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Blank-check companies under fire in the US

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Since the start of this year, investors in the United States have already filed more than a hundred lawsuits against so-called SPACs because they feel they have been tricked. It may be a precursor to similar complaints in Europe.

Special purpose acquisition companies (SPACs) list like a bag of money on the stock market until management finds an unlisted company with which the SPAC can merge. If the SPAC's shareholders agree to that plan, that company takes over the listing. In exchange, the investors get a stake in the new business combination.

This seems like a simple process, but several potential conflicts of interest pop up along the way. Investors who think they have been duped can go to court to get their money's worth. This is happening now especially in the US, where there has been real SPAC hype over the past year. Since the beginning of this year, more than 370 blank-check companies have gone public there. That's half as many as in all of 2020, and six times as many as in 2019. By comparison, Europe has yet to hit the 25 mark this year.

Legal rulings are still pending in most cases, says Jeffrey Steinfeld, an expert at the Chicago law firm Winston & Strawn. 'The legal battle was often started not so long ago, and the pandemic has caused the courts to lag behind.'

Nonetheless, the type of lawsuits give an idea of the pain points that may also be at play in Europe. Just recently, European regulator ESMA published guidance on what SPACs should look out for in their prospectus, and how their investors should be protected.

This is how empty stock market shells, which typically go public at $10 or €10 per share, get filled. It is the originators of the SPACs - sponsors in jargon - who seek a merger candidate, and who make a concrete proposal to the SPAC's shareholders to do so. If this is agreed to, the sponsors usually receive a fifth of the shares for free, or at a low price, for their efforts.

The condition, of course, is that there really is a deal. Sponsors usually have two years to do this. If they don't succeed, the shareholders get their money back and the sponsors cover the costs of the IPO. As the deadline approaches, the risk increases that they will propose a merger with a second-tier company.

An example of investors wary of this is the lawsuit against Acamar Partners Acquisition Corp. There, the plaintiffs alleged that the SPAC's directors breached their fiduciary duty by rushing into a business combination in order to meet the two-year deadline.

They demanded that the sponsors provide additional information about the proposed merger with CarLotz, a physical marketplace for buying and selling cars, and especially about the financial projections that had been used to determine the value of that company. They also asked the judge to prohibit a vote on the proposed merger until then.

After filing the complaint, the SPAC sponsors decided to provide additional information to the U.S. regulator SEC. In exchange for reimbursing them for the legal fees they had incurred in the meantime, some $175,000, the plaintiffs subsequently withdrew their complaint.

So that was all before the proposed business combination could be approved. Several lawsuits are pending in the U.S. from investors who agreed to the merger but feel they were misled into doing so by sponsors who insisted on meeting their deadline.

The lawsuit that stands out the most is directed at Landcadia. According to the plaintiffs, who have joined together in a class action, a class action, the sponsor of this SPAC intentionally misrepresented the risks in the business plan of Waitr, the delivery service that the SPAC's shareholders got their hands on in 2018.

The announcement of this deal came barely two weeks before the two-year term expired. Waitr became a flop. The company once valued at nearly $1 mrd lost about 96% of its value in 2019. Rivals such as Grubhub and UberEats proved far too strong.

According to the complainants, it should have been clear to Landcadia that Waitr was a poor takeover candidate. For example, unlike its competitors, Waitr did not work with cheap freelancers, but rather with more expensive permanent workers. In addition, it charged restaurants only 15% for orders, whereas competitors charged 20% or more. That proved unsustainable, and after the IPO the rate shot up to 30%.

Landcadia's sponsors include such sound names as restaurant entrepreneur and billionaire Tilman Fertitta and Richard Handler, CEO of investment bank Jefferies. 'They believed what they said about Waitr's prospects,' their lawyers argued in court. 'They went out of their way to be successful, and accurate about the company's financial performance.' But that was not enough in the face of 'serious competition'. The court has taken the case under advisement; it is waiting for a ruling.

It can also happen that SPAC investors are actually angry because a company has passed them by. For example, the SPAC Social Capital Hedosophia Holdings IV held takeover talks with online personal finance company Social Finance, but in the end, it was brother Social Capital Hedosophia Holdings V that ran with it in May this year. The share price of that new combination shot up to $20.

“If Social Capital Hedosophia Holdings IV announces a business combination that the market doesn't view as favorably as the SoFi deal, SPAC shareholders could sue its directors for passing on the charity, SoFi, to one of their affiliated entities,” an analysis by Winston & Strawn reads.

Lawyer Jeffrey Steinfeld is especially watching with great interest the lawsuit recently filed around Multiplan Corp, a data analytics company that went public last year through SPAC Churchill Corp III, and is now trading at around $8 a share, significantly below the $10 thus to which investors of the first hour subscribed.

Investors are taking issue with SPACs entire business model in this case, Steinfeld explains. In the state of Delaware, where the dispute is taking place, there is an equity standard for transactions where one party has a controlling interest in both the buyer and the seller. The directors must then prove that the deal is fair to all shareholders, and that a proper price was paid.

In the Multiplan case, the plaintiffs seek to invoke, or rather stretch, this standard, since the sponsors did not exercise control over the intended target. But investors see a similar conflict of interest, as the founders' shares are worthless if the SPAC does not achieve a business combination.

Steinfeld sees a number of problems with that line of argument. 'First, the prospectus for the SPAC's IPO clearly stated that the founder shares would be worthless if a transaction did not occur. In addition, in Delaware, when reviewing business decisions, "there is a presumption that the board of directors is acting with knowledge, in good faith, and in the best interests of the corporation in making business decisions." The fact that the transaction was approved by a majority of the shareholders who had no special interests may strengthen the court in that belief.

Still, he does not rule out the possibility that the court will still decide that the fairness standard applies because of the different interests of the founders and the other shareholders. 'In that case, it will only become more important that the supervisory board of a SPAC can assure that everything was done fairly, and at a fair price.'

There are several ways sponsors can increase their credibility, Steinfeld notes. “Some, for example, stipulate that they can redeem a portion of their founder's shares only if the stock price after the business combination rises above $12.5, $15 or even $17.5.”