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CONSIDERATIONS BEFORE INVESTING IN SPACS

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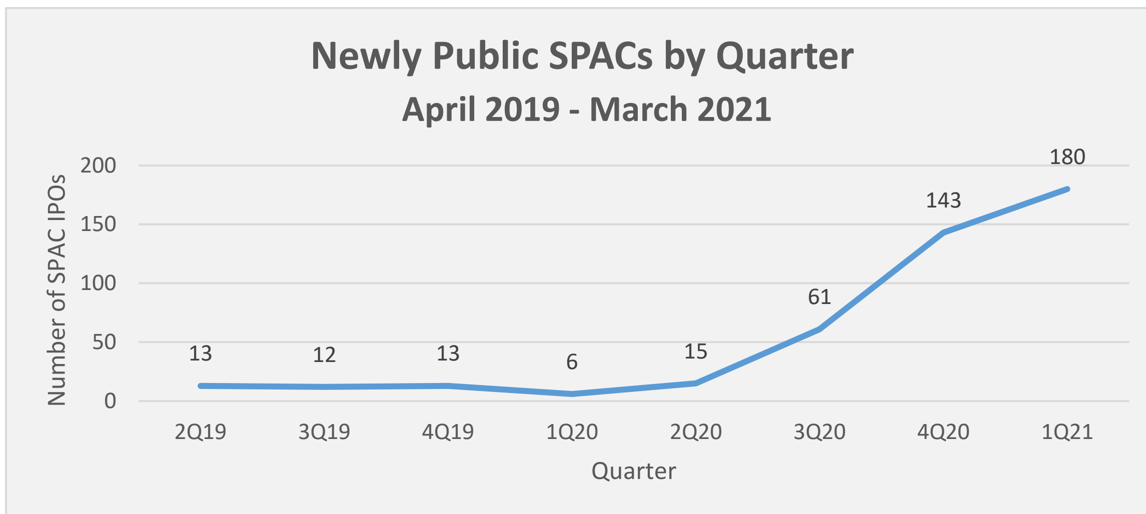
Introduction

A special purpose acquisition company (SPAC), a type of "blank check" company, is a shell investment vehicle formed to bring a private operating company into the public markets with less time, expense and scrutiny than a traditional initial public offering (IPO). A SPAC fulfills its "special purpose" by: raising capital through a fast-track IPO on a stock exchange, identifying a private operating company to acquire, sourcing additional capital, obtaining SPAC shareholders' approval of the deal and deploying the proceeds to acquire the target. Upon this combination of shell and operating company, also known as the "de-SPAC," the operating company survives as the successor public company listed on the exchange. SPAC investors are not obligated to put their capital at risk for the entirety of this process, and their exit opportunities include the chance redeem their shares, prior to the d-SPAC, for the IPO offering price plus accrued interest. [1]

The recent surge in the number of SPAC offerings is familiar to many market participants. SPAC offerings have grown not only in size and frequency, but also as a proportion of total initial public offerings. In the first quarter of 2021, SPACs accounted for 70% of all IPOs and 67% of overall IPO market value, according to data gathered by CII.

[1] Additional capital often takes the form of private investments in public equity (PIPEs). This extra funding is not always necessary but may help attract operating company interest and/or fill unanticipated funding gaps due to over-redemptions prior to the de-SPAC. PIPE investors have greater access to information about the target and can negotiate terms more favorable than public SPAC investors.



As the table shows, the SPAC boom ignited in 2020. SPACs accounted for more than 53% of all IPOs and 41% of the overall IPO market value last year. When CII began tracking SPACs in 2017, they represented just 7% of IPOs and 2% of overall market value.

In view of this transformational shift, it is important for investors to fully understand certain SPAC characteristics. Some are attractive to operating companies and SPAC sponsors but not necessarily to investors. At particular risk are SPAC investors who elect not to redeem their shares. We refer to these SPAC investors as "buy-and-hold SPAC investors." The purpose of this paper is not to dismiss or embrace the SPAC path to going public, but to raise some considerations for investors, who have a wide range of alternatives to put their capital at risk.

1. SPAC investors' incentives are loosely aligned with SPAC sponsors' incentives.

Sponsors invest in a SPAC prior to its IPO and are responsible for the management of the SPAC through the de-SPAC merger. This includes managing working capital, searching for an attractive private operating company, finding additional funders and negotiating deal price.

A SPAC issues a sizable equity intertest in the form of "founder shares" to the SPAC sponsor prior to its IPO. This arrangement is entirely different from the SPAC units or shares investors purchase.[2] Sponsors make a nominal contribution, known as a "promote," in exchange for this stake, which is at risk of forfeiture only if the SPAC does not acquire a target company and must liquidate.

The promote raises a meager amount of capital for a significant stake—typically $25,000 for 20% of the SPAC's equity. While sponsors may inject additional capital beyond the promote, the key imbalance for SPAC investors to understand is that they bear most of the cost of the search for and acquisition of a target company and most of the risk of actually losing invested capital. This core misalignment of risk and reward holds regardless of the quality of the target company, the valuation the SPAC sponsor negotiates for it or the target's success as public company.[3]

[2] In connection with the SPAC's IPO and for a period of time following, investors buy units comprised of one share of common stock and a warrant to purchase stock in the future. Typically, the unit price starts at $10. SPAC IPO investors enjoy not only a guaranteed return of interest if they redeem their shares, but also any upside from free warrants. The units trade for 52 days before "splitting" into separate, independently traded securities. Thirty days after the de-SPAC merger, warrants become exercisable for between one-quarter and one share, typically at an exercise price of $11.50 per share. Some units also include rights to additional fractional shares at no cost.

[3] Not all sponsor terms are so lopsided, and terms are likely to improve as more PACs compete for capital. Bill Ackman's SPAC, Pershing Square Tontine, required Pershing Square to purchase warrants at fair

Sponsors consider the promote compensation for managing the SPAC more than an investment. Yet there remains a formidable difference in risk between SPAC investors and sponsors. Investors have relatively stronger interest in ensuring the SPAC makes a favorable acquisition while sponsors have a relatively stronger interest in simply finalizing an acquisition.

This fundamental misalignment of risk is found across the SPAC market, including at SPACs led by highly regarded sponsors with deep and relevant experience. Last year former Citigroup banker Michael Klein and his team received a $275 million promote for $25,000 before merging Churchill Capital Corp. with health care service company MultiPlan Corporation. At the time, it was the largest-ever SPAC merger. The NYSE-listed stock has since taken a hit since revelations following the de-SPAC, yet the promote arrangement nearly assures upside for the sponsor.[4]

Former Facebook executive Chamath Palihapitiya put up $25,000 for a stake worth in excess of $200 million prior to his SPAC's merger with Clover Health, which has been listed on Nasdaq since January. Clover Health's stock price has cratered since the de-SPAC, yet Palihapitiya's promote has paid off handsomely.[5]

market value with a lock up period of three years following the closing of the initial acquisition of a target company. See Debevoise & Plimpton: Bill Ackman and Pershing Square Launch Largest SPAC To Date: A Harbinger of Things to Come? (July 24, 2020). See also Institutional Investor: Egregious Founder Shares. Free Money for Hedge Funds. A Cluster***k of Competing Interests. Welcome to the Great 2020 SPAC Boom (September 21, 2020).

[4] Both MultiPlan and Clover Health face ongoing shareholder litigation over alleged false and misleading information prior to SPAC investors' redemption opportunity.

[5] Joshua Franklin & Jessica DiNapoli, Reuters: Investors push back on blank-check company insiders' payout bonanza (Dec. 9, 2020).

2. Dynamics unique to the SPAC market exacerbate this divergence.

A SPAC typically commits in its prospectus to closing a business combination within 24 months. If it does not complete a deal in that window, the capital raised from the IPO is returned to investors and the SPAC dissolves.[6] This is a disastrous outcome for the sponsor because the depleted trust account funds not just an acquisition but also the SPAC's operating expenses, which are often financed in part by the sponsor's purchase of warrants. [7]

Given the relatively inflexible timeframe to acquire an operating company, sponsors have a strong incentive to close a deal even if the company's prospects are questionable.[8] This risk rises when there is rapid growth in the number of SPACs, outstripping the supply of high-quality private operating companies ready to go public. While this ecosystem of supply and demand has some positive benefits for public investors (e.g. sponsors reducing their promote or otherwise establishing innovative terms to attract operating company interest[9]), deteriorating deal access stemming from greater competition may spur a sponsor to strike merger agreements with targets they might pass up in a less-crowded market.[10]

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[6] Any extension of the timeline requires shareholder approval.

[7] Statistics on SPAC liquidation bear out this aversion to liquidation. Since 2009, 92% of SPACs completed a business combination. See Wachtell, Lipton, Rosen & Katz The Resurgence of SPACs: Observations and Considerations (Aug. 20, 2020).

[8] Guidance issued in 2020 by the Securities and Exchange Commission's (SEC) Division of Corporate Finance urged enhanced disclosure in cases where the economic interests of SPAC sponsors differ from the economic interests of public shareholders. The SEC warned that these differing interests may harm investors as managers evaluate potential acquisition targets before the SPAC's liquidation date. See Division of Corporate Finance Securities and Exchange Commission: Special Purpose Acquisition Companies. CF Disclosure Guidance: Topic No. 11 (December 22, 2020).

[9] James Thorne, Pitchbook: SPACs face increasing hurdles in race to get deals done (Jan. 4, 2021)

[10] SPAC Analytics is tracking 431 SPACs seeking an acquisition as of April 15, 2021.

3. SPAC investors' decisions on whether to redeem shares before the business combination are informed by financial projections for which accountability is uncertain.

Some supporters of the SPAC path to going public point to investors' redemption rights prior to the de-SPAC merger as an attractive investor safeguard. Investors can limit downside exposure by reviewing information in the de-SPAC merger proxy and redeeming their shares for their original offer price plus accrued interest if they do not see a compelling transaction.[11] This is an important investor protection.

But how reliable is the information they review? The redemption decision is difficult in part because of uncertainty surrounding the dependability of projections about the combined company's future earnings and revenue prospects. Investors should be aware that the legal community is engaged in an active conversation about the consequences for SPAC sponsors and target companies of too-rosy or selective forward-looking projections. The Securities and Exchange Commission (SEC) recently cast doubt on what was a widely held assumption of lower liability risk in de-SPAC proxy statements relative to those of traditional IPOs.

It is widely agreed that the IPO of the SPAC itself carries the same strict liability under Section 11 of the Securities Act for misstatements and omissions that applies to a traditional IPO. But the dominant view has been that de-SPAC disclosures about the operating company carry less liability because they are covered by the "safe harbor" for forward-looking statements in the Private Securities Litigation Reform Act (PSLRA) of 1995.[12] That safe harbor is not available to traditional IPOs.

[11] See SEC Office of Investor Education and Advocacy, What you need to know about SPACs – Investor Bulletin (Dec. 10, 2020).

[12] See: Ericson, Berman and Amdur: The SPAC Explosion: Beware the Litigation and Enforcement Risk; John Jenkins, SPACs: Is the PSLRA Safe Harbor Driving the Boom?, DealLawyers.com (Feb. 3,

However, an April 8 statement by John Coates, acting director of the SEC's Division of Corporation Finance, poured cold water on broad presumptions about de-SPAC filings' qualification under the safe harbor.[13] Coates said: "Any simple claim about reduced liability exposure for SPAC participants is overstated at best, and potentially seriously misleading at worst. Indeed, in some ways, liability risks for those involved are higher, not lower, than in conventional IPOs, due in particular to the potential conflicts of interest in the SPAC structure." Coates pointed out that the PSLRA does not define "IPO," and the legislative history "includes statements that the safe harbor was meant for "seasoned issuers" with an "established track record." The upshot, he said, was that "the PSLRA excludes from its safe harbor 'initial public offerings,' and that phrase may include de-SPAC transactions."

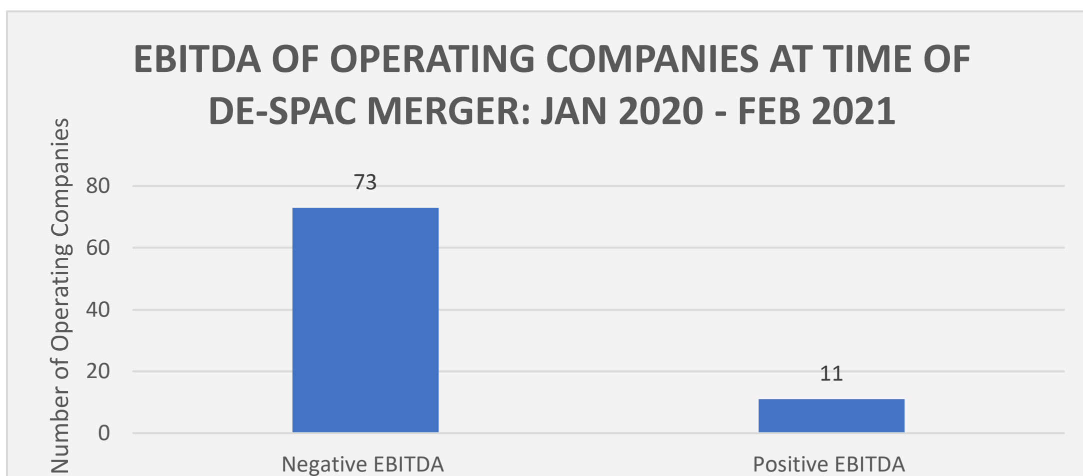
Coates reminded market participants that even if the safe harbor does apply to de-SPAC transactions, it does not shield false and misleading statements, and some of the transactions may be vulnerable to litigation. For example, with respect to the PSLRA, Coates said, "a company in possession of multiple sets of projections that are based on reasonable assumptions…would be on shaky ground if it only disclosed favorable projections and omitted disclosure of equally reliable but unfavorable projections."

Prior to Coates' comments, the conventional wisdom that a de-SPAC transaction faces less accountability may have been a significant factor in the appeal of the SPAC route to becoming a public company, particularly for companies with limited or no

2021); Fenwick memo Financial Projections in SPAC Transactions: Mitigating Class Action Litigation Risk, (October 12, 2020). The PSLRA does not provide a safe harbor with respect to de-SPAC mergers if the defendants knowingly made false forward-looking statements, but *scienter* (intent or knowledge of wrongdoing) can be difficult to prove.

[13] SPACs, IPOs and Liability Risk under the Securities Laws, John Coates. (April 8, 2021).

history of revenue or profitability. It is worth noting the overwhelming predominance of negative EBITDA (earnings before interest, taxes, depreciation and amortization) companies among private companies choosing the SPAC route to going public. A CII review of de-SPAC mergers from January 2020 to February 2021 found that 87% of operating companies going public through a de-SPAC had negative EBITDA at the time of the business combination.[14]



CII-REF analysis of (SEC) EDGAR filings

4. Other reasons for going the SPAC route may not have advantages for SPAC investors.

Beyond the perception of reduced legal liability, additional factors not associated with investor protection may motivate some operating companies' interest in the SPAC route to going public.

Speed to market

From the standpoint of the private company entering the public markets through a de-SPAC, the process is sometimes touted for being faster than a traditional IPO. But

[14] *Based on* SEC EDGAR filings and forms disclosing operating company financials prior to de-SPAC merger (Jan. 2020 – Feb. 2021).

is that speed meaningful, and does that speed benefit investors? The typical timeline for a de-SPAC is 10 weeks, while a traditional IPO usually takes 19 weeks, but preparation for IPOs tends to extend this difference.[15] Investors should be aware that a speedier timeframe may attract a pool of operating companies that is disproportionately focused on capitalizing on a hot market, a hot sector or "short-term fads."[16]

Certainty of value

It is often said that private companies enjoy greater certainty of value with the SPAC process, relative to a traditional IPO, stemming from the up-front determination of equity value."[17] Some SPACs guarantee a minimal cash amount for the merger's completion, but this amount can be waived, and the redemption opportunity means that the amount actually raised is undefined until shortly before the merger.
It is the SPAC process' *method* of valuation that operating companies find attractive. They can negotiate with a single counterparty, the SPAC sponsor, representing a large block of capital rather than risk the volatility that comes with having underwriters and a book building process (roadshow).[18]

Ease of obtaining shareholder approval

SPAC investors can vote down the business combination, but as a practical matter that is highly unlikely. Investors who hold both shares and warrants can redeem their

[15] Mayer Brown presentation Special Purpose Acquisition Companies ("SPACs"): De-SPACing (November 2020). Note that preparation in advance of an IPO drives the practical difference in speed between IPOs than for SPACs (See Klausner, Ohlrogge, Ruan at footnote 97). The total time required for a de-SPAC is likely to increase following SEC acting chief accountant Paul Munter's announcement on March 31, 2021 underscoring a host of measures to be undertaken taken prior to a de-SPAC.
[16] FINRA, Investing in a SPAC (Mar. 29,2021).
[17] See Kirkland & Ellis Private Investment & Family Office Insights, SPAC Overview and the Current Market (Feb. 1, 2021).
[18] Fenwick SPACs 101 FAQ: A Primer on Today's Hottest Exit Strategy (Jan. 15, 2021).

shares and vote in favor of the merger to ensure that their warrants are not worthless.[19] Moreover, depending on the ownership profile of the SPAC, de-SPAC mergers can pass without majority public SPAC shareholder support because of the voting power wielded by sponsors, including super-voting rights for certain classes.[20] In some cases, no solicitation is required because the sponsor and its affiliates can reach the threshold for adoption without support from public SPAC shareholders.[21] Practical impediments can also limit scrutiny. De-SPAC merger proxies are sometimes circulated less than two weeks in advance of the meeting date, reducing the opportunity to dissect the deal. Since 2010, not a single proposal to approve a SPAC-related transaction has failed to pass, according to ISS data.[22]

Investors accustomed to voting on an M&A deal typically expect to see that boards obtained at least one fairness opinion, if not more. A SPAC board has good reason to obtain an outside opinion about the fairness of the deal for an illiquid company, especially considering that directors are often paid through a transfer of founder shares from the sponsor. Yet there are examples of SPAC boards skipping a third-party valuation or fairness opinion, citing the sponsor's expertise and qualifications.[23]

5. SPAC investors' capital may land in ventures the SPAC did not originally intend.

Although some SPAC prospectuses use very broad language to describe targeting strategy to maximize search flexibility, others provide investors with a guidance about

[19] Morrison Foerster Client Alert: SPAC 101 – Selected Q&A (Feb. 3, 2021).
[20] Pershing Square Tontine Holdings, Ltd: Form S-1 Registration Statement (pg. 43).
[21] SEC Office of Investor Education and Advocacy, What you need to know about SPACs – Investor Bulletin (Dec. 10, 2020).
[22] ISS proxy voting database as of April 14, 2021.
[23] See, e.g., MultiPlan business combination.

the target industry or other characteristics. As the acquisition deadline approaches, SPAC sponsors under pressure to secure a deal may look outside of the original scope to avoid liquidation. For example, Leisure Acquisition Corporation originally disclosed that it was targeting a leisure company but ultimately acquired a clinical stage biotech company. Stable Road Acquisition Corporation originally stated it was seeking a cannabis company but ultimately pursued a space exploration firm.[24]

Investors contemplating whether to redeem their shares in these pivot situations are wise to consider whether the strategic redirection stemmed primarily from the appeal of the new opportunity or a desire to close a deal within the 24-month window after an underwhelming target search. Depending on the circumstances, tolerance for a pivot may serve investors well. For example, in the wake of the 2008 financial crisis, some non-real-estate SPACs pivoted into REITs. The shift made sense as originally expected opportunities had evaporated, while significant real estate assets were available at low prices.

6. The SPAC process typically results in substantial dilution, the extent of which SPAC investors don't know until after the business combination.

The promote is just one cost that dilutes the cash raised in the SPAC process. Warrants to purchase shares in the future, no-cost rights to additional shares and underwriting fees become more expensive for SPAC shareholders who hold through the merger as the number of redemptions increases.

A core problem for SPAC investors is that the actual degree of dilution is unknown until after they have decided whether to redeem their shares or support the de-

[24] Yun Li, CNBC: SPACs are becoming less of a sure thing as the deals get stranger, shares roll over (Mar. 4, 2021).

SPAC. De-SPAC merger "minimum-maximum" disclosures describing the impact of dilution under zero and 100% redemption scenarios have limited utility since SPAC redemptions frequently fall somewhere in between those extremes.

Researchers estimate that as a result of all dilutive arrangements, for the median SPAC the $10 raised per share dwindles to $6.67 by the time of the de-SPAC merger, and that in effect, SPAC investors are simply subsidizing the operating company.[25]

Recently, some SPACs have contained some of the dilution associated with this route to going public. For instance, a legacy unit model that included a warrant to a full share has diminished over time to a fraction of a share, and some SPACs now mandate the SPAC's option to redeem outstanding warrants.[26]

7. Underwriting costs are higher than perceived.

Underwriting fees for SPAC IPOs are based on a percentage of the proceeds raised, as with traditional IPOs. However, it is important to keep in mind that due to a SPAC's redemption phase, cash raised can be different from cash received.
The nominal fee percentage is often lower for SPACs than the usual 7% fee for traditional IPOs. It is unusual for SPAC underwriting fees to be adjusted for redemptions at the time of the de-SPAC. Without adjustment, that "attractive" 5% underwriting fee with a redemption rate of 50% is the equivalent of the merged company paying 10%.[27]

[25] Klausner, Ohlrogge & Ruan: A Sober Look at SPACs. NYU Law and Economics Research Paper (March 2021).
[26] Ibid. See also Vinson & Elkins, LLP., Harvard Law School Forum on Corporate Governance: Update on Special Purpose Acquisition Companies (August 17, 2020).
[27] Ibid.

8. SPAC sponsors and affiliates may bring valuable leadership, visibility, both—or neither.

Some SPAC managers have a deep record of leadership in the industry in which the SPAC intends to concentrate its search. Other sponsors have financial expertise and connections to additional capital that may prove crucial during the SPAC process; examples include private equity funds, hedge funds and private investors. Not surprisingly, SPACs in which management has a history of financial or industry acumen have had greater success than other SPACs.[28]

The ease of getting a SPAC off the ground and meager up-front capital required has attracted sponsors and advisors from a range of backgrounds, sometimes with little experience in finance or the targeted industry.[29] Inexperienced sponsors and advisors have been active during the recent SPAC surge, and there appears to be no regulatory or accreditation hurdle impeding its continued proliferation.

The rise of "celebrity" SPACs prompted the SEC's Office of Investor Education and Advocacy to release guidance in March 2021 explicitly warning investors to "[n]ever invest in a SPAC based solely on a celebrity's involvement or based solely on other information you receive through social media, investment newsletters, online advertisements, email, investment research websites, internet chat rooms, direct mail, newspapers, magazines, television, or radio."[30] Just a few of the celebrities to recently

[28] Klausner, Ohlrogge & Ruan: A Sober Look at SPACs. NYU Law and Economics Research Paper (March 2021) stating "SPACs sponsored by large private equity funds and Fortune 500 CEOs and senior executives are, on average, more successful than others."

[29] Traditionally it takes about two weeks to form a SPAC and file a confidential prospectus with the SEC. The SEC then takes 30-60 days to clear the prospectus for public filing, and the SPAC is fully operational in as little as four months. See Jefferies Financial Group: AI: Increasing Number of SPAC Founding Sponsors are Industry Executives (2021).

[30] U.S. Securities and Exchange Commission, Investors Alerts and Bulletins: Celebrity Involvement with SPACs – Investor Alert (March 10, 2021).

sponsor a SPAC include basketball star Stephen Curry and former baseball manager Billy Beane.[31]

Investors are wise to understand the extent of a non-traditional participant's involvement in the SPAC, and the degree to which their participation is paired with proven leadership in industry or finance. For example, Forest Road Acquisition II has received attention for basketball hall of famer Shaquille O'Neal's contribution as a "strategic advisor," but the SPAC is led by former Disney executives Thomas Staggs and Kevin Mayer, which likely fits well with the SPAC's search focusing in technology, media and telecommunications.[32] Quarterback Patrick Mahomes and pitcher Justin Verlander's role in Disruptive Acquisition Corp. I is limited to their membership on an "Athlete Advisory Council."[33] By contrast, celebrities with a role in leadership or who sit on the SPAC board may be a greater cause for investor caution. Former baseball player Alex Rodriguez, as the CEO of the SPAC Slam Corp., may or may not prove to be a skilled SPAC manager; either way, it is reasonable for investors to monitor carefully given that his role extends well beyond an advisory capacity.

9. Buy-and-hold SPAC investors may have weaker rights when they become shareholders in the surviving company.

The combined company following the de-SPAC merger may have weaker governance characteristics relative to the SPAC. This diminution of rights is not entirely a surprise, considering that SPAC shareholders' median ownership in the merged company is 35%, according to one estimate.[34]

[31] Crunchbase News: Athletes and Celebrities Join the SPAC Boom, SEC takes notice (March 11, 2021).
[32] *Id.*
[33] Disruptive Acquisition Corp I. Registration 424B4 (March 25, 2021).
[34] Klausner, Ohlrogge, Ruan A Sober Look at SPACs (2021).

The impact can have long-term effects on the future of the combined company. For example, SPACs Kensington Capital and Diamond Eagle Acquisition were both founded as one-share, one-vote entities before converting to dual-class companies with differential voting rights after completing de-SPAC mergers with QuantumScape and DraftKings, respectively.

SPAC sponsors are not necessarily complicit in the deterioration of governance practices. For example, SPAC sponsor David Hall resigned from the board of Velodyne Lidar shortly after taking the company public through a de-SPAC merger. He publicly accused Velodyne's board of fostering what he described as an "anti-stockholder culture" that lacks public company experience, fails to prioritize shareholder value and "rubberstamps" executive compensation packages.[35]

Conclusion

The SPAC model poses risks to investors, especially those who hold SPAC shares through the de-SPAC merger. Investors can mitigate their downside exposure by selling or redeeming their shares prior to the business combination or by negotiating a favorable subscription agreement through a PIPE investment, which allows for rigorous, confidential evaluation of the operating company. Over time, SPACs could become more attractive to investors who hold shares through the business combination, as disclosure and terms evolve to become more shareholder-friendly.

[35] Peter Vercoe, Bloomberg: Velodyne Founder Who Quit Now Attacks Board as SPAC Deal Turns Sour (Mar. 10, 2021).