Chapter 5A

Special Purpose Acquisition Companies

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§ 5A:1 What Is a SPAC?

§ 5A:1.1 Overview

[A] Definition

A special purpose acquisition company (SPAC) is a shell or blank check company formed for the purpose of acquiring or merging with an unidentified target (or targets) or asset (or assets). The SPAC completes an initial public offering (IPO), raising capital, which is placed in a trust account. The SPAC then must identify and initiate a business combination, known as a "de-SPAC," with one or multiple targets in a specified time frame (typically twenty-four months, but stock exchange rules specify a maximum of thirty-six months.[1]

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1. Nasdaq IM Rule 5101-2(b), https://listingcenter.nasdaq.com/rulebook/nasdaq/rules/nasdaq-5100-series; NYSE LCM § 102.06(e), https://nyseguide.srorules.com/listed-company-manual/document?treeNodeId=csh-da-filter

However, recently, many de-SPACs have occurred less than a year after the IPO[2]).

At the time of the de-SPAC, public shareholders who do not wish to continue to hold shares in the combined company have the opportunity to redeem their SPAC shares. This redemption right exists in current SPAC structures regardless of whether a shareholder vote on the merger is held by the SPAC and regardless of how the redeeming shareholder votes, if such a vote is held. If no merger comes to fruition during the specified time frame, the SPAC liquidates and returns the money in the trust account to shareholders on a pro rata basis.

[B] Capital Structure

A typical SPAC offering consists of a unit. In the vast majority of SPACs, each unit has an offering price of $10[3] and is made up of one common share and usually one-half or one-third of one warrant, though warrant coverage can vary and units may also include a rights component, which often correlates to a fractional share. A SPAC frequently has two classes of stock with varying powers and rights, including, most commonly, director election or appointment and removal rights. Units trade immediately after the offering, and shares and warrants comprising each unit become separable and

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Few SPACs go beyond the twenty-four-month norm, with the exception of those that allow a three-month extension if a definitive agreement is signed within the twenty-four-month time frame and those SPACs recently offering shorter periods to entice investor interest in their IPOs.

2. SPAC TRACK, COMPLETED SPACS SCREENER, https://spactrack.net/closedspacs/; *see also* Jamie Payne, *Market Trends: De-SPAC Transactions*, LEXISNEXIS (Mar. 5, 2022), https://www.lexisnexis.com/community/insights/legal/practical-guidance-journal/b/pa/posts/market-trends-de-spac-transactions#:~:text=SEC%20Scrutiny&text=In%202021%2C%20the%20average%20time,due%20to%20heighted%20regulatory%20scrutiny. The average time between signing and closing of a de-SPAC transaction increased slightly from three months in 2020 to five months in 2021. This increase is partially due to heightened regulatory scrutiny by the SEC, as discussed in further detail below.

3. Very few U.S. SPACs vary from the $10 offer price. By the end of 2021, the only ones that did were Medalist Diversified REIT, Inc. (follow-on offering; $4.80 per share), Pershing Square Tontine Holdings Ltd. ($20.00 per share), Executive Network Partnering Corp. ($25.00 per share), and Periphas Capital Partnering Corp. ($25.00 per share), with the latter three all taking place in the second half of 2020. FACTSET FINANCIAL DATA AND ANALYTICS, https://www.factset.com. International SPACs diverge from the $10 offering price somewhat more frequently, with fifty-one variations since 2019.

begin trading individually (upon investor request) within fifty-two days after the IPO.[4] The SPAC will announce the separation of the units at the time division is available. In certain cases, the units will separate shortly after the over-allotment option has been fully exercised and settled,[5] if that occurs.[6]

Exchange rules mandate that 90% of the IPO proceeds be held in a trust for the benefit of shareholders,[7] though in practice 100%[8] of the gross proceeds are, with the up-front underwriting discount usually topped up by the sale of private placement warrants.[9] Generally, at least part of the underwriting discount will be deferred until, and be contingent on, the initial business combination. The proceeds are only released from the trust as described in the IPO prospectus, most commonly for the de-SPAC or liquidation.[10] To avoid the requirement to register as an investment company pursuant to the Investment Company Act of 1940 (the "Investment Company Act" or the "1940 Act"), SPACs are essentially limited to investing in U.S. government treasuries and certain money market funds that

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4. SPAC RESEARCH, FREQUENTLY ASKED QUESTIONS, https://www.spacresearch.com/faq#spac-trading-units. While the fifty-two-day timeline is not a requirement, it is a very strong market custom from which few SPACs diverge. *PE Jumps into the SPAC Markets*, 17 DEBEVOISE & PLIMPTON: PRIV. EQUITY REP. 2 (Fall 2017), https://privateequityreport.debevoise.com/the-private-equity-report-fall-2017-vol-17-no-2/pe-jumps-into-the-spac-markets.
5. While the greenshoe option in a traditional IPO is thirty days, market custom is for forty-five days in a SPAC IPO. Ramey Layne, Brenda Lenahan & Sarah Morgan, *Update on Special Purpose Acquisition Companies*, HARVARD LAW SCHOOL FORUM ON CORPORATE GOVERNANCE (Aug. 17, 2020), https://corpgov.law.harvard.edu/2020/08/17/update-on-special-purpose-acquisition-companies [hereinafter Layne, Lenahan & Morgan].
6. The SPAC is required to file a Form 8-K with an audited balance sheet within four business days after the closing of the IPO and, if required, depending on the extent to which the underwriter(s) exercise the over-allotment option, at a later date to reflect such later over-allotment option exercise. This is a prerequisite for the separate trading of the SPAC unit components to begin. *Id*.
7. Nasdaq IM Rule 5101-2(a); NYSE LCM § 102.06, *supra* note 1.
8. In certain recent cases, SPAC sponsors have overfunded the trust account, at the time of the IPO, upon a shareholder vote or otherwise, to entice investor interest.
9. *See, e.g.*, CBRE Acquisition Holdings, Inc., IPO Investment Prospectus (Form S-1) (Nov. 9, 2020), https://sec.report/Document/0001193125-20-288585.
10. U.S. SEC. & EXCH. COMM'N, WHAT YOU NEED TO KNOW ABOUT SPACS—INVESTOR BULLETIN (Dec. 10, 2020), https://www.sec.gov/oiea/investor-alerts-and-bulletins/what-you-need-know-about-spacs-investor-bulletin [hereinafter SEC, WHAT YOU NEED TO KNOW ABOUT SPACS].

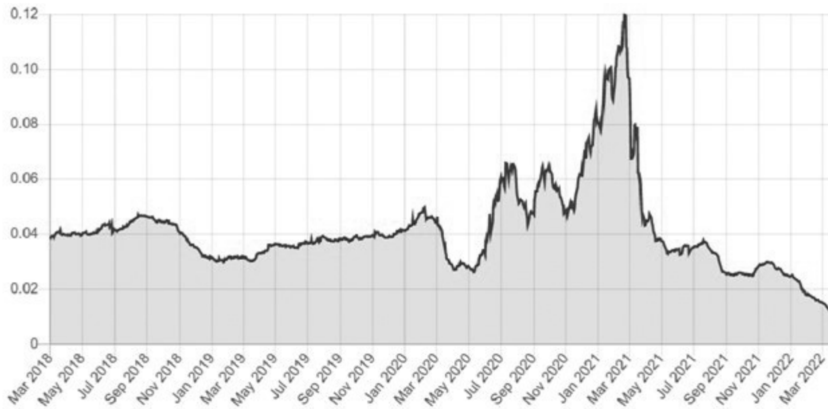
invest in U.S. government treasuries.[11] For further discussion, see section 5A:8.2.

[B][1] Public Warrants

Each unit sold in the SPAC's IPO consists of a share of common stock of the SPAC, accompanied by a warrant component that is usually a fraction of a warrant. In almost all cases, each whole warrant allows the holder to purchase one additional share following the business combination, and is usually exercisable at $11.50 per share (assuming the customary $10.00 per unit offer price). While SPAC units have in the recent past generally included one-half or one-third of a warrant, warrant coverage has varied over time. A lower warrant coverage reduces equity overhang of the post-de-SPAC company for its future activities.

Figure 5A-1

SPAC Warrant Index



Source: *SPAC Research Warrant Index*, *SPAC RESEARCH*, https://www.spacresearch.com/newsletter (showing the ratio of the total market capitalization of all public SPAC warrants without an announced transaction to the initial trust account values for those SPACs).

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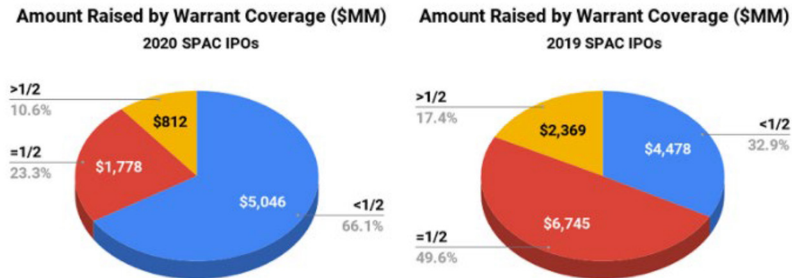
11. These are funds that meet the requirement under Rule 2a-7 of the 1940 Act and that invest only in direct U.S. government treasury obligations, among other requirements. *See also* Special Purpose Acquisition Companies, Shell Companies, and Projections, 17 C.F.R. pts. 210, 229, 230, 232, 239, 240, 249, and 270 (proposed Mar. 30, 2022) [hereinafter Special Purpose Acquisition Companies, Shell Companies, and Projections].

Figure 5A-2

Amount Raised by Warrant Coverage, 2019–2020 SPAC IPOs



Source: More on SPAC IPOs, SPAC RESEARCH (May 8, 2020), https://www.spacresearch.com/newsletter?date=2020-05-18.

Furthermore, the "make-whole" redemption option, which allows the company to redeem the warrants for shares, based upon the Black-Scholes option value of the warrants, started to appear in SPACs in 2017–2018, and is now prevalent in most SPAC structures.[12] This provides the post-de-SPAC operating company with greater flexibility to pursue a transformative transaction, without needing to conduct a public tender offer to manage the equity overhang.

[B][2] Founder Shares

As part of the SPAC's formation process prior to the IPO, the entity or group that forms the SPAC (the "sponsor") purchases founder shares. Founder shares are purchased for a nominal amount, usually $25,000 (or approximately $0.01 or less per share), and are generally seen as compensation for the sponsor's expenses and unpaid work managing the SPAC both prior to the IPO and leading up to the de-SPAC transaction. Transfer restrictions generally apply to founder shares; however, such constraints typically do not limit the sponsor from transferring such shares to directors or members of management, often for de minimis consideration, or to institutional investors that serve as "anchor investors." Founder shares are the basis for the sponsor's profit in the company if there is a successful de-SPAC. Traditionally, the key feature of founder shares is the stipulation that they provide the holders with 20% of the equity raised in the IPO following their conversion at the time of a successful business combination, although some recent SPACs have

12. Layne, Lenahan & Morgan, *supra* note 5.

been adopting innovative structures changing this mechanic, including those that mimic certain private equity approaches to sponsor compensation.[13] Generally, founder shares are automatically converted to public shares upon completion of the de-SPAC transaction. If necessary, dilution is limited by grossing up the founder shares as part of the conversion, though this is often a subject of negotiation in the de-SPAC.

[B][3] Private Placement Warrants

Private placement warrants are sold to the sponsor and, in certain circumstances, to the directors and officers of the SPAC, as part of their compensation, and provide working capital to the SPAC. The sponsor may also transfer private placement warrants to anchor investors to incentivize participation in the IPO. The number of private placement warrants is set to cover the up-front underwriting discount and IPO and de-SPAC expenses, and they are usually sold at $1.50 per warrant, with the number of warrants sold adjusted to match the expected capital needs of the SPAC. The aggregate purchase price of the private placement warrants is known as "at risk" capital. Once exercisable (after the de-SPAC), sponsors typically net-settle their warrants; instead of paying cash for stock upon exercise, they receive an amount of common shares less the number of shares equal to the market value of the strike price. As with public warrants, founder warrants expire worthless in the event of a liquidation.

These warrants provide working capital for the SPAC and top up the trust account for the up-front 2% underwriting discount paid to the IPO underwriters at the closing of the IPO. The working capital is used for two purposes. First, it pays off the pre-IPO working capital loan made by the sponsor (usually $300,000, but this has been scaled up for larger SPACs).[14] Second, it provides working capital for post-IPO expenses in pursuit of the de-SPAC.

SPACs also have certain options if the working capital provided through the sale of private placement warrants is not sufficient for the post-IPO needs of the SPAC. Generally, the sponsor or one of its affiliates (or, in certain cases, other third parties) will provide a loan to the SPAC. Recently, this loan has been in the form of a revolving

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13. *See infra* section 5A:6.
14. *See, e.g.*, Gores Holdings VII Inc., Registration Statement Under the Securities Act of 1933 (Form S-1) (Jan. 20, 2021) (including a $450,000 loan by sponsors in a $400 million offering); Churchill Capital Corp. IV, Registration Statement Under the Securities Act of 1933 (Form S-1) (July 14, 2020) (including a $1.5 million loan by sponsors in a $1 billion offering), among others.

credit facility of up to $1.5 million, which is convertible into private placement warrants at the same price per warrant as the private placement warrants sold to the sponsor at the closing of the SPAC. In a majority of SPACs, interest earned on the investment of the assets held in the trust account may be used to pay applicable tax; in a minority of SPACs, this interest may be used for pre-de-SPAC working capital needs of the SPAC, often up to a cap ranging from $100,000 to $500,000.

[C] Life Cycle of the SPAC

[C][1] Step 1: The IPO (8 to 10 Weeks)

The SPAC's life cycle commences with formation and issuance of founder shares. SPACs are most often organized in Delaware or in the Cayman Islands; this decision is often based on tax considerations, and, in particular, whether the SPAC will plan to pursue targets inside the United States. When the SPAC is launched, as noted above, the sponsor and sometimes the management team, either directly or through an investment in the sponsor vehicle, pay a nominal amount for an equity stake in the SPAC, often referred to as "founders shares" or the "promote" and frequently designated as "Class B" shares. At this point, the SPAC founders must engage counsel, financial statement consultants, auditors, printers, and other service providers. During this stage, the sponsor typically lends the SPAC money pursuant to a promissory note, usually in an amount up to $300,000, to fund ongoing expenses, which is generally repaid at the IPO closing.

Post formation, the SPAC undertakes an IPO. The SPAC must prepare a Form S-1, and typically:

- conducts "testing-the-waters" meetings;
- files the S-1 and amendments responsive to comments of the Securities and Exchange Commission (SEC) (a process that can take more than six weeks);
- negotiates underwriting and ancillary agreements;
- completes a stock exchange listing process;
- submits SEC acceleration requests;
- undertakes a short roadshow; and
- prices, and closes its IPO.

In contrast to a typical operating company IPO, the roadshow is often only a day or two, as the "shadow book" (a roster of potential buyers that gives an indication of what demand will be before the IPO is launched) is built during the "testing-the-waters" meetings.