SPACs: Overview

This Note provides an overview of special purpose acquisition companies (SPACs).

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What is a SPAC?

A special purpose acquisition company (SPAC) is a blank check company formed for the purpose of effecting a merger, share exchange, asset acquisition, share purchase, reorganization or similar business combination with one or more businesses (a business combination transaction).
SPACs are formed by sponsors who believe that their experience and reputations will allow them to identify and complete a business combination transaction with one or more target businesses that will ultimately be a successful public company. A SPAC's management team will optimally be comprised of individuals who collectively have demonstrated success in identifying, acquiring and operating growing businesses and have experience in the public company setting. Some SPACs focus on acquiring a target in a particular industry while others have no such focus. When a SPAC is focused on a particular industry, members of its management typically have significant experience and reputations in that industry.

The SPAC Structure

Common Stock or Units

A SPAC conducts a *initial public offering* (IPO) to raise capital from a mix of institutional and retail investors. Typically, 100% of the cash raised in the IPO is placed in a trust account and not released until the SPAC completes a business combination or upon a specified outside date if the SPAC fails to complete a business combination by such time, as discussed below. In order to compensate investors for agreeing to have their capital held in the trust account for such period, a SPAC generally offers units in its IPO, each comprised of one share of common stock and a *warrant* to purchase common stock. The warrant portion of the unit is intended to provide investors with this extra compensation.

Depending on the size of the SPAC, the prominence and track record of the sponsors, and the particular investment bank leading the IPO, each warrant may be exercisable for a full share of common stock, one-half of one share of common stock, or even one-third of one share of common stock. In any case, the warrants are almost always struck "out of the money." For example, if the per-unit offering price in the IPO is $10, the warrants may have an exercise price of $11.50 per full share.

In order to avoid the need to offer warrants, some SPACs instead have an "overfunded" trust account, so that for each share of common stock sold to public investors, an amount greater than the amount paid by the investors in the IPO is placed into the trust account. The additional cash needed to overfund the trust account comes from an investment the sponsors make in the SPAC through a *private placement* that occurs concurrently with the IPO. Upon redemption of their shares, public investors will be entitled to the amount paid in the IPO plus this extra amount per share.

Where a SPAC IPO includes warrants, the units become separable shortly after the IPO, and the warrants and common stock can trade separately alongside the unseparated units. The warrants become exercisable only if the SPAC completes a business combination transaction.

Sponsor "Promote"

In connection with forming the SPAC, the SPAC's sponsors acquire founder shares for nominal consideration. The ownership of these founder shares, sometimes referred to as the "promote," typically results in the SPAC's sponsors owning 20 percent of the SPAC's outstanding common stock upon completion of the IPO. The founder shares are generally subject to a *lock-up* restriction for a one-year
period following the business combination, subject to earlier release if the trading price of the post-business combination company's stock reaches certain thresholds or upon a post-business combination extraordinary transaction. The founder shares are intended to provide value to the SPAC team, which typically does not draw any salary or take any management fees from the SPAC until a business combination transaction is completed.

In order for the SPAC to be able to pay expenses associated with the IPO—the most significant component of which is the underwriting discounts and commissions—the SPAC's sponsors typically purchase warrants from the SPAC for a purchase price intended to be at least equal to their fair market value, in a private placement that closes concurrently with the closing of the IPO. These warrants are substantially identical to the public warrants. If the SPAC does not offer units, then the sponsors typically purchase shares of common stock at the IPO price in order to allow the SPAC to pay these expenses and, in such case, to "overfund" the trust account.

**Trust Account**

As noted above, an amount equal to at least 100 percent of the gross proceeds of the IPO raised from public shareholders is placed into a trust account administered by a third-party trustee.

The IPO proceeds are not permitted to be released from the trust account until the closing of the business combination or the redemption of public shares if the SPAC is unable to complete a business combination within a specified timeframe. At the closing of a business combination, public shareholders may redeem their shares for a pro rata portion of the cash held in the trust account, with the balance of the trust account released to the company to be used in the business combination transaction or thereafter for working capital purposes. If the SPAC fails to complete a business combination in the required timeframe, all public shares are redeemed for a pro rata portion of the cash held in the trust account.

The proceeds in the trust account generate interest income, some of which may be used for the SPAC's expenses until it completes a business combination transaction.

**Size and Dilution**

The amount that a SPAC raises in its IPO is typically about one-quarter to one-third of the expected enterprise value of its business combination target in order to minimize the effect of the dilution resulting from the founder shares and warrants at the time of a business combination. However, it is of course uncertain at the time of the IPO what the enterprise value of a target actually will be given that a target cannot be identified at the outset. If it turns out that the SPAC needs to raise more capital at the time of the business combination in order to complete the transaction, this may come from the sale by the SPAC of additional equity or equity-linked securities, which would dilute the percentage ownership of the sponsors represented by their founder shares to below 20 percent. In order to maintain that percentage at 20 percent, a SPAC may implement a dual-class structure at the time of its IPO, in which the founder shares consist of a separate class of stock that is automatically converted upon the closing of the business combination into that number of shares of the same class of common stock held by the public.

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shareholders equal to 20 percent of the outstanding shares after giving effect to the sale of additional equity or equity-linked securities (but excluding any shares issued to the owners of the target company as compensation for their interests in the target). The SPAC may also raise debt in connection with a business combination transaction.

The IPO Process

A SPAC IPO is registered using a registration statement on Form S-1 and is conducted in the same manner as an IPO for any other company. As most SPACs will qualify as emerging growth companies under Section 2(a)(19) of the Securities Act of 1933, as amended (the Act), most SPACs may, under Section 6(e) of the Act, confidentially submit to the Securities and Exchange Commission (SEC) a draft registration statement for confidential nonpublic review by SEC staff prior to public filing, provided that the initial confidential submission and all amendments thereto must be publicly filed with the SEC no later than 15 days before the date on which the SPAC conducts its road show for the offering.

Because the SPAC has no operating business to disclose or discuss in the registration statement, the SPAC instead focuses on a discussion of its structure and business combination strategy. If the SPAC intends to focus on a particular industry, the SPAC discusses this industry as well. Because the SPAC has no real operations or assets, the financial statements and the "Management's Discussion and Analysis of Financial Condition and Results of Operations" section are not significant.

The primary asset of a SPAC before the IPO is its management team. As a result, the "Management" section of the registration statement becomes very significant, where the SPAC focuses on disclosure of its management's background and experience.

At the time of its IPO, the SPAC cannot have identified a business combination target; otherwise, it would have to provide disclosure regarding that target in its IPO registration statement. Typically, the SPAC must state in its registration statement that it has not identified any target.

Because the SPAC is a shell company, it is subject to certain restrictions and limitations under the federal securities laws, such as:

- A SPAC is an ineligible issuer that is not entitled to use a free writing prospectus in its IPO or subsequent offerings within three years of completing a business combination.

- After completing the IPO and until it completes a business combination, the SPAC must identify its shell company status on the cover of its periodic reports under the Securities Exchange Act of 1934, as amended.

- A SPAC cannot use a Form S-8 to register any management equity plans until 60 days after completing a business combination.

- Holders of SPAC securities may not rely on Rule 144 under the Act for resales of their securities after the SPAC completes a business combination until one year after the company has filed current "Form 10" information (i.e., the information that would be required if the company were filing a
general form for registration of securities on Form 10 under the Securities Exchange Act of 1934, which is comparable to the information about the company that would be filed in a registration statement on Form S-1) with the SEC reflecting its status as an entity that is no longer a shell company.

**NASDAQ Considerations**

Upon the closing of the IPO, most SPACs choose to list their securities on the NASDAQ Capital Market. NASDAQ has special listing requirements for a SPAC set forth in IM-5101-2, including, among others, that:

- Its initial business combination must be with one or more businesses having an aggregate fair market value of at least 80 percent of the value of the SPAC's trust account.
- It must complete a business combination within 36 months from the effective date of its IPO registration statement, or such shorter time as specified in its registration statement.
- If a shareholder vote on a business combination is held, public shareholders voting against a business combination must have the right to convert their shares of common stock into a pro rata share of the aggregate amount then in the trust account, and if a shareholder vote on the business combination is not held, the SPAC must provide shareholders with the opportunity to redeem all their shares for cash equal to their pro rata share of the aggregate amount then in the trust account.

NASDAQ listing rules also require that the SPAC:

- Have at least 300 round lot shareholders (that is, holders of at least 100 shares) upon listing.
- Maintain at least 300 public shareholders after listing.

Upon the closing of a business combination, the SPAC must meet NASDAQ's initial listing requirements, even if the SPAC is the continuing public company.

**The Process Leading up to the Business Combination**

**Timeframe**

As noted above, until the closing of the IPO, the SPAC cannot hold substantive discussions with a business combination target. Following the IPO, the SPAC begins to search for a target business. Under the terms of the SPAC's organizational documents, if the SPAC is unable to complete a business combination with a target business within a specified timeframe, often 24 months from the closing of the IPO, it must return all money in the trust account to the SPAC's public shareholders, and the founder shares and warrants will be worthless. If a SPAC is running out of time, it may seek a shareholder vote to extend its lifespan. SPAC organizational documents typically provide that in connection with any such vote, the SPAC must offer public shareholders the right to redeem their shares for a pro rata portion of
the cash held in the trust account.

**Expenses**

The proceeds from the sponsors' warrant (or stock) purchases are not placed into the trust account and instead are used to pay the IPO expenses and other expenses until the SPAC completes a business combination. The proceeds in the trust account generate interest, some of which may also be used to pay expenses. If such amounts are not sufficient, the sponsors may also make loans to the SPAC to pay its expenses.

**Shareholder Approval and Redemptions**

After entering into an agreement for a business combination, the SPAC must offer each public shareholder the right to redeem their shares in conjunction with the transaction, and must prepare and circulate to its shareholders a document containing information concerning the transaction and the target company, including audited historical financial statements and *pro forma* financial information. This document typically is in the form of a *proxy statement* for a shareholder vote, which also is filed with the SEC and is subject to SEC review. A SPAC also may conduct *redemptions* pursuant to the SEC’s *tender offer* rules, in which case the SPAC would file tender offer documents with the SEC instead of a proxy statement. The funds from the trust account are primarily used to complete the business combination and to pay for the redemption of shares from any shareholders that have elected to redeem their shares.

If a shareholder vote is held, the voting standard is typically a majority of the shares voted as set out in the SPAC's organizational documents. The management team typically agrees at the IPO to vote its founder shares and any public shares acquired by it during or after the IPO in favor of the proposed business combination.

Any public shareholders can redeem their shares of common stock for a *pro rata* portion of the trust account at the time of the closing of the business combination, whether they vote for or against the business combination. Often, the agreement relating to the business combination contains a condition requiring a specified amount of cash to remain after the SPAC satisfies all redemption requests.

Because the SPAC is a public company, obtaining the vote of the shareholders is governed by the federal proxy rules. Unless it is a *foreign private issuer*, the SPAC must file a proxy statement with the SEC in compliance with *Regulation 14A*, subject to SEC review and comment. A key consideration in preparing this proxy statement is disclosure of financial and other information of the business combination target that complies with applicable SEC requirements (including Regulation 14A, *Regulation S-K* and *Regulation S-X*). Substantially the same information is required if the SPAC instead conducts redemptions in accordance with the SEC’s tender offer rules.

Once the SPAC completes a business combination, it becomes an ordinary public operating company, albeit with certain rules applying to it due its former status as a shell company.
**Failure to Complete a Business Combination**

If the business combination does not receive a majority vote, or if the transaction otherwise fails to be completed, the SPAC may search for another business combination target if the specified timeframe for completing a business combination has not ended.

As noted above, if the SPAC cannot find an appropriate business combination target or complete a business combination within the applicable timeframe, and the timeframe is not extended by vote of the shareholders, the trust account must be liquidated and the proceeds held in the trust account are returned to the public shareholders.

**Certain Benefits of the SPAC Structure**

**Public Investor Perspective**

From the public investors' perspective, a SPAC IPO represents the opportunity to invest in a company led by experienced investment professionals who are incentivized to identify and complete an attractive business combination.

In addition, the units public investors purchase in the SPAC IPO provide the public investors with several options. Investors can hold the units until the announcement of a business combination, and then decide, based on the detailed financial and other information presented to them, whether or not the business combination appears to be an attractive transaction from the SPAC's point of view. If a public investor likes the business combination, then it can simply continue to hold its securities after the business combination. If a public investor decides that it is not interested in continuing as an investor after the business combination, it can either sell its securities in the open market or have its common stock redeemed at the time of the business combination for an amount equal to its pro rata share of the trust account.

Public investors can sell their units before the announcement of a business combination, or break their units apart and sell either the shares of common stock or the warrants.

Finally, their downside is protected because if the SPAC is unable to complete a business combination within the required timeframe, a public investor's shares of common stock will be redeemed for their pro rata share of the trust account.

**Management Team Perspective**

From the management team's perspective, a SPAC offers the opportunity to raise a significant amount of cash in the public markets to complete a business combination transaction. This capital-raising process can be easier than raising a similar amount of cash in the private markets because investors will have liquidity. The management team's compensation, which is typically in the form of its founder shares, is an outright ownership position, as opposed to the "carried interest" paid to private equity fund managers, which is a percentage of profits. The management team also has the opportunity to profit
from an increase in value post-business combination from its warrant position.

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