Aligning Incentives: Finding a Better Way Forward with Special Purpose Acquisition Companies

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I. Introduction

Special purpose acquisition companies (SPACs) first began to emerge in the 1990s as an alternative means to conduct an initial public offering (IPO) and take private companies public.[1] With the rapid increase in popularity of SPACs in 2020 and early 2021, and with many politicians and mainstream celebrities trying to get a piece of the SPAC action, it has become far more important to evaluate carefully the merits and potential drawbacks of this process. This Article focuses primarily on addressing one key question: Are public investors who sign on to SPACs adequately protected by the current legal and regulatory frameworks, and, if not, what changes ought to be made going forward to help ensure they are?

Although SPACs may be seen as an appealing alternative pathway for raising financial capital and bringing companies public, the diverging interests between the major parties to a SPAC venture and the lack of adequate checks on a SPAC's decision to proceed once it has identified a promising private company (the "Target Company") are likely leaving some unsophisticated investors insufficiently protected within the current framework of limited disclosures and information asymmetries. This Article suggests that by altering the compensation structure for the sophisticated investor or management team that forms a SPAC (the "Sponsor"), the Sponsor's financial interests can be more closely aligned with that of the other investors. Achieving this should leave the Sponsor in a well-suited position, and with adequate financial incentive, to conduct meaningful due diligence on Target Companies that will better protect unsophisticated investors in SPACs.

II. Analysis

A. What are Special Purpose Acquisition Companies?

A special purpose acquisition company is a shell corporation that is formed for the sole purpose of raising capital through an IPO and using that capital to merge

[1] Special Purpose Acquisition Companies, Shell Companies, and Projections, 86 Fed. Reg. 29458 (proposed Mar. 30, 2022) (to be codified at 17 C.F.R. at pt. 210, 229, 230, 232, 239, 240, 249, 270).

with an existing private company, thereby bringing that company public.[2] SPACs are often viewed as a pathway for retail investors to partner with more sophisticated investors and "invest in promising privately held companies."[3] David Nussbaum created SPACs in 1993, "a time when blank check companies were prohibited in the US."[4] By the end of 2021, with investments in SPACs totaling more than $160 billion,[5] SPACs were viewed as an increasingly popular alternative avenue for private companies to access capital by way of the public market.[6] While the number of successful SPAC mergers with private companies dramatically increased in 2020 and 2021—with "SPACs account[ing] for more than 50% of the new publicly listed U.S. companies" in 2020[7]—this trend has slowed considerably in recent times.[8]

SPACs are typically formed by a Sponsor who, in exchange for a nominal initial capital investment, often secures a 20–25% interest in the SPAC (the "Founder Shares").[9] These Founder Shares serve as compensation for the Sponsor's efforts toward accomplishing three primary goals: (1) identifying a Target Company within a specific time frame, (2) negotiating with the Target Company to facilitate the eventual acquisition or merger, and (3) attracting investors to the SPAC. The remaining interest in the SPAC is then sold off to a mix of retail and institutional investors in the form of common shares offered at a set price—often $10 per share.[10]

For each share purchased, the investor is typically offered a warrant, or a fraction of a warrant, that gives the investor the right to purchase additional shares of common stock at some established price in the future.[11] The proceeds from the offering are then placed "into a trust or escrow account for future use in the acquisition

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[2] Julie Young, *Special Purpose Acquisition Company (SPAC) Explained: Examples and Risks*, INVESTOPEDIA (Mar. 15, 2023), https://perma.cc/24YE-WK5T.

[3] *Id.*

[4] *What is a SPAC and Why are They Suddenly so Popular*, EXCELSIOR CAPITAL, https://perma.cc/DJZ6-KKCC (last visited Oct. 26, 2023).

[5] *Id.*

[6] Mike Bellin, *Why Companies Are Joining the SPAC Boom*, PWC (Sept. 22, 2020), https://perma.cc/3VY7-433Q; Max H. Bazerman & Paresh Patel, *SPACs: What You Need to Know*, HARV. BUS. REV. (July–Aug. 2021), https://perma.cc/L5C6-FTKY.

[7] Bazerman & Patel, *supra* note 6.

[8] Delman v. GigAcquisitions3, LLC, 288 A.3d 692, 701 (Del. Ch. 2023).

[9] *See How Special Purpose Acquisition Companies (SPACs) Work*, PWC, https://perma.cc/83S8-ERDK (last visited Oct. 25, 2023) [hereinafter *How SPACs Work*].

[10] Bazerman & Patel, *supra* note 6.

[11] *Id.*

of one or more private operating companies."[12] With the funds being held in an interest-bearing trust account, and the fact that investors have redemption rights that allow them to reclaim a pro rata share of the trust account before any merger takes place, the initial purchasing of SPAC shares up until the time of merger can be viewed as a "short-term fixed income investment."[13]

From inception, SPACs normally have anywhere from 18 months to two years to identify a Target Company, negotiate a merger with the Target Company, receive approval for the merger from the investors, and successfully complete the merger with the private company (often referred to as "de-SPACing").[14] If de-SPACing is successful, SPAC shareholders and Target Company shareholders would then be the owners of "the now-public operating company."[15] If de-SPACing does not occur within the allotted time, the Sponsor can attempt to obtain approval from investors to extend the deadline. If approval is not obtained, the SPAC is then forced to liquidate, returning all funds held in the trust account to the shareholders on a pro rata basis.[16]

However, even if a Sponsor finds a Target Company and SPAC investors vote in favor of a merger, investors who do not believe the Target Company is promising—or who want to exit the arrangement for any other reason prior to the merger—are still able to exercise their "redemption right to get their money back in advance [of the merger]," including any accumulated interest on the initial investment.[17] Moreover, investors who choose to exercise their redemption rights are allowed to keep their warrants going forward.[18] This added benefit serves to mitigate some of the risk of the overall investment.[19]

With the existence of these redemption rights, Sponsors may worry that too many investors will choose to exercise these rights, leaving the SPAC with insufficient funds to complete a potential merger. For this reason, after raising the initial funds for the SPAC, the Sponsor may seek to raise additional capital from private investments

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[12] *SPACs Explained*, FIDELITY (Mar. 1, 2022), https://perma.cc/5MVB-WDV4.

[13] Frank Fagan & Saul Levmore, *SPACs, PIPEs, and Common Investors*, 25 U. PA. J. BUS. L. 103, 109 (2023) ("During this 'pre-deal' period . . . the market value of the SPAC shares reflects that of a short-term fixed income investment, as well as the expected value of a merger.").

[14] *How SPACs Work*, *supra* note 9.

[15] Paul Munter, *Financial Reporting and Auditing Considerations of Companies Merging with SPACs*, U.S. SEC. & EXCH. COMM'N (Mar. 31, 2021), https://perma.cc/443J-ZKUT.

[16] *How SPACs Work*, *supra* note 9.

[17] James Chen, *SPACs Look Like a Bubble Within a Bubble*, INVESTOPEDIA (Feb. 9, 2021), https://perma.cc/B7AC-JJAQ.

[18] *Id.*

[19] *Id.*

in public equities (PIPEs).[20] PIPEs play a key role in ensuring that adequate funds will be available for the eventual merger even if a considerable number of investors elect to exercise their redemption rights. To guarantee this, PIPE investors agree not to remove their capital for an agreed-upon period.[21] PIPE investors are often willing to bear this additional risk because (1) they are confident in the Sponsor's ability to identify a high-quality Target Company and (2) they are usually offered shares at a discounted rate compared to other investors as compensation for the added risk they are bearing.[22]

B. Legal and Regulatory Framework Governing SPACs

Although not explicitly governed by the requirements of Rule 419 under the Securities Act of 1933, SPACs still largely follow these requirements as a way to promote investment,[23] including holding investment funds in an interest-bearing trust and liquidating the funds if a merger does not occur.[24] SPACs are also subject to far less stringent disclosure requirements upon creation of the SPAC and when the merger is approved as compared to more traditional IPO structures.[25] The relaxed disclosure standards and conflicting interests among the relevant parties in the SPAC process have led to a wave of litigation in the Court of Chancery of Delaware with investors claiming that Sponsors violated their duty of loyalty.[26] Certain investors are seeking to have Sponsors held accountable by contending that the entire fairness standard of review applies "due to inherent conflicts between the SPAC's fiduciaries and public stockholders in the context of a value-decreasing transaction."[27]

While final judgment on the merits of this issue has not yet been reached in any of these cases, the Court of Chancery of Delaware—through denying the defendant's motion to dismiss in *In re Multiplan Corp. Shareholders Litigation*[28]—appeared to endorse the idea that "[t]he entire fairness standard of review applies" in this

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[20] *See SPACs Explained*, *supra* note 12.

[21] Bazerman & Patel, *supra* note 6.

[22] *Id.*

[23] *See* Special Purpose Acquisition Companies, Shell Companies, and Projections, *supra* note 1.

[24] 17 C.F.R. § 230.419.

[25] *See* Young, *supra* note 2.

[26] Delman v. GigAcquisitions3, LLC, 288 A.3d 692, 713–14 (Del. Ch. 2023).

[27] *Id.*

[28] 268 A.3d 784 (Del. Ch. 2022).

context.[29] It is alleged that the defendants in *In re Multiplan Corp.*, through misstatements and omissions, discouraged public stockholders from exercising their redemption rights—to the benefit of the defendants.[30]

Research conducted on SPAC performance from 2019 through the first half of 2020 suggested that "although the creators of SPACs were doing well, their investors were not."[31] With the apparent danger of interests diverging between Sponsors and investors, the Securities and Exchange Commission (SEC) has repeatedly attempted to warn investors of the risks.[32] Additionally, in line with its "three-part mission to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation[,]"[33] the SEC published proposed regulations on March 30, 2022, that could come to impact how SPACs are regulated going forward.[34] The general goal was to bring protections for SPAC investors more in line with the protections that investors would receive in a more traditional IPO.[35] At a high level, these proposed rules, if adopted, would increase disclosure obligations from Sponsors and expand the potential liability under Section 11 of the Securities Act of 1933 for underwriters of a SPAC for any material misstatements or omissions in registration statements.[36]

C. Competing Incentives Among the Major SPAC Parties

Although the adoption of new regulations would likely lead to increased protection for SPAC investors, the worry is that over-regulating this space could lead to an overall decrease in the viability of using SPACs to bring Target Companies public. Reflecting on the SEC's three-part mission, one can begin to see the inherent tension between protecting investors on the one hand and continuing to facilitate capital formation by way of SPACs on the other.[37] This tension highlights the importance of being able to find the right balance between serving these partially

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[29] *Id.* at 792.

[30] *Id.* at 800.

[31] Bazerman & Patel, *supra* note 6.

[32] Yun Li, *SPAC Lawsuits Jump in Another Sign of Suspect Deal-Making for the Once Red-Hot Space*, CNBC (Aug. 9, 2021, 6:11 AM ET), https://perma.cc/2WVZ-NQVE.

[33] Munter, *supra* note 15.

[34] E. Ramey Layne & K. Stancell Haigwood, *SPAC Regulation—Past, Present and Future*, 45 U. ARK. LITTLE ROCK L. REV. 233, 233 (2022).

[35] Special Purpose Acquisition Companies, Shell Companies, and Projections, *supra* note 1, at 29463.

[36] Erin Gordon et al., *M&A, Professional Perspective - SEC's Proposed SPAC Rules & Market Reaction*, BLOOMBERG LAW (Sept. 2022), https://perma.cc/ZL3V-K6CM.

[37] Munter, *supra* note 15.

competing goals with whatever new regulations may be adopted.[38] However, to strike this balance, it is necessary to first understand the relevant incentives of the "three main stakeholder groups: Sponsors, investors, and Target Companies."[39]

Sponsors have a strong interest in successfully merging with a Target Company to capitalize upon their investment of time, effort, and funds. This is so because Sponsors are largely compensated with Founder Shares, which only pay out if the de-SPACing process is completed. Potential problems arise due to the radically different compensation schemes between Sponsors and investors, such that Sponsors may be financially motivated to find a sub-par private company and try to force a merger through in such a way that it would result in a profit for the Sponsors to the financial detriment of the investors who chose not to exercise their redemption rights.[40]

For Target Companies, one of the primary interests is to extract as much value out of the negotiations as possible. Being able to negotiate its own acquisition agreement may lead to higher valuations[41] and less uncertainty when compared to a traditional IPO that is more susceptible to the will of the market.[42] Also, considering the strong incentives of the Sponsor to close a deal before their time to find a Target Company elapses, it becomes clear how a Target Company may be able to exercise more leverage in negotiations the closer it gets to the Sponsor's deadline for effectuating a de-SPACing.[43] However, this leverage is partially reduced because (1) the Sponsor can ask for, and is usually granted, at least one extension of the deadline and (2) investors can vote against the merger after it has been announced (provided they possess enough information to accurately assess the quality of the Target Company).

Less sophisticated retail investors are often motivated to engage in SPAC dealings due to the appeal of joining forces with savvy investors and directly engaging in the IPO space. Additionally, with the warrants and redemption rights, these ventures seem like a relatively low-risk investment. The real problems often emerge for the minority of investors who decide not to exercise their redemption rights before de-SPACing occurs.[44]

With the two largest players—the Sponsors and the Target Companies—often pushing forward to close the deal, unwary investors "unable to fully assess the quality

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[38] Layne & Haigwood, *supra* note 34, at 235.

[39] Bazerman & Patel, *supra* note 6.

[40] Delman v. GigAcquisitions3, LLC, 288 A.3d 692, 708 (Del. Ch. 2023).

[41] Bellin, *supra* note 6.

[42] *How SPACs Work*, *supra* note 9.

[43] Bazerman & Patel, *supra* note 6.

[44] *See* Usha Rodrigues & Michael Stegemoller, *Redeeming SPACs*, University of Georgia School of Law Legal Studies Research Paper No. 2021-09, 44–45 (2021).

of a deal" can end up getting stranded.[45] Knowing whether there is a sophisticated PIPE investor on board can send valuable information to smaller investors as to the quality of the SPAC and whether the smaller investors should exercise their redemption rights.[46]

Still, as valuable an indicator as the presence of PIPEs may be, it is, of course, no panacea for the many concerns facing investors. First, investors may still be left questioning whether the PIPE investor has conducted a quality investigation of the SPAC. Second, smaller investors with whom we ought to be concerned may not fully understand the presence or absence of a PIPE investor to be such a strong market signal. Third, there simply appear to be far more SPACs than there are PIPEs. This asymmetry may lead us to be more confident in the quality of the SPAC with which the PIPE ends up aligning;[47] however, it communicates to the market very little about the quality of the many other SPAC ventures left without any form of PIPE involvement.

The core problem with this dynamic is that "[t]here is no player structurally incentivized to second-guess the decision to go public."[48] In the past, one check on the decision to go public was the implementation of a redemption threshold. With active redemption thresholds, if the redemption rate exceeded some previously established limit, then the merger would not be allowed to proceed.[49] This allowed the decisions of more sophisticated investors to act as a layer of protection for unsophisticated investors. However, historical threshold rates to prevent an acquisition have been raised from originally needing only 20% to prevent an acquisition to a staggering 95% today.[50]

This, coupled with the fact that investors could simultaneously vote for a merger while still choosing to exercise their redemption rights, creates the possibility of empty voting "where the economics of the transaction are misaligned with the formal vote."[51] In other words, investors who vote in favor of a merger while simultaneously electing to exit by way of exercising their redemption rights are able to impact the results of the vote without having to subject themselves to the financial consequences of the decision to merge. Under this scheme, unwary investors with

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[45] Jeffrey Goldfarb, *SPAC Shell Games Will Keep Hiding the Ball*, REUTERS (Oct. 5, 2023, 10:44 AM CT), https://perma.cc/62W8-JB6B.

[46] Fagan & Levmore, *supra* note 13, at 126–27.

[47] *Id.*

[48] Rodrigues & Stegemoller, *supra* note 44, at 45.

[49] *Id.*

[50] Daniele D'Alvia & Milos Vulanovic, *Capital Markets, Professional Perspective - The Promise and Limits of a SPAC Revolution*, BLOOMBERG LAW (Sept. 2020), https://perma.cc/SGX9-3BGQ.

[51] Rodrigues & Stegemoller, *supra* note 44, at 5.

inadequate information may be getting stranded in unprofitable mergers without any formal mechanism to protect their interests.[52] Those unwary investors that choose not to exercise their redemption rights are poised to face significant dilution from multiple sources, including warrants and the highly favorable share prices often used to entice PIPE investors.[53]

D. Aligning Incentives Among the Major SPAC Parties

Finding a solution to these problems that will strike a balance between adequately protecting investors and continuing to facilitate capital formation by way of SPACs will be challenging. By considering the varied interests of the relevant parties to the SPAC transaction, a few guiding principles appear to emerge that would seem to offer a path toward better aligning the interests of these parties while reducing the occurrence rate of conflicted interest transactions.

Providing unsophisticated investors with additional information and disclosures is certainly a good start but not enough on its own. The real difficulty is that without a PIPE-like entity serving the important role of evaluating the quality of the SPAC, no other single actor is sufficiently incentivized to conduct this due diligence. Sponsors can, of course, assist in this process of conducting due diligence and making disclosures to investors, but even such disclosures "are complex and suffer from a lack of standardization" that serves to reduce the positive impact disclosures can have for investors.[54] Additionally, as noted above with the ongoing SPAC lawsuits, there appear to be cases where de-SPACing can be a profitable proposition for the Sponsor at the expense of other investors.[55] This further reduces the likelihood that Sponsors will be sufficiently motivated to adequately protect investors.

Although there appear to be problems with relying on the Sponsor to gather and disclose material information, it does seem that with modifications the Sponsor could become the best situated party for this task. Changing the compensation structure for the Sponsor in a way that more closely aligns the Sponsor's financial interests with the rest of the investors should further incentivize the Sponsor to

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[52] *Id.*

[53] *See* Fagan & Levmore, *supra* note 13, at 111.

> Commentators have suggested that the relevant gap for assessing the magnitude of dilutions to the normal SPAC shareholder is the difference between the purchase price of a SPAC share (standardized at $10.00) and the amount of cash per share left in the SPAC upon delivery to the target. An estimate of this difference from January 2019 to June 2020, for the median SPAC, is $5.70. If so, the target must indeed be well chosen for the original investment by the public investor to be worthwhile. *Id.*

[54] Rodrigues & Stegemoller, *supra* note 44, at 46.

[55] *See supra* note 28.

investigate Target Companies in a way that will better protect the financial interests of unsophisticated investors. This proposed compensation modification would likely have to be brought about from within the SPACs themselves, but self-imposed regulation is no foreign concept in the world of SPACs.[56] The motivations for Sponsors of SPACs to adopt these changes are to (1) avoid potential exposure to litigation[57] and (2) reduce the likelihood that the SEC will find it necessary to impose harsher dictates that could end up regulating SPACs out of existence.[58]

Finding the right "new" compensation scheme for Sponsors will be no easy task. Any such plan should motivate Sponsors to conduct proper and adequate due diligence and ensure that serving in the role of a Sponsor may still be profitable enough to sufficiently compensate Sponsors for their time, energy, effort, and risk. In terms of the actual changes that might be made to accomplish these goals, one potential way forward would be to change how Founder Shares are structured. Instead of securing a 20–25% interest in the SPAC from the outset for a nominal initial capital investment, a portion of the Sponsor's potential stake should be linked to the long-term performance of the post-merger public company.[59]

For example, perhaps the Sponsor would only get a 10–15% interest at the outset; however, depending on how successful the new public company were to become post-merger, the Sponsor would be able to earn the equivalent of bonuses linked proportionally to the company's performance. These bonuses could be arranged in a way that the Sponsor might end up with as much of a stake as if the Sponsor had initially been given a 30–35% interest in the SPAC.

Decreasing the initial percentage of shares received when becoming a Sponsor would make forcing through a bad merger with an undesirable Target Company less financially appealing to the Sponsor. The Sponsor would also then have an added incentive not only to find a higher quality Target Company at the outset but also to remain involved after de-SPACing in the hope of capitalizing on future bonuses tied to corporate success. While this may result in lower profits for Sponsors depending on the compensation formula employed, this new compensation scheme may well provide a more sustainable way forward for SPACs and, if adopted, may lead to a renewed interest in this alternative means to conduct an IPO.

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[56] *See supra* Section B.

[57] *See* In re MultiPlan Corp. Shareholders Litigation, 268 A.3d 784 (Del. Ch. 2022).

[58] Carson S. Clear, *Saving SPACs from the SEC's Potentially Ruinous Overreach*, 72 EMORY L. J. 1017, 1034 (2023).

[59] *See generally* Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 309–10 (1976) (exploring how compensation structures can be used to "provide appropriate incentives for the agent to make choices which will maximize the principal's welfare, given that uncertainty and imperfect monitoring exist").

Sponsor bonuses would likely have to be negotiated with Target Companies during the pre-merger process. What would a Target Company's incentive be to consider adopting such terms? Target Companies presumably want to go public and be successful in the long run. With flexibility to negotiate with SPACs in the pre-merger process, deals could be set up specifically to serve these two vital interests. Target Companies could establish well-defined corporate performance metrics that must be achieved as a prerequisite to pay Sponsor bonuses. The takeaway from all this is that adopting a new compensation structure along these lines might be able to strike the right balance between the interests of all key parties involved.

III. CONCLUSION

SPACs provide an alternative route to the traditional IPO to raise capital and take privately held companies public. While the rate of SPAC mergers continues to decrease significantly,[60] the usefulness and attractiveness of SPACs could potentially be renewed by better aligning interests of Sponsors, Target Companies, and investors. The adoption of new compensation schemes for Sponsors along the lines proposed may very well accomplish such an end goal for SPAC proponents.

By modifying Sponsor compensation in a way that serves to better align the interests of the principal parties in a SPAC venture, the Sponsor should be incentivized to conduct additional due diligence and make further disclosures in a manner that better safeguards interests of investors who decide not to exercise their redemption rights before de-SPACing occurs. Also, by adopting Sponsor bonuses linked to long-term success of the post-merger company, Sponsors should be even more motivated to identify quality Target Companies and remain involved to promote the success of the merged company. With ongoing concerns of exposure to litigation and new proposed regulation still being considered by the SEC, the time may be ripe for SPAC Sponsors to recognize the appeal of implementing greater self-regulation while also fashioning supplemental compensation arrangements that incentivize conduct likely to benefit all SPAC participants. Doing so may very well lead to a resurgence in the use of SPACs and provide a more desirable and acceptable way forward for SPACs.

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[60] STATISTA RESEARCH DEPARTMENT, *Number of Special Purpose Acquisition Company (SPAC) IPOs in the United States from 2003 to August 2023*, STATISTA (Aug. 21, 2023), https://perma.cc/8FKN-E997 (noting that the number of SPACs declined from a peak of 613 in 2021 to only 86 in 2022).