The Year of the SPACs: The Incredible Rise and Welcome Fall of Special Purpose Acquisition Companies

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By John C. Browne and Lauren A. Ormsbee

While most of us spent the past eighteen months binging Netflix and dreaming of a return to normal life, Wall Street was hard at work creating a new way to conduct initial public offerings. As usual, when Wall Street gets creative it is bad news for shareholders.

exceedingly dull, an acronym that fails to raise alarm bells. But look again. SPACs were all the rage in 2020—an intersection of glamour, celebrity and wealth. SPACs provided a safe space for hedge funds to team with mega-rich CEOs like Tilman Fertitta (owner of the Houston Rockets) and A-listers like Jay-Z, Alex Rodriguez, and Ciara in an environment where meaningful oversight by the Securities Exchange Commission (SEC) was sorely lacking.

In the past month the curtain started lowering on the SPAC show. A string of high-profile failures, mounting investor skepticism, and an increasingly vigilant SEC cooled the red-hot SPAC market. Below we discuss the rise of SPACs in 2020 and argue that their recent collapse, assuming it is not temporary, is good news for investors.

What Is A SPAC?

A SPAC is a shell company formed for the purpose of raising cash to acquire an existing business. Because SPACs are created without identifying a specific acquisition target, they are called "blank-check" companies. For example, the SPAC formed by Alex Rodriguez (Slam Corp.) has the exceedingly broad mandate: "to acquire an established leader in the sports, media, entertainment, or health and wellness sectors."

Once formed, SPACs conduct an initial public offering (IPO). The approval process is a mere formality given the SPAC's lack of financial history, assets or operations for the SEC to diligence. Newly-public SPACs, merely piles of cash waiting to be spent, have two years to find a merger target. If they do, the target company files an S-4 registration statement as part of a "de-SPAC" transaction. The S-4 solicits a shareholder vote on the acquisition without requiring the full panoply of disclosures required by an S-1 registration statement used in a traditional IPO. If the purchase is approved, the target emerges from chrysalis through a "reverse merger" and becomes a public company

The undisputed winners in all of this are SPAC sponsors and the hedge funds who act as early investors. The hedge funds achieve a near-guaranteed profit by selling prior to the merger, while sponsors fare even better as they are granted deeply-discounted warrants and their shares are automatically converted to a 20 percent stake in the new company. A recent study by professors at Stanford and NYU found that early investors average a return of over 11% on a risk-free investment while sponsors typically earn more than 32% in the year following the merger.

The Blank Check Bonanza

So how did we get here? Although SPACs have been around for decades, they were associated with pump-and-dump scams and other sketchy practices. Historically, reputable investment banks avoided SPACs in favor of traditional IPOs.

That all changed as a perfect storm of regulatory and market factors converged to make SPACs more attractive, beginning with the WeWork IPO in 2019. After filing its S-1 registration statement, WeWork faced intense questioning from investors and the media. The company was openly mocked for its "hilarious" double speak and ambitious plans to achieve revenues of $3 trillion (with a "T") even though it had suffered $4 billion in losses over previous years. The IPO was canceled, and the company nearly collapsed into bankruptcy.

The WeWork debacle spoiled a hugely lucrative transaction for its insiders and the Wall Street banks acting as underwriters. Venture capitalists and corporate issuers were aghast—WeWork had a private valuation of nearly $50 billion dollars and its founder claimed the company was profitable.

market had experienced several significant fluctuations, and uncertainty was plaguing the IPO market.

Enter the COVID-19 pandemic, which added even more unpredictability to an already skittish marketplace. Combine all of this with the structural “advantages” inherent in SPACs, including a faster route to regulatory approval, fewer disclosure requirements, and a perceived reduction in legal liability, and the SPAC boom was born. Some commentators even credit COVID stimulus checks for contributing to increased SPAC investment by retail investors.

The upshot was an unprecedented surge in SPAC-related IPOs. Between 2009 and 2018, SPACs completed less than 170 IPOs. In 2020 alone there were nearly 250, raising more than $80 billion from investors, and representing almost 70% of all IPO transactions. The trend accelerated at an astonishing rate during the first quarter of 2021, which saw 308 SPAC-related IPOs, worth $99 billion, in Q1 alone.

The SEC Stirs: Regulators Awake From Their Slumber

The SEC began to catch up to the SPAC boom in late December 2020 when it highlighted possible conflicts of interest between SPAC founders and shareholders, as well as disclosure issues regarding the compensation paid to acquire target companies. On March 8, 2021, the SEC somewhat amusingly cautioned the public that “it is never a good idea to invest in a SPAC just because someone famous sponsors it,” and a few weeks later it sent letters to multiple investment banks seeking information about their SPAC dealings.

Then, in early April, the SEC sent shockwaves through the SPAC market when it warned that SPACs are likely excluded from the “safe harbor” protections afforded to

SPACs than for conventional IPOs."

Days later, the SEC announced that warrants issued by SPACs must be booked as liabilities instead of equity. This hit SPAC insiders where it hurt—their pocketbooks. Warrants are an important deal sweetener for SPAC founders. They provide a low-risk path to enormous profits. Hundreds of SPACs may be forced to restate their financials to account for the SEC's new guidance on warrants. Compounding this problem is the astonishing fact that more than 90% of all SPACs are audited by just two accounting firms, which could create a significant backlog as SPACs adjust to these new rules and scramble to issue restated financials.

In April, the SPAC surge came to what Goldman Sachs called a "screeching halt." There were just 10 deals announced in the entire month, a 90% drop from March. A combination of increased regulatory activity, high-profile SPAC failures, and changing market conditions all contributed to this decline.

Is the Bloom Off the SPAC Rose?

Investors are realizing that SPACs may not be good investments. The failure of the medical claim evaluator MultiPlan, Inc. feels like the canary in the coal mine. Multiplan was taken public in October 2020 through an $11 billion SPAC founded by a former Citibank executive. Its shares have since collapsed more than 37%. This disappointing return did not stop the SPAC founders from reportedly reaping more than $140 million in insider compensation.

Multiplan is not an isolated case. Shareholders are beginning to push back against a system that is inherently biased in favor of insiders. The SPAC boom enabled Wall Street to bypass regulatory oversight and rush speculative and risky companies to the process were stripped away in the SPAC frenzy, investors were left bearing all the risk. Insiders, by contrast, mostly sold out at enormous profit and enjoyed a nearly guaranteed risk-free investment that presented nothing but upside.

In recent months, dozens of shareholder lawsuits have been filed against SPACs accusing them of insider dealing, false and misleading disclosures, and crippling conflicts of interest. This trend is sure to accelerate as fundamental flaws in many SPACs continue to come to light.

Changing market conditions also contributed to the SPAC decline. Increasing concerns over inflation have spilled onto risky asset classes, including SPACs. Data also suggests that retail investors are starting to turn away from SPACs in favor of more established companies that conduct traditional IPOs.

Conclusion

The SPAC boom was an unprecedented disruption to IPO markets. The recent collapse suggests it was not a sustainable one. As the world inches towards normalcy in 2021, shareholders hope the IPO markets follow suit. A return to the traditional IPO model would be a welcome return to normal after an extraordinary 2020. But like many things that happened in 2020, the repercussions from the SPAC boom will linger. With hundreds of SPACs already in existence, investors will be dealing with the fallout, including increased shareholder litigation and likely more failed companies, for years to come.

John C. Browne and Lauren A. Ormsbee are partners at Bernstein Litowitz Berger & Grossmann LLP, which is widely recognized worldwide as a leading law firm advising institutional investors on issues related to corporate *and pioneered the use of the litigation process to achieve precedent-setting governance reforms. Unique among its peers, BLB&G has obtained several of the largest and most significant securities recoveries in history, recovering over $33 billion on behalf of defrauded investors. More information about the firm can be found online at www.blblaw.com.*