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The Resurgence of SPACs: Observations and Considerations

The special purpose acquisition company ("SPAC") is on the rise. A surge of offerings by a series of high-profile SPACs in the last several months has led to record levels of capital being raised by SPACs in 2020. As SPACs become a routine part of M&A processes, private company sellers and their shareholders are being presented with new opportunities that require informed and creative navigation.

I. *Background*

A SPAC is a company formed to raise capital in an initial public offering ("IPO") to finance a subsequent merger or acquisition within a time frame specified in its charter, typically two years. The target firm, which must not yet be identified at the time of the SPAC's IPO, becomes public as a result of the transaction (often referred to as a "business combination" or a "de-SPAC transaction"). So far this year, a total of $30.4 billion of capital has been raised by SPACs in over 75 IPOs, a marked increase from the previous record, set in 2019, of $13.6 billion raised in 59 IPOs. The average size of SPAC IPOs has also grown from approximately $230 million in 2019 to more than $400 million so far in 2020.

Along with larger offering sizes, a greater number of SPACs are being established by prominent former public company executives with the goal of acquiring a target in the executive's industry or a related industry. A number of large, well-regarded financial institutions and private equity firms are also sponsoring SPACs. Not coincidentally, a growing number of deal announcements by SPACs have been well received by investors, and many companies that have gone public through a de-SPAC transaction have maintained stock prices well above the SPAC's IPO price. These trends have helped SPACs become a fixture of the current M&A environment and reduced their historical associations with financial underperformance and risk.

II. *The Modern SPAC*

SPACs have evolved considerably since their origins in the blank-check companies of the 1980s, raising new complex commercial and legal issues. The key elements of the modern SPAC are summarized below:

1. Public Equity. In a typical SPAC IPO, a SPAC will offer units (generally at a per unit purchase price of $10), each composed of one share of common stock and a fraction—commonly one-third—of a warrant to purchase a share of common stock. The warrants are typically exercisable for $11.50 (15% above the IPO price), shortly after the de-SPAC transaction or, if later, one year after the IPO. The public offering proceeds from the IPO are placed into a trust account that can only be used to fund the SPAC's business combination or to redeem shares in the circumstances described below.

2. Redemption. In connection with the business combination, public shareholders are entitled to require the SPAC to redeem their shares for a *pro rata* portion of the cash in the trust account. If a sufficient number of public shareholders elect redemption, the remaining funds in the trust account may be insufficient to fund the transaction, and could cause the failure of conditions typical of SPAC transaction agreements relating to either minimum cash or maximum redemption levels. In the SPAC transactions completed in the last five years, a little more than half of aggregate trust funds have been redeemed, but, as described below, SPAC sponsors frequently make backstop financing arrangements to manage this risk. Since 2009, approximately 8% of SPACs have liquidated without completing a business combination, most often due to lack of investor support for announced deals.

3. Sponsor Equity. Before the IPO, the SPAC's sponsor will purchase, for a nominal amount, shares of a separate class of common stock (often referred to as "founder shares"), that gives the sponsor the right to receive, upon consummation of the de-SPAC transaction, 20% of the post-IPO common stock (often referred to as the "promote"). In addition, the SPAC's sponsor will purchase warrants with terms mostly similar to those offered to the public. The purchase price for these warrants (typically 2% of the IPO size), will be added to the trust account and pay for IPO expenses and the SPAC's operating expenses before its business combination. This is often referred to as the sponsor's "at risk capital," because, if the SPAC does not consummate a business combination in the time allotted in its charter, then, absent shareholder approval for an extension, the SPAC must liquidate, rendering the warrants worthless (a fact that may provide a seller greater negotiating leverage toward the end of a SPAC's liquidation window).

4. Financing. SPACs typically enter into additional arrangements to help finance the de-SPAC transaction and mitigate the risk of excessive

redemptions. At the time of the IPO, some SPACs enter into forward purchase agreements ("FPAs") with institutional investors or affiliates of the sponsor in which the forward purchaser commits to purchase equity in connection with the de-SPAC transaction and agrees to certain limitations on redemption or transfer. If an FPA is not sufficient to make up for any redemptions, SPACs commonly seek committed financing for the business combination in the form of a private investment in public equity ("PIPE") announced simultaneously with the announcement of the business combination. SPAC sponsors sometimes relinquish some of the founder shares as an inducement to attract investors providing FPAs or PIPE financing.

As the SPAC market has attracted new entrants over the years, variations on the typical SPAC structure have continued, often with an objective of reducing the execution risks associated with de-SPAC transactions. Just one recent example is Pershing Square Tontine Holdings, which completed a $4 billion IPO in July, with an FPA from Pershing Square providing an additional $1–3 billion in committed financing. Shareholders of Pershing Square Tontine Holdings who elect to have their shares redeemed will be required to forfeit two-thirds of the warrants issued to them in the SPAC's IPO. The forfeited warrants will then be distributed to the remaining shareholders, thus creating an incentive not to redeem (imitating a traditional Tontine investment pool structure). Pershing Square Tontine Holdings departed from the typical SPAC structure in other ways as well, most notably by reducing the dilution to investors and counterparties from founder shares. Instead of receiving a typical promote, the SPAC's sponsor and directors purchased warrants exercisable three years after the closing of the business combination for 6% of the equity of the post-business combination company, at an exercise price 20% above the IPO price. The success of the Pershing Square offering suggests that SPACs need not be viewed as cookie-cutter vehicles and that innovations may be appropriate and accepted by the marketplace in particular circumstances depending upon the sponsor's objectives.

III. *Considerations for Transactions with SPACs*

From the perspective of a private company target or seller, a transaction with a SPAC is similar in some ways to a transaction with a non-SPAC acquiror. The SPAC structure, however, results in a process that may more accurately be described as a hybrid between an M&A transaction and an IPO.

The typical SPAC deal process begins with the SPAC and target negotiating a term sheet with key economic terms. That term sheet is then used to market the deal to potential PIPE investors or other financing sources, including sources of standby financing to cover potential redemptions. When the business combination and any committed financing are announced, the public marketing process begins right away, with SPACs and their targets expending IPO-like efforts, with required public disclosures broadly similar to an IPO registration statement, to build support for the transaction among investors, who, through their redemption option, ultimately decide the fate of the deal. Because the SPAC shares and warrants are separate and freely tradable, there is often significant rotation among investors during this period as SPAC sponsors and their financial advisors seek to move shares to investors that will be supportive of the business combination. The business combination is unlikely to succeed unless the SPAC shares are trading at or above the redemption price (approximately $10 plus interest in a typical SPAC) at the time of closing.

The risk of excess redemptions can influence each step of the deal process until closing. To attract PIPE investors or other financing sources needed to mitigate redemption risk, the SPAC and the target may agree to adjust the term sheet, including with terms that could create additional dilution for the target's shareholders. Based in part on the financing commitments actually obtained, the parties will build minimum cash or maximum redemption conditions into the definitive agreement. Once the business combination is announced, if investors are insufficiently supportive, the specter of excess redemptions often leads the parties to renegotiate the agreement—possibly more than once—to achieve the necessary level of support to close the deal. From the perspective of the seller or target, this means that, in terms of closing certainty, a transaction with a SPAC adds elements of a traditional IPO (and associated market risk) to those of a typical M&A transaction. Compounding these risks is the fact that, unlike in a typical M&A transaction, a seller in a SPAC transaction has limited recourse against the SPAC. Because the funds in the SPAC's trust account are held solely for the benefit of its shareholders, transaction agreements with SPACs typically provide extremely limited contractual remedies for the SPAC's breach of its covenants or failure to close.

SPAC transactions present several other considerations that are more typical of an M&A transaction than an IPO. Unlike IPO underwriters, the SPAC sponsor retains significant equity in the combined company, often together with others, such as PIPE investors. SPACs also typically provide liquidity to a significantly larger portion of the private company's capital structure than a traditional IPO, where the public markets often like to see that earlier, private market investors retain "skin in the game." These dynamics present both economic and governance issues: How much dilution will be caused by the sponsor's promote and the conversion of any other investors' founder shares? What portion of the consideration will be paid in cash and what portion in stock (the value of which will be diluted by founder shares), and how much will be subject to an earn-out or other contingencies? What post-closing governance rights or board representation will be afforded to significant equityholders (including the seller(s) as a result of rollover equity)? What positions will be held by members of the target's senior management team?

Nonetheless, for companies seeking a relatively clear path to the public markets, SPAC transactions offer certain advantages. Especially in today's volatile and uncertain market conditions, some companies may prefer the relative pricing transparency, speed and confidentiality afforded by a SPAC transaction as compared to an IPO. Other companies may conclude that partnering with a SPAC management team that includes former public company executives or seasoned investors will facilitate a more successful public listing or enhance their long-term business prospects.

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As always, the merits of any particular SPAC transaction will depend greatly on the specific parties involved. Sellers should evaluate potential SPAC counterparties—including especially the track record and experience of the sponsor and businesspeople involved, and their detailed financing plans—carefully in light of the considerations above. Parties to SPAC transactions must be prepared to market the transaction not just at announcement or at the time of the merger vote, but all the way through closing, and to a shifting investor base. But a SPAC transaction, if properly understood and executed, can offer a superior method of reaching the public markets. In any case, the steady rise of SPACs suggests that the SPAC model has arrived at a new plateau and will be a feature of many transactions in the days to come.

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