

SEC Indicates SPACs Should Provide Robust, Clear Disclosure Regarding Conflicts Between Insiders and Public Shareholders

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Special Purpose Acquisition Companies (SPACs) are blank check companies with no operations that undergo an Initial Public Offering (IPO) to raise capital with the intent of acquiring an operating company. SPACs raise capital based on the public's confidence in a SPAC's management team (sponsor) to identify an operating target company and complete a business combination transaction (de-SPACing transaction), typically within a 24 month timeframe, resulting in a public operating company. Almost all IPO proceeds are held in a trust account for use primarily in a de-SPACing transaction. Prior to a de-SPACing transaction, public shareholders may exchange their shares for an amount approximately equal to the cost of the shares at the IPO.

SPACs have grown in popularity over the last ten years. In 2011, SPACs raised \$1.1 billion, and in 2020, they raised \$83.2 billion. By 2019, SPAC IPOs accounted for approximately 25% of the money raised by IPOs in the US. The average size of SPAC IPOs also increased over the last decade, with the average SPAC IPO raising \$335 million in 2020 compared to \$69 million in 2011. Further demonstrating the increased popularity of SPACs, the number of SPAC IPOs more than quadrupled to 248 in 2020 from 59 in the previous year. 2020 saw more SPAC IPOs than all of 2011 through 2019 combined.

Underlying Conflicts of Interest

The compensation structure of the SPAC sponsor, directors, officers, and affiliates (collectively, insiders) creates potential conflicts of interest between insiders and public shareholders. Insiders often receive compensation tied to the closing of a de-SPACing transaction and are responsible for negotiating and recommending that public shareholders approve a de-SPACing transaction. Accordingly, the disclosure of when the interests of insiders diverge from those of public shareholders is important. Understanding the compensation structure of insiders can influence the public's investment decisions relating to a SPAC, and proper disclosure of such compensation structure is therefore important to investors.

Sponsors typically receive, for a nominal price, a "promote" of shares (founder shares) representing 20% of the SPAC's outstanding shares at the IPO. Founder shares, in most instances, convert to public shares upon a de-SPACing transaction. The conversion ratio may include a mechanism to result in a 20% equity holding by the sponsor in the resulting public company. Sponsors also purchase warrants (founder warrants) for a price typically equal to 2% of the IPO gross proceeds plus an additional \$2 million for offering expenses and operating expenses following a de-SPACing transaction. The purchase of founder warrants represents the "at risk capital" of the sponsor.

The founder shares and founder warrants have no value if a de-SPACing transaction is not completed. However, if a de-SPACing transaction is not completed, the SPAC is dissolved and public shareholders will receive a payment from the trust account equal to about the cost of the public shares in the IPO. This creates a great incentive for the sponsor to complete a de-SPACing transaction. The risk is partially mitigated by the public shareholders' right to redeem their shares for cash prior to the de-SPACing transaction.

Independent directors of a SPAC may share similar incentives with the sponsor to complete a de-SPACing transaction. Some independent directors are compensated with founder shares from the sponsor that are sold to the directors at cost. Accordingly, independent directors, like sponsors, may have a financial interest in a de-SPACing transaction that diverges from public shareholders.

SPAC underwriters are compensated differently than underwriters of a traditional IPO. Underwriters of a traditional IPO receive a discount of about 5%-7% of the IPO gross proceeds on closing of the IPO. However, SPAC underwriters typically receive the majority of their compensation on a delayed basis after completion of the de-SPACing transaction. As a result, if a de-SPACing transaction is not completed, the underwriters do not receive the majority of their compensation. Like insiders, underwriters may have a diverging financial interest in a de-SPACing transaction from the public shareholders.

SEC Releases Guidance on SPAC Disclosure Relating to Conflicts of Interest

In the midst of an increase in the popularity of SPACs, the Division of Corporate Finance of the Securities and Exchange Commission issued CF Disclosure Guidance: Topic No. 11 (the Guidance) on December 22, 2020, relating to the need to provide disclosure of conflicts of interest by SPACs. The Guidance addresses disclosure both at the IPO and de-SPACing stages.

IPO Stage

The Guidance acknowledges that insiders do not always work exclusively on behalf of the SPAC, and accordingly may have fiduciary or contractual obligation to entities other than the SPAC. SPACs must disclose insiders' conflicts of interest that may arise from competing obligations to the SPAC and other entities. Disclosure should include how potential conflicts of interest may affect an insider's ability to evaluate and present a potential de-SPACing transaction to public shareholders and how the potential conflicts will be addressed. SPACs should also disclose if they may enter into a de-SPACing transaction with a target that an insider has an interest in.

The Guidance advises SPACs to disclose how the incentives to enter into a de-SPACing transaction differ between insiders and public shareholders. This should include the losses the insiders are subject to if a de-SPACing transaction is not completed, the amount of control the insiders have in approving a de-SPACing transaction, if the SPAC's governing documents may be amended to enable a de-SPACing transaction and the required approval to amend the governing document, and if and how the time to enter into a de-SPACing transaction may be extended. SPACs should also disclose how the underwriter is compensated, including what services it is providing and if their compensation is dependent upon completing a de-SPACing transaction.

Insiders often receive securities, including founder shares and founder warrants, with terms that differ from those securities held by the public shareholders. SPACs should disclose the terms of these securities and how they differ from the securities purchased by public shareholders. SPACs should also disclose: if they have raised, or seek to raise, additional funds; the terms of the securities expected to be issued in future offerings; and whether insiders or affiliates of insiders may participate in the future offerings.

De-SPACing Transaction

SPACs generally consider multiple potential targets. Because insiders may have additional incentives to complete a de-SPACing transaction, it is important to disclose information related to selection of the target, including why the target was selected over other candidates, how consideration for the target was determined, what factors the directors considered in selecting the target, any conflicts of interest for insiders and how they will be addressed, and the insider's beneficial ownership in the company post-transaction.

Additional financing is often required to complete a de-SPACing transaction. The financing may be debt or equity, and is often committed to prior to entering into a de-SPACing transaction. SPACs should disclose information related to additional financing, including how the financing

will affect public shareholders and the beneficial ownership of the company after the de-SPACing transaction; the terms of the securities to be issued, if any; and whether insiders may be involved in the additional financing.

Underwriters often provide services in addition to underwriting the IPO. Details relating to services provided, including the consideration paid and whether payment is contingent on the completion of a de-SPACing transaction should be disclosed. Any conflict of interest arising from the additional services and deferred compensation arrangements with the underwriter should also be disclosed.

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