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Managing shareholder activism directed at SPACs

FW discusses how to manage shareholder activism directed at SPACs with Keith Billotti and Edward S. Horton at Seward & Kissel LLP.

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THE PANELLISTS

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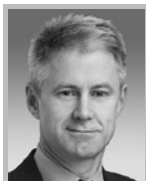

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FW: Could you provide an overview of the extent to which special purpose acquisition companies (SPACs) are being targeted by shareholder activists, particularly since the outbreak of the coronavirus (COVID-19) pandemic which led to a surge in SPAC-related activity?

Horton: A significant amount of recent special purpose acquisition companies (SPAC) activism has been focused on post-merger operating companies shortly following their initial business combination. Several factors have contributed to this increased activity. Most obvious is that SPACs accounted for more than half of all companies going public in 2021 in the US, and therefore represent an increasing percentage of the pool of potential activist targets. Additionally, the disappointing stock performance of a number of recent SPACs following their initial business combination, combined with the recent or pending expiration of founder lock-up periods, have resulted in greater public floats allowing activists greater opportunity to build a position from which to mount an activist campaign. The increasing number of SPACs running up against deadlines to do deals is also offering activists opportunities to come in prior to the business combination with the aim of forcing the return of the trust account assets to investors, or, in some cases, influencing the target selection process. However, the separation of the shareholder approval of the merger from shareholders' redemption right, together with limitations on redemption rights for certain large holders, have reduced the frequency of activist activity at this stage of the SPAC lifecycle.

Billotti: SPACs have recently experienced an explosion of growth in the US capital markets. Some market participants estimate that companies that go public through a SPAC could number upwards of 10 percent of all listed companies in the US, while at the same time the number of public companies may be decreasing. With the level of shareholder activism against public companies at sustained levels and an increasing number of companies that are becoming public through SPAC transactions, activists have looked, and it may be inferred that more activists will look, for targets across the SPAC landscape, which is outside of traditional hunting grounds. Activists may continue to focus their attention on SPACs because the SPAC structure may lend itself to activism. Given the use of projections in investor marketing materials, certain inherent conflicts of interest that are present in all SPACs, and potentially inexperienced management teams, SPACs may provide sufficient fodder for activists, even if the SPAC is ultimately successful and does not merit such criticism.

FW: What factors are driving activists and the types of SPAC-related campaigns being launched? At what point in the SPAC lifecycle do shareholders typically begin to agitate?

Billotti: Many of the target companies that are going public through SPACs are in the early stages of their development, have management teams that are not seasoned at navigating the public company landscape and investor relations, and are valued at high multiples of their prior year financials. These foregoing factors are likely to contribute to more activism in the sector. Activism is present at all stages of the SPAC lifecycle, but the risk of activism increases as the SPAC matures. An activist may attempt to influence the choice of the SPAC's acquisition target, in which the activist may or may not have an interest, before the initial business combination is consummated. The risk of activism increases as the SPAC approaches its expiration and possible liquidation, upon which, the sponsor of the SPAC will generally lose its investment in the SPAC. As a result, sponsors of SPACs that approach expiration are often accused of being desperate and careless in evaluating potential business combinations. Activism risk continues after a target is selected and during the de-SPAC process, including in connection with the shareholder vote or tender offer when activists agitate against the deal. After the consummation of the de-SPAC, the risk of activism transfers to the newly formed public company.

Horton: Unlike traditional initial public offerings (IPOs), SPAC business combinations typically use projections in connection with the shareholder approval of the merger, which results in large part from SPACs, unlike traditional IPO candidates, being able to rely on a safe harbour provision that provides protection from shareholder lawsuits based on these forward-looking statements. The failure to meet these forecasts provides an immediate basis for activists to attack current management and the board. As a result, activist campaigns are generally occurring much sooner in the former SPAC's life as a public company than for those companies that became public through a traditional IPO. Another factor contributing to the recent rise of activism in the SPAC space is the expiration of the insider and sponsor lock-ups. In contrast to traditional IPO companies, where founders often retain significant holdings in the company, sponsor shares are often sold into the market soon after the lock-up expiration, making it easier for activists to acquire sizeable positions early in the company's lifecycle.

> THE BEST DEFENCE OF ANY ACTIVIST CAMPAIGN ULTIMATELY DEPENDS ON DENYING AN ACTIVIST SHAREHOLDER A COMPELLING ARGUMENT FOR CHANGE.
>
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FW: How does SPAC-related activism differ from other types of campaigns and affect defence strategies?

Billotti: We have observed more investors deploying short-selling strategies, such as publicly expressing criticism of a company's management or valuation to drive the price of the stock down, targeted at issuers that went public through de-SPACing transactions compared to 'long activism', that is, agitating for changes that will drive the price of the stock up, which is generally seen at more established companies. After the SPAC IPO and before the initial business combination, SPACs are well insulated from short activism – since the IPO proceeds are held in a trust account until the initial business combination and SPAC shareholders can redeem their shares for the trust proceeds, which of late have been overfunded by sponsors to complete the IPO of the SPAC. Given the sustained SPAC IPO activity over the last year and half and the need for a significant number of SPACs to find acquisition targets, we expect certain companies that recently went or will go public through a de-SPAC transaction to become attractive targets for short activism, particularly when the company's actual performance does not meet the projections disclosed during the de-SPAC process. Activists targeting such companies will likely use rhetoric that focuses on allegations that a company exaggerated its financial performance or prospects.

Horton: A notable characteristic of recent shareholder activism in the SPAC context is that it is coming sooner following the initial business combination than in the traditional IPO context. One factor contributing to this is the extensive use of projections for purposes of marketing the business combination. The failure of actual performance to meet these projections gives activists an immediate basis to criticise management and the board, where companies having gone public through a traditional IPO must generally establish a track record of several years or more of disappointing results on which an activist can base its attack.

FW: What steps do SPACs need to take to prepare for a potential shareholder activist attack?

Billotti: Companies that complete the de-SPACing process should employ the same well-established measures that many tenured companies take advantage of now to defend against activism. Such companies should consider having corporate governance features that allow for a classified board, the issuance of blank cheque preferred, director removals only for cause and certain supermajority shareholder voting requirements, such as in the case of changes to a company's organisational

documents, and shareholders should not be allowed to call special meetings. These practices are often criticised by Institutional Shareholder Services (ISS), Glass Lewis and institutional investors, so companies need to actively balance the protections implemented against investor demands to avoid providing an additional source of criticism for activists.

FW: To what extent are SPACs falling under regulatory scrutiny? What are the main causes of concern?

Horton: The Securities and Exchange Commission's (SEC's) regulatory approach to SPACs has thus far been very light, and even the SEC's statement on the accounting treatment of warrants last year ultimately had a minimal impact on SPAC structures or investor interest. However, recent comments from Gary Gensler, chairman of the SEC, suggest we may be in the early days of a more hands-on approach by the SEC that could potentially have far-reaching implications for SPACs generally. Specifically, the chairman's comments make it clear that the SEC is focusing on regulations aimed at making SPACs look more like traditional IPOs in terms of the timing and extent of disclosures relating to the target and to potential sponsor and insider conflicts, among others. The SEC also appears to be taking aim at SPACs' use of projections and other forward-looking statements by suggesting that the staff may put an end to the safe harbour provision protecting SPACs, but not traditional IPO candidates, from shareholder lawsuits relating to such forward-looking statements. Finally, the chairman also indicated that the SEC is focusing on certain conflicts and 'misaligned' incentives, which appears to be a reference to the sponsor's promote. Until the SEC releases specific rule proposals the final impact of these change cannot be assessed. However, the clear intention to make SPAC processes and procedures look more like the traditional IPO process indicates that anticipated regulations could materially impact the SPAC industry.

Billotti: In the middle of last year, the SEC brought the first enforcement action against a SPAC and its major participants, demonstrating the importance of conducting adequate due diligence in the de-SPAC process and the SEC's heightened focus on these transactions and their related public filings. With this action, the SEC staff has signalled that they will be carefully evaluating statements in proxy solicitations to SPAC investors and that any material misstatement or omission in connection with a proxy solicitation will be subject to liability under the Securities and Exchange Act of 1934. Given the outcome of this case, which resulted in civil penalties and certain investors receiving rescission rights, other enforcement actions and the SEC's statements focusing on the de-SPACing process, we expect a continuing focus on these transactions for a number of reasons. First, Mr Gensler has warned that conflicts of interest are inherent in SPACS, as those who stand to earn significant profits from a SPAC merger may conduct inadequate due diligence and mislead investors. Additionally, the SEC has made it crystal clear that SPACS are expected to conduct their own due diligence and cannot rely on representations from the target company, with Mr Gensler stating that the fact that a target lied to a SPAC does not absolve the SPAC of its failure to undertake adequate due diligence to protect shareholders. In addition to the foregoing, the SEC has also been focused on corporate reporting disclosure relating to ESG issues, such as diversity and climate change, and performance metrics.

FW: What advice would you offer to SPACs in terms of implementing an effective strategy to deal with shareholder activism, at whatever stage of the SPAC lifecycle it arises?

Billotti: SPACs have raised billions of dollars to fund business combinations to create publicly traded companies. In connection with these capital raises, investors are generally provided with up to five years of projections relating to the ongoing public company. These projections form the foundation of investor expectations of the company's future financial performance. Any time performance is disappointing, activist shareholders can ramp up short-selling campaigns and call for new management, new directors, cost cuts and other changes. Companies should take a balanced approach in respect of their capital raising and corporate governance. SPACs should be encouraged to conduct fulsome due diligence on their targets and take a conservative approach in the preparation of the projections that are supplied to investors as part of the de-SPAC process and the related capital raise. Once public, the ongoing company should consider a classified board and the ability to implement a poison pill, while maintaining quality management and high corporate governance standards. This should limit potential activism while at the same time providing the necessary protections to defend against activist threats if they arise.

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Horton: Like other public companies, SPACs may look to the standard arsenal of defences such as staggered boards, retention of significant shareholdings by founders and other insiders, and even shareholder rights plans. However, the best defence of any activist campaign ultimately depends on denying an activist

shareholder a compelling argument for change. This means that the SPAC must prioritise the selection and retention of the high-quality board and management talent, adopt robust corporate governance structures, particularly relating to potential insider conflicts of interest at both the SPAC and post business combination entity, and carefully vet and conduct robust due diligence on the target. Additionally, SPACs must be responsible in the use of the projections and forecasts that are commonplace in the current SPAC market, taking particular care that these projections are both realistic and supportable.

FW: Looking ahead, how do you envisage shareholder activism unfolding across the SPAC ecosystem? To what extent do SPACs represent a new frontier for activist campaigns?

Horton: The volume of companies that have gone public through the SPAC process in recent years, in both absolute terms and as a percentage of all new public companies, has made it inevitable that SPACs will be a significant focus of activist shareholders in 2022 and beyond, and contributed to the uptick in published shareholder activism in 2021. Many strong businesses have utilised the SPAC process to go public because of the advantage in terms of time to market and efficiency. However, there is also a basis for the conventional wisdom that the lighter regulations applicable to SPACs as compared to traditional IPOs, together with the strong financial incentives for SPACs to complete an initial business combination, have resulted in a number of public companies that would not have gotten through the traditional IPO process. These companies will be potential activist targets in the months and years ahead and are likely to contribute to greater activism in the years ahead. With additional SPAC IPOs coming to market, even if at a slower pace, and a large number of SPACs currently hunting for merger targets, former SPACs will continue to fuel activist shareholder activity.

Billotti: We expect activism to remain strong during this year and in the near term, despite the market volatility and uncertainty created by the coronavirus (COVID-19) pandemic and resulting governmental responses, supply chain disruptions and inflationary pressure. As the number of de-SPAC transactions continues to accelerate the formation of new public companies, we expect to see activism campaigns focused on these types of companies. Activism should be boosted by the regulatory focus on the performance metrics disclosed in connection with de-SPAC transactions, conflicts of interest issues and the increased corporate reporting disclosure relating to environmental, social and governance (ESG) issues, such as diversity and climate change, that are applicable to all companies. Underperformers in any of these areas are likely to be targeted. ■

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