Westlaw Today
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Despite slowdown in SPAC activity, opportunities remain

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OCTOBER 13, 2022

Key points

- SPAC activity continued to slow in the first half of 2022, a sharp decline from the number of deals and IPOs in the same period in 2021. Redemption rates soared, and a record number of SPAC deals were terminated.
- Factors contributing to the slowdown include disappointing performance by newly de-SPACed companies, rising inflation, macroeconomic uncertainty and increased regulatory scrutiny from the SEC.
- Lawsuits and demands continue throughout the SPAC life cycle. Filings of SPAC-related securities lawsuits through the first half of 2022 are on pace to exceed the total number of SPAC-related lawsuits filed in 2021.
- SPAC participants have to consider the new 1% excise tax on stock buybacks by U.S. public corporations starting in 2023.
- Despite the challenges, opportunities remain in the SPAC market, and we expect participants will continue to explore innovative strategies to pursue transactions.

Slowdown in SPAC activity in the first half of 2022

The first half of 2022 experienced a slowdown in SPAC activity when compared to recent years. Only 77 de-SPAC M&A deals were announced in the first half of 2022, compared to 167 de-SPAC transactions in the same period of 2021. In addition, only 69 SPAC IPOs were priced in the first half of 2022, compared to 362 SPAC IPOs priced in the first half of 2021.[1]

2022 has also had the highest number of withdrawn SPAC deals on record, with 143 SPAC IPOs withdrawn and 46 de-SPAC transactions terminated through the end of August 2022. SPACs that went public during the SPAC boom of 2020 are now approaching their deadlines to complete initial business combinations and must make the choice to either seek an extension (and likely see high redemptions) or dissolve.

SPACs that have completed transactions this year have also faced redemption rates that have been rising significantly. Between January and July 2021, the average monthly redemption rate for SPACs ranged from 7% to 43%. In contrast, average redemption rates ranged from 43% to 67% between July and November 2021, and have risen significantly in 2022, with an average redemption rate above 81% this year.

This higher redemption rate environment has posed challenges to SPACs aiming to complete business combinations, as less cash remains in the trust account to satisfy any minimum cash condition to complete acquisitions. High redemptions also result in decreased cash proceeds that the combined company can use for its future operations.

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Moreover, higher redemption rates can also lead to reduced liquidity in the stock of the combined company post-transaction. The new 1% excise tax on stock repurchases by U.S. public corporations, passed as part of the Inflation Reduction Act, could also have an incremental impact on a SPAC's cash position, including in connection with a de-SPAC transaction.

SPAC sponsors and their targets have tried different approaches to offset the impact of increased redemptions, including one-on-one negotiations with redeeming stockholders in an effort to reverse redemptions, "redemption recapture" facilities and loan commitments to serve as financial backstops to redemptions, post-closing liquidity facilities (such as committed equity lines of credit) and other post-closing issuances (such as follow-on primary equity offerings). To date, these approaches have had varying levels of success.

This slowdown in activity can be attributed to numerous factors, including disappointing performance by newly de-SPACed companies (though this could be fairly said of the market performance over the same period of newly public companies more generally), rising inflation, macroeconomic uncertainty and increased regulatory scrutiny.

SEC proposed rules and continuing regulatory scrutiny

On March 30, 2022, the Securities and Exchange Commission (SEC) approved the issuance of proposed rules governing SPACs[2] and

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established a public comment period for the proposed rules that is now closed.

These proposed rules include enhanced disclosure requirements for SPACs and de-SPAC transactions, and, among other requirements: (i) impose a mandatory requirement for a novel fairness determination from the SPAC as to the de-SPAC transaction and any related financing transaction; (ii) impose underwriter liability for certain participants in de-SPAC transactions; (iii) create a safe harbor that would be available for SPACs under the Investment Company Act of 1940 that may have the effect of limiting SPACs to an 18-month life; and (iv) render unavailable to SPACs the liability safe harbor in the Private Securities Litigation Reform Act of 1995 for forward-looking statements.

SPAC participants continue to face challenges with the SEC review process, such as increased comments and longer transaction timelines.

The SEC's proposed rules are expected to be finalized later in 2022 or in the beginning of 2023, yet they are already impacting market practice. For example, market participants in de-SPAC transactions have started undertaking enhanced diligence processes and requiring deliverables that generally mirror those in traditional IPOs, including negative assurance letters from counsel and comfort letters from auditors.

In addition to the SEC's proposed rules, Nasdaq has also sought comment on whether the listing standards for SPACs should prohibit the consummation of a business combination when a majority of a SPAC's public shareholders exercise their redemption rights.

SPAC participants also continue to face challenges with the SEC review process, such as increased comments and longer transaction timelines. Thus, SPACs, sponsors and target companies should be prepared for increased diligence, longer transaction execution time frames and greater cost to complete transactions.

Challenges remain in the PIPE market

The PIPE market has also continued to tighten. Potential PIPE investors have also been scrutinizing potential SPAC deals more closely, both given the large number of SPACs searching for a deal and in light of recent performance issues of many newly de-SPACed companies. As a result, PIPE transactions have deviated from their traditional $10 per common share structures in order for SPACs to obtain the financing necessary to close their business combinations.

There has been a rise in "insider only" PIPEs — where the PIPE investors consist solely of SPAC sponsors, target insiders and their respective "friends and family" — and in "strategic" PIPEs, in which the investors have a business or commercial relationship with the target, all resulting from the lack of interested third-party financial PIPE investors.

Some PIPEs have also deviated from traditional pricing structures, with investors receiving more than just one share of common stock (*e.g.*, warrants) in exchange for a $10 investment.

SPACs have also issued convertible debt and preferred stock to provide investors with more certain returns and potential upside from an equity conversion. In addition, SPAC sponsors and targets have had to account for the ongoing market impact of these structures, particularly if also considering redemption mitigation facilities and post-closing liquidity options.

Recent trends in SPAC litigation

Plaintiff interest in SPAC and de-SPAC transactions remains robust, with various lawsuits and demands arising throughout the SPAC life cycle. Demands and/or lawsuits (generally alleging breaches of fiduciary duty or claims under Section 14(a) of the Securities Exchange Act) continue to be commonplace around the issuance of proxy and registration statements concerning de-SPAC transactions.

Seizing on the *MultiPlan* decision[3] and its application of the entire fairness standard of review, plaintiffs often attack alleged conflicts of interest and the structural features of these transactions in addition to purported disclosure deficiencies.

The increasing number of withdrawn transactions and SPAC liquidations provide new potential avenues for litigation, some of which have begun to materialize.

More traditional securities fraud lawsuits have become increasingly common after de-SPAC transactions where the price of the common stock falls or the post-transaction company fails to meet projections included in the de-SPAC registration materials.

Indeed, filings of SPAC-related securities lawsuits through the first half of 2022 are on pace to exceed the total number of SPAC-related lawsuits filed in 2021, according to Cornerstone Research's midyear report.[4] The increasing number of withdrawn transactions and SPAC liquidations also provide new potential avenues for litigation, some of which have begun to materialize.

Finally, as noted above, the SEC's proposed rules, if adopted, stand to have significant impacts on SPAC-related litigation going forward, in terms of those subject to potential liability and the defenses that may be available in the litigations.

Nontraditional targets and structures

Typical targets for SPAC business combinations have been high-growth companies, oftentimes at the pre-revenue stage and in the technology sector. However, some of this year's largest SPAC combinations have been with companies that have consistent revenues. Moreover, several of the de-SPAC transactions announced

in 2022 include companies outside of the technology sector, with targets in the construction, transportation, hospitality and mining industries.

SPACs have also found acquisition opportunities in emerging markets. According to Deal Point Data, in the first half of 2021, only 4.2% of business combination targets were headquartered in emerging economies, whereas in the first half of 2022, this figure increased to 10.4%.

The sheer number of SPACs still looking for business combinations suggests that the SPAC market will continue to be active in the short to medium term.

SPACs have also adopted creative structures to complete business combinations and entice investors, such as three-way transactions involving two target companies that would not have been viable public companies on their own. Sponsors have also been eyeing alternative listing arrangements in response to the waning U.S. SPAC market.

New stock repurchase excise tax

Among the provisions in the Inflation Reduction Act, which President Joe Biden signed into law on August 16, 2022, is a new 1% excise tax on stock repurchases by publicly traded corporations. The excise tax has important ramifications for SPACs.

The excise tax is imposed on the fair market value of stock repurchased by a U.S. publicly traded corporation after December 31, 2022. A "repurchase" is defined to include a "redemption" within the meaning of the U.S. tax code and any transaction that the Internal Revenue Service (IRS) determines to be "economically similar" to such a redemption.

Absent regulatory guidance to the contrary, the new excise tax provision will apply to redemptions of stock by a U.S. SPAC in connection with a de-SPAC transaction or a request for extension occurring after December 31, 2022. This will be the case even if the SPAC was formed before that date and is contractually compelled to honor the redemption requests, and even if the redeeming shareholders are merely recouping their original investments without any economic gain.

Importantly, the amount of stock repurchases subject to the excise tax for a given year is determined by netting the value of stock repurchased by a corporation during the year against the value of any stock issued by that corporation during the year.

The amount of excise tax imposed on redemptions made in connection with a de-SPAC transaction could be reduced or eliminated by this netting rule based on issuances to PIPE investors and target shareholders. But on its face, the netting rule only applies to issuances by the same corporation in the same tax year. Netting may not be available where a corporation other than the SPAC issues shares or the SPAC's tax year technically closes between redemptions and issuances.

For example, in a de-SPAC transaction structured as a "double dummy" combination or as an acquisition of the SPAC by the nominal target, a corporation other than the SPAC is typically the entity that issues shares, and such issuances appear to be ineligible for netting against redemptions by the SPAC itself.

Further, some tax practitioners have expressed concern that the excise tax may apply to taxable liquidations, including SPAC liquidations, either because those liquidations are arguably "redemptions" within the meaning of the U.S. tax code or could be designated as "economically similar" to such redemptions by the IRS. Accordingly, SPACs that expect to liquidate after December 31, 2022, should carefully consider the potential applicability of the excise tax.

Because the excise tax generally applies only to redemptions by U.S. SPACs, it may provide an additional incentive for sponsors to domicile newly formed SPACs in non-U.S. jurisdictions.

Conclusion

In light of these factors, we expect the SPAC market to continue to face challenges for the rest of 2022. Despite these challenges, the sheer number of SPACs still looking for business combinations (over 500 at the time of this article) suggests that the SPAC market will continue to be active in the short to medium term, with SPACs finding targets for business combinations or, failing that, winding up.

In August 2022, 15 SPACs announced plans for business combinations with more than $6.1 billion in combined enterprise value. While this deal volume is considerably lower than the peak of the SPAC market 12-18 months ago, it demonstrates that, despite significant headwinds, market participants will continue to explore creative strategies to pursue transactions.

Notes

[1] The numbers in this article are from the research firm Deal Point Data.

[2] https://bit.ly/3EvO5F6

[3] https://bit.ly/3rqKilG

[4] https://bit.ly/3rLjueX

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This article was published on Westlaw Today on October 13, 2022.

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