SPACS – Is the Party Over?

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The boom in special purpose acquisition company (SPAC) IPOs continued at its record pace during the first quarter of 2021, and there didn't seem to be any reason to doubt its continued record growth. Then, April 2021 happened, and the number of SPAC IPOs and the amount raised declined precipitously. The question now is whether April portends the SPAC "boom" cycle ending and becoming a "bust."

To answer that question, we need to examine several factors:

- **Increased Securities and Exchange Commission (SEC) Scrutiny.** Commencing late last year, the SEC indicated that it would be examining SPAC transactions to ascertain that SPAC transactions they were properly structured and that investors were adequately protected before investing in SPAC IPOs and approving de-SPAC transactions. From December 2020 through mid-April 2021, the SEC has issued statements to the participants in SPAC IPO transactions and de-SPAC transactions, stressing issues such as: the risks that SPAC transactions pose; the necessity of complete and accurate disclosures concerning all participants in the transactions, their relationships and potential conflicts of interest that may arise among SPAC investors, SPAC sponsors, underwriters, target companies and their shareholders and management; post de-SPAC limitations imposed on former shell companies; the necessity for the target company to be public company ready (for example, in all accounting and financial statement matters and corporate governance); and details of the due diligence of the target company and the de SPAC transaction.

  However, the two most significant SEC statements occurred in April and addressed:

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  - Guidelines that SPACs should use to determine whether warrants issued by them should be accounted for as equity of the SPAC or as an asset or liability, and that the determination should be based on an evaluation of

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the warrant's terms and the SPAC's specific facts and circumstances. In addition, the SEC indicated that existing SPACs might have to restate their financial statements based on the outcome of this analysis.

- The assertion that the safe harbor for certain forward-looking statements contained in the Private Securities Litigation Reform Act is available to the target company projections in the de-SPAC transaction documents and that a de-SPAC transaction subjects its participants to less liability than an IPO. The SEC questioned both of these conclusions and indicated that SPAC participants might be subject to greater potential liability than IPO participants.

- **Increased Liability Exposure.** It is expected that the SEC will continue to focus on SPAC and de-SPAC transactions to make certain they will meet all legal requirements and that investors are protected. As more and more de-SPAC transactions come to market, the plaintiffs' bar is zeroing in on de-SPAC transactions, and more SPAC shareholders are filing suits alleging inadequate or false and misleading disclosures, omissions in the de-SPAC transaction documents, and state law breaches of fiduciary duty, especially when the post de-SPAC company doesn't meet its projections. The SEC's statements regarding SPACs are providing a playbook for the plaintiffs' bar to follow.
- **More Educated Investors.** As SPACs' popularity has increased, more investors have informed themselves about the advantages and risks of SPACs. The investors have realized that many companies being taken public in a SPAC merger have little or no operating revenues and that there is no guaranty that the sponsors will be able to effect the target company's projections post-merger. In fact, they are realizing that for every SPAC home run, there are many post-de-SPAC companies that are trading below their initial IPO price.
- **Excessive Number of SPACs Seeking Transactions.** There are currently approximately 427 SPACs seeking target companies. Will all of them find a target company with which

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to enter a de-SPAC transaction? Will there be an increase in SPAC redemptions?

So, are SPAC IPOs and de-SPAC transactions headed into a bust cycle? I don't think so.

What I think we'll see is a slow down or delay in the number of SPACs coming to market as sponsors and their associates wrestle the proper accounting treatment of "warrants" to the ground, and they spend additional time making certain that their disclosures in the SPAC and de-SPAC transaction documents are totally transparent and do not contain untrue statements of fact or material omissions, especially when they address the target company's projections and the meaningful cautionary language that is required to accompany the projections.

As for the target companies being considered for acquisition, I do not see any immediate slowdown. There are too many existing SPACs that will need to acquire a target in the next two years. In addition, both the favorable (to sponsors) economics and the SPAC process are hard to ignore and will continue to motivate the parties to consummate de-SPAC transactions. For more information, please contact Neil Ganulin of Frost Brown Todd's Private Equity industry team.

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