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SPACs Explained, in Five Minutes or Less

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In the financial world, 2020 was the year of the SPAC. During the past few years, many Silicon Valley start-ups were chomping at the bit to get listed and cash out via initial public offering (IPO). And in 2020, over half of the companies that went public did so using a SPAC. Exchanges are also getting in on the fun, with at least three SPAC ETFs hitting the stock exchange in the past few months.

But what is a SPAC? Are they just the next financial fad, or are they here to stay? And what types of litigation risk does a company accept by taking the SPAC approach? If you take a few minutes to review our cheat sheet below, you should be able to speak *SPAC* fluently in no time:

What is a SPAC?

The SEC defines a SPAC as a company "created specifically to pool funds in order to finance a merger or acquisition opportunity within a set timeframe. The opportunity usually has yet to be identified." SPACs are a subset of "blank check" company and these terms are often used interchangeably in the media.

In short, a SPAC is a publicly traded pile of money waiting to be used to acquire a private company.

How do SPACs work?

The SPAC process has many of the same steps as a traditional IPO, but SPACs typically get to market much faster.

A sponsor, seeking to acquire or merge with an existing private company or asset, goes through the process of getting the SPAC underwritten, registered, and traded publicly. Prior to the SPAC's IPO, the sponsor owns 100% of the SPAC. During the roadshow, the sponsor seeks investors to purchase common stock and warrants, which entitle the buyer to purchase more stock at a later date (typically once the future target has been acquired). During the IPO, the SPAC will sell these units (containing a share and a portion of a warrant) for a set price, typically at $10 per unit. Given the dearth of historical data or audited financial statements for the newly formed SPAC, this process can be completed more quickly than a more traditional IPO.

Once the SPAC IPO is completed and the sponsor's ownership stake is diluted (typically to 20%), the search for the intended target begins. Up until this point, the SPAC cannot know for certain what company it will acquire or merge with. During the search (which usually takes between 12 and 24 months), the funds raised through the IPO are held in a trust account that the sponsor cannot access until they are used for their intended purpose (an acquisition or combination).

The SPAC, however, can also raise additional funds in support of the potential business combination. PIPEs (Private investments in public equity) have become a significant piece of the SPAC business combination formula allowing SPACs to take on larger targets than they otherwise would be able to with the amounts raised in the IPO and held in trust. The PIPE also provides the target company with certainty in the face of potential public SPAC shareholder redemptions.

If the SPAC finds its target and signs a merger agreement (what is sometimes called a "de-SPAC transaction"), it will announce the planned acquisition and file the necessary documents with the SEC. The transaction is then put to a shareholder vote, where investors can approve or vote down the deal. As part of the shareholder vote, shareholders can elect to have the SPAC redeem (often whether or not they vote for or against the transaction) the shares of the SPAC they purchased in the IPO (and can keep the warrants). Following shareholder approval, the deal closes.

However, if the SPAC strikes out during its stated timeline for action, it returns the money from the trust account to the public investors on a pro rata basis. In such an event, the sponsor's investment in the SPAC becomes worthless.

Are SPACs new?

No, SPACs have been around in some form or another since the 1990s.

However, they have recently seen a resurgence. In 2013, $1 billion in funds were raised through SPACs, or less than two percent of the total capital raised through IPOs. Even in 2019, SPACs only accounted for less than one-fourth of the market. 2020 was the first time that more money was raised through SPACs than through traditional IPOs.

Why would a company choose to use a SPAC?

Traditional IPOs are costly and take time. The Corporate Finance Institute has a good explainer on this topic, but in short, IPOs require negotiating with banks and investors while filing complex documents with federal regulators. There can be significant scrutiny on a company’s actual financials or business model during this roadshow. Even well-known and promising companies have fallen flat when gearing up for an IPO.

SPACs, on the other hand, typically operate on a much quicker timeline, and involve fewer parties. In this environment, it is not surprising that investors have looked to other means to shepherd more “unicorns” into the market.

Do SPACs risk litigation?

SPACs bear many of the same risks that plague newly public companies. However, with their newfound popularity, SPACs have not yet faced a breadth of legal challenges. As SPACs continue to be used in the market, they may face two buckets of potential challenges: failing to act in the best interests of shareholders due to conflicts of interest, and failing to disclose material information.

- **Conflicts of Interest**: SPACs can have different incentives than traditional IPOs, as a SPAC may rely more heavily on PIPE financing. Directors and officers, while still bound by stock exchange listing requirements for corporate governance, may have ties to PIPE financers or the sponsor. Furthermore, SPACs may also produce profits for interested parties in a manner different than IPOs. For example, a SPAC sponsor vests their shares upon the closing of the merger. As sponsors and investors may have different motivations and sources of profit, there will always be concerns about conflicts of interest when it comes to SPACs and mergers.
- **Disclosure**: Once the de-SPAC transaction has occurred, the new company still must make the same SEC filings and disclosures that are required of public companies created through an IPO. Failing to properly alert the market to material findings could prompt actions brought under Sections 10(b), 14(a), and 20 of the Securities Exchange Act of 1934 due to alleged false or misleading statements in

their public disclosures.

The SEC issued two documents in December 2020 – a notice for investors and disclosure guidance from the Division of Corporate Finance – on SPACs, and more guidance may come in 2021. Unsurprisingly, the SEC appears focused on disclosures, and specifically on potential conflicts of interest.

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