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SPACs and De-SPACing: Considerations for Going Public Through a Combination with a SPAC

By Brian D. Short and David B. Gross

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April 28, 2021

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In the last year, there has been an unprecedented surge of special purpose acquisition company (SPAC) formations. This has attracted a lot of attention to the SPAC space, from the sponsor side (traditional private equity firms, athletes, and celebrities) to the investor side (hedge funds and retail traders). Vast sums of capital and new found popularity have attracted private companies looking for potential exits or additional sources of capital. In addition, the Securities and Exchange Commission (SEC) recently expressed a strong interest in these vehicles.

While merging with a SPAC, a process known as a de-SPAC, may offer a compelling alternative for a private company, there are some unique considerations that companies should be cognizant of and weigh while contemplating a combination. Below is an overview of SPAC and de-SPAC transactions and key considerations for companies contemplating a combination with a SPAC.

SPAC IPO

SPACs are public companies that have no operations. These shell companies raise hundreds of millions of dollars through an initial public offering (IPO) with the sole goal of merging the shell company with an existing private operating company. The SPAC will register with the SEC for the issuance of units to the public for $10 per unit. The units typically contain one share of stock and a warrant for a fractional share of stock usually exercisable at $11.50. The money raised from the IPO is placed in a trust account to be used, together with additional financing, to complete the acquisition. After the IPO, the SPAC management team, typically made up of experts in a particular industry, has a limited time (usually 24 months) to find a suitable acquisition target and complete the transaction. If, after 24 months, the SPAC has not completed a transaction with an operating company, it must liquidate and return all of its IPO funds back to its shareholders.

De-SPAC Mergers – Operating Company Going Public

De-SPAC mergers take a private company public without using the traditional IPO process. The SPAC sponsors have a strong incentive to complete the merger because upon a liquidation, their founder shares and warrants will be worthless and they will be out of their at-risk investment which usually amounts to several million dollars. Once a target is identified the SPAC and the private company sign a letter of intent, begin due diligence, and negotiate the merger transaction.

The de-SPAC transaction may be structured as a merger, a purchase of stock, or a purchase of assets. The sellers of the target company may receive cash or equity or a combination of both. The structuring of these transactions usually involves negotiations of the SPAC sponsor's economics, including dilution of founder shares, earn-out criteria, and post-closing capitalization of the combined company. Also note that, due to the SPAC's IPO proceeds being in a protected trust account, the de-SPAC transaction agreement will not typically include a reverse break-up fee in the event of a broken deal.

The de-SPAC transaction agreement generally contains customary representations, warranties, conditions, and covenants which include obtaining regulatory approvals, necessary third-party consents, and the SPAC's shareholder consent for approving the de-SPAC transaction. In addition, SPAC-specific conditions may include minimum cash thresholds to be maintained in the trust account to limit shareholder redemptions.

Upon agreeing to a letter of intent and in advance of signing the de-SPAC transaction agreement, the SPAC will work to arrange committed debt or equity financing – e.g., a private investment in public equity (PIPE) commitment – to finance a portion of the purchase price for the company and/or further capitalize the company. This financing is contingent upon the closing of the de-SPAC transaction.

De-SPAC Closing Process

In connection with the closing of a de-SPAC transaction, the public shareholders of a SPAC have the right to redeem their shares in exchange for the shares' pro rata amount held in the SPAC's trust account (roughly equal to the IPO share price). This redemption right is offered to the public shareholders through either the proxy statement soliciting approval for the de-SPAC transaction or the tender offer process.

The proxy statement or tender offer documents include the de-SPAC transaction agreement, audited financial statements of the SPAC and the target company, pro forma financial information, management's discussion and analysis of financial condition and results of operations, and selected audited and pro forma financial information. The disclosures also include information about director and officer compensation and risk factors that are similar to those provided in an Annual Report on Form 10-K or annual meeting proxy statement.

Within four days after consummating the de-SPAC transaction, the combined company files a Current Report on Form 8-K (a "Super 8-K") disclosing, among other things, the de-SPAC transaction, financial statements and additional disclosures that would be required by a company in a Form 10 registration statement. Many of these disclosures are similar to those provided in the proxy statement or tender offer materials.

What makes a de-SPAC transaction attractive to a private company?

Speed

Merging into a SPAC can be much faster than a traditional IPO process. The time from a SPAC and target company reaching a letter of intent through closing can be approximately 10 weeks. A traditional IPO process is generally about 20 weeks or more. However, the timeline is heavily dependent on the nature of the negotiations between the SPAC sponsor and the company, as well as the shareholder approval process. The amount of time and focus required by the company's management team should not be underestimated even though it may occur over a much more condensed period than a traditional IPO.

Valuation Certainty

A key advantage of a de-SPAC transaction is setting the valuation of the company through a negotiation with the SPAC sponsors. In a traditional IPO, valuations are informed by a number of factors and inputs – meetings with investors, guidance from the investment bankers, similar recent offerings – and are subject to significant fluctuations based on market timing. In a SPAC transaction, the company negotiates value directly with one party, the SPAC sponsor, and it will generally remain at that amount through the completion of the transaction. The valuation is supported through the PIPE investors and trading of the SPAC stock following the announcement of the transaction. That support has generally been more stable (though repricings do occur) than the quirks of the market on any particular day or week.

Communication Flexibility

In a traditional IPO, management's projections are only shared with analysts and are not publicly released - primarily due to the lack of protection under the safe harbor of the Private Securities Litigation Reform Act (PSLRA). In a de-SPAC transaction, the target company typically provides its projections to potential investors under confidentiality agreements in connection with the PIPE and later includes those projections in the Form S-4/proxy statement filed in connection with the shareholder approval. Once the deal is announced, the PIPE investors expect that these financial statements will be filed publicly to "cleanse" them from holding material non-public information about the future combined company. This ability to provide projections in a de-SPAC transaction has made these transactions more attractive for earlier stage companies that may not have historical financials that would gather investment, but have very attractive future projections. Of course, along with this potential advantage, target companies should be prepared to live with those expectations as a public reporting company. In addition, the SEC has recently questioned the public disclosure of projections in these transactions.

Control of the Company and Growth Capital

Target companies usually receive consideration from the SPAC that is a combination of equity and cash. If the target company wants to maintain more control in the company post-merger, then the target can negotiate more equity in the new company and less cash, or even no cash. In addition, more equity consideration allows for more capital to remain in the company going forward. However, if the target desires more of an exit or liquidity event, it can negotiate the consideration to more cash consideration and less equity of the combined company. Targets are generally in a position to negotiate favorable terms, such as management and control in the combined company going forward.

What are Important Factors for a Company Considering a Combination with a SPAC?

Fit with SPAC

Not all SPAC sponsors are the same and it is imperative to find a SPAC with a leadership team that has the same long-term business goals as the company. Companies should seek out SPAC sponsors with relevant industry knowledge and experience operating a public company. A good sponsor will also have experience raising money and significant contacts to assist with arranging financing in connection with the de-SPAC transaction. Many SPAC sponsors will align themselves with the operating company and other shareholders by committing to lock-up their shares and warrants for a meaningful period following the closing of the merger but ideally the leadership will be committed to stay engaged with the company beyond this time.

Public Company Readiness

Following the de-SPAC transaction, the company will have to ensure that its historical financial statements meet public company reporting standards and its internal operations are ready to meet the ongoing public reporting requirements. The disclosed financial statements have to meet the Public Company Accounting Oversight Board (PCAOB) rules and the company should be ready to publish quarterly statements and provide management reports which can occupy much of leadership's time. The reporting requirements of a public company require establishing internal financial and compliance teams. In addition to the SEC disclosure requirements, the NYSE and NASDAQ have qualitative and quantitative listing requirements that must be met.

SEC Oversight and Review

Given the prevalence of SPAC IPOs in the past year, the SEC has taken a renewed interest in the regulation of SPACs and has recently released statements reminding the industry of securities rules and regulations that apply to them. Recent SEC commentary has sought to limit the common practice of SPACs releasing optimistic financial projections by suggesting that these statements may not fall under the safe harbor in the PSLRA. Without this protection, SPACs that do not meet their future projections are at risk of investor lawsuits. Additionally, the Form S-4 registration statement is subject to the SEC's comment process.

Governance

After a de-SPAC transaction, the company will need a strong corporate governance system to ensure the board and management have the proper structure to operate as a public company. Board composition and voting rules, which take into account the scrutiny of public companies, should be implemented. The company will also have to meet its stock exchange's corporate governance requirements. For example, the NYSE and NASDAQ require a company to have a majority independent board, and an audit committee and compensation committee composed entirely of independent directors.

Advisers and Cost

The de-SPAC process can be expensive in terms of fees and equity dilution. Underwriters and placement agents need to be retained, and the costs of readying a private company for public reporting could be significant. Each investment bank involved in the de-SPAC and the PIPE financing will also have to be compensated. Additionally, the SPAC practice of rewarding the sponsor with founder shares, often amounting to 20% of the company's shares, dilutes the ownership of the company.

With the tremendous amount of capital currently deployed in SPACs, de-SPAC transactions are an important alternative for private operating companies to consider. The considerations discussed above will continue to evolve and respond to real-time market and regulatory developments.