SPACs Are Back, Back Again: What You Should Know

August 14, 2020

Key Takeaways:

- A SPAC is a company, with no initial assets or operations, that raises capital through an initial public offering ("IPO"). The IPO proceeds are held in a trust for up to a defined period of time for the purpose of acquiring a private business, known as the "De-SPAC Transaction".
- SPACs have a wide range of potential investors, including retail investors, who otherwise may not have access to the management teams of a SPAC or the investment opportunities that SPACs target.
- SPAC investors have limited downside exposure given that investors are entitled to vote to approve or disapprove the De-SPAC Transaction. If the transaction is not approved, 100% of the trust proceeds, plus accrued interest, are returned to the investors, and investors have the right to redeem their own shares for cash at the time of the De-SPAC Transaction.
- SPAC sponsors are compensated similarly to a private fund sponsor in that they receive a "promote" for sponsoring the SPAC; however, in the case of a SPAC, the sponsor typically receives 20% of the shares of the SPAC for a nominal investment.
- However, there are several conflicts of interest and fiduciary duty issues that investment advisers to private funds must consider if they want to sponsor a SPAC and own the SPAC's securities.

Special purpose acquisition companies (SPACs), also known as "blank check companies", are currently experiencing a significant resurgence. SPAC activity in 2020 has already exceeded 2019 levels, which itself was a record breaking year for total capital raised, and the number of SPACs in 2020 has nearly matched the number of completed SPAC IPOs in 2019. In fact, the number of SPAC IPOs to date in 2020 has exceeded the number of traditional IPOs in 2020. Recent high-profile IPOs[1], such as Pershing Square Capital Management's $4 billion SPAC IPO, and business combinations (either announced or completed)[2] by SPACs are also contributing to this resurgence.

[1] On July 22, 2020, a SPAC sponsored by an entity owned by three hedge funds managed by Pershing Square Capital Management, L.P. raised a record-setting $4 billion in a SPAC IPO. The Pershing Square hedge funds also entered into a forward purchase agreement that could make an additional $3 billion available to the SPAC for its initial business combination.

[2] On August 2, 2020, a SPAC sponsored by Cantor Fitzgerald, L.P. announced a merger with Grovesnor Capital Management, LLP.

Attorney Advertising. Prior results do not guarantee a similar outcome.

What is a SPAC?

A SPAC is a company with no initial assets or operating business that completes an IPO, with the IPO proceeds held in trust for an unspecified future acquisition or other business combination (the "De-SPAC Transaction"). Following the IPO, the SPAC management team has a defined period of time (typically 18 to 24 months) to complete a successful De-SPAC Transaction, which must be approved by the SPAC's investors. If the De-SPAC Transaction is not approved and the SPAC investors do not approve an extension of the initial period, then the trust proceeds, plus accrued interest, will be returned to investors.

What Benefits Does the SPAC Structure Offer?

- *For Sponsors*:
  - Management teams deploying a buy-out or acquisition strategy through a SPAC have the potential to earn a substantial return on their nominal investment for sponsoring the SPAC (the "promote") if the De-SPAC Transaction is successful.
  - SPAC sponsors, which may include investment advisers to private funds (*i.e.* hedge fund, PE fund, VC fund or real estate fund), have access to a larger group of potential investors.
  - Unlike in the case of the typical private fund, retail investors can invest in a SPAC IPO and there is no private placement restriction on advertising the SPAC IPO.
  - SPAC units are traded on the secondary market and SPACs may require additional financing before the De-SPAC Transaction, offering arbitrage and special situation investment opportunities during a SPAC's life-cycle.

- *For SPAC Investors:*
  - Retail investors can get exposure to strategies and investments opportunities that are liquid and which they might not otherwise be eligible to invest in through a private fund.
  - As mentioned above, given that SPACs may require additional financing before a De-SPAC Transaction, investors may have access to arbitrage and special situation investment opportunities during a SPAC's life-cycle.
  - Investors have limited downside exposure as a result of each investor's opportunity to redeem their common shares for cash at the time of the De-SPAC Transaction, and if the De-SPAC Transaction is not approved by investors, the trust proceeds, plus interest, will be returned to all investors.

- *For SPAC Merger Targets:*
  - Private operating companies can use a SPAC to become a public company without going through the traditional IPO process since the SPAC is already publicly listed and typically meets the requirements for trading on the relevant stock exchange. This process results in a much quicker time frame and can reduce market pricing exposure since the terms are negotiated and agreed with the SPAC.

Attorney Advertising. Prior results do not guarantee a similar outcome.

SPAC Capital Structure Overview

Typically, a share of common stock (the "Class A Shares") and a warrant equal to a fraction of a Class A Share are issued to investors in the IPO. The Class A Shares, which trade on a national securities exchange following the IPO, will ultimately represent common shares in the post-business combination public company. The warrants have a strike price in excess of the IPO price and typically become excisable for additional Class A Shares 30 days following the De-SPAC Transaction. After a fixed period of time following the IPO, the SPAC units are decoupled and the Class A Shares and the warrants can be traded separately on the secondary market. Holders of Class A Shares are entitled to vote to approve or disapprove a De-SPAC Transaction. They may also vote to extend the initial period if the SPAC sponsor requests additional time to locate an acquisition target. In addition, current SPAC structures provide holders of Class A Shares with the right to redeem their common shares for trust proceeds, regardless of whether they vote to approve the business combination, allowing these investors to preserve the potential upside of their warrants in the event the De-SPAC Transaction is successful.

The management team sponsoring the SPAC establishes a separate entity to serve as the SPAC sponsor. The SPAC sponsor pays a nominal price for founder shares of the SPAC (the "Class B Shares"), which typically entitles the SPAC sponsor to 20% of the total shares outstanding following the IPO. This potential return on the SPAC sponsor's nominal investment is known as the "promote". Class B Shares are generally not redeemable prior to the De-SPAC Transaction, are not entitled to vote for the De-SPAC Transaction or to extend the initial time period required to consummate a De-SPAC Transaction,[3] and do not have the right to participate in the trust proceeds. The SPAC sponsor also typically receives founder warrants in exchange for its payment of the underwriting discount and may receive restricted Class A Shares. Generally speaking, all of the securities owned by the SPAC sponsor are subject to various contractual and legal trading restrictions for certain periods of time.

PIPEs & Other De-SPAC Transaction Financing Arrangements

SPAC sponsors (and the acquisition target) are often unable to ascertain whether the SPAC's assets will be sufficient to complete the De-SPAC Transaction until any redemptions of Class A Shares have been accounted for, or even whether they will vote to approve the business combination. Certain SPACs have therefore sought to mitigate this risk by restricting the portion of Class A Shares that a particular holder is permitted to convert to cash (*e.g.*, at 10% of a person's Class A Shares). Additionally, the recent Pershing Square SPAC provides that a portion of the warrants will only be issued and become exercisable following the De-SPAC Transaction if the applicable Class A Share holder votes in favor of the business combination and does not redeem its Class A Shares. SPAC sponsors may also enter into a forward purchase agreement to finance the De-SPAC Transaction. Alternatively, a SPAC sponsor may seek "back-end" financing closer to the time of the De-SPAC Transaction, which may include: (i) forfeiting, assigning or otherwise transferring Class B Shares and founder warrants; (ii) a bridge loan; or (iii) a PIPE (private investment in public equity) transaction. In a PIPE transaction, the SPAC identifies an investor or group of investors to provide additional capital to the SPAC in exchange for a private placement of the SPAC's public securities at a price typically equal to the IPO price.

[3] Class B Shares do vote to appoint the SPAC's majority independent board of directors prior to the De-SPAC Transaction.

Attorney Advertising. Prior results do not guarantee a similar outcome.

SEWARD & KISSEL LLP

Conflicts of Interest

The economic rights of the SPAC sponsor and the holders of Class A Shares are not necessarily aligned. The SPAC sponsor has the potential upside of the promote, while the Class B Shares and founder warrants will become worthless if there is not a successful De-SPAC Transaction. Therefore, the SPAC sponsor may be incentivized to try and consummate a less than favorable De-SPAC Transaction rather than see the trust proceeds returned to the holders of Class A Shares, irrespective of the prospects of the post-business combination public company. Conversely, holders of Class A Shares may seek to block a De-SPAC Transaction or win concessions from the SPAC sponsor in exchange for their vote to approve the De-SPAC Transaction and/or agreement not to redeem their Class A Shares.

Special Considerations for Advisers to Private Funds

An investment adviser to private funds will need to determine whether an investment is consistent with the fiduciary duty it owes to its clients, including any private funds.[4] For example, if the investment adviser or its affiliates have interests in a SPAC sponsor or SPAC units it may not be appropriate to make an investment on behalf of the private fund in the SPAC IPO units, which could be seen as being made to "prop-up" the investment by the adviser or its affiliates. The adviser's interests may be better aligned with its clients if the adviser's only investment in the SPAC's securities are made through its private fund clients. There is also the potential for conflicts of interest to the extent that multiple private fund clients participate in different securities of the SPAC.[5]

If the investment adviser's private fund clients use strategies that are similar to the strategy that will be used by the SPAC, the investment adviser will also need to consider whether the SPAC is diverting investment opportunities, or the time of its investment professionals, from the private fund clients. Moreover, existing funds contemplating an investment in a SPAC's securities will need to determine that the investment is permitted under the relevant fund agreements and that the risks, including any potential conflicts of interest, relating to the investment have been adequately disclosed.

S&K Observations

Seward & Kissel has been involved with a large number SPACs over the years, advising investment manager clients and other clients in connection with the structuring and legal considerations relating to their sponsorship of SPACs, assisting clients investing in the accompanying PIPE transactions and representing the SPAC or the target operating company in the De-SPAC Transaction. Our involvement has spanned more than 15 years which has provided us with a deep understanding of all aspects of SPACs, including the more recent changes to their structure.

If you have any questions about SPACs, please contact any one of your Seward & Kissel relationship attorneys.

---

[4] As an investment adviser, a private fund sponsor's fiduciary duty, prohibits the private fund sponsor from placing its own interests ahead of the interests of its clients. An investment adviser is also required to seek to avoid conflicts of interest with clients, and, at a minimum, make full disclosure of all material conflicts of interest.

[5] This potential conflict is similar to the scenario where multiple clients of an adviser invest in different parts of a typical portfolio company's capital structure. The SEC's Office of Compliance Inspections and Examinations recently highlighted this and other potential conflicts of interest for private funds in a risk alert. More information on the risk alert is available here.

Attorney Advertising. Prior results do not guarantee a similar outcome.