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Special purpose acquisition companies, or SPACs, are growing in popularity as many investors are looking to get in the game. Schulte Roth & Zabel LLP attorneys provide an overview of this investment tool and explain the importance of understanding the liquidity profile of what is being purchased and regulatory implications during the process.

Special purpose acquisition companies (SPACs) have seen a surge in 2020. There have been several high-profile private companies, such as DraftKings and Nikola, going public by completing business combinations with SPACs and high-profile investment firms, such as Bill Ackman's Pershing Square (for the second time) and Jeff Smith's Starboard Value, sponsoring SPACs of their own.

A SPAC is a public shell company formed for the purpose of completing a business combination within a specified period of time with a private operating company. Combining with an already public shell allows the private company to essentially complete an IPO with an intact public shareholder base at a lower cost than a traditional IPO. It can also provide greater deal certainty in uncertain times.

The SPAC founders have attractive upside potential for a relatively small investment of capital, often holding 20% or more of a SPAC's outstanding equity immediately following its IPO in the form of so-called "founders shares", along with a significant number of warrants purchased in a private placement.

Holders of SPAC IPO shares also have upside potential following the business combination and enjoy downside protection, as typically the IPO proceeds are placed in a trust account pending completion of a business combination and such holders have redemption rights at the time of the business combination. A SPAC must also return the funds held in that trust account if it fails to complete a business combination within a specified period of time.
With its growing popularity, many investors are looking to get into the SPAC market. For those new to the SPAC space, it is important to understand what you are getting into.

Buying the IPO Shares

A SPAC typically issues units in its IPO that consist of one share of stock and a fraction of a warrant. Non-affiliates of the SPAC can generally trade these units freely in the public market post IPO. Soon after the IPO, the common stock and warrants will begin trading separately and continue to be traded freely by non-affiliates. If the issuer fails to complete a business combination within a certain

proscribed time period (typically 18-24 months), the SPAC will redeem any shares issued in its IPO with the funds in the trust account and the warrants will expire worthless.
Typically, the warrants do not become exercisable until the later of one year after the IPO and 30 days after the business combination. While the SPAC shares are "beneficially owned" by shareholders for Section 13(d) purposes once they are purchased, the warrants do not give rise to beneficial ownership of the underlying shares until the conditions to their exercisability (i.e., the business combination and registration) have been satisfied. It is important to understand how to calculate your beneficial ownership not just for Section 13(d) reporting purposes, but also to understand the potential to trigger Section 16reporting and short swing profit disgorgement issues as you transact in the SPAC securities.

Investments in the Sponsor Vehicle

Many SPAC founders form sponsor vehicles to hold their founders shares and warrants. Investments in the SPAC sponsor vehicle can provide investors with silent investment interests in the SPAC sponsor's founders shares and private placement warrants. These founders shares and/or private placement warrants are then typically distributed out to investors in the sponsor vehicle once any applicable lock-ups expire post-business combination. The founders shares are typically not redeemable with the funds in the trust account, but they have an extremely low cost basis and generally provide the bulk of the upside afforded to a SPAC's founders.

The founders shares and private placement warrants are also typically registered for resale post business combination. Registration is particularly important for SPACs because Rule 144 is not available for sales of SPAC securities until one year after the SPAC's business combination. This means that prior to that time registration is the only option for those looking to sell restricted or control securities of a SPAC in the public market. Non-controlling investors in the sponsor vehicle would not typically beneficially own any shares held by the sponsor vehicle for Section 13(d) purposes unless and until they are distributed, but it is important to understand how this ownership may ultimately impact the investor.

Forward Purchase Agreements and the Business Combination PIPE

Another way investors are getting exposure to SPACs is by investing in a capital raise at the time of the business combination. Some investors enter into a forward purchase agreement with the SPAC at the time of the IPO committing to invest additional capital into the SPAC at the time of the business combination. Others agree at the time the business combination is being negotiated to participate in a PIPE transaction that is conducted concurrently with the consummation of the business combination.

These investors will ultimately purchase unregistered stock, sometimes with warrants, and receive registration rights in order to have their securities registered for resale. Again, this registration is important because it is the only path to selling in the public market until Rule 144 becomes available.

These investors will be given information about the proposed business combination (and PIPE) before it is made public and will be restricted from trading. Investors interested in trading in the public market, should evaluate the impact of becoming restricted before going over the wall. While it certainly is an exciting time in the world of SPAC investments, being able to properly manage these investments requires an understanding of the liquidity profile and of what you are buying and the regulatory implications along the way.

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