding conflicts of interest in SPAC transactions, with a general focus on protecting investors and in particular retail investors. With this in mind, we offer a few practice considerations:

- **Establish and Execute upon an Appropriate Diligence Process** – Parties to a SPAC business combination transaction should carefully consider and implement an appropriate and tailored diligence process. Though SPAC business combinations operate on a different timeline than traditional IPOs, parties should avoid shortcuts in the due diligence process to accommodate compressed timelines. The SEC's enforcement action shows that the SEC will scrutinize the due diligence process of private company targets by SPACs, their sponsors and other transaction participants.
- **Thoroughly Investigate Core Business and "Red Flag" Issues** – The SEC pointed to two alleged diligence failures in the Momentus action. Transaction parties are reminded to appropriately diligence core business and operational issues that inform the target company's prospects as well as "red flag" issues such as those that may arise in connection with management background investigations or company regulatory matters. Given previous SEC staff guidance on the topic, diligencing forward looking information, including a target's financial projections and the underlying assumptions, should be a high-priority item for all transaction participants.
- **Take Action to Address Areas of Concern** – In the recent enforcement action, the SEC notably took action even before the proxy statement / prospectus was finalized and sent to shareholders. SPACs and their sponsors should recognize that the SEC expects them to act on the findings that arise from the due diligence process. Not only must public disclosures be materially accurate, but SPACs and sponsors may need to consider other more significant actions based on their findings, which could include management or operational changes at the target company or walking away from the deal altogether.
- **Penalties Will Be Tailored to SPAC Transactions** – The remedies in the settlement of this action were tailored to the workings of a SPAC transaction. The

forfeiture of founder shares by the Sponsor and the ability of PIPE investors to terminate their subscription agreements were both substantive steps designed to address the SEC's analysis of realities of SPAC transactions, including the economic incentives of the various transaction participants. In addition, the requirement that the target company establish an independent board committee and engage an independent consultant to conduct a comprehensive ethics and compliance program assessment relating to disclosure practices underscore that the SEC will focus on whether the target company is prepared to become a public company.

We believe that, from the SEC's perspective, cases like this serve to force a better alignment of incentives of parties to a SPAC transaction with the interests of investors and improve public disclosures that investors rely on when making investment and voting decisions. From the perspective of SPAC transaction participants, this case serves as a forceful reminder to thoroughly conduct due diligence, take seriously the findings of the due diligence process, and consider the implications of such findings in light of required disclosures to investors and their investment decision making process.

Copies of the SEC's public announcement, order and complaint are available here:

SEC.gov | SEC Charges SPAC, Sponsor, Merger Target, and CEOs for Misleading Disclosures Ahead of Proposed Business Combination

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