Capital Markets Alert

Skadden

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SEC Staff Issues CF Disclosure Guidance on Conflicts of Interest and Special Purpose Acquisition Companies

If you have any questions regarding the matters discussed in this memorandum, please contact the attorneys listed on the last page or call your regular Skadden contact.

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On December 22, 2020, the Division of Corporation Finance (Staff) of the U.S. Securities and Exchange Commission issued its CF Disclosure Guidance: Topic No. 11 regarding special purpose acquisition companies (SPACs). The guidance addresses certain disclosure considerations for SPACs that arise in connection with their initial public offerings and subsequent business combination transactions, particularly with regard to potential conflicts of interest.

In a SPAC IPO, investors purchase a stake in a shell company with no operating assets with the understanding that, post-IPO, the SPAC's management team (sponsor) will identify one or more acquisition targets that can be purchased with the funds raised in the IPO within a specified timeframe. If an acquisition is not completed within the specified time frame — generally two years — investors' money is returned. Any company or companies the SPAC acquires will, as a result of the business combination, become public. Prior to consummation of the initial business combination, the original investors have the option of redeeming their shares in the shell company or maintaining an interest in the newly combined operating company. Staff have observed that SPAC transactions create potential conflicts of interest between public shareholders and the insiders, private investors and underwriters participating in the SPAC. These conflicts of interest must be disclosed at appropriate times throughout the IPO and business combination process.[1] Certain of these disclosure considerations are highlighted below.

IPO Stage

In exchange for forming the SPAC and consummating a business combination transaction, the sponsor generally receives equity in the SPAC at more favorable terms than other investors, and has a greater economic incentive to consummate the business transaction within the specified time frame. The guidance makes clear that, at the IPO stage, the SPAC should disclose the circumstances in which a sponsor, director, officer or their affiliate's (insider's) financial incentives may not align with those of the public investors, as well as the power of any insider to approve, or facilitate approval, of the transaction.

[1] The guidance noted that these disclosure considerations may be relevant pursuant to the SPAC's disclosure obligations under Regulation S-K, the requirements of Form S-4, Form F-4, Schedule 14A, Schedule 14C and Schedule TO, as applicable.

For example, SPACs should disclose the amount and terms of any securities held by insiders, and how those insiders stand to benefit if a transaction is consummated, including whether they will be directly compensated upon a business combination or risk substantial loss upon liquidation and *pro rata* distribution of the SPAC. SPACs also should disclose whether insiders are able to approve the business combination either directly or upon changing the SPAC's governing documents and, if so, the process required and effects of these approvals. If the SPAC can extend the time frame during which a business combination may be consummated, the terms of that extension, including whether shareholders have a right to redeem their shares if one is sought, also should be disclosed. If insiders have been involved in prior SPACs, the SPAC should provide balanced disclosure of the outcomes of such SPACs.

The obligation to disclose financial interests that may diverge from those of the public investors extends to other participants in the offering, such as underwriters, who may have agreed to defer their compensation for work done in the IPO or condition it upon consummation of the business combination, in exchange for a role in that business combination transaction. Similarly, if the SPAC has sold any securities privately, or entered into a forward-purchase contract, with either the sponsor or another entity, the ways those securities differ from those available to IPO investors also should be disclosed. Any future plans for fundraising, to the extent known, should be disclosed, with an explanation of their dilutive effects on existing shareholders.

It also is possible that sponsors or other insiders may be associated with other entities that compete with the SPAC for business combination opportunities. The guidance makes clear that SPACs should disclose any such conflict of interest between insiders and public shareholders. This includes disclosing whether any insider has contractual or fiduciary obligations to other entities, and whether the SPAC will pursue opportunities where an insider interest has been identified. The SPAC also should disclose whether it has a policy regarding potential conflicts of interest or how it otherwise plans to handle such instances.

Business Combination

Many of the disclosure considerations relevant at the IPO stage remain important through the business combination stage, such as disclosure involving the terms of any additional financing sought or obtained to facilitate the business combination and how that funding affects the interests of existing shareholders. As during the IPO stage (when SPACs disclose the disproportionate interest and control sponsors and other insiders would stand to gain in a business combination generally) once a specific acquisition is proposed and the valuation is known, the SPAC should disclose the expected total percentage ownership of the insiders in the combined entity and the total expected return on the insiders' initial investment, giving effect to the exercise of warrants and the conversion of convertible debt. The SPAC also should update investors with respect to the services provided by the underwriter in the business combination, the compensation due for such services and the terms of the compensation, including whether any of it is delayed or contingent.

Additionally, the SPAC also should provide clarity with regard to the acquisition selection process and inform investors about how the target was selected. Details should include the circumstances involving first contact; explaining why a particular target was selected over others; what factors the board determined were material in its selection process; whether the interests and potential conflicts of individual insiders were considered; and the process for negotiating the value of the acquisition. To the extent any conflicts of interest were identified, the SPAC should disclose them and how they were handled, including whether any waivers to a policy that addressed conflicts of interest were granted.

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