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Stable Road Enforcement Action Post Mortem: Lessons for the SPAC Market After Momentus Begins Trading

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Stable Road And Momentus Close Business Combination. On August 11, Stable Road Acquisition Corp., a special purpose acquisition company (SPAC), announced that its shareholders had approved its business combination with Momentus, Inc., an aspiring provider of “space infrastructure”[i] services, a month after settling charges with the SEC that alleged false and misleading disclosures were made to investors during the lead up to the merger. The combined company's shares began trading on NASDAQ on August 13 under the “MNTS” ticker.

First SPAC Enforcement Action under Gary Gensler Focused on Diligence Failures. The landmark enforcement action, which was brought before the business combination was allowed to proceed to a vote, charged Stable Road, its sponsor, SRC-NI Holdings, LLC, Stable Road's CEO, Momentus and Momentus' former CEO with violating antifraud provisions of the federal securities laws.[ii] The charges focused on statements and claims made by Momentus and its former CEO to Stable Road regarding the commercial viability of its technology, statements and claims Stable Road repeated to investors, and Stable Road's allegedly inadequate due diligence efforts to confirm the veracity of such statements and claims.[iii] The SEC also found that Stable Road did not adequately or properly inform investors of several ongoing national security investigations concerning Momentus' former CEO, a Russian citizen, despite the potential of such investigations to prevent Momentus from securing key government licenses essential to its operations.[iv] Significantly, it was the SEC's view that, although Momentus had deliberately mislead Stable Road several times during the de-SPAC process, Stable Road's own diligence failures and inadequate vetting is what ultimately lead to fraudulent information being disseminated to investors, both in private presentations to Private Investment in Public Equity (PIPE) investors and to public shareholders through the filing of inaccurate registration statements and proxy solicitation materials. In other words, the SEC was going to hold the SPAC and sponsor teams accountable, even if the inaccurate or misleading disclosure did not originate with them.

Civil Penalties. The SEC assessed over $8 million in fines against Momentus, Stable Road and Stable Road's CEO (who had signed off on the public filings and investor presentations which contained the relevant disclosure).[v] Momentus' former CEO has reportedly fled the country without settling the charges against him.

Founder Shares Forfeiture. Stable Road's sponsor agreed to forfeit 250,000 (or approximately 6 percent) of its “founder shares” or sponsor “promote.” Founder shares are purchased by the SPAC's sponsor pre-IPO for nominal consideration (typically a total of $25,000), and customarily represent 20 percent of the SPAC's outstanding float after going public, fully vesting upon consummation of the business combination. Founder shares represent a key source of value for sponsors and are viewed by the market as the reward sponsors receive for finding a target and consummating a successful merger.

PIPE Investors Allowed to Back Out. Following the enforcement action about 40 percent of the funding commitments previously provided by PIPE investors was withdrawn. As part of the settlement agreement, the SEC mandated that PIPE investors be offered the opportunity to terminate previously executed subscription agreements, given the disclosure provided to them when making their investment decisions. Committed financing from PIPE investors is regularly used in de-SPAC transactions to provide funding certainty, back-filling any gap between the purchase price for the acquisition target and the funds initially raised in the SPAC's IPO, as well as topping-off any funding shortfalls resulting from shareholders who choose to redeem their shares at the shareholder vote rather than hold shares in the newly combined company. Although Stable Road ultimately consummated a de-SPAC merger with Momentus, allowing PIPE investors to withdraw their commitments represented a significant new weapon in the SEC's enforcement arsenal, with the potential to derail entire transactions by calling into question a sponsor's ability to successfully close deals without supplemental financing.[vi]

Lessons For The SPAC Market After Stable Road

SPACs and Sponsors Must Take Ownership of Target Business Disclosure (Even If The Target Is Being Less Than Truthful). SPACs and sponsors must take care to redouble their efforts to ensure any due diligence process regarding a potential business combination target is both rigorous and well documented. Although Stable Road engaged several consulting firms to assist in evaluating Momentus' technology, the SEC found the firms were not provided a reasonable amount of time to complete their work (they were engaged only a month before the initial merger agreement was signed), resulting in a diligence process which the SEC suggested, if properly performed, may have uncovered the apparent red flags before disclosures and solicitations reached investors.

The SEC has made clear that policing misconduct in the SPAC market is high on their regulatory agenda, and Stable Road likely represents only the first shot across the bow in terms of heightened enforcement activity. SPACs and their sponsors would be well served to strategically conduct due diligence of potential merger targets in light of Stable Road's message that they too will be on the hook in the event disclosures made to investors about a target business prove deficient and are challenged, even if that disclosure originally originated solely from the target. Best practices include the involvement of third party advisors, the SPAC's board of directors, sponsor representatives and other key stakeholders such as PIPE placement agents, legal counsels and other experts early on in the diligence process, including the creation of a robust, thoroughly documented and iterative record of the diligence efforts taken when evaluating a potential target, which in the event of litigation may be presented to a court to demonstrate an appropriate and thorough process was conducted. In short, a deceptive source resulting in bad disclosure does not excuse SPACs and their sponsors who do not conduct a thorough diligence exercise in the eyes of the SEC. Chair Gensler succinctly noted: "[t]he fact that Momentus lied to Stable Road does not absolve Stable Road of its failure to undertake adequate due diligence to protect shareholders."

Perception of Misaligned Structural Incentives In Focus. By including the forfeiture of founder shares as part of the settlement package, the SEC may be responding to certain perceived concerns that SPAC structures, in some cases may have the effect of incentivizing sponsors to consummate a de-SPAC transaction, despite concerns about the acquisition target, solely to maintain the value of their founder shares. SPACs are customarily provided an 18-to-24-month window (with some recent SPACs shortened to 15 months or less, with three month extension periods requiring sponsors to pay-in more at-risk capital into the trust account) to find a suitable acquisition target and complete a successful combination.[vii] If no deal is reached by the end of this pre-determined lifespan (which is also subject to extension if shareholders approve), funds raised in the SPAC's IPO and held in trust are returned to shareholders, the SPAC is dissolved, and most importantly for sponsors, their founder shares are rendered worthless.

The SEC found that Stable Road's rushed diligence process as it neared the end of its life-span, as well as a late stage pivot to a general search for any acquisition target, regardless of industry or geography (Stable Road had initially told investors it was focusing exclusively on targets in the cannabis industry), all signaled that Stable Road and its sponsors were more incentivized to get a deal done, any deal done, than to find a quality acquisition candidate. With SPACs currently under the regulatory microscope, optics matter, and market participants must take care to ensure their actions in pursuit of a business combination do not become suggestive of an overzealous sponsor, over-eager to get a deal done, and thereby risk drawing comparisons to Stable Road, which Gensler characterized as a textbook "illustrat[ion of the]risks inherent to SPAC transactions, as those who stand to earn significant profits from a SPAC merger may conduct inadequate due diligence and mislead investors."

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I Momentus is developing a "transfer vehicle" that would be deployed to outer space and be able to reposition satellites into different orbits.

II Momentus was charged with violating the scienter-based (i.e. willful) securities law antifraud provisions, while the charges against Stable Road were negligence-based. Stable Road and its CEO were also charged with violating certain reporting and proxy solicitation provisions.

III Momentus claimed that it had successfully tested its technology in a 2019 test mission, even though by Momentus' own standards the mission appeared to have been a failure. The false claims of a successful test were used to support financial projections provided to shareholders and PIPE investors to garner support for the de-SPAC transaction.

VI The national security concerns included an open investigation by the Committee on Foreign Investment in the United States and the Commerce Department's previous denial of an export license.

V Momentus, Stable Road and its CEO (who is also a managing member of Stable Road's sponsor) were assessed civil penalties of $7 million, $1 million, and $40,000, respectively.

VI In addition to the penalties discussed above, Momentus also agreed to undertakings requiring enhancements to its disclosure controls, including the creation of an independent board committee and retention of an internal compliance consultant for a period of two years.

VII Stable Road's charter allowed for an 18-month search.

CONTACTS

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