Client Alert:

SPACs Boom: Too Good To Be True?

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By Julie Copeland and Sarah Keeling

During these uncertain times, one thing *is* certain: Special Purpose Acquisition Companies—or SPACs—are back and gaining momentum every day. SPACs seemed to be a thing of the past until last year, when the total issuance soared to over $25 billion from $2.5 billion just 10 years earlier. Current estimates place the amount of money raised by SPACs in 2020—in the U.S. alone—to be approximately $82 billion.

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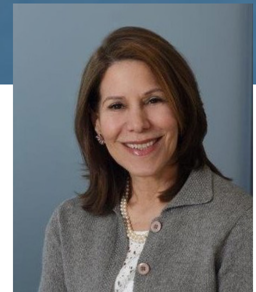
According to Nasdaq, there are 81 publicly filed SPACs in the pipeline for 2021, a 1520% increase over the same time last year. *The Financial Times* recently reported former Credit Suisse chief executive Tidjane Thiam is raising a $250 million special purpose acquisition vehicle to invest in financial services businesses in the developed and developing world. Bill Ackman, of Pershing Square fame, launched Pershing Square Tontine Holdings in July—the largest SPAC to date—and raised $4 billion.



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SPAC Defined

A SPAC is a "blank check company" created by sponsors who raise capital for the purpose of acquiring a private company. The SPAC goes public through an IPO and once a target acquisition has been identified, merges that company with the SPAC. The SPAC typically has two years to make a purchase or return the capital to its investors. The SPAC, essentially a publicly-traded shell company, comes to life through the efforts of experienced investment professionals or industry executives, who promote the SPAC to recruit investors and begin their search for the 'right company.' In return, promoters receive up to 20% equity in the SPAC.

The popularity of the SPAC market can be attributed largely to the notion that all parties involved benefit from the transactions. Investors expect SPACs to deliver speedy returns, while companies prefer them as a quick and less resource-intensive means to go public. Investment banks also earn a substantial profit in fees from SPACs. In 2020 alone, investment banks generated $3.4 billion in SPAC-related fees.

Further, unlike traditional IPOs, SPACs and their targets are protected by safe harbor provisions under the securities laws for projections and other forward-looking statements. Companies going public through the traditional IPO route are not covered by this safe harbor and rarely provide such information. However, these benefits come with the risk of rushing proper due diligence processes in order to conform to a SPAC's aggressive two-year timeline. Due to the financial benefits sponsors receive when completing a SPAC acquisition, there is immense pressure to find the "perfect" investment before the end of the two-year limit.

The Importance of Due Diligence

Investors wishing to take advantage of SPACs face two very important decision points: the decision to invest initially in the SPAC and the decision to stay with the business combination once it is announced. Below, we discuss suggestions for due diligence that should be performed at each of these critical junctures.

It is important to independently perform thorough financial and reputational due diligence **before** any investment is made in a SPAC. This should include due diligence into the investor team and the purpose and strategy for the SPAC. Then, once an acquisition target has been identified, questions should be asked to determine if the target is ready to go public, what the history and caliber of management is, are there broader risks in the market and how will the financials of the target company hold up to public scrutiny. All of these due diligence steps are necessary to assess whether an investor should stay in the combined entity or redeem the shares.

The Consequences of Not "Doing Your Homework"

An example of a SPAC potentially gone wrong is Nikola, a company creating heavy-duty trucks fueled by batteries and hydrogen fuel cells—in essence zero-emission vehicles. This SPAC, initially valued at $3.3 billion, is now being investigated by the Department of Justice and the

Securities and Exchange Commission regarding **allegations of fraudulent claims** about the company's products. Nikola was found to be reliant on a manufacturer for a major component of their product—the Romeo Power Technology, which runs their trucks.

Famously, a video purporting to show one of the trucks running on its own power appeared to have given a false impression: the truck was actually pushed down a hill and simply gained momentum. So, investors put their money on the line without knowing Nikola's dependence on third parties and the associated risks. Ultimately, this demonstrates investors may be taking great risks with large sums of money to 1) acquire companies they do not know much about, and 2) acquire those that may not be ready to go public. Although Nikola may wind up becoming a success story after all, the SEC and DOJ subpoenas shed light on the lack of information known and disclosed before a SPAC acquisition.

Looking Beyond the IPO

Companies transitioning into the public domain face a range of challenges; savvy investors will ensure that their SPAC acquisition target has the governance protocols and infrastructure to thrive beyond IPO day. In addition to sound due diligence, investors should confirm that the target company has an effective compliance program, robust internal controls and a diverse Board to overcome the obstacles that undoubtedly lie ahead for early-stage companies:

- **Compliance matters:** A well-designed and practical compliance program says a lot about the start-up's leadership team, gives stakeholders confidence and demonstrates a commitment to longevity from Day One. After all, even well-established companies doing business across the globe today face an uphill battle when it comes to compliance. Compliance failures can lead to the sort of financial and reputational damages that can easily erode shareholder value.
- **Strong internal controls:** The Securities and Exchange Commission (SEC) requires that publicly traded companies have an effective internal control function, a transparent investor relations function, and a commitment to identifying related process improvement opportunities. SPAC acquisition targets should be well-prepared to meet the rigor of regular filings and ever-evolving, complex financial reporting rules.
- **A well-governed Board:** Similarly, the SEC sets specific requirements for the composition of the board of directors, frequency of meetings and other governance protocols. The target company should design a Board with the right mix of director skills, independence, diversity and experience-level in order to sustain a course for long-term success.

Unlike traditional IPOs, which typically include a 90-day lockup period, SPAC investors can more quickly liquidate their shares of common stock. Still, data suggests that **individual investors who buy into a SPAC lose an average of 12% of their investment within six months of the IPO**. Sound due diligence practices and governance protocols will help ensure the highest return when SPAC investors ultimately exercise their warrants or sell their shares.

A Final Word of Caution from FINRA

In its recent "**2021 Report on FINRA's Examination and Risk Monitoring Program**," FINRA highlighted what it perceived to be risks associated with investing in SPACs, among them:

- Misrepresentations and omissions in offerings documents and communications with shareholders regarding SPAC acquisition targets, such as the prospects of the target company and its financial condition;
- Fees associated with SPAC transactions, including cash and non-cash compensation and compensation earned by affiliates;
- Control of funds raised in SPAC offerings; and
- Insider trading (where underwriters and SPAC sponsors may possess and trade around material non-public information regarding potential SPAC acquisition targets, including private placement offerings with rights of first refusal provided to certain investors prior to the acquisition).

The bottom line is that SPACs offer investors the potential for substantial profits but the key to realizing such profits is the rigor of an investor's homework on the SPAC.

About the Authors

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