Latest SPAC Trends Point To Risk Of Negative Outcomes

By **Adam Karageorge, Adrienna Huffman and Monet Lee** (June 17, 2022)

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The 2020 and 2021 calendar years witnessed a boom in special purpose acquisition companies, with an unprecedented number going public. A SPAC is a shell company created by sponsors — typically private equity, venture capital or hedge fund investors — who raise funds by selling shares of the SPAC through an IPO.

The proceeds raised through the SPAC's IPO are held in a trust and used by the sponsors to identify and acquire a target company. SPACs seek to acquire or combine with an operating company through an initial business combination, and investors rely on the sponsors to execute the business combination.

SPACs generated 199 initial business combinations during 2021, contributing to the large number of companies that went public last year.[1] Given the sheer quantity, SPACs are expected to remain a market force over the next few years.

However, events during 2022 suggest that the recent upward trend has reached its apex. Today, nearly 600 SPACS are seeking a target company to acquire, and 25% of those SPACs face liquidation this year.[2]

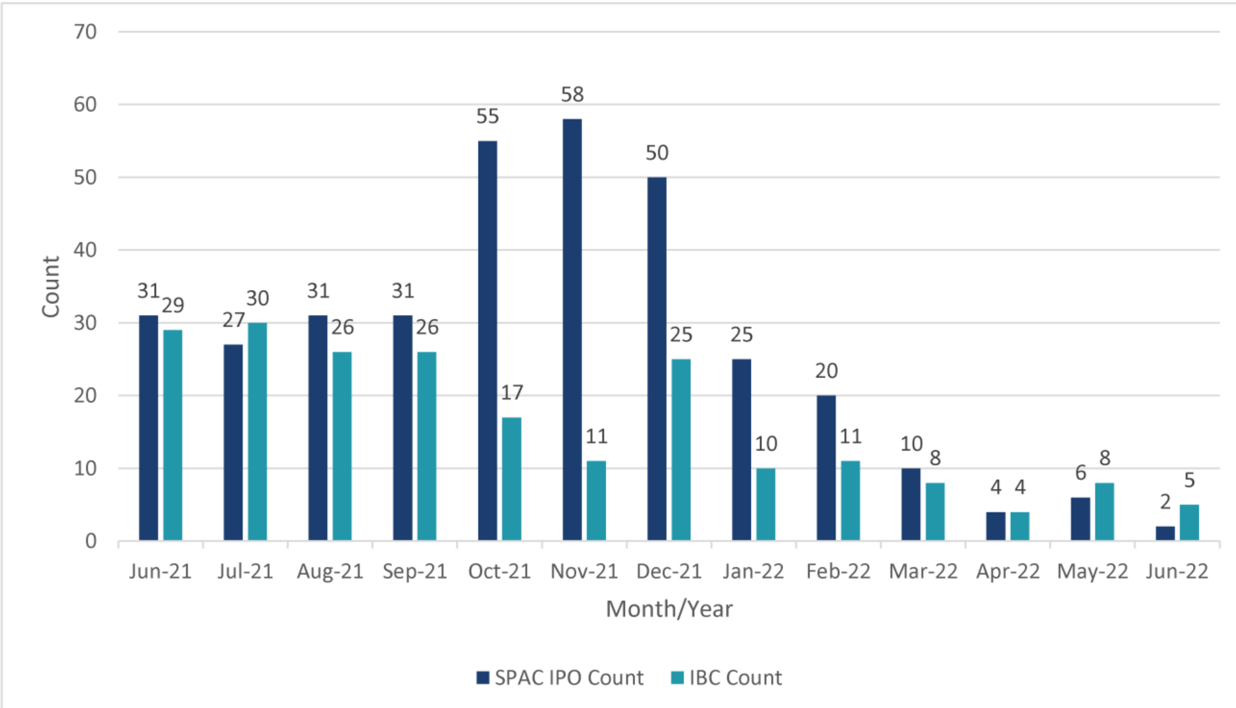
The SPACs still searching for a target face more imminent liquidation deadlines, which might generate hastily done deals. Moreover, the market likely reflects lower quality potential targets — lemons — as some highly valued private companies are delaying initial public offerings. All of these factors point to a high risk of negative outcomes.

As 2022 continues, we expect to see sustained levels of SPAC shareholder redemptions, increased liquidations for those SPACs unable to successfully consummate an initial business combination and increased litigation risk for those that successfully do.

Filings Decline As Redemption rates and Liquidations Increase

Both initial business combinations and SPAC IPOs are occurring at much lower rates thus far in 2022 than during the SPAC craze of 2021. As shown in Figure 1, the first quarter of 2022 has seen a decline in SPAC IPOs and initial business combinations, a downward trend that began in December 2021.

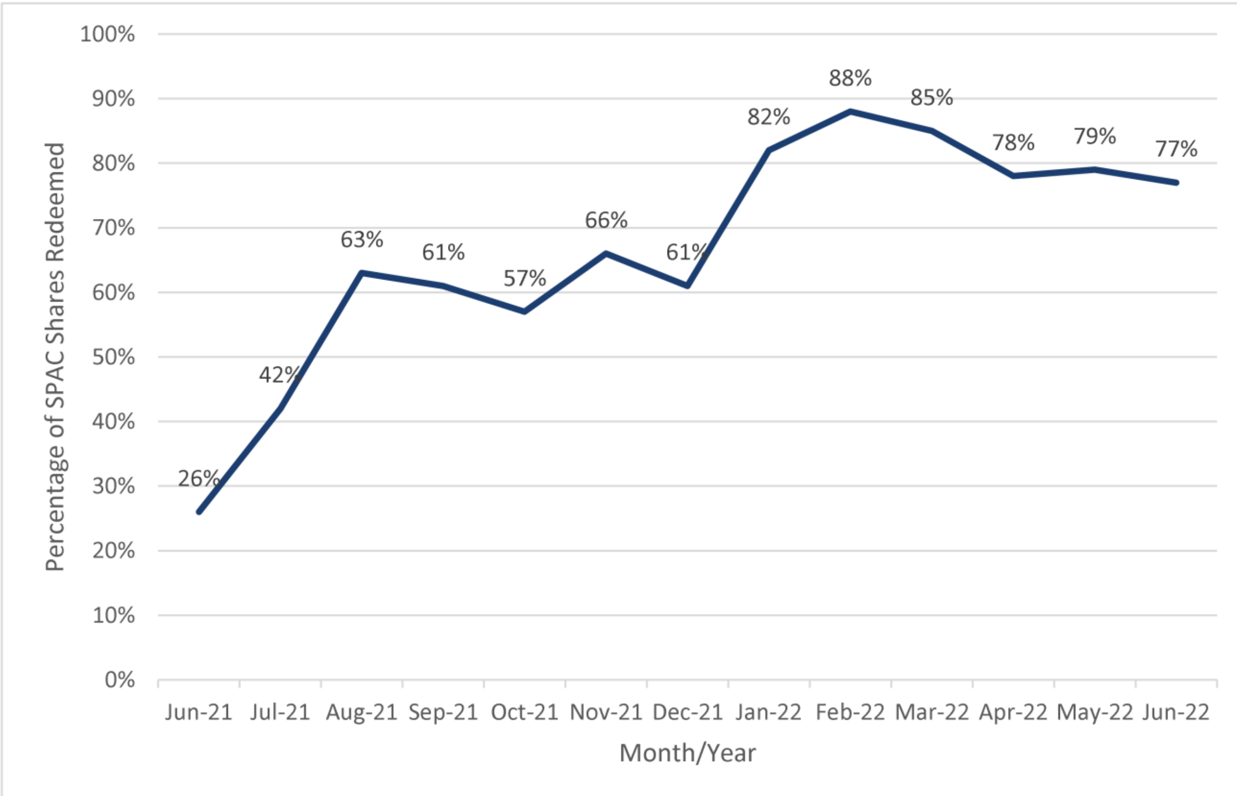
Figure 1: SPAC IPOs and Initial Business Combinations, From June 2021 to June 17, 2022 (Source: Boardroom Alpha)



As further evidence of the softening SPAC market, redemption rates — the proportion of shares redeemed for initial investments — are up. At any point until an initial business combination transaction closes, a SPAC shareholder can redeem their shares for their initial investment at the original IPO price — typically $10 per share — which is attractive to initial investors as downside protection, or a money-back guarantee of sorts.

High redemption rates drastically reduce the cash proceeds that the combined company — the initial business combination — will have for its future operations, and, if exceptionally high, the SPAC itself may run the risk of failing to meet the minimum amount of cash it needs to complete the initial business combination transaction. Since January 2022, the average redemption rate has remained at 75% or higher, as shown in Figure 2.

Figure 2: SPAC Shares Average Monthly Redemption Rates, From June 2021 to June 17, 2022 (Source: Boardroom Alpha)



The high redemption rates in SPAC shares indicate that most SPAC shareholders do not expect the initial business combinations proposed by the SPAC sponsors to maintain the initial offering price for an initial business combination of $10 per share.

This is seen in the many initial business combinations listed during 2021 that are trading below their original offer price of $10; for example, as of the close of trading on June 17, Aurora Innovation Inc. was at $2.24 a share, while BuzzFeed Inc. shares were at $1.60 each.

For these companies, SPAC shareholders who redeemed their initial investment avoided losing money, and many initial business combinations who experienced such stock price drops have been subject to related litigation.

In a relatively new development resulting from the intersection of the SPAC IPO boom and a general two-year liquidation deadline, several SPACs face liquidation this year if they do not find a target. A liquidation occurs if the SPAC sponsors do not complete an initial business combination within the allotted time limit, usually 24 months; instead, the SPAC liquidates and the proceeds raised by the SPAC IPO are returned to shareholders.

In the event of a liquidation, the expenses and fees related to the original SPAC IPO are not reimbursable to the sponsor and the sponsor's "promote" shares and warrants will become worthless. That is, sponsor's typically collect as much as a fifth of a SPAC's stock after it completes a merger. Consequently, there are incentives for sponsors to get deals done.

SPAC liquidations are rare, at least recently. In 2021, only one SPAC was liquidated,[3] while six SPACs have liquidated this year.[4] Despite this relatively low number of liquidations, 25 SPACs face liquidation deadlines between June and July 2022,[5] and more than 150 do by the end of the year.[6]

While it is uncertain, it is unlikely that all of these SPACs will be able to close deals successfully by then. Those that do are more likely to face litigation.

A Market for Lemons?

High redemption rates are also a symptom of the glut of SPACs that have gone public since 2019 in what is an already saturated market. SPACs have snatched up much of the supply of IPO-ready private company targets.

Figure 3, shown below, reports statistics for SPACs by the vintage year — the year in which the SPAC publicly listed its shares. The figure reveals that SPAC IPOs continue to outpace those consummating initial business combinations, such that — of the 1,135 SPACs created since 2019 — 24% have completed an initial business combination. Furthermore, the number of SPACs still searching for targets remains is 590, or 52%.

Figure 3: SPAC Status by Year of IPO, Through June 17, 2022 (Source: SPAC Insider)

SPAC Vintage	Total SPACs	Searching for Target	Completed IBC
2019	59	-	55
2020	250	62	153
2021	722	460	65
2022	104	68	-
TOTAL	**1135**	**590**	**273**
% of Total	*100%*	*52%*	*24%*

Despite the large number of SPACs seeking target companies to take public, there has been a slowdown in the number of companies going public during 2022. According to SPAC Alpha, 43 total initial business combinations from SPACs of earlier vintages have been completed thus far in 2022. Meanwhile, several large, high valued private companies, including Stripe Inc. — which is valued at over $150 billion — delayed publicly listing this year.[7]

Another high valued private company, Chime Financial Inc., opted out of listing publicly,[8] despite being valued at $25 billion. Similarly, Justworks Inc. delayed its IPO planned for January 2022, citing unfavorable market conditions — which is not surprising, given that 60% of companies that went public in 2021 are now trading below their IPO offer price.[9]

Did the SPAC craze of 2021 create these unfavorable market conditions for public listings? During 2020 and 2021, the companies that went public via SPAC were mostly high-growth, often pre-revenue companies that underperformed the forecasts they provided to the market.

While the U.S. Securities and Exchange Commission's recently proposed SPAC rules are a harbinger of change in that respect, those missed forecasts contributed to the poor post-IPO return performance, resulted in litigation, and will continue to create future litigation for those initial business combinations completed before the proposed rule changes take effect.

What does this scenario portend for the 590 SPACs seeking to take a company public during 2022? It seems that we have a lemons problem on our hands — that is, the problem introduced in George Akerlof's seminal 1970 paper "The Market for Lemons: Quality Uncertainty and the Market Mechanism," in the Quarterly Journal of Economics, exploring the game-theoretic implications of used car sales in the presence of information uncertainty.[10]

Similar to Akerlof's model, the SPAC market has become a market for lemons, where the highest quality private companies — e.g., Stripe and Chime — are sitting out to wait for possibly higher valuations, while other high-quality private companies already went public last year. Therefore, lower-quality private companies remain.

If this forecast is accurate, we will continue to observe the poor performance of initial business combinations produced by SPACs, which will lead to increased SPAC litigation and perhaps a stay on the market for SPAC IPOs.

Litigation Outlook

New and growing regulatory scrutiny, coupled with overall poor return performance for companies that did go public via SPACs, has generated a wave of securities litigation targeting this industry. SPACs and de-SPAC operating companies have been a target of securities litigation by both public and private litigants.

Meanwhile, a recent development in SPAC litigation is the SEC's March 30 proposed rules for SPACs,[11] which will hold underwriters who participate in de-SPAC transactions liable under Section 11 for "untrue statements of material facts or omissions of material facts" disclosed in the initial business combination's Form S-4.[12]

As a result, investment banks, including Goldman Sachs Group Inc., have announced their withdrawal from the SPAC market.[13] It seems that the SEC's proposed rules have had a chilling effect on the market and will likely lead to additional litigation.

Although not as voluminous, we have also seen an increase in SPAC-related litigation in the Delaware courts.[14] This includes nuanced decisions that may result in the filing of new and additional Delaware suits seeking to vindicate SPAC shareholders' redemption rights, at least for Delaware-incorporated SPACs with stock prices that decline below their redemption price after their de-SPAC transactions.

For example, in a January decision in In re: Multiplan Corp. Stockholders Litigation related to redemption actions, the Delaware Court of Chancery allowed investor-plaintiff's claims that a SPAC's board of directors, sponsors and controlling stockholder breached their fiduciary duties to proceed; the plaintiffs alleged that defendants impaired shareholders' redemption rights, and by doing so, concealed material information about the SPAC's merger target.[15]

Other courts may not adopt the Delaware court's view that the "entire fairness" standard —

rather than the business judgment rule standard — applied, due to "inherent conflicts between the SPAC's fiduciaries and public stockholders in the context of a value-decreasing transaction." However, market participants should continue to monitor the pending redemption actions to see if this type of litigation takes hold.

Indeed, most SPAC-related securities litigation filed thus far involves SPACs with IPOs during 2019 or 2020. Since litigation lags the market, the 2021 class of SPACs has yet to face much litigation. As such, all parties to a SPAC — including the board of directors, sponsors and controlling stockholder — will still be subject to the types of litigation described above.

We expect that the current developments in litigation — especially suits related to accounting restatements and forward-looking statements — will begin to be more substantially reflected in the year to come, especially — as indicated by the March rule proposal by the SEC — considering the regulatory scrutiny SPACs face is unlikely to subside.

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[1] SPAC Alpha, US SPAC Weekly Monitor, June 13, 2022, slide 3. https://spacalpha.com/cdn/2022/06/US%20SPAC%20Weekly%20Monitor_13Jun22.pdf.

[2] According to the research firm Dealogic, 153 SPACs that went public in 2020 and 2021 have between now and Dec. 31 to acquire a target.The vast majority of time limits will occur in the second half of 2022, starting July 1. https://www.law360.com/articles/1472673.

[3] SPAC Alpha, US SPAC Weekly Monitor, December 27, 2021, slide 42, https://spacalpha.com/cdn/2021/12/US%20SPAC%20Weekly%20Monitor_27Dec21.pdf.

[4] SPAC Alpha, US SPAC Weekly Monitor, June 13, 2022, slide 4. https://spacalpha.com/cdn/2022/06/US%20SPAC%20Weekly%20Monitor_13Jun22.pdf.

SPAC Alpha, US SPAC Weekly Monitor, May 9June 13, 2022, slide 24, weekly SPAC monitor.4, https://spacalpha.com/cdn/2022/06/US%20SPAC%20Weekly%20Monitor_13Jun22.pdf.

[5] SPAC Alpha, "Investment Ideas," Accessed June 17, 2022, https://www.spacalpha.com/ideas?deal-status=live-deal&deal-sector=&deal-geography=US%2FCanada#liquidation-deadline.

[6] According to the research firm Dealogic, 153 SPACs that went public in 2020 and 2021 have between now and Dec. 31 to acquire a target.The vast majority of time limits will occur in the second half of 2022, starting July 1. https://www.law360.com/articles/1472673.

[7] Bram Berkowitz, "IPO Watch: 3 things we just learned about Stripe," April 10, 2022, https://www.nasdaq.com/articles/ipo-watch%3A-3-things-we-just-learned-about-stripe.

[8] Jeff Kauflin, "With fintech stocks down 40%, Chime delays its IPO," February 18, 2022, https://www.forbes.com/sites/jeffkauflin/2022/02/18/with-fintech-stocks-down-chime-delays-ipo-to-second-half-of-2022/.

[9] Reuters, "HR software company Justworks delays U.S. IPO plans," January 12, 2022, https://www.reuters.com/technology/hr-software-startup-justworks-delays-us-ipo-plans-2022-01-12/.

[10] George Akerlof, 1970, "The market for lemons: Quality uncertainty and the market mechanism," Quarterly Journal of Economics, 84(3): 488-500.

[11] See https://www.sec.gov/rules/proposed/2022/33-11048.pdf.

[12] See https://www.sec.gov/rules/proposed/2022/33-11048.pdf, p. 15.

[13] Tom Zanki, "Goldman pulling back on SPACs amid regulatory crackdown," May 9, 2022, Law360, https://www.law360.com/capitalmarkets/articles/1491591/goldman-pulling-back-on-spacs-amid-regulatory-crackdown?nl_pk=f2c2b707-48a1-4e0e-89e5-f037e3aac1c9&utm_source=newsletter&utm_medium=email&utm_campaign=capitalmarkets&utm_content=2022-05-10.

[14] See https://www.financierworldwide.com/qa-director-and-shareholder-disagreements#.YoU7jajMKUk.

[15] See In re Multiplan Corp. Stockholders Litig., C.A. No. 2021-0300-LWW.