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GLOBAL PUBLIC COMPANY ACADEMY

Trends in SPACs and Reverse Merger Transactions

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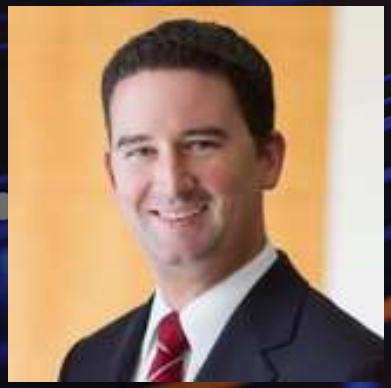

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Overview

- Recap of SPAC Deal Activity in 2022
- Key Features of a SPAC
- Regulatory Developments Impacting the SPAC Market
- PIPE Market Challenges
- Shareholder Redemption Environment
- SPAC Litigation
- Traditional Reverse Merger Transactions

Recap of SPAC Deal Activity in 2022

- A **S**pecial **P**urpose **A**cquisition **C**ompany is a blank check company formed for the purpose of effecting a business combination with one or more businesses
  - SPACs can list on either Nasdaq or NYSE – historically, most SPACs have listed on the Nasdaq because NYSE listing rules were more restrictive, but NYSE rules have recently changed
- The volume of SPAC IPOs and De-SPAC transactions has fluctuated significantly in recent years.
  - In 2020, there were 248 SPAC IPOs, raising $83 billion in proceeds. In 2021, the number of SPAC IPOs exploded to 613, raising $162.6 billion in proceeds.
  - The 2022 SPAC IPO Slowdown: In 2022, there were 83 SPAC IPOs on US exchanges, totaling $13.4 billion in proceeds.
  - Further, De-SPAC transactions in 2022 also decreased significantly. In 2022, there were 101 De-SPAC transactions, versus 199 in 2021.
  - In 2022, the aggregate US De-SPAC M&A value was $59.86 billion, as compared to $368 billion in 2021.
  - Factors contributing to the slowdown include disappointing performance by newly De-SPACed companies, inflation, macroeconomic uncertainty, geopolitical conflict and increased regulatory scrutiny from the SEC.
- Despite various challenges, opportunities remain in the SPAC market and we expect participants will continue to explore innovative strategies and financing options to effect desired transactions.

Key Features of a SPAC

- SPACs are formed to raise capital in an IPO with the purpose of using the proceeds from the IPO to acquire an unspecified business after the IPO.
- SPACs are formed by a **Sponsor** (typically a private equity fund, financial institution or group of investors).
  - The Sponsor makes an initial (pre-IPO) investment of $25,000 in exchange for "founder shares" typically referred to as the "**Promote**."
  - The Promote is a substantial portion of the SPAC's post-IPO equity. Frequently, the Promote is approximately 20% of Post-IPO equity.
- Capital Structure
  - In its IPO, the SPAC typically issues equity that is structured to include one share of common stock and a warrant to purchase common stock.
  - Simultaneously with the IPO, the Sponsor acquires additional units, shares or warrants in a private placement.
- Trust Account
  - The proceeds of the IPO and a portion of the concurrent private placement proceeds are held in a trust account until released to fund the De-SPAC transaction.
  - SPACs generally invest such proceeds in low-risk interest bearing instruments.

Key Features of a SPAC (Continued)

- A portion of the proceeds of the Sponsor's private placement investment is held outside of the trust account and is available to the SPAC for use in seeking a target for a business combination
- De-SPAC Transaction
  - Following the IPO, the SPAC will seek an opportunity to acquire an operating business (the "**Target**"). This is known as a "**De-SPAC**" or the "**Business Combination**."
  - It allows a private company to become a US public company outside the typical IPO process
  - Additional Private Investment in Public Equity ("**PIPE**") Investors
  - Approvals and Trust Account
    - The De-SPAC transaction requires approval from the SPAC's stockholders
    - The IPO investors have the option to convert their shares into a pro rata portion of the trust account and keep their warrants ("**Redemptions**").

Key Features of a SPAC (Continued)

  - The portion of the proceeds of the Sponsor's private placement investment deposited in the trust account is used to "gross up" the trust account for the underwriting discount so that the IPO investors receive the IPO price for the units, plus interest, upon redemption.
  - Investors may redeem their shares for a variety of reasons. For example, investors may redeem their shares if they are not in favor of the announced Business Combination (e.g., investors may want out if a SPAC intends to merge with a Target in a highly speculative industry, such as commercial space flight). Investors may also redeem shares that trade below the IPO price for a pro rata portion of the proceeds held in the trust account (typically $10.00 per share).
- As a result of the De-SPAC transaction, the Target becomes a publicly traded company.

SPAC Timeline

Timing Considerations:

- Going public through a SPAC is typically faster than through an underwritten IPO.
- Some SPAC transactions close as quickly as two months following the execution of the De-SPAC merger agreement (although timing is significantly impacted by whether the Target has the appropriate audited financial statements available).

Timing Trends:

- In 2022, the time between the SPAC's IPO and signing the De-SPAC merger agreement was on average 10 months for closed deals, as compared to an average of 7.4 months in 2021.
- In 2022, the time between signing the De-SPAC merger agreement and closing was on average 7+ months, compared to 5 months in 2021 and 4.4 months in 2020.
- In 2022, deals with an S-4/F-4 were subject to 4.5 months of SEC review process, as compared to 3.3 months in 2021 and 2.7 months in 2020.

Regulatory Developments Impacting the SPAC Market

On March 30, 2022, the SEC issued Proposing Release No. 33-11048 (Mar. 30, 2022) (the "Proposed Rules").

- The Proposed Rules are the SEC's response to the increased prevalence of SPAC IPOs and Business Combinations between SPACs and private Target operating companies in the US public securities markets.
- SEC Chair Gary Gensler stated "[SPAC] investors deserve the protections they receive from traditional IPOs, with respect to information asymmetries, fraud, and conflicts, and when it comes to disclosure, marketing practices, gatekeepers, and issuers."
- Among the Proposed Rules, the SEC called for:
  - Enhanced Disclosure Requirements through New Subpart 1600 of Regulation S-K
  - Aligning De-SPAC Transactions with IPOs
- Many law firms, industry associations, SPAC market participants and others submitted comments to the SEC challenging various aspects of the Proposed Rules.
- The Proposed Rules are expected to be finalized during the first half of 2023.

Enhanced Disclosure Requirements (New Subpart 1600 of Regulation S-K)

- SPAC Sponsors, conflicts of interest, and dilution
  - Require additional disclosures regarding the experience, roles, responsibilities, and material interests of the SPAC Sponsor and affiliates and the relationships among such parties
  - Disclosure relating to compensation earned by or paid to the Sponsor and its affiliates
  - Discussion of the conflicts of interest, including the potential benefits, risks, and effects for investors, as well as potential benefits for SPAC Sponsors and other affiliates
  - Potential for dilution in the SPAC IPO and De-SPAC transaction, the sources of dilution, and the possible disproportionate impact on non-redeeming shareholders
  - **Observations**: The Proposed Rules would largely codify existing SEC guidance and practice. If adopted, the proposed disclosure requirements may help to standardize the scope and detail of disclosures included in De-SPAC registration statements.
- Fairness of the De-SPAC transaction to the SPAC investors
  - State whether the SPAC reasonably believes that the De-SPAC transaction and any related financing transactions are fair or unfair to the SPAC's unaffiliated security holders
  - Provide a description of the bases for this statement
  - SPACs may seek a fairness opinion from a financial advisor to substantiate the SPAC's "reasonable belief"
  - **Observations**: Although not required under the Proposed Rules, SPACs are obtaining fairness opinions from financial advisors with greater frequency. Fairness opinions are negotiated and delivered in De-SPACs in a manner similar to traditional public company M&A deals. Fairness opinions can help protect a SPAC board in connection with a De-SPAC transaction, by supporting the Board's determination of the suitability of the prospective transaction. In 2022, 32% of closed deals had fairness opinions, as compared to 15% in 2021.

Aligning De-SPAC Transactions with IPOs

- Require that the Target company be a co-registrant when a SPAC files a registration statement on Form S-4 or Form F-4 for a De-SPAC transaction
  - Requirement would expand liability for material misstatements and omissions in registration statements to the Target's PEO, PFO, PAO and a majority of the board (subject to a due diligence defense for all parties other than the SPAC and Target operating company)
- Redetermination of smaller reporting company status within four business days following the consummation of a De-SPAC transaction
- Eliminate the safe harbor in the Private Securities Litigation Reform Act of 1995 (PSLRA) for forward-looking statements, such as projections, in filings by SPACs and certain other blank check companies
- Require that SPAC stockholders have adequate time to consider the information presented in a De-SPAC transaction
  - Proxy/Information sttements to be distributed to stockholders at least 20 calendar days in advance of the stockholder meeting
- Underwriters in a SPAC IPO to be deemed underwriters in a subsequent De-SPAC transaction when certain conditions are met
  - If adopted, liability under Section 11 of the Securities Act for the contents of a registration statement used in connection with a De-SPAC transaction would apply to any SPAC IPO underwriter who participates in the De-SPAC transactions
- **Observations**: Market participants in De-SPAC transactions are undertaking enhanced diligence processes and requiring deliverables that generally mirror those received in traditional IPOs (e.g., negative assurance letters from counsel and comfort letters from auditors) and seeking additional due diligence calls with Company management, customers, suppliers, etc.

PIPE Market Challenges

- PIPE capital has become more limited, leading SPACs to consider alternative funding sources and arrangements to complete De-SPAC transactions.
  - In 2022, the average PIPE financing in closed deals was approximately $128 million (and only $93 million in Q4 of 2022), as compared to $316 million for closed deals in 2021.
  - In 2022, the average PIPE financing in closed deals was less than 50% of the amount of the SPAC's trust account, while the average PIPE financing in closed deals in 2021 was nearly 100% of the SPAC's trust account.
- PIPE investors are scrutinizing SPAC deals more closely, focusing on Target valuations, size of Sponsor Promote and other deal terms.
- Increase in "insider only" PIPEs – where PIPE investors consist solely of SPAC Sponsors, Target insiders and respective "friends and family", or "strategic" PIPES where investors have a commercial relationship with the Target.
- Alternative funding possibilities include SPAC issuances of convertible debt or preferred stock (fixed returns and potential equity upside upon conversion) and other third-party backstop funding arrangements.

Shareholder Redemption Environment

- In 2022, the average redemption rate for closed De-SPAC transactions was over 80%, as compared to an average of approximately 50% for closed deals in 2021.
- Significant stockholder redemptions reduce the amount of cash available to SPACs to satisfy any minimum cash condition to complete De-SPAC transactions.
- High redemptions also decrease the cash proceeds that are available to the combined company for future operations, following completion of the De-SPAC transaction.
- SPAC Sponsors and Targets are employing different strategies to offset the impact of high redemptions. These strategies include, but are not limited to:
  - Negotiating with stockholders to reverse redemptions;
  - Obtaining loan commitments to serve as financial backstops to redemptions;
  - Post-closing liquidity facilities (e.g., committed equity lines of credit); and
  - Post-closing issuances (e.g., follow-on primary equity offerings).

SPAC Litigation

- Plaintiff interest in SPAC and de-SPAC transactions remains robust, as evidenced by various lawsuits and demands arising throughout the SPAC life cycle. Shareholder plaintiffs often allege:
  - Conflicts of interest (e.g., potential conflicts between SPAC sponsors, D&Os and the interests of public stockholders in connection with Target company selection)
  - Disclosure deficiencies (e.g., failure to disclose financial projections for SPAC, details relating to negotiations or pursuit of other potential acquisition targets, reasoning for not hiring a financial advisor)
  - False and misleading disclosures post-closing (e.g., where a surviving operating company's performance turns out to be disappointing despite optimistic representations in SEC filings)
  - Structural features of de-SPAC transactions (e.g., selection of unattractive Target company in light of time pressures to complete de-SPAC, deferral of underwriting compensation and fees, issuance of securities to SPAC sponsors and affiliates)
- Recent Developments: *Garfield v. Boxed, Inc.* (Del. Ch. Dec. 27, 2022).

Garfield v. Boxed, Inc.

- *Garfield v. Boxed, Inc.* (Del. Ch. Dec. 27, 2022): The Delaware Court of Chancery (the "Court") held that Sec. 242(b)(2) of the DGCL required a company seeking to authorize additional shares (as part of a de-SPAC transaction) hold separate class votes
  - This decision poses risk to all Delaware corporations with multiple share classes
  - Section 205 petitions to remedy the issue raised by *Boxed* are ongoing
- Summary of *Boxed*:
  - Seven Oaks Acquisition Corp. (SPAC), in preparing to complete its merger with Boxed, Inc., needed to amend its charter to increase the number of authorized shares of Class A common stock and change the requisite vote to increase/decrease the number of authorized shares going forward
  - In order to amend the charter, Seven Oaks sought the vote of Class A and Class B common stockholders, voting together as a single class
  - Prior to the vote, the plaintiff (SPAC stockholder) submitted a pre-suit demand to the Seven Oaks Board that the holders of Class A common stock vote on the amendments as a **separate class pursuant to Sec. 242(b)(2)***
  - Seven Oaks held the separate class vote for the Class A common stock
  - Plaintiff filed suit seeking attorney's fees and expenses for corporate benefit conferred on Seven Oaks
  - Seven Oaks argued that the plaintiff was not entitled to fees and expenses because (i) the separate class vote was not required under its charter or the DGCL and (ii) the Class A common stock was a *series* of common stock, not a class of common stock.

* Note: Sec. 242(b)(2) permits companies to amend their charter to expressly "opt-out" of separate class voting in connection with changes to the number of authorized shares, par value, powers, preferences and/or rights of such class.

Garfield v. Boxed, Inc. (Continued.)

- **Ruling:** The Court interpreted the Seven Oaks charter as **creating the Class A common stock as a class of stock**, rather than a series of a class of stock. As a result, the separate class vote was required, and plaintiff was awarded attorney's fees and expenses.
  - The Court reached its conclusion based upon a review of the language used to describe the different types of stock in the Seven Oaks charter (i.e., the charter referred to "Class A" and "Class B" common stock instead of "series" and separately listed the number and par value of shares of each class of common stock authorized thereunder).
- **Potential Remedy:** Under Sec. 205 of the DGCL, companies seek Court validation of share issuances that are arguably in violation of Sec. 242(b)(2). Such violation would constitute a "defective corporate act" under the DGCL.

  The Court considers multiple factors when determining whether to validate a "defective corporate act," including:
  - Belief the original approval was made in compliance with the DGCL
  - Whether the corporation and Board have treated the defective corporate act as a valid act or transaction
  - Whether any person will be or was harmed by the validation of the defective corporate act
  - Whether any person would be harmed by the failure to ratify or validate the defective corporate act
  - Any other factors or considerations the Court deems just and equitable

Traditional Reverse Merger Transactions

- In connection with the recent market downturn and difficult financing environment, we have observed more traditional reverse merger transactions recently
- What is a reverse merger transaction?
  - A public company, typically one that has either ceased operations or is in the process of winding down
  - A private company seeking access to the public markets outside the traditional IPO process
  - The parties merge, with the private company typically surviving as the operating entity
  - Private company stockholders receive shares in the public entity
  - Public company stockholders retain an ownership stake in the post-transaction company

Key Considerations

- Post-transaction ownership split
- Exchange listing
  - Nasdaq or NYSE may consider the transaction a change of control, which would require the surviving company to apply for their new listing
- Acquired company financial statements
  - Must be PCAOB audited and filed with the SEC
- Registration requirements for share issuance to the private company's stockholders
  - Typically depends on the size of the private company's stockholder base and accredited investor status of investors
- Public company stockholder approval requirements
  - 20% and change of control considerations

Biography

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Bryan S. Keighery represents life science and technology companies in a range of corporate and securities transactions. He handles a variety of corporate finance transactions for public companies, including initial public offerings, follow-on offerings, registered direct offerings (RDOs), and private investments in public equity (PIPEs), as well as venture capital and other financing transactions for privately held companies. Additionally, Bryan counsels both public and privately held companies on general corporate law, mergers and acquisitions, and other business matters.

Bryan also regularly counsels public companies in annual, quarterly, and periodic reports; proxy statements and SEC compliance under US federal securities laws; and corporate governance requirements of various stock exchanges, including NYSE and Nasdaq

Biography

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Thurston J. Hamlette focuses his practice on corporate and securities matters, primarily representing issuers and investment banks in public and private corporate finance transactions. His experience encompasses registered offerings of debt and equity securities, Rule 144A and Regulation S transactions, high-yield and investment grade debt offerings, follow-on and secondary equity offerings, initial public offerings, special purpose acquisition companies (SPACs), and liability management transactions. In addition, Thurston counsels on securities law compliance, public company reporting, corporate governance, and other general corporate matters.

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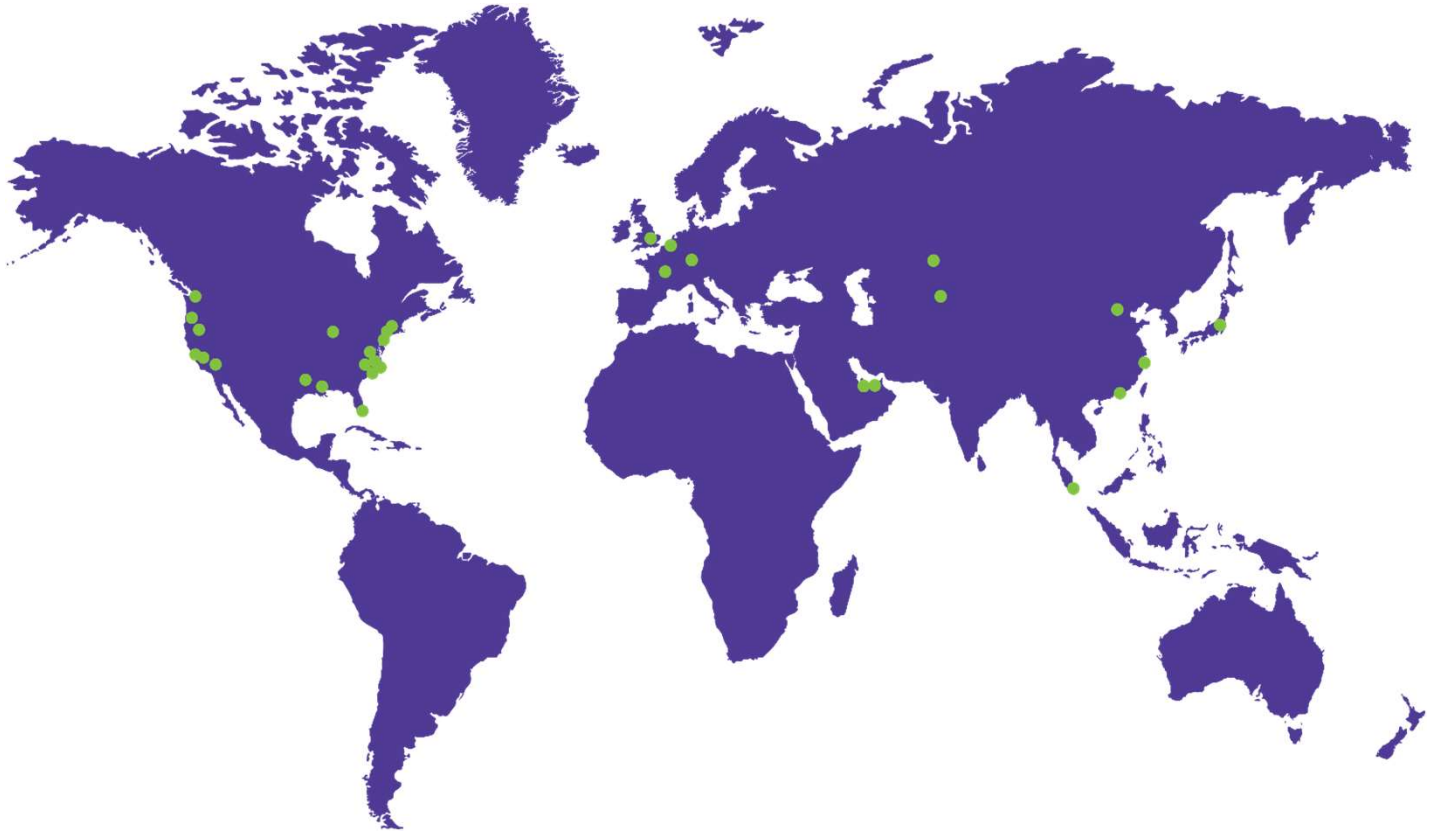

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