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The SPAC: Entrenched or Endangered?

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The years 2020 and 2021 have seen a frenzy of M&A activity. Following a pandemic-induced equity market flash crash in the first quarter of 2020, M&A activity levels soared to historic heights in terms of both volume and value. 2021 saw a record $5.9 trillion in announced M&A transactions – a 57% increase over 2020. In the United States, the aggregate value totalled $2.6 trillion, a whopping 82% increase over 2020, while dealmaking in Europe jumped by 47% to $1.26 trillion.[1]

Amid the flurry of activity, a new driver emerged, constituting 10% of all global deals by value in 2021: business combination transactions (de-SPACs) entered into by special purpose acquisition companies (SPACs), whose special purpose is to combine with private company targets to take them public.

SPACs have in fact been around for a number of decades. They were, for several years, a niche product designed to facilitate going public for companies that had few other means of IPOing. From 2009 through 2016, SPAC IPOs averaged only 11 per year, and approximately a third of those SPACs ended up liquidating as opposed to combining with a target through a de-SPAC.

The following three years saw a jump in activity. SPAC IPOs quadrupled to 46 per year, and SPAC liquidations decreased to less than two per year. The SPAC began to establish itself as a stable product in the market that was responsible for over 40 private companies going public every year, principally in the United States.

It was in 2020 and 2021, however, that SPACs exploded in popularity to become a mainstream product. In 2020, 248 SPACs IPOed and a staggering 613 came to market in 2021, counting for two-thirds of all IPOs in that year.[2] In the first five months of 2022 – notwithstanding the regulatory and other pressures on SPACs – 68 SPACs have IPOed, raising almost $12 billion of monies in trust.[3]

The number of SPACs active in the market and the amount of capital held by them in trust to fund business combinations with private targets generated a surge in de-SPACs. There were 289 de-SPACs announced in 2021, amounting to $624 billion in deal value, which was a nearly threefold increase over 2020.[4] Since then, the number of de-SPACs appears to have levelled off, with 43 de-SPACs announced in 2022 to date.[5] As a result, the number of pre-deal SPACs actively looking for targets has stabilised at around 600, with approximately US$160 billion in undeployed capital in trust.

The slowdown in both SPAC IPOs and completed de-SPACs in 2022 is due in part to weakness in the equity markets, but also to regulatory uncertainty precipitated by a series of new rules and rule amendments proposed by the SEC in March.

In light of fluctuating market conditions and an uncertain regulatory regime, the question now is whether SPACs have become a fixture of the capital markets and will continue to drive capital formation and M&A in the coming years, or whether the use of this structure will peter

out and return to its sporadic pre-2020 levels after the 24- to 18-month lifecycle of SPACs that IPOed in 2020, 2021 and 2022 comes to an end.

In order to assess whether SPACs will have an enduring role going forward, we must first look at the distinguishing features of de-SPACs that have led them to become so popular in the first place.

SPACs have attracted significant amounts of capital because they have provided – so far – a compelling proposition for both SPAC investors and sponsors

Public investors in a SPAC IPO typically purchase "units" for $10 each, which consist of a common share and a warrant, permitting investors to buy additional shares in a target at a specified exercise price. SPAC shareholders are then entitled to opt out of participating in the de-SPAC at or about the time that the de-SPAC is brought to a shareholder vote (for example, if they dislike the target or deal terms), in which case they can elect to redeem their shares and get back the $10 they paid for each unit. However, redeeming investors are allowed to keep the warrants – effectively a free call option that permits investors to partake in the upside of a de-SPAC without being exposed to the volatility of the target shares themselves. Meanwhile, sponsors are incentivised with the low-risk proposition of exchanging their SPAC founder shares for approximately 20% of the listed common shares of the target on a fully diluted basis, if the de-SPAC completes and there has been no alteration to the terms of their "promote".

The ability to use projections relying on a safe harbor under the PSLRA has allowed early-stage companies to raise significant amounts of capital through a de-SPAC

In de-SPACs, companies have used forward-looking financial projections assuming this could be done in reliance on the "safe harbor" provision of the Private Securities Litigation Reform Act of 1995 (the PSLRA), limiting liability associated with using projections in business combinations, whereas no such "safe harbor" is available in the context of an IPO. The ability to use financial projections has been particularly advantageous for early stage (pre-money) targets that would otherwise struggle to substantiate the robust historical financial information required by a traditional IPO, providing the opportunity for these companies to raise a significant amount of ready capital and access the public markets through a single transaction, and avoiding the need to go through multiple venture or private capital raising rounds.

De-SPACs have been attractive to PIPE investors, which have in turn buttressed deal certainty

In de-SPACs, investors are often invited to inject additional capital through a private investment in public equity (PIPE), to supplement the SPAC's money in trust and validate the valuation of the private target originally agreed between the SPAC and the target principals. PIPE investors are drawn to de-SPACs as they provide a pre-market opportunity to invest in a potentially high growth target on favourable terms, immediately prior to it becoming a listed company. Additionally, because the subscription monies provided by PIPE investors generally cannot be withdrawn (other than where the business combination transaction otherwise fails), PIPE investors deliver deal certainty by increasing the probability that the "minimum cash condition" often agreed between the SPAC and the target is met.

While speed and lack of complexity generally are not distinguishing features of de-SPACs, earlier price certainty than in a traditional IPO is

The argument has been made that de-SPACs are a faster and relatively straightforward way

to raise public capital without expending the time and diversion of resources required by a traditional IPO. However, by combining the complexities of what amounts to three distinct transactions – a private placement, a public/private merger and a public registration and listing process – a de-SPAC is neither simple nor quick. In practice, a de-SPAC may be slightly faster or slower than an IPO, depending largely on the regulatory framework of the transaction itself (for example, required securities, SEC and stock exchange clearances, regulatory approvals and tax applications/submissions). However, the preparatory work required to take a company public is largely the same. Speed, therefore, is not the primary driver for choosing a de-SPAC over an IPO. Conversely, price certainty in a de-SPAC is achieved earlier in the process than in an IPO, established upon announcement of the business combination in advance of the several months needed to work through the regulatory process to complete the transaction, whereas in an IPO the price is established towards the end of the process.

Over the past several months, however, headwinds have been gathering force, calling into question whether SPACs will continue to play the outsized role in the markets they have occupied in the last two-and-a-half years.

The regulatory landscape for SPACs and de-SPACs has been tightening, led primarily by dynamics in the United States

SPAC IPOs have taken place principally in the U.S. markets – most SPACs are incorporated in Delaware or the Cayman Islands and are listed on the NYSE or Nasdaq, reflecting the favourable regulatory environment for these vehicles to date. In the latter half of 2021, however, there was a marked surge in interest among Congress and new leadership at the SEC spurred by the spate volume of de-SPACs hitting the market, focusing primarily on investor protection issues implicated by the way the SPAC is itself structured. In March 2022, the SEC published a number of proposed rules and rule amendments aimed at reforming the SPAC and de-SPAC process to "provide investors with disclosures and liability protections comparable to those … [in] a traditional firm commitment initial public offering". The amendments, if implemented, would have the effect of substantially changing the SPAC and de-SPAC process as conducted up to the publication of the proposed rules, including by significantly expanding disclosure and financial statement mandates, requiring a fairness determination from the SPAC as to the de-SPAC transaction, broadening underwriter liability for de-SPACs, and specifying the inapplicability of safe harbour rules for the use of projections in de-SPACs. In practice, while final rules have not yet been published, the process has arguably already begun to accommodate some of the concepts set forth in the proposed rules. The SEC has also investigated and/or taken enforcement action in respect of purported misrepresentations made in connection with certain de-SPACs (e.g., Nikola/VectolQ Acquisition, Momentus/Stable Roads Acquisition), and it is anticipated that there will be more to follow in the next several months. It is against the background of increased U.S. regulatory scrutiny that SPACs, modelled heavily on the U.S. listed form, have been gaining a following in Europe over the past 18 months. During this time, Euronext Amsterdam has established itself as the preferred listing venue for continental European SPACs, which are otherwise incorporated in a number of different jurisdictions, and the UK Financial Conduct Authority implemented rule changes in order to attract to the London Stock Exchange SPACs similar to those adopted in the United States. It remains to be seen whether similar regulatory scrutiny will materialise in these jurisdictions, or, if not, whether this will result in an increase in listings of SPACs on non-U.S. exchanges.

Court decisions are likely to influence SPAC governance and disclosure of de-SPACs

The first significant court decisions relating to de-SPACs have also begun to leave their mark. The *Churchill III/MultiPlan* case, wherein the Delaware court denied a motion to dismiss on January 3, 2022, has put the spotlight on certain important structural features of SPACs and de-SPACs. *MultiPlan* centres around a sponsor's fiduciary duties, asking fundamental questions about the independence of SPAC directors, the incentives of SPAC sponsors to push a deal through given the way the promote is structured, and the resulting applicable standard of review of de-SPACs – at least in respect of Delaware SPACs. While the *MultiPlan* case continues to make its way through Delaware courts, it is an open question whether it will spur additional litigation in Delaware, and whether similar litigation will be brought in other jurisdictions where SPACs are typically incorporated, such as the Cayman Islands or European Union Member States.

Market uncertainty in the last months of 2021 and continuing throughout H1 2022 is causing de-SPACs to be renegotiated

While the mantra has always been that once signed, a de-SPAC delivers price certainty to all parties involved, that dynamic has begun to change as a result of the weakness in the equity markets in the last several months. De-SPACs signed on the basis of valuations agreed earlier in 2021 are being threatened by increasing percentages of redemptions, which in turn undermine the chances of achieving the agreed minimum cash condition and seeding a target with the expected levels of capital investment needed to facilitate its IPO. Deals have become subject to post-signing negotiations, often involving supplemental methods of financing or upsizing of the PIPE, and deal terms themselves have started to shift towards promotes and lock-ups that incentivise longer-term investment periods, in order to bolster sponsor support of a transaction, as well as the creation of bonus pools to disincentivise shareholders from redeeming. Additionally, in light of underwriter liability potentially increasing, 10b5 letters from law firms and comfort letters from auditors are being increasingly sought, which compounds the time and cost associated with de-SPACs. As a result of this general uncertainty in the market, an unprecedented number of SPACs have pulled their IPOs or dissolved ahead of completing a de-SPAC. It is unsurprising that as SPACs and de-SPACs have rapidly increased in number and prominence, regulatory and judicial review has materialised in equal measure. While it remains to be seen whether the tightening regulatory landscape in the United States will erode the timing and cost advantages that de-SPACs initially offered to companies looking to go public, it would seem, on the basis of continued levels of activity around SPACs, that as long as SPACs continue to adjust in terms of structure, commercial terms, governance and disclosure to meet regulatory and market demands, there is an opportunity for them to continue as a productive feature of capital raising and dealmaking going forward.

* * *

Endnotes

1. PitchBook.
2. SPAC Analytics.
3. SPACInsider.
4. SPACInsider.
5. SPAC Track.

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