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The Covid-19 pandemic and resulting economic dislocation has dramatically altered the merger and acquisition and IPO markets. Since the beginning of the pandemic, the corporate world experienced a slew of unprecedented developments, including the resurgence of Special Purpose Acquisition Companies (SPACs).

This article describes a typical U.S. domestic SPAC lifecycle, from formation of the SPAC to acquisition of the target, also known as "de-SPACing." It also reviews certain material considerations for a private company considering a SPAC merger and highlights some of the reasons behind the significant uptick in private equity participation in SPACs.

SPACs are "blank check" companies generally led by experienced sponsors and management teams with demonstrated track records that raise capital through an initial public offering. The IPO is completed within a significantly compressed timeline, as compared with IPOs of traditional companies with operating histories.

The IPO proceeds are used to acquire one or more unspecified targets, typically within 18 to 24 months following consummation of the IPO. There are numerous reasons why the SPAC cannot identify a target at the time of the IPO, including the fact that detailed financial and other information regarding the target company would be required to be disclosed to potential investors, likely lengthening the time period needed to complete the SPAC IPO.

According to Dealogic, U.S.-listed SPAC IPOs raised more than $40 billion in 2020, up from just over $13.5 billion in all of 2019 and a mere $3.5 billion in 2016. In 2020 (as of Sept. 22) U.S.-listed SPAC IPOs accounted for approximately 44% of total IPO capital raised, up from 22% in 2019. Since the beginning of 2019 through July 30, 2020, 41 SPAC mergers were completed and an additional 24 were announced. 2020 may well represent an inflection point as SPACs seem to have caught the attention of institutional investors and the public alike.

Prior to the current wave of SPAC-related transactions, historically there had been a reticence by certain sponsors, investment banks, and other market participants to become involved with SPACs, either as a vehicle or a merger partner. However, with certain changes made recently to the structure of SPACs, several well-known private equity firms and bulge bracket investment banks are leveraging their platforms to engage in the space. This new involvement, combined with the participation by more traditional players, appears to be fueling the surge in SPAC-related transactions.

As market terms for SPAC transactions become more settled, sponsors now have a better defined path to raise a blind pool fund for the ultimate acquisition of a target.

SPAC Lifecycle

Formation

The entity type and jurisdiction of formation of a SPAC is driven by accounting, tax, and corporate law considerations. U.S.-listed SPACs are either incorporated as U.S. domestic corporations or formed in foreign jurisdictions. They are initially capitalized by contribution of nominal capital by sponsors in exchange for founder shares.

The founder shares typically constitute 20% of the SPAC ownership post IPO (the promote) and are subject to anti-dilution adjustments. Recent SPAC IPOs suggest that sponsors are increasingly agreeing to a smaller percentage of promote. In a remarkable departure from the 20% promote model, the sponsor (Pershing Square TH Sponsor, LLC) of a recent SPAC (Pershing Square Tontine Holdings, Ltd.) has not taken any founder shares. The absence of any promote in the Pershing Square Tontine Holdings, Ltd. transaction is a game changer for sponsor economics since it has less dilutive impact on the public shareholders of the SPAC as compared to other blank check companies, and, as such, makes the SPAC more attractive to and better aligned with the public shareholders and potential merger partners.

IPO

Once capitalized, the SPAC files an initial registration statement on Form S-1 with the SEC to register the shares that will be sold to the public in the IPO. The SPAC will then go through a review process with the SEC and clear SEC comments, following which the SPAC will undertake a road show and close on a firm commitment underwriting. It is critical that the private issuance of founder shares (during the SPAC formation) and the IPO are structured in such a way so that the two issuances are not integrated for SEC purposes. As a "shell company," a SPAC is not eligible to use "free writing" prospectuses, such as graphic materials or recorded roadshows. Additionally, the SPAC and its sponsors must comply with applicable limitations on publicity and communications under securities laws so as not to violate the "gun jumping" rules of Section 5 of the Securities Act of 1933.

A SPAC IPO registration statement generally becomes effective within eight to 12 weeks following its initial filing, as compared to a traditional IPO registration statement that generally takes approximately four to six months. As a shell company with no operating history and simplified financial statements, the SPAC registration statement focuses more on the management team and the securities being sold, as compared to the more involved and comprehensive disclosures for companies with operating histories.

As such, absent fraud, there is a lesser likelihood of lawsuits under Section 11 of the Securities Act against SPACs, alleging material misrepresentations or omissions of material facts in registration statements. A SPAC may focus on a particular industry, geography, or sector, or it may retain the flexibility to pursue a transaction of any kind. Any such focus will be described in the registration statement.

A SPAC typically lists its securities on either NASDAQ or NYSE. A SPAC must therefore meet the applicable stock exchange listing standards both at the time of the IPO and the de-SPACing transaction. The listing standards are somewhat similar for both stock exchanges with a few exceptions. Notably, NYSE prescribes a higher threshold for market value of listed securities, $100 million, which is twice the size prescribed by NASDAQ—$50 million.

The equity sold in the IPO consists of "units." Typically, a unit comprises one share of common stock and either a whole or a fractional warrant. The warrants are typically detachable and trade separately from the shares. These warrants are out of the money at issuance, with a strike price that is generally 15% above the IPO price. Recent SPAC IPOs reflect a significant drop in warrant coverage with each unit containing less than one-third of a warrant. A SPAC IPO (Mountain Crest Acquisition Corp.) that came to market in July 2020 had no warrant coverage whatsoever.

The public warrants usually become exercisable on the later of 30 days from the de-SPAC transaction and 12 months from the IPO. Often, SPACs issue warrants to sponsors, known as founder warrants) in exchange for contributions by the sponsor beyond the nominal capital contribution referred to above. These additional contributions made by the sponsor represent "at risk" capital and cover upfront underwriting discounts, typically 2% of the gross IPO proceeds, as well as offering expenses and post-IPO working capital.

The founder warrants are similar to public warrants, except that they contain transfer restrictions and can be net-settled on a cashless basis. The public warrants typically expire on the fifth anniversary of the completion of the de-SPAC transaction. Both public and private warrants expire worthless if a de-SPAC transaction is not consummated.

After the IPO, a SPAC files a Current Report on Form 8-K with the SEC, including an audited balance sheet reflecting its receipt of the gross proceeds of the IPO. The audited balance sheet must reflect at least $5 million in net tangible assets to avoid classification as a blank check company. Upon becoming a public company, the SPAC maintains its financials, tax filings, holds board meetings, and makes SEC filings in accordance with applicable securities laws and stock exchange rules.

The proceeds from the IPO are placed in a trust as the SPAC begins identifying potential operating targets for acquisition. It typically has 18 to 24 months to complete the acquisition, but some SPACS include a mechanism by which stockholders can vote to extend the timeline. If an acquisition is not consummated prior to the outside date, the SPAC dissolves and returns the proceeds in the trust back to the investors. The founder shares are not entitled to any liquidating distributions.

Identification of Target and Transaction Size

After the IPO, the SPAC identifies acquisition opportunities and negotiates the de-SPAC transaction. It simultaneously instructs its professional services providers to conduct diligence on the potential target or targets. The diligence process consists of a comprehensive M&A review that includes, among others, conducting legal, business, financial, tax, and HR diligence; producing a quality of earnings report; studying product, industry and market potential; preparing market research reports; conducting background checks on principals; D&O; and obtaining a fairness opinion in connection with the de-SPAC transaction.

While the size of the acquisition cannot be less than approximately 80% of the IPO proceeds in the trust account, it is often in the range of two to three times the IPO size. There is no maximum limit for the purchase price for acquiring a target, however, it should remain within a range such that the SPAC is not required to be registered as an investment company under the Investment Company Act of 1940.

De-SPAC Transaction Structure

A successful SPAC IPO really accomplishes nothing from the perspective of the management team and the sponsor unless there follows a successful de-SPACing. The de-SPAC transaction may be structured as a merger or purchase of assets or stock. A reverse triangular merger is a popular choice because it reduces friction costs related to assignment of contracts, governmental permits, and third-party consents as compared to an asset sale or forward merger. The sellers of the target may receive cash or SPAC equity or a combination of both.

Significant negotiations revolve around sponsor economics, such as dilution of promote, criteria for forfeiture of founder shares, earn-out criteria, milestones for earn-out shares issued to sponsors or stockholders, and post-closing capitalization of the combined company to name a few. A distinct feature of the de-SPAC transaction agreement is the absence of a reverse break fee because the SPAC has insufficient capital to pay such a fee in the event of a broken deal.

In addition to the items highlighted above, the de-SPAC transaction agreement contains customary representations, warranties, conditions, and covenants that include obtaining regulatory approvals, necessary third-party consents, and SPAC's stockholder consent, if applicable, for approving the de-SPAC transaction. Some SPAC-specific conditions may include minimum thresholds to be maintained in the trust account after the stockholders have exercised their redemption rights and availability of additional funding and credit arrangements.

In advance of signing a de-SPAC transaction agreement, the SPAC arranges committed debt or equity financing, such as a private investment in public equity (PIPE) commitment, to finance a portion of the purchase price for the business, or enters into a contingent-forward contract—typically with an affiliate of a sponsor—or debt arrangements to backstop any shortfall caused by stockholders exercising redemption. The SPAC may elect not to undertake the financing under these arrangements in its sole discretion without incurring any liability. The financing is contingent upon closing of the de-SPAC transaction.

De-SPAC Transaction Process

Before the SPAC can close on a de-SPAC transaction, the public stockholders of a SPAC have the right to return their shares (also known as the redemption right) in exchange for the pro rata amount applicable to such shares held in the SPAC's trust account (which is roughly equal to the IPO share price). The redemption right is offered to the public stockholders either in the proxy statement soliciting approval for the de-SPAC transaction or through a tender offer process.

Stockholder approval will be required in the event the SPAC is not the surviving entity in the merger, if changes to the SPAC charter are required, such as reincorporation in another jurisdiction, or if equity equal to or more than 20% of a SPAC's then outstanding voting stock is issued in the de-SPAC transaction.

When stockholder approval is required, the SPAC files a proxy statement for the transaction that includes, among other things, a proposal for approval of the de-SPAC transaction and an offer to redeem the shares of its stockholders. The proposal and offer are independent, meaning a stockholder may vote in favor of the de-SPAC transaction and also accept the offer to redeem its shares. By contrast, the sponsors typically do not have the ability to redeem their shares since they agree in advance to vote their shares in favor of the de-SPAC transaction.

The proxy statement also includes the de-SPAC transaction agreement, audited financial statements of the SPAC and the target for at least the two most recent fiscal years, and unaudited financials for the interim period, pro forma financial information, management discussion and analysis of financial condition and results of operations, and selected audited and pro forma financial information. There are also disclosures related to director and officer compensation, risk factors, market risks, etc. that are similar to those provided in an annual report on Form 10-K or annual meeting proxy statement.

Where a stockholder approval is not mandatory, the SPAC undertakes a tender offer process, offering the redemption right to the stockholders. The disclosures made under the tender offer are similar to those provided in the proxy statement.

Post-Transaction Requirements

Upon the closing of the de-SPAC transaction, the combined company becomes a publicly traded company responsible for complying with the reporting and other requirements under applicable securities laws. Many combined companies file their registration statements on Form S-3 to register shares issuable upon the exercise of the warrant or any other private shares. However, as a former shell company, a combined company can qualify for the use of Form S-3 only after 12 months have elapsed since the date of de-SPACing.

Also, the combined company is prohibited from qualifying as a well-known seasoned issuer (WKSI) for at least three years following a change in shell company status. In other words, until the combined company qualifies as a WKSI, any shelf registration statement filed on Form S-3 would not be automatically effective, as it would for WKSIs, and will be subject to SEC review before it can be declared effective.

Within four days after closing the de-SPAC transaction, the combined company files a Form 8-K, also known as a "Super 8-K," disclosing, among other things, the de-SPAC transaction, financial statements, updated to reflect actual redemptions and other updates, and other items typically required by a company in a Form 10 registration. Many of the disclosures are similar to those provided in the proxy statement.

Considerations for a Company Navigating its Sale to a SPAC

A private company desiring to go public may consider an acquisition by a SPAC as an alternative to an IPO. On the upside, the SPAC merger is faster and may provide a locked-in price and liquidity certainty in a choppy IPO market. On the flip side, it presents certain structural and execution risks inherent to a SPAC transaction. A few considerations for a target navigating its sale to a SPAC are set forth below.

Closing Risk for Insufficient Funds Post-Redemption. The target bears the risk that the SPAC could be unable to close the de-SPAC transaction if the number of stockholders exercising the redemption right leaves the SPAC with insufficient cash. Although, PIPE and other financing can ameliorate this risk to a significant extent, in some cases, the risk to closing the transaction remains.

Limited Recourse For SPAC's Breach. Given that SPAC mergers do not have a reverse break fee and the trust account cash is not available to backstop SPAC's obligations under the de-SPAC transaction agreement, targets have limited recourse to indemnification or other pre-closing deal protection mechanisms.

Combined Company's Status as a Former Shell Company. As a former shell company, the post-merger combined company is restricted from availing itself of certain safe harbor exemptions and is not eligible to be a WKSI or issue free writing prospectuses for a period of three years from the date of de-SPACing. As noted above, the combined company can qualify for the use of Form S-3 only after 12 months have elapsed since the date of de-SPACing.

SPAC Transaction Costs Are Comparable to IPO Costs. SPAC transactions are often touted as being less expensive as compared to the traditional IPO. In fact, at best, the costs are perhaps only marginally lower than those incurred in a traditional IPO. The costs relating to negotiation, execution, and closing of the de-SPAC transaction agreement and preparation of disclosures, financial statements, pro forma financials, etc., are comparable to those related to a traditional IPO.

The underwriting fee in a SPAC deal is around 5.5% of the IPO gross proceeds with 2% paid upon the SPAC IPO and 3.5% paid on a deferred basis following de-SPACing. This compares to an underwriting fee for a traditional IPO, which is in the range of 5% to 7% of the gross IPO proceeds.

Negotiating Leverage. A target may want to assess where the SPAC is in its lifecycle to determine its negotiating leverage. In early stages, a SPAC is typically looking at multiple targets and may not be as motivated a buyer as a SPAC in the end of its lifecycle. The closer a SPAC is to the end of its lifecycle (18 to 24 months), the more likely it would be to make concessions during merger negotiations.

Being IPO Ready. Since many of the disclosures and financial statements requirements for proxy statements are similar to the disclosures in the IPO registration statement, the target's preparedness is key to keeping the timeline compressed. For instance, the financial statements have certain age requirements and should be audited in accordance with Public Company Accounting Oversight Board (PCAOB) standards. Given the numerous lead-time items needed to get the target prepared for the merger, it is worthwhile to engage professional service providers early in the process.

Rollover Stock. Typically, the stock of the combined company issued as consideration to sellers of targets is subject to lock-up or other resale restrictions. Also, the stock of the SPAC may trigger reporting obligations and short-selling restrictions pursuant to Section 16 of the Securities Exchange Act of 1934. Therefore, a careful review of registration rights, reporting obligations, and resale restrictions is advisable for sellers.

Management of the Combined Company. Given that SPAC transactions are often financial in nature as opposed to strategic, typically, the existing directors, officers, and management of the target continue in their respective roles in the combined company. As a result, the post-closing friction and power struggles in the operations and management of the combined company that at times exist in the aftermath of strategic M&A are much less likely to exist in a de-SPAC transaction.

Private Equity's Increased Participation in SPACs

Historically, some private equity firms have used the SPAC structure as part of their exit strategy by selling their portfolio to a SPAC. However, the past few years have witnessed an increasing interest among the private equity players to step on the other side and sponsor a SPAC instead.

Private equity participation in SPACs has risen from $54.5 million in 2012 to $230.5 million in 2019. It stands at more than $400 million year to date in 2020. SPACs are gaining traction among the private equity players, in part, because the SPAC structure solves the problem of committed permanent capital and provides the flexibility to structure the transaction with lesser leverage and more equity. Also, the economics of the 20% promote—along with warrants to purchase shares and coupled with a fee for arranging PIPEs or other debt arrangements in exchange for the initial "risk capital" contribution—is attractive.

The success of a SPAC is driven by sponsors with experience and track record in identifying, acquiring, and operating a company within an industry and an established network of anchor investors to leverage for PIPEs and other debt arrangements. Therefore, it is hardly surprising why private equity firms are a natural fit.

The hold period of a SPAC is significantly less—18 to 24 months—than that of a traditional private equity investment—about five years with fund life of 10 years. On or after de-SPACing, the sponsor can access the public market and trade its securities subject to lock-up periods. By contrast, in a traditional private equity investment, the fund sponsor typically has the opportunity to realize gain only once the value of the portfolio increases in excess of the annual hurdle rate of 7% to 8%.

Not all private equity firms are structured for SPAC deals. Fund documents of a private equity firm may prohibit investments into SPACs. Some limited partners may view the private equity firm's participation in SPAC as a digression from its core investment business. It may become especially challenging for a private equity firm to explain the SPAC structure to its limited partners and allay concerns regarding competition to find opportunities between the SPAC and existing funds.

The Way Forward

As of Sept. 22, 2020, there were more than 100 active SPACs with more than $40 billion of equity held in trust seeking acquisitions. Given that most de-SPAC transactions tend to be in the range of two to three times the proceeds raised in a SPAC IPO, it means that as of Sept. 22, there is $80 to $120 billion of SPAC-related capital available to be deployed in the M&A market. While this is a big number, it is still modest in comparison to the aggregate value of U.S. domestic M&A market. Nevertheless, over the last decade, the SPACs have increased in size at a steady clip. In 2020, the average SPAC IPO size is north of $400 million as compared to a mere $50 million in 2010.

With repeat sponsors and enhanced participation of established managers and private equity players to sponsor SPACs, there also has been increased willingness among sellers of targets to go public via the SPAC route. As a result, the quality and performance of companies going public via SPACs have grown tremendously in the last few years. A few recent examples include Diamond Eagle Acquisition Corp's acquisition of DraftKing that closed on April 24, 2020, and Nebula Acquisition Corp.'s acquisition of Open Lending that closed on June 10, 2020. The market maintains an "outperform" status on the stock of these companies.

The novelty of the SPAC model is that it has successfully addressed the need for permanent capital solution for sponsors, price and liquidity certainty for sellers of targets, and the public investors' ability to make leveraged buyout type investment in a professionally managed target. The unprecedented rise of SPACs in 2020 was made possible by increasingly aligned economics of various players combined with unusual market conditions. If anything, 2020 illuminates any gaps that still remain. As more alpha targets consider SPAC deals, further changes to sponsor economics, warrant coverage, deal protection measures, and post-closing capitalization are inevitable.

