# EXIT, VOICE, AND REPUTATION: THE EVOLUTION OF SPACS

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ABSTRACT

*This Article tells the story of a new type of business—the special purpose acquisition corporation ("SPAC"). The promoters of a SPAC begin by forming a shell corporation with no assets. They then take the company public on little more than a promise that they will strive to complete the acquisition of a target in the near future. We present the first empirical study of the SPAC contract design, and use a hand-collected dataset to trace its evolution over the past nine years.*

*While SPACs are a new form, their contract design borrows heavily from private equity's playbook. Private equity managers famously (and sometimes controversially) receive 20% of their funds' profits, and funds typically last only ten years. From the traditional 20% incentive compensation to a short investment shelf life, SPAC entrepreneurs tried to transfer many hallmarks of the private equity contract to the public market.*

*Reputational constraints got lost in translation. The private equity fund model is built on repeat business, and reputation is a crucial contractual gap filler. In contrast, SPACs are one-shot deals. Without managerial reputation to rely on, investors demanded increasing amounts of "skin in the game" from SPAC managers, and placed more conditions on managerial claims to 20% of the profits. On the other hand, without the force of reputation constraining investors, a supermajority vote created a powerful holdout right, which shareholders used to exploit SPACs until the form evolved to eliminate it. Our study of SPACs—by demonstrating the ways in which parties contract for credibility in the absence of long-term relationships between investors and managers—thus underscores the importance of reputation to the relational dynamics in traditional private equity.*

*Aside from making private equity publicly tradable (with its concomitant loss of reputation as gap filler), SPACs' chief innovations were*

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*in the classic governance mechanisms of voice and exit. SPACs evolved from granting investors a supermajority vote to eliminating the vote altogether. At the same time, they granted investors an even stronger walk-away right. Thus, the SPAC story, new as it is, casts light on an old governance question: the relative value of voice and exit.*

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## I. INTRODUCTION

The development of a new kind of corporation is a rare occurrence. Yet in recent years, such a new species has emerged—the special purpose acquisition corporation, or "SPAC." SPACs constitute a uniquely public form of private equity fund. The promoters of a SPAC take the entity public as a shell corporation and then commence a time-limited hunt for an acquisition target.[1] If a target is found, investors in the SPAC have a pre-acquisition choice either to get their money back, or to remain as shareholders of the now-public firm.[2] Sometimes called a "poor man's private equity fund,"[3] SPACs give a wide range of investors an opportunity previously only afforded to accredited (*i.e.*, wealthy) investors: the opportunity to invest in a fund that acquires a private company.[4]

The SPAC's developers did not, however, create this new corporate form from whole cloth. Almost every SPAC feature borrows from the playbook of the traditional private equity firm.[5] The most well known forms of private equity are venture capital and leveraged-buyout ("LBO" or "buyout") funds.[6] In this multi-billion dollar industry, sophisticated investors entrust their money to managers, who then invest the funds in a variety of private targets.[7] At their inception, the creators of SPACs attempted to translate key private equity features to the public markets, and the law of unintended consequences promptly went to work.[8]

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[1]William K. Sjostrom, Jr., *The Truth About Reverse Mergers*, 2 ENTREPRENEURIAL BUS. L.J. 743, 756 (2008). Sjostrom's article describes SPACs as a species of reverse merger, and at a high level of generality. *See id.* at 756-59. In contrast, we conduct an empirical analysis of individual characteristics of SPACs, and document how they change over time.

[2]*See id.* at 758 (citation omitted).

[3]*See, e.g.*, Jim Fink, *Special Purpose Acquisition Companies (SPACs): Will Investors Live Long and Prosper?*, INVESTING DAILY (Apr. 10, 2012), http://www.investingdaily.com/10914/special-purpose-acquisition-companies-spacs-will-investors-live-long-and-prosper.

[4]*See* Steven M. Davidoff, *Black Market Capital*, 2008 COLUM. BUS. L. REV. 172, 225 (2008):

> SPACs are a species of private equity: these are capital pools organized to acquire individual businesses. But because of the general requirement that the initial acquisition comprise eighty percent of its assets, SPACs typically only acquire a single privately-held business. Despite these important distinctions, SPACs otherwise attempt to mimic private equity returns by employing comparable structures and practices. For example, SPACs utilize similar leverage to increase the size and potential returns of their acquisitions. The managers of SPACs are also typically provided twenty percent of the initial share offering at nominal amounts; ownership they are required to maintain until and after consummation of an acquisition.

*Id.* (footnotes omitted); *see also* Carol Boyer & Glenn Baigent, *SPACs as Alternative Investments: An Examination of Performance and Factors that Drive Prices*, 11 J. PRIVATE EQUITY 8, 8 (2008) ("SPACs . . . provide the public with access to the private equity investments area, which was previously available only to institutional clients such as hedge funds and investment banks.").

[5]*See, e.g.*, Davidoff, *supra* note 4, at 225.

[6]*See infra* Part II.

[7]*See infra* Part II.

[8]*See* Davidoff, *supra* note 4, at 225-28 ("[T]he SPAC phenomenon has been publicly attributed and promoted as a private equity substitute, one the public can now freely access.").

The problem for the SPAC's inventors was that private equity's contract was delicately calibrated for an essentially *private* relationship. Private equity's contractual strategies simultaneously reassure both investors and fund managers in a setting ripe for opportunism on both sides.[9] Fund managers must convince the mistrustful wealthy investor to hand over money, despite considerable information asymmetries (*i.e.*, the managers know much more about the value of their talents and the venture's prospects for success than the investors do)[10] coupled with the familiar risk of agency costs (*i.e.*, the goals of self-interested agents necessarily diverge from the interests of the principals they represent).[11] Private equity managers employ a variety of strategies to comfort the nervous investor who faces these real-world difficulties.[12] Incentive compensation means that the manager only profits if his investors do.[13] Requiring the manager to invest his own money in the fund further aligns incentives by ensuring that he internalizes some downside costs if the fund fails to perform—the so-called "skin in the game."[14] Furthermore, investors make payments for their equity positions in stages, delivering only a portion of the promised investment up front.[15] To

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[9]*See generally* Kate Litvak, *Governance Through Exit: Default Penalties and Walkaway Options in Venture Capital Partnership Agreements*, 40 WILLAMETTE L. REV. 771, 773 (2004) [hereinafter Litvak, *Governance Through Exit*] (describing the value of a venture capital investor's bargained-for right to withdraw support if displeased with the fund's management); Kate Litvak, *Venture Capital Limited Partnership Agreements: Understanding Compensation Arrangements*, 76 U. CHI. L. REV. 161, 162 (2009) [hereinafter Litvak, *Venture Capital Limited Partnership Agreements*] (stating that venture capital fund managers, as opposed to corporate managers, bargain for their compensation with the funds' investors); Paul Gompers & Josh Lerner, *An Analysis of Compensation in the U.S. Venture Capital Partnership*, 51 J. FIN. ECON. 3, 4, 6 (1999) [hereinafter Gompers & Lerner, *Analysis of Compensation*] (describing how the contract between venture capital fund managers and investors controls management salaries); William A. Sahlman, *The Structure and Governance of Venture-Capital Organizations*, 27 J. FIN. ECON. 473, 489-93 (1990) (describing the various components of venture capital contracts, including management compensation and profit distributions); Andrew Metrick & Ayako Yasuda, *The Economics of Private Equity Funds*, 23 REV. FIN. STUD. 2303, 2304 (2010) (explaining the "fixed and variable components" of the general partners/managers' compensation, as outlined in the contract between the general partners/managers and limited partners/investors).

[10]Sahlman, *supra* note 9, at 493 ("In the venture-capital industry, the agency problem is likely to be particularly difficult. There is inevitably a high degree of information asymmetry between the venture capitalists, who play an active role in the portfolio companies, and the limited partners, who cannot monitor the prospects of each individual investment as closely.").

[11]*Id.* ("Venture capitalists have many opportunities to take advantage of the people who invest with them.").

[12]*See infra* Part VI.

[13]*See infra* Part VI.A.1.

[14]*See infra* Part VI.A.2.

[15]Sahlman, *supra* note 9, at 491.

prevent the manager from merely sitting on the money, the fund faces a limited investment horizon; after ten years, investors get their money back.[16]

In private equity, overarching all of these contractual protections against agency costs and informational asymmetries looms reputation. Each private equity firm operates several different funds at one time, and successful managers expect to go on to raise subsequently larger, and correspondingly more profitable, funds.[17] If a manager wants to succeed in the private equity world, she must develop a reputation for making wise choices for her investors.[18] SPACs mimicked nearly all of traditional private equity's contractual features reasonably well but, being publicly traded one-shot deals, they lost the beneficial effects of reputation.[19]

On the other side of the relationship, just as investors have their misgivings about managers, managers have their own reasons to be fearful of investors. SPACs seemed to improve on the risks that managers face in traditional private equity.[20] Because private equity investors make payments in stages, they may be tempted to treat their promise of future funding more like an option, and renege if the fund fails to perform as expected or if their personal financial circumstances change.[21] Again, in private equity, reputation steps into the breach.[22] Most private equity investors are pension funds and wealthy individual investors; they face harsh reputational sanctions if they do not honor their commitments.[23] These sanctions are potent because of the risk of being locked out of future private equity investments—and the 20% (or higher) annual returns that the funds often generate.[24] That, in turn, counterbalances the moral hazard risk that investors will renege.[25] In contrast, SPAC managers receive the money up front.[26]

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[16]*See id.* at 490.

[17]*See infra* Part II.C.

[18]*See, e.g.*, Matthew D. Cain, Steven M. Davidoff & Antonio J. Macias, *Broken Promises: Private Equity Bidding Behavior and the Value of Reputation*, AFA 2012 CHI. MEETINGS 1, 11 (Sept. 2012), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1540000## (citation omitted) ("[R]eputation is valuable as it improves the ability of the firm to attract future capital investments from limited partners.").

[19]*See infra* Part VIII.

[20]*See* Sjostrom, *supra* note 1, at 757-58.

[21]*See* Sahlman, *supra* note 9, at 491.

[22]*See* Cain, Davidoff & Macias, *supra* note 18, at 11.

[23]*See* Sahlman, *supra* note 9, at 491.

[24]*Id.* at 491, 513-14; *see also* Ronald J. Gilson, Charles F. Sabel, & Robert E. Scott, *Braiding: The Interaction of Formal and Informal Contracting in Theory, Practice, and Doctrine*, 110 COLUM. L. REV. 1377, 1379 (2010) (stating that breach of an informal contract can damage a reputation, which can reduce the party's chances for future business opportunities).

[25]*See* Sahlman, *supra* note 9, at 491.

Therefore, investors' funds are safe in a trust account and are only released on acquisition. Accordingly, managers can rest assured that the money is actually available and not subject to an investor's response to future capital calls.[27]

In sum, reputational constraints hold the richly dynamic tension between traditional private equity investors and managers largely in equilibrium.[28] But the SPAC entrepreneurs shook things up: they made the investment publicly tradable and thus subject to public reporting requirements.[29] Because of the anonymous interactions of the public markets, reputation no longer constrained either side.[30] Cognizant of the need to reassure skittish investors in this new form, SPACs' creators gave investors a vote on any proposed acquisition, as well as a low-cost exit right available for use before any pending deal was finalized.[31] The trust account comforted not only investors, but also managers, who no longer had to fear that investors would not honor their capital commitments.[32]

While the SPACs preserved (and indeed strengthened) traditional private equity's mechanisms for addressing information asymmetries and agency costs, the creation of a public entity removed a key reputational check on managers and investors alike.[33] Lacking the ability to control the identity of their investors, SPACs proved vulnerable to new kinds of investor opportunism.[34] On the flipside, SPACs are one-off transactions, so reputational constraints on managers no longer had much traction.[35] We document how SPACs have evolved their managerial compensation and

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[26] *See* Sjostrom, *supra* note 1, at 758 ("[T]he operating company will receive a large cash infusion because the SPAC with whom it merges will contain the proceeds from its IPO.").

[27] *See id.*

[28] *See* Gilson, Sabel & Scott, *supra* note 24, at 1379-80 (explaining generally the role of reputation in informal contract enforcement); Sahlman, *supra* note 9, at 513.

[29] Sjostrom, *supra* note 1, at 756-58 (explaining SEC Rule 419 governing "blank check companies" and how SPACs, although technically not under that rule's purview, nonetheless incorporate some of its features in order to provide investor security) (citing 17 C.F.R. § 230.419 (2007)).

[30] *See id.* at 758.

[31] *Id.*; Davidoff, *supra* note 4, at 225.

[32] *See* Sjostrom, *supra* note 1, at 758.

[33] *See id.*; Amanda Thompson, Organizational Form and Investment Decisions: The Case of Special Purpose Acquisition Companies 12-13 (Jan. 2012) (unpublished dissertation, Purdue University), *available at* http://proquest.umi.com/pqdlink?did=2344790561&Fmt=7&clientId=79356&RQT=309&VName=PQD; *see also* Davidoff, *supra* note 4, at 225 (discussing the rights of investors in SPACs, *i.e.* the right to pre-approve the acquisition).

[34] *See* discussion of "greenmailing" *infra* Part III.A.

[35] *See* Thompson, *supra* note 33, at 12-13 (asserting that reputational checks are only important to SPAC managers in the pre-acquisition phase, as opposed to the post-acquisition phase of the venture).

voting schemes in order to compensate for the absence of the ameliorating influence of reputation. The SPAC experience thus demonstrates the importance of reputation to both sides of the private equity contract.

The literature has so far paid only glancing attention to SPACs, describing their function at a high level of generality.[36] Researchers have overlooked the wealth of empirical data SPACs' public disclosures afford. Likewise, scholars have ignored what light this uniquely public form of private equity can shed on the classic private equity contract.

In this Article we summarize an original hand-collected dataset, drawn from public SPAC filings, and use it to trace the evolution of key characteristics in the development of this new breed of corporate form. We provide the first detailed empirical description of SPACs, highlighting their similarities and differences with traditional private equity firms. Managerial compensation in both cases is incentive driven, with managers reaping 20% of the gains achieved by the investment fund.[37] Although the original SPACs required only a nominal upfront investment by promoters, they evolved to require promoter investment, or "skin in the game," just as venture and buyout funds do.[38]

On the other hand, our empirical study shows that SPACs diverge in notable ways from the traditional private equity template, in part because the SPAC investment time horizon is much shorter—a matter of two to three years, rather than ten.[39] The most notable deviations from the traditional private equity mold involve exit and voice—the chief protections available to investors.[40] As to exit, the bulk of the money that SPAC shareholders invest in the company has always been initially "locked up" in a trust account and made subject to recapture by those shareholders, at least under

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[36]*See, e.g.*, Davidoff, *supra* note 4, at 224-28 (providing a general overview of SPACs).

[37]*See, e.g.*, *id.* at 225 (describing SPAC managers' ownership interests in the venture).

[38]*See* Victor Fleischer, *Two and Twenty: Taxing Partnership Profits in Private Equity Funds*, 83 N.Y.U. L. REV. 1, 8 (2008); *Spicing Up the SPAC Structure: Underwriters Tweak New Offerings to Entice Investors*, THE REVERSE MERGER REPORT, 11 (Nov. 2005), *available at* http://www.littmankrooks.com/wp-content/uploads/2010/11/Spicing-Up-the-SPAC-Structure.pdf ("One of the first innovations investment bankers added to SPACs is management [share] purchase agreements. The commitment by management to buy warrants demonstrates to potential investors that management has a real financial investment because if a deal is not consummated the [shares] purchased will expire and be worthless.").

[39]*See infra* Part V.

[40]*See* John C. Coffee, Jr., *The SEC and the Institutional Investor: A Half-Time Report*, 15 CARDOZO L. REV. 837, 892 (1994) (internal quotation marks omitted) ("All investors confront a choice between exit and voice. That is, they can participate in corporate governance (thereby exercising voice) or they can rely on market liquidity (*i.e.*, exit).").

most conditions.[41] As to voice, as originally conceived, SPAC investors received a vote—two votes, really—on any proposed acquisition. First, if a majority of the SPAC investors voted against the acquisition, it would not occur.[42] Second, if more than a specified percentage (called the conversion threshold) of SPAC investors cashed out their shares from the trust fund—typically 20% in early SPACs—the acquisition would not go forward.[43] In effect, the creation of this second right gave rise to a supermajority voting requirement for any acquisition.[44]

Our research reveals that the original SPAC template worked only until the market figured out its fatal flaw. In transplanting the model from the insular world of private equity to the faceless public market, the leavening influence of reputation was lost.[45] Investors were free to act opportunistically—and so they did.[46] The supermajority requirement created what turned out to be a costly holdout right.[47] As a result, the most recent SPACs have reduced shareholder voting rights, making the majority vote optional (at the managers' discretion) and raising the deal-rejection threshold to 88% or higher—that is, 88% of shareholders must cash out before an acquisition fails.[48] The SPAC shareholder vote, a key selling point of the initial form, has thus been largely eliminated.[49] At the same time, trust account rights have grown in strength and importance.[50] Initially, SPACs promised that 85% of investor money would be placed in escrow.[51] Over

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[41]*See, e.g.*, M. Ridgway Barker & Randi-Jean G. Hedin, *Special Purpose Acquisition Corporations: Specs to Consider When Structuring Your SPAC – Part I*, METRO. CORP. COUNSEL, 6 (Aug. 2006), *available at* http://www.metrocorpcounsel.com/pdf/2006/August/06.pdf (describing how SPAC investment capital, held in trust, can be reclaimed by investors).

[42]*See, e.g., id.* (describing how the SPAC's proposed acquisition is subject to a majority of investors' approval and how dissenting investors can, if they choose, receive their money back).

[43]M. Ridgway Barker & Randi-Jean G. Hedin, *SPACs – Continuing to Grow and Evolve*, METRO. CORP. COUNSEL, 38 (June 2007), *available at* http://www.metrocorpcounsel.com/pdf/2007/June/38.pdf ("Most typical SPACs require that the acquisition be approved by a majority of its public stockholders and that not more than 20% of its stockholders vote against the acquisition and elect to convert their shares for cash.").

[44]*See id.*

[45]*See, e.g.*, Daniel S. Riemer, *Special Purpose Acquisition Companies: SPAC and Span, or Blank Check Redux?*, 85 WASH. U. L. REV. 931, 960 (describing the ease with which investors can enter and exit SPACs).

[46]*See, e.g., id.*

[47]*See infra* Part VII.A.

[48]This change started with the 57th Street General Acquisition Corporation in 2009. *See infra* Part VII.A.

[49]*See infra* Part VII.A.

[50]*See infra* Part VII.B.

[51]*See infra* Part VII.B.

time, as competition among SPACs increased, that percentage rose to 95% and even 100%.[52] In fact, the most recent SPACs now go so far as to promise to return to investors *more* than they put in.[53] On the manager's side, the contract has evolved to require managerial investment in SPACs and to condition managerial equity payoffs on market performance.[54] We suggest that these mechanisms may function as public market substitutes for the missing reputational constraint.[55]

Finally, the story of SPACs' evolution contributes to the literature on the relative value of voice and exit. Professor Albert O. Hirschman's classic *Exit, Voice, and Loyalty* first described the mechanisms by which consumers or investors could express disapproval of organizational choices.[56] Hirschman's insight has been applied in a myriad of contexts, from securities class actions,[57] to local government services,[58] to the viability of Delaware's dominance of corporate law,[59] to the federalism debate.[60] In a recent article, Professors John Morley and Quinn Curtis posit that voting in mutual funds may be a less reliable constraint on agency costs because exit is so cheap—cheaper even than in a publicly traded corporation.[61] SPACs reveal that, like all investor-protection mechanisms, the grant of the vote has costs as well as benefits; the costs of voting quickly became apparent as hold-outs by some shareholders exposed other shareholders—including promoters—to counter-efficient results.[62] The vote receded in importance as the shareholders' walk-

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[52]*See infra* Part VII.B.

[53]*See, e.g.*, Universal Bus. Payment Solutions Acquisition Corp., Amendment No. 5 to Registration Statement (Form S-1/A) (Apr. 29, 2011) (offering price of $6.00 per unit, trust value $6.06); Trio Merger Corp., Amendment No. 5 to Registration Statement (Form S-1/A) (June 6, 2011) (offering price of $10.00 per unit, trust value $10.10).

[54]*See infra* Part VI.A.2.

[55]*See infra* Part VIII.

[56]ALBERT O. HIRSCHMAN, EXIT, VOICE, AND LOYALTY: RESPONSES TO DECLINE IN FIRMS, ORGANIZATIONS, AND STATES 3-4 (Harvard Univ. Press, 1970).

[57]*See* John C. Coffee, Jr., *Class Action Accountability: Reconciling Exit, Voice, and Loyalty in Representative Litigation*, 100 COLUM. L. REV. 370, 376 (2000).

[58]*See* Vicki Been, *"Exit" as a Constraint on Land Use Exactions: Rethinking the Unconstitutional Conditions Doctrine*, 91 COLUM. L. REV. 473, 476 (1991); Carol M. Rose, *What Federalism Tells Us About Takings Jurisprudence*, 54 UCLA L. REV. 1681, 1687 (2007).

[59]*See* Mark J. Roe, *Delaware's Shrinking Half-Life*, 62 STAN. L. REV. 125, 152 (2009).

[60]*See* Heather K. Gerken, *The Supreme Court 2009 Term Foreword: Federalism All the Way Down*, 124 HARV. L. REV. 4, 14 & n.19 (2010) (discussing scholars' use of the concepts of voice and exit and distinguishing her own).

[61]John Morley & Quinn Curtis, *Taking Exit Rights Seriously: Why Governance and Fee Litigation Don't Work in Mutual Funds*, 120 YALE L.J. 84, 89-91 (2010).

[62]*See* Thomas Friedmann & D. Chad Larson, *Special Purpose Acquisition Companies: A SPAC Evolution*, THE HEDGE FUND J. (May 2008), http://www.thehedgefundjournal.com/magazine/

away right became more robust.[63] SPACs, however, did not merely address the hold-out problem by requiring a simple majority. Recent SPACs have entirely removed the shareholder vote on acquisition.[64] This effective elimination of the vote offers empirical support for Morley and Curtis's thesis by demonstrating that, as an exit vote becomes more robust, shareholders will tolerate even the complete eradication of a voting right.[65]

This Article proceeds as follows: Part II situates SPACs within the private equity landscape by describing the two predominant forms of private equity, venture capital funds and leveraged buyout funds. Part III introduces the SPAC, tracing the origins and history of this new business form. Part IV offers three case studies to give a more textured understanding of the array of fates that SPACs can meet; some SPACs fail to complete their IPO, some go public but fail to complete an acquisition, and some successfully locate a target and merge with it, enabling a once-private company to trade publicly without an IPO. Part V provides an overview of the data from our original dataset. Part VI then compares our new SPAC data with the features of traditional private equity funds, including managerial compensation, the lifespan of the fund, and limits on the amount the fund can invest. In general, Part VI reveals that SPACs hew fairly closely to the traditional private equity template. Particularly in the area of managerial investment, or "skin in the game," early SPACs deviated from the private equity playbook, but more recent ones have adhered to it.[66]

Part VII highlights the two main differences between SPACs and the rest of private equity. In contrast to private equity investors, early SPAC investors had robust voting and exit rights.[67] Part VII also traces the evolution of these twin rights. Most notably, we find that as the form evolved, the voting right weakened, while exit rights strengthened. We include a case study of the SPACs of one particular investment bank—the successor to the investment bank that first developed SPACs—to illustrate that the trends we identify are not merely the result of new entrants; the

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200805/technical/a-spac-evolution.php (describing how some SPAC investors/hedge fund arbitrageurs vote against the SPAC's proposed acquisition, "thereby making themselves eligible to redeem their shares and receive proceeds from the SPAC trust fund or to receive cash upon the SPAC's liquidation").

[63]*See id.* (stating that recently, SPAC investors/hedge fund arbitrageurs have opted for selling their shares to long-term investors).

[64]*See infra* Part VII.A; *see also* Friedmann & Larson, *supra* note 62 ("SPACs' founders are now revamping SPACs' terms to attract long-term investors and to induce shareholders to vote for a proposed business combinations [sic].").

[65]*See infra* Part VIII.

[66]*See infra* Part VI.A.2.

[67]*See infra* Part VII.

original SPAC entrepreneurs followed the same trend of strengthening exit rights and weakening the vote.[68] Part VIII then explores the implications of the SPAC story. It emphasizes that SPAC developers appear to have underestimated the effect of reputation in addressing private equity's information asymmetries and moral hazard problems. The form has evolved mechanisms to substitute for the absence of reputational constraints in the public market.[69] The move toward complete elimination of the vote contributes to the literature on voice and exit, suggesting that given a cheap enough exit, investors no longer demand *any* vote as a tool for constraining agency costs.[70]

## II. TRADITIONAL PRIVATE EQUITY

In order to understand SPACs, we must first understand their origins. Although Part III will trace the particulars of SPAC history, these new entities only make sense when situated in the larger world of private equity. Developers consciously modeled many SPAC elements after the form's private equity forbearers.[71] Where they depart from the traditional model, the deviations are best understood in light of the larger private equity context.

First, a word on terminology: venture capital ("VC") and leveraged buyout ("LBO") funds comprise part of the larger universe that is sometimes termed "private equity." Private equity, understood broadly, encompasses any investment in a private company.[72] Private equity is also sometimes used as a synonym for investment entities that acquire both public and private companies financed principally by debt—*i.e.*, funds that were once called buyout funds are now sometimes referred to as private equity funds.[73] For clarity we will refer to these funds as "buyout funds," but some citations will refer to them as "private equity."

Second, a word on this Article's area of interest. The financial contracting literature has focused largely on the relationship between fund

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[68] *See infra* Part VII.C.

[69] *See infra* Part VIII.

[70] *See infra* Part VIII.

[71] *See* Davidoff, *supra* note 4, at 225.

[72] Steven M. Davidoff, *The Failure of Private Equity*, 82 S. CAL. L. REV. 481, 482 n.4 (2009).

[73] *Id.*; *see also* Steven N. Kaplan & Per Strömberg, *Leveraged Buyouts and Private Equity*, 23 J. ECON. PERSP., 121, 121 (2009), *available at* http://faculty.chicagobooth.edu/steven.kaplan/research/ksjep.pdf ("The leveraged buyout investment firms today refer to themselves (and are generally referred to) as private equity firms.").

and target.[74] This focus is understandable, given that entrepreneurial firms are a locus of innovation and figuring out how best to finance them is a subject of continued debate.[75] But the relationship between investor and fund also matters. Many U.S. businesses, from start-ups to established companies, rely on pools of money helmed by managers that claim to be able to identify an undervalued company and manage it better. Accordingly, this Article focuses on the investor/investment vehicle relationship; as SPACs further develop, future work will explore the success (or failure) of SPACs' investments in particular targets.

Figure 1.

Individual investor

Fund/investment vehicle

Target/company

## A. *Venture Capital*

VC funds invest in early-stage companies (*i.e.* start-up firms). These funds, however, do not acquire start-up firms outright; rather, their strategy involves investing early, when shares are cheap, and hoping that they will

[74] *See, e.g.*, Litvak, *Venture Capital Limited Partnership Agreements*, *supra* note 9, at 162 ("A large body of theoretical and empirical studies concentrates on the relationship between venture capitalists . . . and entrepreneurs who run young companies, yet very little is written on the relationship between VCs and investors in venture funds."). VC funds stage their commitment to start-ups, preserving the option for the fund to abandon a company whose business model does not pan out as expected. *See* Litvak, *Governance Through Exit*, *supra* note 9, at 773 ("[S]taged financing of portfolio companies and the accompanying threat of VC walkaway improve incentives of entrepreneurs of portfolio companies."). Both private equity and VC funds also employ incentive compensation for a target company's management by granting options that tie compensation to the fate of the company. *See* Kaplan & Strömberg, *supra* note 73, at 121. These are important questions, but we set them aside in order to focus our lens more closely on the investor/fund relationship.

[75] *See, e.g.*, Gompers & Lerner, *Analysis of Compensation*, *supra* note 9, at 6 (describing the "reluctan[ce]" of early VC investors).

make five or even ten times their initial investment (the much-desired "home run") when the company eventually goes public or is acquired (*i.e.* "getting in on the ground floor").[76] Ideally, VC funds partner with management and help the fledgling corporation grow.[77] Venture-backed companies are more likely to succeed than the average start-up because talented venture capital managers spot promising companies and (arguably) provide advice that helps pave the road to success.[78] To give some perspective, in 2011, there was over $195 billion of VC funds under management,[79] with over $28 billion raised in that year.[80]

VC fund investors are wealthy individuals, pension funds, endowments, and insurance companies.[81] Indeed, VC funds typically only allow participation from individuals who are accredited investors.[82] The wealth test for accredited investors includes individuals with a net worth over $1 million or an individual income of $200,000 in the past year, with a reasonable expectation of the same income in the coming year.[83] For those investors who make the cut, VC funds have offered returns of 16-20% a year.[84]

VC funds are generally structured as limited partnerships.[85] The fund managers serve as the general partners ("GPs"), and the investors are limited

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[76]*See, e.g.*, *id.* at 5 (stating that VC fund managers look for "high-potential companies" which in time can be offered to the public); RICHARD A. BREALEY ET AL., PRINCIPLES OF CORPORATE FINANCE-GLOBAL EDITION 392 n.4 (10th ed. 2011), *available at* https://connect.mcgraw-hill.com/sites/007131430x/student_view0/ebook/chapter15/chbody1/15-1_venture_capital.htm ("[V]enture capitalists . . . get in on the ground floor.").

[77]*See, e.g.*, BREALEY ET AL., *supra* note 76, at 392 ("[M]any adolescent companies raise capital from specialist venture-capital firms, which pool funds from a variety of investors, seek out fledgling companies to invest in, and then work with these companies as they try to grow.").

[78]*See id.* at 393 ("Venture capital firms . . . provide ongoing advice to the firms that they invest in and often play a major role in recruiting the senior management team. Their judgment and contacts can be valuable to a business in its early years and can help the firm to bring its products more quickly to market.").

[79]*See National Venture Capital Association Yearbook 2012*, THOMPSON REUTERS, 9 (2012) http://www.nvca.org/index.php?searchword=Yearbook&ordering=&searchphrase=all&Itemid=103&option=com_search.

[80]*Id.* at 11-13.

[81]Sahlman, *supra* note 9, at 488.

[82]*See* Robert G. Frucht & Tasneem S. Novak, *No Direction: The Obama Administration's Financial Reform Proposal and Pending Legislation Proposing the Registration and Further Regulation of Hedge Funds and Private Pools of Equity are Overbroad and Fail to Address the Actual Risks That These Funds Pose to the Financial System*, 29 B.U. REV. BANKING & FIN. L. 157, 168 (2009).

[83]17 C.F.R. §§ 230.501(a)(5)-(6) (2011).

[84]Lee Harris, *A Critical Theory of Private Equity*, 35 DEL J. CORP. L. 259, 261 (2010).

[85]*See, e.g.*, Sahlman, *supra* note 9, at 487 ("[Five hundred] firms with $20 billion in capital

partners ("LPs").[86] The GPs manage the limited partnership and assume general liability, while the limited partners enjoy limited liability, but may not manage.[87] As such, the LPs have little to no voice in running the fund, and, in particular, do not have a say on individual investment decisions.[88] LPs do have limited information rights, however: they receive periodic reports and have an annual meeting with the GPs and portfolio company management teams.[89] Investors generally commit to contribute a certain amount to the fund, paying a percentage up front and then phasing in the rest of their investment over several years.[90] Notably, there are harsh penalties if a limited partner reneges on the commitment to contribute.[91]

The roster of companies in which a fund has invested is termed its "portfolio," and the companies in which it invests are "portfolio companies."[92] One study found a median of twenty investments per fund.[93] Funds tend to specialize by industry, stage of investment, or geographic region,[94] and are particularly visible in Silicon Valley,[95] and in the technology[96] and pharmaceutical industries.[97] For example, Google, Facebook, and FedEx were all venture-backed companies.[98]

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in 1987 were structured as limited partnerships.").

[86] *See id.* (describing the structure of venture capital firms).

[87] *Id.* at 490.

[88] *See id.* Some VC funds establish advisory boards, which may have limited partner representation. Sahlman, *supra* note 9, at 493. Some also have boards solely made up of limited partners. *Id. But see* Ronald J. Gilson, *Engineering a Venture Capital Market: Lessons from the American Experience*, 55 STAN. L. REV. 1067, 1088 (2003) (characterizing advisory committees as "largely inconsequential").

[89] Sahlman, *supra* note 9, at 492.

[90] *Id.* at 491 (referring to this arrangement as a "takedown schedule").

[91] *Id.* (explaining how the limited partner may lose one-half of her capital account and thus one-half of the profits that would have been designated to her).

[92] *See* Harris, *supra* note 84, at 262 & fig. 1.

[93] Metrick & Yasuda, *supra* note 9, at 2309.

[94] Sahlman, *supra* note 9, at 489.

[95] Emilio J. Castilla, *Networks of Venture Capital Firms in Silicon Valley*, 25 INT'L J. TECH. MGMT. 113, 115 (2003), http://web.mit.edu/ecastill/www/publications/Castilla (IJTM2003).pdf ("West Coast venture capitalists have helped make Silicon Valley the focus of world attention and the cradle of technology-based entrepreneurship.").

[96] *Id.*

[97] Jessica Leber, *Merck Looks to Startups*, MIT TECH. REV. (June 1, 2012) http://www.technologyreview.com/news/428064/merck-looks-to-startups/ ("The multinational drug giants [e.g. Merck, Eli Lilly, and GlaxoSmithKline] are moving to partner with venture-capital firms and nascent biotechnology companies in hopes of feeding their drug development pipelines.").

[98] *See* SVB Fin. Grp., *Restrictions on Proprietary Trading and Certain Interests in and Relationships with Hedge Funds and Private Equity Funds*, at 10 http://www.federalreserve.gove/ SECRS/2012/March/20120322/R-1432/R-1432_021312_105539_ 519233900450_1.pdf.

Most VC firms are management companies that oversee several different VC funds, where each is a separate limited partnership.[99] Kleiner Perkins, Sequoia, and Benchmark are generally considered the dominant firms, but there are over 842 firms managing over 1,274 funds today.[100] Individual VC funds have a lifespan of about ten years.[101] After the end of legal existence, all assets are distributed.[102] With such a limited time horizon, reputation matters.[103] If a fund is successful, the managers can capitalize on the reputation of their prior achievements, and generate larger follow-on funds.[104]

There is substantial literature focusing on the compensation of VC managers.[105] The goal is to align the managers' incentives appropriately, so they maximize their investors' profit.[106] Ordinarily, GPs receive an annual management fee ranging from 2 to 2.5% of committed capital.[107] Most of their compensation, however, comes from the share of the profits they receive, known as "carried interest" or "carry."[108] The industry norm is for VC managers to receive 20% of the venture funds' realized profits, which is taxed (controversially) at the preferential 15% capital gains rate.[109] Most

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[99] Sahlman, *supra* note 9, at 488.

[100] *See* Victor Fleischer, *The Missing Preferred Return*, 31 J. CORP. L. 77, 101 (2005) (referring to Kleiner Perkins, Sequoia, and Benchmark as the "royalty of Silicon valley"); *National Venture Capital Association Yearbook 2012*, *supra* note 79, at 9.

[101] Sahlman, *supra* note 9, at 490. Almost all permit extension, some requiring the consent of limited partners, although 48% leave it to the general partner's discretion. *Id.*

[102] *Id.*

[103] *See generally* Paul A. Gompers & Josh Lerner, *What Drives Venture Capital Fundraising?* 12-13 (Nat'l Bureau of Econ. Research, Working Paper No. 6906, Jan. 1999) [hereinafter Gompers & Lerner, *What Drives Venture Capital Fundraising?*] (stating that a fund's size and age can be indicia of its reputation).

[104] *See id.* ("Older and larger venture organizations are likely to have more established reputation. They may therefore receive larger capital commitments than similar younger funds.").

[105] *See, e.g.*, Litvak, *Venture Capital Limited Partnership Agreements*, *supra* note 9, at 169 (stating that management's compensation is an out-of-pocket expense for the investor, and is usually tacked onto the investor's capital commitment).

[106] *See, e.g.*, Sahlman, *supra* note 9, at 494 (describing the system worked out by fund manager and investor regarding management's compensation as "critical . . . in aligning the interests" between the two parties).

[107] *See* Litvak, *Venture Capital Limited Partnership Agreements*, *supra* note 9, at 173.

[108] *See* Sahlman, *supra* note 9, at 492.

[109] *See id.* at 491 ("In 88% of the funds surveyed, venture capitalists are entitled to 20% of the realized gains on the fund. In the remaining partnerships, the general partner's share of realized gains ranges from 15% to 30%. Given the diversity of fund organizers and their differing stated purposes, this seems remarkably consistent . . . ."); Gompers & Lerner, *Analysis of Compensation*, *supra* note 9, at 6 (stating that, in addition to a fixed annual fee, the venture capitalist usually receives 20% of the fund's profits); Note, *Taxing Partnership Profits Interests: The Carried Interest*

funds specify the percentage of time that VCs must devote to management.[110] They also limit the amount of money that can be invested in any one portfolio company.[111] VC fund managers also provide about 1% of the capital raised in venture funds—the "skin in the game" that ensures they suffer some downside risk.[112]

In sum, the VC contractual design features limited life[113] and incentive compensation in the form of 20% of the profits coupled with personal investment.[114] Given that the venture capital world is limited to a relatively small number of institutions, investors, and managers, reputation figures highly on both sides of the contract.[115] Investors have no voice in individual investment decisions, and while in theory they stage their investment, in practice investors tend to follow through with their funding promises.[116] We see this model largely recapitulated in LBO funds.

### B. *Private Equity/LBO*

Unlike VC funds, which invest in a portion of pre-IPO firms, LBO firms focus on acquiring outright mature companies that produce a steady stream of income, in excess of required expenditures.[117] This "free cash flow" presents a high risk of agency cost—a constant influx of money that tempts managers to slack or spend on perquisites rather than using the money as principals would want.[118] Advocates of LBOs argue that they solve the free cash flow problem by purchasing the company essentially by

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*Problem*, 124 HARV. L. REV. 1773, 1774 (2011) ("[P]rivate equity GPs are taxed at long-term capital gains rates as low as 15% on partnership profits allocated to a carried interest, while the same amount of compensation structured as a salary would be taxed at ordinary income rates as high as 35%."). GPs also may receive early distributions. Litvak, *Venture Capital Limited Partnership Agreements*, *supra* note 9, at 163 (characterizing part of managerial compensation as an interest-free loan, which can give the managers a higher return than the nominal carry percentage).

[110]Sahlman, *supra* note 9, at 492.

[111]*Id.* at 496-99.

[112]Sahlman, *supra* note 9, at 488; Fleischer, *supra* note 38, at 8 ("The GP . . . contributes some of its own capital to the fund so that it has some 'skin in the game.' This amount ranges from one to five percent of the total amount in the fund."). The 1% contribution helps to assure a "favorable tax treatment." Sahlman, *supra* note 9, at 490. Sometimes this contribution comes in the form of a promissory note instead of cash. *Id.*

[113]*See supra* notes 101-02 and accompanying text.

[114]*See supra* notes 108-12 and accompanying text.

[115]*See supra* notes 103-04 and accompanying text.

[116]*See supra* notes 88-91 and accompanying text.

[117]Kaplan & Strömberg, *supra* note 73, at 121.

[118]*See* Michael C. Jensen, *Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers*, 76 AM. ECON. REV. 323, 323 (1986).

mortgage, using the company itself as collateral.[119] The company is thus highly leveraged, and the theory is that the need for regular repayments of the loan soaks up the excess cash flow and enforces discipline on the company,[120] which pays off its debt and then is generally resold to the public leaner and more valuable than pre-LBO.[121] Many LBO firms now specialize in certain industries.[122] Top names in the field include KKR, the Carlyle Group, and Blackstone.[123]

Leveraged buyouts of public companies rose to prominence in the 1980s—financed by the junk bond industry—and waned in the 1990s.[124] Private equity funds, however, were still purchasing private companies.[125] In the mid-2000s, LBOs of public companies once again became popular and reached a fever-pitch before the financial crisis of 2008.[126] As we will see, SPACs formed as a part of the acquisitive activity of this time, bidding side-by-side with their private equity cousins.[127] By 2009, private equity funds managed $1 trillion of capital worldwide.[128] In 2010, buyout activity totaled $221 billion (consisting of over 2,000 deals).[129]

Even while focusing on a different investment sector, LBO funds share many features in common with venture funds. Like VC funds, buyout funds are almost all organized as limited partnerships, with the firm serving as the GP of each fund, and outside investors serving as LPs.[130] A private

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[119]*See, e.g*, Kaplan & Strömberg, *supra* note 73, at 131 ("Leverage creates pressure on managers not to waste money, because they must make interest and principal payments. This pressure reduces the 'free cash flow' problem[] . . . .").

[120]*See* Jensen, *supra* note 118, at 324 ("By issuing debt in exchange for stock, managers are bonding their promise to pay out future cash flows in a way that cannot be accomplished by simple dividend increases. . . . [D]ebt reduces the agency costs of free cash flow by reducing the cash flow available for spending at the discretion of managers.").

[121]*See id.* at 328-29 (describing how under "free cash flow theory," when debt is used properly, "a much leaner and competitive organization results").

[122]Kaplan & Strömberg, *supra* note 73, at 132.

[123]*Id.* at 123.

[124]*Id.* at 121-22; *see also* Margaret M. Blair, *Financial Innovation, Leverage, Bubbles and the Distribution of Income*, 30 B.U. REV. BANKING & FIN. L. 225, 237-38 (describing how in the 1980s, LBOs were financed by issuing "high yield bonds" [a.k.a. "junk bonds"]).

[125]Kaplan & Strömberg, *supra* note 73, at 122.

[126]*Id.*

[127]*See* Davidoff, *supra* note 4, at 226 ("With the increasing prominence of private equity, the growth of SPACs has also accelerated.").

[128]Metrick & Yasuda, *supra* note 9, at 2303.

[129]Paul J. Shim, *Private Equity M&A Recent Developments 2011*, *in* MERGERS & ACQUISITIONS 2011: WHAT YOU NEED TO KNOW NOW, at 347 (PLI Corp. Law & Practice, Course Handbook Series No. 29607, 2011).

[130]Kaplan & Strömberg, *supra* note 73, at 123; *see also* Metrick & Yasuda, *supra* note 9, at

equity firm generally organizes multiple funds.[131] Investors include pension funds, endowments, insurance companies, and wealthy individual investors.[132] Private-equity funds, like VC funds, generally offer to sell only to accredited investors.[133]

Funds have a fixed life, generally ten years, with extensions of up to three years being possible.[134] Generally investments in companies occur in the first five years of the fund's life.[135] One study found that LBO funds made a median of twelve investments.[136] Generally fund investors have "little say" in the fund's investments.[137] Sometimes there are limits on the types of securities in which a fund can invest, and on the level of debt a fund can take on.[138]

Early exit is difficult. As Professor James C. Spindler posited:

> The limited partners generally cannot withdraw their money and are dependent upon the general partner to make distributions. While there is the possibility of selling the limited partnership interest to someone else, there are often significant impediments to doing so. The first, and most important, is that in many agreements, such a sale will often require the permission of the general partner. The general partner can simply say no.[139]

Even without a GP veto, a market for lemons problem arises: why would an LP sell if the investment was a valuable one?[140]

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2304 ("Virtually all private equity funds are organized as limited partnerships.").

[131]Metrick & Yasuda, *supra* note 9, at 2304.

[132]Kaplan & Strömberg, *supra* note 73, at 123.

[133]*See, e.g.*, Jill E. Fisch, *Rethinking the Regulation of Securities Intermediaries*, 158 U. PA. L. REV. 1961, 2037 n.413 (2010) (stating that the author's proposal could be applied to investment funds which "have traditionally been restricted to accredited investors"); James C. Spindler, *How Private Is Private Equity, and at What Cost?*, 76 U. CHI. L. REV. 311, 325 (2009) (describing how private equity funds avoid SEC disclosure requirements by "limit[ing] its offering to accredited investors only, rather than, say, placing ads in the newspaper the way that a mutual fund might do").

[134]Kaplan & Strömberg, *supra* note 73, at 123.

[135]*See, e.g.*, *id.* (stating that the first five years of the fund's life are spent investing, while the remaining five years are spent trying to pay back investors).

[136]Metrick & Yasuda, *supra* note 9, at 2309.

[137]Kaplan & Strömberg, *supra* note 73, at 123 ("After committing their capital, the limited partners have little say in how the general partner deploys the investment funds, as long as the basic covenants of the fund agreement are followed.").

[138]*Id.*

[139]Spindler, *supra* note 133, at 330.

[140]*Id.* at 330-31.

As with venture capital, the fund manager receives an annual management fee from investors, generally a percentage of the capital committed.[141] The more significant form of compensation is a share of the profits, which is "almost always" 20%.[142] Variations in the payout can occur. For example, sometimes the fund must return a preset percentage (called the "hurdle") before any money can be distributed to the GP;[143] however, VC funds do not typically have this feature.[144] Sometimes the carried interest can be collected early, although there are usually "clawback" provisions that allow the outside investors to reclaim some of their money if the fund's overall returns fall short.[145] In a departure from the venture model, some GPs charge deal fees or monitoring fees to their portfolio companies.[146] Usually the manager invests at least 1% of her own capital in the fund, which some financial contracting scholars suggest is merely a product of bygone tax law.[147] The SPAC experience may suggest that the personal investment of managers is more important than the literature implies.[148] As Part VI will show, SPAC managers initially contributed little of their own money to their fund, but were soon expected to put some "skin in the game."

One key additional discipline that does not apply to venture capitalists operates on buyout fund managers. Buyout funds must seek outside capital—in the form of loans from financial institutions—before each

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[141] *See* Metrick & Yasuda, *supra* note 9, at 2309-10 ("Historically, the most common method was to assess fees as a constant percentage of committed capital. For example, if a fund charges 2% annual management fees on committed capital for ten years, then the lifetime fees of the ten-year fund would be 20% of committed capital, with investment capital comprising the other 80%. In recent years, many funds have adopted a decreasing fee schedule, with the percentage falling after the investment period. For example, a fund might have a 2% fee during five-year investment period, with this annual fee falling by 25 basis points per year for the next five years.").

[142] Kaplan & Strömberg, *supra* note 73, at 124; *see also* Metrick & Yasuda, *supra* note 9, at 2311 ("The overwhelming majority of funds—including all 144 BO funds—use 20% as their carry level. Among the ninety-four VC funds, one has a carry level of 17.5%, three have carry levels of 25%, and one has a carry level of 30%. The exact origin of the 20% focal point is unknown, but previous authors have pointed to Venetian merchants in the Middle Ages, speculative sea voyages in the age of exploration, and even the book of Genesis as sources.") (footnote omitted).

[143] Metrick & Yasuda, *supra* note 9, at 2310.

[144] *See* Litvak, *Venture Capital Limited Partnership Agreements*, *supra* note 9, at 165.

[145] Metrick & Yasuda, *supra* note 9, at 2312-13.

[146] Kaplan & Strömberg, *supra* note 73, at 124.

[147] *See id.* ("It is customary for the general partner to provide at least 1 percent of the total capital."). Professor Victor Fleischer calls this an "artifact of tax history." Fleischer, *supra* note 100, at 82. "Before the check-the-box rules, a 1% capital interest was necessary to help ensure partnership classification for tax purposes." *Id.* at 82 n.25.

[148] *See infra* Part VI.

investment in a portfolio company.[149] This external check on managerial discretion might serve some of the function of staged commitment in VC funds—if the acquisition is a lousy one, then no bank will fund it, and it will not go through.[150]

## C. *Reputation*

One final non-contractual and difficult-to-quantify element of the relationship between managers and investors merits our attention: reputation.[151] In a foundational article on venture capital, Professor Ron Gilson describes the "braiding" of the reputational market.[152] The point is an elegant one: the long-term relationship between investor and manager comforts the entrepreneur who fears opportunistic behavior from the VC.[153]

In order to explain the nature of the "braiding" of the two contracts, we must explain how private equity's business model depends on scale and scope economies.[154] Professor William A. Sahlman explains that in venture capital both scale and scope economies exist.[155] Since "rent, information acquisition, accounting, and certain legal costs" are fixed, creating a large

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[149]*See, e.g.*, Kaplan & Strömberg, *supra* note 73, at 124 ("The buyout is typically financed with 60 to 90 percent debt—hence the term, leveraged buyout. The debt almost always includes a loan portion that is senior and secured, and is arranged by a bank or an investment bank."). Hedge funds can also buy this debt from the banks and then resell it. *Id.* Also, "mezzanine debt" (or junior debt) can also own some portion of the fund's financing. *Id.* at 124-25.

[150]*See, e.g.*, Larry E. Ribstein, *Partnership Governance of Large Firms*, 76 U. CHI. L. REV. 289, 299 (2009) ("[M]arket scrutiny of individual deals through ex post debt financing reduce limited partners' need to vote on or seek judicial review of the fund's investments.").

[151]*See generally* Gilson, *supra* note 88, at 1092 (introducing a theory of reputation and "braiding").

[152]*See id.*

[153]According to Gilson's theory, the contracts between the fund's investors and managers and between the fund's managers and the target entrepreneurs are "braided" together because of reputation. *Id.* The manager-entrepreneur contract cedes power over to the managers; however managers have an incentive to not act badly or else other entrepreneurs will not want to deal with them in the future. *Id.* The investor-manager contract encourages managers to have this control. Gilson, *supra* note 88, at 1092. Therefore, the contracts are "braided" because reputation and behavior in one contractual relationship influences and is influenced by the other. *See id.*

[154]*See* Sahlman, *supra* note 9, at 500 ("Scale economies exist if the unit cost of production and distribution of a product or service declines as volume increases. In the venture-capital organization, production and distribution encompass raising capital, finding and structuring deals, monitoring the investments, and distributing the proceeds. Scope economies exist if unit costs decline if multiple products or services are produced simultaneously (for example, if more than one fund is managed at a time). Learning-curve effects exist if the unit cost of a process declines over time with accumulated volume.").

[155]*See id.* at 500-01.

fund is not that much more expensive than a small fund[156] – both require the same kind of institutional knowledge, deal flow, contacts, and relationships.[157] Operating different funds within the same family creates scope economies. Again, cost does not rise in a linear fashion, so successful managers can trade on their deal-making reputation and increase returns.[158] Two additional benefits exist: "[f]irst, keeping the venture-capital management company in existence preserves the learning that has taken place. Second, managing multiple funds takes advantage of any scale or scope economies. From 1977 to 1988, new funds averaged less than one-half the size of follow-on funds."[159] Reacting to this natural tendency, sometimes VC funds restrict their managers from raising new funds until a given date or a set percentage has been invested.[160]

The desirability of scale and scope economies creates an emphasis on reputation that has ripple effects for both targets and fund investors.[161] As an illustration, suppose Emma Entrepreneur is considering allowing Venture Fund to buy a portion of her company. She has no prior experience with Venture Fund, and this is her first entrepreneurial endeavor. Accepting the proposed investment is risky because she must cede control to an outside investor with whom she has had no prior dealings, and she rightfully fears opportunism. But Venture Fund's particular portfolio investments are "braided" with the reputation of the fund's managers for selecting deserving companies and nurturing them to successful outcomes.[162] If Venture Fund treats Emma's company poorly, then it will be more difficult for it to find companies willing to accept its money in the future. A bad enough reputation among would-be portfolio companies will jeopardize its ability to raise the future funds that are critical to its business model.[163]

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[156] *See id.* at 500.

[157] *See* Joshua Lerner, *The Syndication of Venture Capital Investments*, 23 FIN. MGMT. 16, 20 (1994) ("More established venture organizations should be able to access capital from investors for larger and more frequent funds. Venture capitalists generally prefer larger funds because of the substantial economies of scale in operating a large venture fund (or several large funds).").

[158] Sahlman, *supra* note 9, at 500-01 (describing how, once scale or scope economies are met, if costs continue to go down, a "learning curve" is being met in which "[t]he venture-capital organization develops a reputation that has economic value").

[159] *Id.* at 501 (citation omitted).

[160] Paul Gompers & Josh Lerner, *The Use of Covenants: An Empirical Analysis of Venture Partnership Agreements*, 39 J.L. & Econ. 463, 482 (1996) [hereinafter Gompers & Lerner, *The Use of Covenants*].

[161] *See* Gompers & Lerner, *What Drives Venture Capital Fundraising?*, *supra* note 103, at 28-29 (implying that a venture fund's size is tied to reputation).

[162] *See* Gilson, *supra* note 88, at 1092.

[163] *See id.* (describing how "braiding" functions in the reputation market).

The literature on reputational effects in LBO funds is less robust, but reputation remains a matter of concern.[164] Various scholars have argued that these funds are mindful of their reputation when invoking contractual rights to walk away from a deal.[165] However, reputation for successful investments clearly matters as well.[166]

## III. SPACs

The reader is now familiar with the general contours of private equity funds. Patterns emerge: a limited partnership with no investor say in individual portfolio investments;[167] compensation consisting of a modest management fee and incentive compensation entitling managers to 20% of the fund profits;[168] accredited investors—wealthy individuals and large institutional players[169]—who make illiquid investments, protected principally by a ten-year term investment, which can be extended, but not by much.[170] Staged investment is common in venture funds, and in buyout funds the necessity of third-party capital for each investment functions in a similar way, offering a kind of mid-term examination of managerial performance.[171]

What if we change the parameters of the investment? Specifically, what if the investment is liquid—publicly traded, in fact—so that non-accredited mom-and-pop investors can participate? What if they can pull their money out after committing it? What if investors are allowed a voice on individual investment? SPACs tell the story of such an experiment.

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[164] *See, e.g.*, Cem Demiroglu & Christopher M. James, *The Role of Private Equity Group Reputation in LBO Financing*, 96 J. FIN. ECON. 306, 308 (2010) ("[Private Equity Group] reputation may be related to the structure of LBO financing.").

[165] *See, e.g.*, Afra Afsharipour, *Transforming the Allocation of Deal Risk Through Reverse Termination Fees*, 63 VAND. L. REV. 1161, 1186 n.99 (citing Demiroglu & James, *supra* note 164, at 310) ("Private equity firms may have an incentive to achieve a high reputation by investing their committed capital and completing acquisition deals. This commitment to completing transactions may be beneficial to the private equity firm in a number of ways. A recent study by Demiroglu and James found that LBOs initiated by private equity firms with good reputation typically pay narrower loan spreads, have fewer, less restrictive loan covenants, utilize less traditional bank debt, and borrow more at a lower cost from institutional loan markets."); Davidoff, *supra* note 72, at 502-03.

[166] *See* Christopher W. Kirkham & Jennifer M. Taylor, *Working Through a Workout: A Practitioner's Guide from the Perspective of Private Equity Sponsors, Venture Capital Funds and Other Significant Equity Investors*, 5 HASTINGS BUS. L.J. 355, 360 (2009).

[167] *See supra* notes 85-89, 130 and accompanying text.

[168] *See supra* notes 107-09, 141-42 and accompanying text.

[169] *See supra* notes 81-83, 132-33 and accompanying text.

[170] *See supra* notes 101-02, 134-35 and accompanying text.

[171] *See* notes 90-91, 149-50 and accompanying text.

### A. *Introduction to the Form*

A SPAC is born when a group of founders, known as sponsors, incorporate a "blank check" company: a shell company with no assets or operating history.[172] They then take the company public with the promise that they will soon attempt to complete an acquisition of a target (generally, but not always, private) using various bonding mechanisms to assure investors that their money will not be misapplied.[173] Most notably, the bulk of the offering proceeds must be escrowed in a trust account, and are only released upon completion of the acquisition.[174] Going public is a relatively cheap proposition because, unlike the typical initial public offering, there is very little for the SPAC to disclose.[175] The SPAC investor is essentially buying a management team.[176] Once the managers identify a target, the SPAC shareholders may vote against the acquisition and receive their money back, or maintain their investment and become shareholders of the newly acquired company.[177]

A typical SPAC is a unit offering, that is, a combination of stock shares and warrants to purchase shares.[178] Sponsors (the SPAC's founders) initially buy a small number of shares at a low valuation.[179] These shares are escrowed.[180] If a deal goes through, they are released from escrow, and sponsors wind up owning 20% of the post-acquisition company.[181] If no business combination occurs, the sponsors receive nothing for their escrowed shares; they do not participate in any liquidation distribution.[182]

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[172]Sjostrom, *supra* note 1, at 756.

[173]*See* Davidoff, *supra* note 4, at 224-25.

[174]*See id.* ("During this interim period [before the acquistion(s)], the proceeds of the initial public offering are held in a trust or escrow account.").

[175]*See* Sjostrom, *supra* note 1, at 757 (citing 17 C.F.R. § 230.419 (2007)) (describing how a SPAC, unlike a normal corporation, avoids application of SEC Rule 419).

[176]Because the SPAC has no assets, other than the potential to make valuable acquisitions and business decisions, the investor is essentially investing solely in the SPAC's management. *See* Davidoff, *supra* note 4, at 224 & n.170.

[177]*See id.* at 225 (stating that proposed acquisitions are put to an investor vote, and that if an investor "vote[s] against it and follow[s] certain perfection procedures they are entitled to redeem their shares for a pro rata share of the remaining offering proceeds held in trust").

[178]Riemer, *supra* note 45, at 952.

[179]*Id.* at 959.

[180]*Id.*

[181]*See id.* at 959 & n.187.

[182]Riemer, *supra* note 45, at 959 & n.188.

After the IPO, the SPAC searches for a target.[183] In contrast to the typical public company, SPAC officers and directors are generally not obligated to devote all of their time to running the SPAC.[184] Officers and directors are often reimbursed for out-of-pocket expenses incurred in connection with identifying businesses and performing due diligence,[185] but generally receive no salary or fees until after the initial business combination occurs.[186]

The announcement of a proposed acquisition heralds a SPAC's end game.[187] Most SPACs give stockholders a chance to vote on the acquisition.[188] SPACs sometimes repurchase shares, bargaining for a positive vote on an acquisition in exchange for the promise to buy shares once the acquisition is completed.[189] There have also been reports of hedge funds "greenmailing" SPACs in exchange for a positive vote (*i.e.*, requiring additional consideration in exchange for a "yes" vote),[190] which has prompted the development of a new generation of SPACs, described in Part VII. If the business combination is voted down, the money from the trust is distributed to the shareholders.[191] If the combination is approved, the newly

[183]*Id.* at 950 ("[SPACs] are incorporated with the sole objective of raising funds for an acquisition through a public offering of their securities.").

[184]*See, e.g.*, Alpha Sec. Grp. Corp., Registration Statement (Form S-1), at 12 (Aug. 31, 2005) ("We do not intend to have any full time employees prior to the consummation of a business combination. Each of our executive officers are engaged in several other business endeavors and are not obligated to contribute any specific number of hours per week to our affairs.").

[185]*See, e.g.*, Bank St. Telecom Funding Corp., Registration Statement (Form S-1), at 17 (Aug. 5, 2005) ("[E]ach of our directors may receive reimbursement for out-of-pocket expenses incurred by them in connection with activities on our behalf such as identifying potential target businesses and performing due diligence on suitable business combinations . . . .").

[186]*See, e.g.*, HCM Acquisition Co., Registration Statement (Form S-1), at 84 (Oct. 10, 2007) ("[N]o officers or directors will receive compensation prior to [the firm's] initial business combination . . . ."); Alpha Sec. Grp. Corp., Form S-1, *supra* note 184, at 2.

[187]*See* Riemer, *supra* note 45, at 950 (stating that only after securing a merger or acquisition with a private company will a SPAC turn its attention to conducting business for profit).

[188]*See id.* at 952 (explaining how the SPAC shareholder vote works).

[189]*See* Steven M. Davidoff, *Behind the Re-Emergence of SPACS*, N.Y. TIMES DEALBOOK (Oct. 21, 2009, 3:27 PM ), http://dealbook.nytimes.com/2009/10/21/behind-the-re-emergence-of-spacs/ (describing how one SPAC [GHL Acquisition Corporation] entered into a repurchase agreement with its investors in order to secure a vote whereby the SPAC purchased 32% of the investors' shares for more than they were worth and gave up some of its own shares).

[190]Order Approving Proposed Rule Change to the Special Purpose Acquisition Company Listing Standards, Exchange Act Release No. 34-63607, 2010 WL 5301044, at *5 (Dec. 23, 2010) [hereinafter Order].

[191]*See, e.g.*, Riemer, *supra* note 45, at 954-55 tbl. 1 (explaining that in a SPAC, a successful acquisition requires shareholder majority vote and that the escrowed funds are returned unless a successful acquisition occurs).

acquired target begins trading publicly, often under a new symbol.[192] SPACs often use stock to purchase targets, reserving the cash in the trust account for possible redemptions and perhaps to finance the operations of the target.[193] Indeed, corporate disclosures often draw attention to the existence of authorized, but unissued, shares that may be used for a combination, thereby diluting existing shareholders.[194] Post-acquisition, sponsor shares are often subject to a lock-up period.[195]

No special legislation or administrative rules govern SPACs.[196] The bonding mechanisms that SPAC sponsors use to gain the trust of investors are relatively simple, and largely track the requirements of SEC Rule 419, even though SPACs are specifically structured to avoid the terms of that regulation.[197] Their relative freedom from regulation enables SPACs to innovate quickly.[198] Indeed, as long as SPAC organizers can persuade the

[192]*See* Michael J. De La Merced, *Tile Shop to Go Public in Merger with "Blank Check" Company*, DEALBOOK (June 27, 2012, 10:24 AM), http://dealbook.nytimes.com/2012/06/27/tile-shop-to-go-public-in-merger-with-blank-check-company/ ("[SPACs] raise money from public investors and exist as thinly traded shell companies, which look to invest in privately held corporations that would assume their stock ticker symbol.").

[193]Order, *supra* note 190, 2010 WL 5301044, at *3.

[194]*See, e.g.*, Bank St. Telecom Funding Corp., Form S-1, *supra* note 185, at 16-17 ("In connection with this offering, as part of the units, we [the SPAC] will be issuing warrants to purchase 11,000,000 shares of common stock. . . . If and to the extent these warrants are exercised, you [new investors] may experience dilution to your holdings."); *see also* Mark A. Bonenfant, *Special Purpose Acquisition Companies*, BUCHALTER NEMER PC (Dec. 1, 2007), http://www.buchalter.com/bt/index.php?option=com_content&task=view&id=239&Itemid=1 (stating that one of the problems in SPACs is that "management receives 20% of the SPAC equity to find a deal, diluting the public shareholders").

[195]*See, e.g.*, HCM Acquisition Co., Form S-1, *supra* note 186, at 1; *see also Legal Alert: The SPAC Phenomenon: A Discussion of the Background, Structure and Recent Developments Involving Special Purpose Acquisition Companies*, SUTHERLAND ASBILL & BRENNAN LLP, 7 (July 17, 2006), http://www.sutherland.com/files/News/74ae02a0-d2b5-42cb-9655-93110fc3be4f/Presentation/NewsAttachment/deb8e907-69d8-43d5-a6d0-8814b81cf32a/The%20SPAC%20Phenomenin%20-%20A%20Discussion%20of%20the%20Background,%20Structure%20and%20Recent%20Developments%20Involving%20S.pdf (defining a "lock-up agreement" as one in which the SPAC's sponsors, in the post-acquisition phase, agree to not sell their shares for a specified time period).

[196]*See* Riemer, *supra* note 45, at 933 (describing how SPACs are "no more regulated than traditional public offerings").

[197]*See* Sjostrom, *supra* note 1, at 757-58 (describing how a SPAC avoids application of Rule 419 because its IPO well surpasses the amount necessary to be considered a "blank check company" by the SEC, but nevertheless mimics *some* of Rule 419's requirements so that investors will want to join the enterprise).

[198]*See* Riemer, *supra* note 45, at 965 ("Permitting SPACs to continue operating without additional regulation will allow the SPAC structure to remain dynamic and adaptive.").

SEC to acquiesce, changes can occur in a matter of months.[199] Because of the uniquely uniform structure of the underlying business (essentially an empty shell), we are able to compare SPACs' voting schemes, investor protections, and outcomes, free from the confounding variables (*e.g.*, differing industry types, capital structure) of the typical IPO.[200]

In a nutshell, SPACs can be seen as a tidy solution to the problem of the high cost of accessing the public markets.[201] They create value for a variety of market participants.[202] To retail investors they provide a sort of poor man's private equity fund—a chance to finance a crack management team's hunt for an undervalued private company and get in on the cheap.[203] They allow a management team to raise funds from the public to finance the quest for a target.[204] Finally, they give existing companies another path to liquidity and the capital markets, allowing them to bypass the costly process of going public while maintaining their autonomy in a way they could not if acquired by private equity or a strategic acquirer.[205]

We find that a number of contractual constraints that were attractive to initial SPAC investors made the ultimate acquisition more difficult, and therefore evolved over time.[206] In particular, a provision that granted 20% of shares an effective veto over the acquisition created the potential for holdup that hedge fund arbitrageurs learned to exploit.[207] Recognition of this cost

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[199]*See id.* (describing how, presently, SPACs have presented no legal problems and how, therefore, their "innovation and creativity" should be left alone to thrive); *see also* Jayson Caruso, *Special Purpose Acquisition Company (SPAC) Funding Opportunities*, EVANCARMICHAEL.COM, http://www.evancarmichael.com/Small-Business-Loans/571/SPECIAL-PURPOSE-ACQUISITION--COMPANY-SPAC---FUNDING-OPPORTUNITIES.html ("SPACs . . . raise money faster than private equity funds.").

[200]*See* Riemer, *supra* note 45, at 933 & n.11 (describing the essential emptiness of a SPAC).

[201]*Id.* at 966 ("SPACs are uniquely situated to take companies public that otherwise could not.").

[202]*See id.* ("While the fraudulent blank checks offerings of the 1980s destroyed capital, SPACs make a positive contribution to domestic capital formation.").

[203]*See, e.g.*, *id.* (explaining how SPACs can offer advantages that traditional private equity cannot).

[204]*See* Riemer, *supra* note 45, at 966 ("SPACs present investors with the unique opportunity to invest in a management team with a proven track record and to participate in a private-equity style venture in a safer and more liquid manner.").

[205]*See id.* (describing how a SPAC provides a small private firm a pathway to a public exchange of its shares).

[206]*See* Order, *supra* note 190, 2010 WL 5301044, at *5.

[207]*See id.* at *5-*7 (explaining the problem of "greenmailing"); *see also* Joseph R. Magnas, *A New SPAC Structure May Lead to Renewed Interest in SPAC Offerings*, 5 BLOOMBERG LAW REPORTS—MERGERS & ACQUISITIONS 1, 3 (8th ed. 2011), *available at* http://www.mofo.com/files/Uploads/Images/110401-A-New-SPAC-Structure-May-Lead-to-Renewed-Interest-in-SPAC-

has recently led to major changes in the ability of shareholders to disapprove of a proposed business combination, ultimately resulting in the loss of the vote entirely.[208] But before one can appreciate the rapid changes the SPAC has undergone, one must understand its origins.

### B. *How SPACs Developed*

SPACs' precursors were blank check companies that sprang up in the 1980s under the somewhat unseemly circumstances associated with "pump-and-dump" schemes.[209] A blank check company is one whose stated purpose is to merge with a yet-to-be-identified target.[210] Most of the blank check company's stock would be distributed to the underwriter and its associates and, in problematic cases, the brokerage would disseminate false reports about a profitable upcoming merger, thereby "pumping up" the stock.[211] The insiders would then "dump" the stock, leaving it virtually worthless when the vaunted merger failed to materialize.[212]

The Securities Enforcement Remedies and Penny Stock Reform Act of 1990 largely shut down these fraudulent blank check companies of the 1980s.[213] This Act required the SEC to promulgate rules regarding blank check companies.[214] The SEC responded with Rule 419, which defines a blank check company as one that:

> (i) Is a development stage company that has no specific business plan or purpose or has indicated that its business plan is to engage in a merger or acquisition with an unidentified company or companies, or other entity or person; and

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Offerings.pdf ("[T]he charter documents of many SPACs formed prior to 2010 provide that the SPACs may not complete an acquisition if holders of a fixed number of the outstanding shares of common stock (generally 20% to 30%) vote against the acquisition.").

[208] *See infra* Part VII.A.

[209] *See* Sjostrom, *supra* note 1, at 756 & n.87 (describing how the "pump and dump" schemes led to new federal laws).

[210] *See id.* (quoting H.R. REP. NO. 617, 101st Cong., 2d Sess. 9 (1990)) (defining "blank check company").

[211] *See id.* at 756 n.87 (quoting H.R. REP. NO. 617) (describing how defrauders "pump up" the stock by lying about its value to potential investors).

[212] *See id.* (quoting H.R. REP. NO. 617) (describing how after the price has risen, defrauders then "unload" their shares).

[213] *See* Penny Stock Reform Act of 1990, Pub. L. No. 101-429, §§ 501-510, 104 Stat. 931, 951-58 (1990).

[214] Riemer, *supra* note 45, at 941-42.

(ii) Is issuing "penny stock," as defined in Rule 3a51-1 (17 C.F.R. 240.3a51-1) under the Securities Exchange Act of 1934 ("Exchange Act").[215]

Penny stock is in turn defined as stock that has a price of less than $4 per share, and whose company market value is less than $5 million, among other criteria.[216]

A little more than a decade after the passage of the Penny Stock Reform Act, a banker named David Nussbaum[217] created a new business form that melded the basic structure of the blank check company with the protective principles of Rule 419.[218] He introduced the form in the 1990s, and twelve of his thirteen SPACs went public and completed acquisitions during that period—all relatively small-scale.[219] With the internet bubble of the late 1990s, it became easy for private companies simply to go public on their own, and the form was abandoned.[220]

SPACs avoid the reach of Rule 419 because, although their business plan involves a future unidentified merger, they do not issue penny stock; if their IPO is successful, the proceeds are comfortably over the $5 million threshold, and always priced higher than $4 per share.[221] The requirements of Rule 419 are still worth describing, however, because SPACs track many of them.[222] Rule 419 requires that the securities offered in connection with a blank check offering, and the gross proceeds of the offering, be deposited into an escrow account (after deductions for underwriting commissions, expenses, and dealer allowances) and invested in liquid government-backed securities.[223] It requires that interest on these funds also

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[215] 17 C.F.R. §§ 230.419(a)(2)(i)-(ii) (2011).

[216] *Id.* § 240.3a51-1(a).

[217] *See* Riemer, *supra* note 45, at 931 n.5, 945. Nussbaum at the time headed GKN Securities Corporation, but left it to found EarlyBirdCapital, Inc., which we study in Part VII.C. *See id.* at 931 n.5, 948 n.110.

[218] *Id.* at 945-46.

[219] *See id.* at 945-47.

[220] *See* Riemer, *supra* note 45, at 946.

[221] *See* Sjostrom, *supra* note 1, at 757-58 ("[P]ost-IPO, SPACs easily exceed the $5,000,000 net tangible assets threshold given they have no operations and therefore minimal liabilities.").

[222] *See id.* at 758 ("Although SPACs are exempt from Rule 419 compliance, they nonetheless voluntarily incorporate a number of Rule 419-type provisions in their IPO terms in order to attract investors.").

[223] *See* 17 C.F.R. §§ 230.419(b)(2)(i)-(iv) (2011) (requiring offering proceeds to be invested in a "deposit," as defined in the Federal Deposit Insurance Act; in "[s]ecurities of any open-end investment company registered under the Investment Company Act of 1940; or [in] . . . [s]ecurities that are direct obligations of, or obligations guaranteed as to principal or interest by, the United

be held in an escrow or trust account, and provides that the company may receive up to 10% of the proceeds remaining after expenses are deducted.[224] The funds are released upon execution of an agreement for the acquisition of a business or line of businesses where the fair value represents at least 80% of the maximum offering proceeds.[225] Importantly, under Rule 419, shares do not trade on the open market until the acquisition.[226] The company must disclose: (1) the financial statements of the company and target, (2) the amount of gross offering proceeds, (3) the amount paid for underwriting, (4) the amount remaining in the trust account, and (5) the amount, use, and application of the funds paid to the company, officers, directors, promoters, and controlling shareholders.[227] Each purchaser then receives a prospectus, and has twenty to forty-five business days to notify the company that she chooses to remain an investor; if not, she receives back her pro rata share.[228] Funds must be returned if no acquisition occurs within eighteen months.[229] Developers of SPACs purposefully modeled their features on Rule 419's protective features, with the key distinction that the stock would trade as soon as the vehicle went public.[230]

Some readers may associate SPACs with the reverse mergers that have recently made headlines.[231] Reverse mergers, however, are a different animal. In a typical reverse merger, a corporation looking to go public on the cheap merges with a publicly traded shell corporation—an entity that, for example, previously sold all of its assets but remained publicly traded.[232] Several Chinese companies went public by being acquired via reverse merger and were subsequently revealed to have questionable accounting practices.[233] SPACs, in contrast, disclose material information about the

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States").

[224] *Id.* §§ 230.419(b)(2)(v)-(vi).

[225] *Id.* § 230.419(e)(1).

[226] Sjostrom, *supra* note 1, at 757 (citing 17 C.F.R. § 230.419(b)(3)) ("Rule 419 . . . [p]rohibits trading of the [blank check company's] securities by requiring them to be held in an escrow or trust account until consummation of an acquisition . . . .").

[227] 17 C.F.R. § 230.419(e)(1).

[228] *Id.* §§ 230.419(e)(2)(i)-(ii).

[229] *Id.* § 230.419(e)(2)(iv).

[230] Sjostrom, *supra* note 1, at 758.

[231] *See infra* note 234 and accompanying text.

[232] *See* Sjostrom, *supra* note 1, at 743.

[233] Nanette Byrnes & Lynnley Browning, *Special Report: China's Shortcut to Wall Street*, REUTERS (Aug. 1, 2011), http://www.reuters.com/article/2011/08/01/us-shell-china-idUSTRE7702S520110801; *see also* Linette Lopez, *Listing A Sketchy Chinese Company In The US Sounds Pretty Easy*, BUSINESSS INSIDER, Dec. 12, 2012, *available at* http://www.businessinsider.com/chinese-companies-and-reverse-mergers-2012-12.

target before acquisition, and the SEC reviews all of these disclosures.[234] One might even consider SPACs to be reverse mergers "done right."

The second wave of SPACs began in May 2003, when EarlyBirdCapital, an investment bank founded by the creator of SPACs, David Nussbaum,[235] filed an S-1 for a SPAC named Millstream Acquisition Corp.[236] Millstream went public in August 2003 and acquired NationsHealth, LLC in March 2004.[237] Thereafter, the number of SPACs grew steadily in number until July 1, 2005, when the American Stock Exchange ("AMEX") began to list them on its exchange.[238] By 2007, SPACs made up almost 25% of all U.S. IPOs.[239] The New York Stock Exchange ("NYSE") and NASDAQ allowed SPACs to list in 2008,[240] but the financial crisis meant that very few SPACs were formed after the second quarter of 2008.[241] The form seemed close to moribund, with no IPOs in all of 2008.[242]

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[234]*See* Bonenfant, *supra* note 194, at *2 ("SPAC managements refrain from looking for prospective acquisition targets until the IPO is completed, because if a SPAC identifies a target prior to filing the registration statement, then the SEC will require the SPAC to disclose significant information about the target even though the SPAC and target may not ultimately consummate a transaction.").

[235]*See Management*, EARLYBIRDCAPITAL, http://www.earlybirdcapital.com/management.html (last visited Oct. 7, 2011) ("Mr. Nussbaum was the innovative force behind the creation of the Special Purpose Acquisition Corp. ("SPAC") financing product."); *see also supra* notes 217-20 and accompanying text (describing Mr. Nussbaum and the origins of the SPAC).

[236]*See* MillStream Acquisition Corp., Registration Statement (Form S-1) (May 19, 2003).

[237]Edward Mason & Alexander Soule, *'Blank Check' Investment Co. Files for IPO*, BOSTON BUS. J. (July 11, 2005), http://www.bizjournals.com/boston/stories/2005/07/11/story4.html; *Millstream Acquisition Corporation Completes Initial Public Offering*, BUSINESSWIRE (Aug. 28, 2003), http://www.businesswire.com/news/home/20030828005453/en/ Millstream-Acquisition-Corporation-Completes-Initial-Public-Offering (stating that Millstream made known on August 28, 2003 that it had completed its IPO).

[238]*See* James S. Murray, *The Regulation and Pricing of Special Purpose Acquisition Corporation IPOs* 1, 7 (Jan. 24, 2011) (unpublished manuscript) *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1746530. We found no announcement of a policy change on the part of AMEX to permit SPACs; it appears that AMEX simply began to permit them to do so. *See id.*; *American Stock Exchange Lists Units of Courtside Acquisition*, PR NEWSWIRE (July 1, 2005), http://www.thefreelibrary.com/American+Stock+Exchange+ Lists+Units+of+Courtside+Acquisition...-a0133708234 (listing Courtside Acquisition Corp. as the first SPAC to be listed on AMEX). Because Services Acquisition Corporation filed an F-1 as a foreign issuer, it is not included in our dataset.

[239]Boyer & Baigent, *supra* note 4, at 8.

[240]*See* Murray, *supra* note 238, at 1.

[241]*See* Floyd Wittlin & Kristen Ferris, *Can the SPAC Make It Back? Structural Changes, Including Elimination of the Stockholder Vote to Approve an Initial Acquisition, May Help Renew Interest in SPACs*, 4 BLOOMBERG LAW REPORTS—MERGERS & ACQUISITIONS 1 (2010), *available at* http://www.bingham.com/Publications/Files/2010/12/Can-the-SPAC-Make-It-Back-Structural-Changes-Including-Eliminating-the-Stockholder-Vote-to-Approve-an-Initial-Acquisition-May.

In the post-crisis period, SPACs have resurged with twenty-five preliminary prospectuses filed in between 2010 through 2011, and eleven IPOs.[243]

## IV. A TALE OF THREE SPACS

Some SPACs succeed—that is, they go public and complete acquisitions.[244] Others fail to locate a target or, having found one, fail to gain shareholder approval.[245] Still other SPACs do not even make it to market.[246] Before describing our data, we offer three case studies to give the reader a sense of how SPACs work in the real world.

*Filed but failed to go public.* HCM Acquisition Company ("HCM") filed its initial registration statement on October 10, 2007.[247] It planned to sell 25 million units at $10 per unit, for an aggregate of $250 million.[248] Its prospectus did not single out a particular industry, but rather focused on "industries and target businesses in the United States and Europe that may provide significant opportunity for growth."[249] It proposed to be listed on the AMEX.[250] Citigroup Global Markets, Inc. was its underwriter.[251]

The sole member of HCM's founding stockholder, HCM Acquisition Holdings, LLC, was Highland Capital Management, L.P. ("Highland"), whose CEO James D. Dondero, was also CEO of the SPAC.[252] Highland was described as a "manager of assets in niche markets and complex areas including distressed investing (predominantly control-oriented), corporate credit, real estate, and equities."[253] Basically, the SPAC management team consisted of Highland people using Highland advisors.[254] The SPAC stated: "Our investment philosophy will be based on the strategies employed by [Highland and its affiliates, or the "Highland Group"] which reflect the private equity and control distressed investing experience of its senior management."[255] It entered into a "right of first review" agreement with

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242 *Id.*
243 *See* Magnas, *supra* note 207, at 2.
244 *See infra* notes 298-320.
245 *See infra* notes 264-97.
246 *See infra* notes 247-63 and accompanying text.
247 HCM Acquisition Co., Form S-1, *supra* note 186, at i.
248 *Id.*
249 *Id.*
250 *Id.*
251 HCM Acquisition Co., Form S-1, *supra* note 186, at 109.
252 *Id.* at 1.
253 *Id.*
254 *See id.* at 1-2.
255 HCM Acquisition Co., Form S-1, *supra* note 186, at 3.

Highland, whereby any business opportunities Highland Group encountered valued at $200 million or more would be submitted first to HCM.[256] Highland and Dondero entered into non-competes, providing they would not work with another blank check company.[257] Highland was to be repaid $200,000 for offering-related and organizational expenses, plus $10,000 per month for office space and administrative support.[258] The prospectus discussed the AMEX requirement that independent directors comprise a majority of the board, and it stated that the company had "agreed not to enter into our initial business combination with any entity in which any of our initial stockholders, officers, directors or the Highland Group or its affiliates has a financial interest."[259] It filed several amendments, including one on November 21, 2007, disclosing forms of stock certificates, bylaws, charter, indemnity agreements, and many other corporate organizational documents.[260] The most recent amendment was on May 23, 2008.[261] The SPAC ceased making filings, and has never issued shares to the public.[262] The registration statement has never been withdrawn, as was the case for fifty-seven of those ninety-three SPACs that did not go public.[263]

*Went public and liquidated.* Alpha Security Group Corp. ("Alpha Security") filed an S-1 on August 31, 2005.[264] It hoped to raise $64 million by selling 8 million units at $8 a share (warrants exercisable at $6 per share).[265] Maxim Group, LLC, a small investment bank that was one of the pioneers in SPAC offerings, was the underwriter.[266] The prospectus

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[256]*Id.* at 4.

[257]*Id.* at 84-85.

[258]*Id.* at 92.

[259]HCM Acquisition Co., Form S-1, *supra* note 186, at 86.

[260]*See* HCM Acquisition Co., Amendment No. 2. to Registration Statement (Form-S-1/A), at II-2 (Nov. 21, 2007).

[261]*See* HCM Acquisition Co., Amendment No. 5 to Registration Statement (Form-S-1/A), at i. (May 23, 2008).

[262]*See Initial Key Offerings Public Offerings Deal Data*, EDGAR ONLINE, http://www.sec.gov/Archives/edgar/data/1414123/000095013408010199/0000950134-08-010199-index.htm (last visited Nov. 19, 2012) (showing that for 2012 "Shareholder Shares Offered," no dollar figure is offered).

[263]*See infra* Table 4.

[264]Alpha Sec. Grp. Corp., Form S-1, *supra* note 184, at i.

[265]*Id.*

[266]*Id.* at 58; *Investment Banking: Raising Capital Through Innovative Solutions and Global Distribution Channels*, MAXIM GRP. (2012), http://www.maximgrp.com/ investmentbanking/ ("Maxim Group is recognized as a leading underwriter of Business Combination Companies (BCCs), commonly referred to as Special Purpose Acquisition Companies (SPACs), with over $2.6

announced a focus on the homeland security and defense industries.[267] The company had eighteen months to consummate an acquisition, unless it entered into a letter of intent in that period, in which case it would have another six months to complete an acquisition.[268] Initially Alpha Security intended to be traded OTC,[269] but by September 21, 2006 it switched to the AMEX.[270] Although many of the risk factors it presented were similar to those of other SPAC offerings,[271] its filings did identify a special set of risk factors pertaining to unique risks associated with the homeland security and defense industries.[272] In other words, the registration statement was somewhat tailored—not wholly a cut-and-paste job. Alpha Security agreed to pay ASG Management, Inc., an affiliated third party of which the CEO and executive vice president were principals, $7,500 per month for office space and administrative services.[273] Later amendments changed the size of the offering to 6 million units at $10 per share.[274] On March 6, 2007, the SPAC revised its conversion threshold from the original 20% (which the SEC in a comment letter described as the "industry standard") to 35%, thus making it harder for investors to veto the deal.[275]

Alpha Security finally went public March 23, 2007.[276] The overallotment was not exercised, but the offering generated $63,200,000: $60 million from the sale of units and $3.2 million from a private placement of warrants priced at $1.00 per share.[277] On June 14,

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billion in issuance in 26 transactions, including acting as lead manager in 11 transactions.").

[267] Alpha Sec. Grp. Corp., Form S-1, *supra* note 184, at 1.

[268] *Id.* at 9.

[269] *Id.* at i ("We intend to apply to have our units quoted on the OTC Bulletin Board . . . ."); *see also About the OTC BB (Over the Counter Bulletin Board)*, OTC STOCK LIST, http://www.otcstocklist.com/about-the-otcbb/ (last visited Nov. 19, 2012) ("[T]he OTC BB typically trades securities that are not listed on one of the major US Exchanges (NASDAQ, New York Stock Exchange (NYSE), American Stock Exchange (AMEX) and more . . . .").

[270] *See* Alpha Sec. Grp. Corp., Amendment No. 2 to Registration Statement (Form-S-1/A), at i (Sept. 21, 2006).

[271] *See* Alpha Sec. Grp. Corp., Form S-1, *supra* note 184, at 9-20 (describing the risks Alpha brought to investors as a SPAC in general).

[272] *See id.* at 20-24 (describing the risks Alpha brought to investors as a homeland security/defense SPAC).

[273] Alpha Sec. Grp. Corp., Form S-1, *supra* note 184, at 2.

[274] Alpha Sec. Grp. Corp., Form S-1/A, *supra* note 270, at i.

[275] Letter from John Reynolds, Assistant Dir. of the SEC, to Steven Wasserman, CEO of Alpha Sec. Grp. Corp., at 2 (Mar. 13, 2007), http://www.sec.gov/Archives/edgar/data/1329361/000000000007012986/filename1.pdf. If a percentage between 20% and 35% exercise their redemption rights, a proportional percentage of the initial stockholders' common stock would be forfeit. Alpha Sec. Grp. Corp., Annual Report (Form 10-K), at 6 (Apr. 15, 2008).

[276] *See* Alpha Sec. Grp. Corp., Notice of Effectiveness (Form S-1) (Mar. 23, 2007).

[277] Alpha Sec. Grp. Corp., Current Report (Form 8-K), at 2 (Apr. 3, 2007).

2007, the stock and warrants began trading separately.[278] Alpha Security board members included the former governor of New Mexico[279] and a former Air Force general.[280] The SPAC was late in filing several 10-Qs and its first 10-K, painting a picture of a somewhat unsophisticated company.[281] On September 26, 2008, when the eighteen-month acquisition period was about to elapse, the company issued a press release stating that it had entered into a letter of intent and had until March 28, 2009 to complete a business combination.[282]

On December 31, 2008, Alpha Security entered into a merger agreement with Soya China Pte. Ltd. ("Soya"), under which it was to transfer 6,300,000 shares of Alpha Security common stock and an aggregate of $30,000,000 for the company's outstanding shares.[283] Soya appears to be a food and beverage company;[284] it is hard to characterize it as within the

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[278]Alpha Sec. Grp. Corp., Current Report (Form 8-K), at Item 8.01 (June 12, 2007).

[279]*Capital Markets: Company Overview of Alpha Security Group Corp.*, BLOOMBERG BUSINESSWEEK, http://investing.businessweek.com/research/stocks/private/person.asp?personId=24208127&privcapId=23733880&previousCapId=248869&previousTitle=ALLIANT%20TECHSYSTEMS%20INC.

[280]*Ronald Fogleman*, RIGHT WEB (Feb. 5, 2011), http://rightweb.irc-online.org/profile/Fogleman_Ronald/.

[281]*See, e.g.*, Alpha Sec. Grp. Corp., Notification of Late Filing (Form 12b-25) (May 16, 2008) [hereinafter Alpha Sec. Grp. Corp., Notification of Late Filing 10-Q] (stating Alpha's reasons for being late with its 10-Q); Alpha Sec. Grp. Corp., Notification of Late Filing (Form 12b-25) (Apr. 1, 2008) (describing Alpha's reasons for being late with its 10-K). The excuse on every Notification of Late Filing for the 10-Qs was the same:

> The report of Alpha Security Group Corp. (the "Company") on Form 10-Q could not be filed within the prescribed time period because the Company's financial statements could not be completed by its accountants within the prescribed time period without unreasonable effort or expense. As a result, the Company could not solicit and obtain the necessary review of the Form 10-Q and signatures thereto in a timely fashion prior to the due date of the report.

*See* Alpha Sec. Grp. Corp., Notification of Late Filing 10-Q, *supra* note 281. This explanation seems particularly feeble given the simple nature of the financials, which basically just reported the interest earned on the trust account and the amounts spent on things like Delaware franchise taxes. *See, e.g.*, Alpha Sec. Grp. Corp., (Form 10-Q), at 2-5 (May 21, 2008) (containing Alpha's financial statements).

[282]PR Newswire, *Alpha Security Group Corporation Announces Fulfillment of Condition for Six Month Extension to Complete a Business Combination*, SECURITY INFOWATCH (Sept. 26, 2009), http://www.securityinfowatch.com/news/10545907/alpha-security-group-corporation-announces-fulfillment-of-condition-for-six-month-extension-to-complete-a-business-combination.

[283]PR Newswire, *Alpha Security Group Corporation to Acquire Soya China Pte. Ltd.*, BLOOMBERG (Jan. 6, 2009) [hereinafter PR Newswire, *Alpha to Acquire Soya*], http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aD2RYFMWmN1o.

[284]*See News and Intelligence for the Soybean and Oilseed Industries*, SOYATECH, http://www.soyatech.com/index.php (last visited Sept. 18, 2011) ("For more than 20 years,

homeland security or defense industries on which Alpha Security had set out to focus.[285] Soya agreed to certain milestone payments, escrowing a number of Alpha Security shares that would be released only if certain income thresholds were met.[286] The agreement also contemplated reincorporating as a Bermudan corporation.[287]

On March 12, 2009, Alpha Security announced that it would no longer be pursuing the acquisition of Soya and would proceed with its liquidation and dissolution.[288] On April 6, 2009, AMEX sent Alpha a notice threatening delisting for failure to file its 10-K on time.[289] On May 5, the company sent out a proxy statement requesting a vote to amend the certificate of incorporation to allow for the company to continue post-distribution—distribution would still be $10 per share.[290] Alpha Security did not file its next 10-Q.[291] On June 15, 2009, Alpha Security sent out a second proxy proposing dissolution, abandoning its plan of surviving after distribution.[292] It sent out three successive proxies seeking a majority vote for dissolution, and was de-listed August 29, 2009.[293]

A review of the beneficial ownership filings (required for holders of greater than 5% of the company and insiders)[294] reveals investments by

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Soyatech's products and services for the global soybean and oilseed industry have fostered growth in food, feed and renewable energy markets.").

[285] *See supra* note 267 and accompanying text.

[286] *See* PR Newswire, *Alpha to Acquire Soya*, *supra* note 283.

[287] *See id.*

[288] PR Newswire, *Alpha Security Group Corporation Terminates Merger Agreement With Soya China Pte....*, Reuters (Mar. 12, 2009), http://www.reuters.com/article/2009/03/13/idUS19551+13-Mar-2009+PRN20090313.

[289] PR Newswire, *Alpha Security Group Corporation Notified by NYSE Amex*, BLOOMBERG (Apr. 10, 2009), http://www.bloomberg.com/apps/news?pid=newsarchive &sid=aN6ipAVnbWl8.

[290] Alpha Sec. Grp. Corp., Proxy Statement (Schedule 14A), at 2 (May 5, 2009) [hereinafter Alpha Sec. Grp. Corp., Proxy Statement]. Some language makes it seem as if distribution is conditioned on approving the proposal. *See id.* ("To consider and vote on a proposal to permit the Company to distribute the assets of the Trust Account to the holders of the IPO Shares (the 'Distribution Proposal'). This proposal will be acted upon following, and will be conditioned upon, the approval of the Certificate of Incorporation Amendment Proposal.").

[291] Alpha Sec. Grp. Corp., Current Report (Form 8-K), at 2 (June 1, 2009).

[292] Alpha Sec. Grp. Corp., Preliminary Proxy Statement (Schedule 14-A), at 1 (July 29, 2009).

[293] *See, e.g.*, Alpha Sec. Grp. Corp., Definitive Proxy Statement (Schedule 14-A), at 1 (July 30, 2009) ("[O]ur board of directors has determined it would be in the best interests of our stockholders to liquidate and dissolve and distribute now to stockholders holding shares of our common stock . . . in the trust account . . . ."); Alpha Sec. Grp. Corp., Notification of Removal From Listing and/or Registration Under Section 12(b) of the Securities Exchange Act of 1934 (Form 25) (Aug. 19, 2009).

[294] *Schedule 13D*, SEC, http://sec.gov/answers/sched13.htm (last modified Apr. 4, 2012). For Alpha, the relevant information is found on its Schedule 13G; *see Exchange Act Sections*

individuals,[295] investment funds (including entities that appear to specialize in SPAC investments, *e.g.*, "Fir Tree SPAC Holdings"),[296] and Harvard University's endowment, which made an investment when the acquisition was announced and sold shortly before Alpha Security was delisted.[297]

*Successful combinations*. Services Acquisition Corp. International ("Services") registered its S-1 on February 14, 2005.[298] It hoped to raise $40 million by selling 5 million units at $8 per share (warrants exercisable at $6 per share).[299] Broadband Capital Management, LLC was the underwriter.[300] The prospectus announced that it would seek as a target a service business in the United States, although it left open the possibility of an international acquisition.[301] The company had eighteen months to consummate an acquisition, unless it entered into a letter of intent in that period, in which case it would have a six-month extension.[302] Initially Services intended to be traded OTC,[303] but by June 28, 2005 its plans had switched to the AMEX.[304] The conversion threshold was set at 20%.[305] No executives received a salary, but Services was to pay two entities—one a corporation owned and managed by the CEO, the other an "affiliate" of the Vice President and a director—a total of $7,500 per month for office space and administrative support.[306] Sponsors would own 20% of the company if an acquisition were to go through.[307] In connection with the offering, the sponsors bought 1 million warrants at $1.20 on the open market, agreeing not to sell them until after the business combination.[308]

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*13(d) and 13(g) and Regulation 13D-G Beneficial Ownership Reporting*, SEC, http://www.sec.gov/divisions/corpfin/guidance/reg13d-interp.htm (last modified Nov. 16, 2009) (explaining the subtle differences between Schedules 13D and 13G).

[295]Alpha Sec. Grp. Corp., (Schedule 13G) (June 5, 2009) (naming Bulldog Investors, Phillip Goldstein, and Andrew Dakos as investors).

[296]*See* Alpha Sec. Grp. Corp., Amendment No. 3 to Schedule 13G, (SC13G/A), at 5 (Feb. 16, 2010).

[297]*See* Alpha Sec. Grp. Corp., Amendment No. 1 to Schedule 13G, (SC13G/A), at 2-5 (Sept. 8, 2009).

[298]Servs. Acquisition Corp. Int'l, Registration Statement (Form S-1), at i (Feb. 14, 2005).

[299]*Id.* at 2.

[300]*Id.* at 43.

[301]*Id.* at 1.

[302]Servs. Acquisition Corp. Int'l, Form S-1, *supra* note 298, at 4.

[303]*Id.* at i.

[304]Servs. Acquisition Corp. Int'l, Amendment No. 4 to Registration Statement (Form S-1/A), at i (June 28, 2005).

[305]Servs. Acquisition Corp. Int'l, Form S-1, *supra* note 298, at 5.

[306]*Id.* at 33.

[307]*Id.* at 17.

[308]*Id.* at 37.

Services went public on July 6, 2005.[309] The underwriters exercised the overallotment option.[310] The warrants separated from the common stock on July 28, 2005.[311] It timely filed 10-Qs[312] and its annual report.[313] On March 10, 2006, the company announced an agreement with Jamba Juice Company, a maker of juices and smoothies, for $265 million.[314] If the business combination were to go through, the warrant holders would be able to exercise their warrants and pay $6 for stock trading at $10.55, thus creating substantial dilution for Jamba Juice.[315] Services also conducted a private placement financing on March 10 and March 15, 2006, which included as investors certain current Jamba Juice stockholders and board members.[316] It appears that the private placement not only raised $231.6 million to be used as merger consideration, but also allowed Jamba Juice insiders to avoid at least some dilution from the warrants.[317] On November 28, 2006, Services' shareholders approved the acquisition.[318] The company "up-listed" to the NASDAQ[319] and its common stock began trading under the symbol JMBA, under which it still trades today.[320]

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[309]Servs. Acquisition Corp. Int'l, Current Report (Form 8-K), at 2 (July 6, 2005).

[310]Servs. Acquisition Corp. Int'l, Amendment No. 1 to Current Report (Form 8-K/A), at 2 (July 7, 2005).

[311]Servs. Acquisition Corp. Int'l, Current Report (Form 8-K), at 2 (July 25, 2005).

[312]*See generally* Servs. Acquisition Corp. Int'l, Quarterly Report (Form 10-Q) at F-1 to F-4 (Aug. 15, 2005) (containing Services' financial statements).

[313]*See* Servs. Acquisition Corp. Int'l, Annual Report (Form 10-K), at 2 (Mar. 29, 2006) ("This 10-K was prepared and relates to the Company as of December 31, 2005.").

[314]Servs. Acquisition Corp., Current Report (Form 8-K), at Ex. 99.1 (Mar. 13, 2006).

[315]*See* Servs. Acquisition Corp. Int'l, Current Report (Form 8-K), at 2-3 (Mar. 16, 2006); Servs. Acquisition Corp. Int'l, Preliminary Proxy Statement (Schedule 14-A), at 34 (Mar. 29, 2006) ("Each warrant expires on June 28, 2009, or earlier upon redemption, and entitles the holder to purchase one share of our common stock at an exercise price of $6.00 per share.").

[316]Servs. Acquisition Corp. Int'l, Current Report (Mar. 16, 2006), *supra* note 315, at 4.

[317]*See id.*; Servs. Acquisition Corp. Int'l, Schedule 14-A, *supra* note 316, at 34. Presumably, with this $231.6 million, any dilution problems could be at least partially remedied. *See* Servs. Acquisition Corp. Int'l, Form 8-K, *supra* note 315, at 4; Servs. Acquisition Corp. Int'l, Schedule 14-A, *supra* note 315, at 34.

[318]*Services Acquisition Corp (SVI) Says Shareholders Approve Merger with Jamba Juice*, STREETINSIDER.COM, (Nov. 28, 2006), http://www.streetinsider.com/Mergers+and+Acquisitions/Services+Acquisition+Corp+(SVI)+Says+Shareholders+Approve+Merger+with+Jamba+Juice/1384982.html (announcing the shareholder approval of the merger and stating the transaction was expected to close the following day on November 29, 2006).

[319]Letter from Gary Sundick, Vice President of Listings/Investigations to Brian K. Johnson, Office of Filings Information Services, SEC (Nov. 29, 2006), *available at* http://www.sec.gov/Archives/edgar/vprr/06/9999999997-06-047263.

[320]*See Investor Relations*, JAMBA JUICE, http://ir.jambajuice.com/phoenix.zhtml?c=192409&p=irol-irhome (last visited Aug. 22, 2012).

## V. OVERVIEW OF SPAC DATA

Having surveyed the potential fates SPACs may experience, we turn to our empirical data. Our sample of SPACs consists of 243 firms that filed a preliminary prospectus with the SEC as a blank check company from 2003 to 2008. We also include some preliminary analysis of the SPAC activity from 2009 to December 2011, which consists of 30 filings.[321] We put together the main sample by using Morningstar Document Research[322] to search all S-1 filings on EDGAR[323] from January 1, 2003 to December 31, 2008 for the term "6770," which is the Standard Industrial Classification ("SIC") designation for blank check companies.[324] We could not rely on the SIC category itself because the SEC may reclassify successful SPACs with the target's SIC code number.[325] For example, a SPAC may originally file under the blank check 6770 category. Upon acquiring a company that makes and sells cookies, it would be assigned the code 2052 (the "cookies and crackers" category).[326] A current search of 6770 SIC codes thus would not reveal this SPAC. But a word search for the term "6770" in its original S-1 filing does.

After deleting duplicate observations and S-1s for secondary equity offerings, we were left with a sample of 297 possible SPACs. Of these filings, fifty-four transactions had one or more characteristics that caused us to eliminate them from our sample. In particular:

- Twenty-nine potential SPACs did not have 6770 as their SIC code in their preliminary S-1.[327]

- Nine were subject to Rule 419, and thus by definition not a SPAC.[328]

[321] *See infra* Table 4. We do not include these firms in the main analysis since their period to find an acquisition has not yet expired.

[322] Morningstar Document Research is a database that "streamlines public company research" *Morningstar Document Research*, MORNINGSTAR (2012), http://www.10kwizard.com/.

[323] EDGAR is the SEC's online filing system. *See Filings and Forms*, U.S. SECURITIES AND EXCHANGE COMMISSION, http://www.sec.gov/edgar.shtml (last modified Feb. 21, 2012).

[324] *Division of Corporation Finance: Standard Industrial Classification (SIC) Code List* [hereinafter *SIC Code List*], U.S. SECURITIES AND EXCHANGE COMMISSION, http://www.sec.gov/info/edgar/siccodes.htm (last modified Oct. 26, 2011).

[325] *See supra* note 320 and accompanying text.

[326] *SIC Code List, supra* note 324.

[327] For example, the word search for "6770" in S-1s may net a firm with the address of "6770 Main Street."

- Four were not unit offerings, which is a standard characteristic of SPACs.[329]

- Seven firms were limited partnership commodity pools, which are atypical of the classic SPAC.[330]

- Three firms filed under small business guidelines.[331]

- One proposed offering was under $10 million and proposed to trade in only a few states.[332]

These screens left us with a sample of 243 SPACs from 2003 to 2008 as to which we were able to learn about the entire life of the entity. We provide some analysis of thirty additional SPACs that filed an S-1 from 2009 to December 2011. For example, 57th Street Acquisition Corp. filed an S-1 in 2009,[333] and completed an acquisition in May of 2011.[334]

We used the Securities Data Company ("SDC") M&A database,[335] EDGAR filings, and LexisNexis news announcements[336] to collect the specific data related to the proposed IPO, the IPO, and any business combination. We found that there is no standard way to collect SPAC data from SDC, through either its IPO database or its M&A data. The main reason is that SDC does not uniformly classify SPACs by a particular industry or even by the SIC code listed in the S-1. Thus, we used SDC only as a supplemental source of SPAC life-cycle data. All business combination announcement dates were collected through LexisNexis and EDGAR filings.

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[328] *See supra* notes 196-200 and accompanying text.

[329] *See supra* note 178 and accompanying text.

[330] *See supra* notes 172-77 and accompanying text.

[331] Firms going public as "small businesses" or, after February 4, 2008, as "smaller reporting companies," are subject to less stringent disclosure requirements. *See Changeover to the SEC's New Smaller Reporting Company System by Small Business Issuers and Non-Accelerated Filer Companies: A Small Entity Compliance Guide*, *available at* http://www.sec.gov/info/smallbus/secg/smrepcosysguid.pdf. We exclude these filers for the sake of consistency across the sample.

[332] Contrast this with the amounts usually invested in a SPAC, and their hallmark of free tradability. *See, e.g.*, *supra* note 232 and accompanying text (describing how SPAC offerings are usually well over $5,000,000) and *supra* note 230 and accompanying text (stating that SPAC offerings can trade as soon as the vehicle goes public).

[333] 57th St. Gen. Acquisition Corp., Registration Statement (Form S-1) (Nov. 16, 2009).

[334] *See* 57th St. Gen. Acquisition Corp., Current Report (Form 8-K) (May 6, 2011).

[335] *SDC Platinum – Securities Data Company*, HARVARD BUS. SCH. BLOOMBERG CTR., http://www.library.hbs.edu/go/sdcplatinum.html.

[336] *Information Professional*, LEXISNEXIS, http://www.lexisnexis.com/en-us/other-business-solutions/news-and-business-research.page.

We also conducted several interviews with SPAC participants—sponsors, investment bankers, and lawyers—in order to further our understanding of these transactions.

In Table 1, we provide an overview of the most notable SPAC characteristics for the purposes of this Article: the months allowed for combination, the conversion threshold, and the percentage of contributed funds held in trust. "Months allowed for combination" corresponds to the limited life of the SPAC. The shelf life of all SPACs is much shorter than the 10-year standard for traditional private equity.[337] As seen in Table 1 below, the longest lived SPAC observed had thirty-six months to complete an acquisition, and the shortest-lived SPAC observed had a mere eighteen months.

TABLE 1. STATISTICS FOR 243 SPACS THAT FILED AN S-1 FROM 2003 TO 2008

| | Mean | Median | Maximum | Minimum |
|---|---|---|---|---|
| Months allowed for combination | 25.5 | 24.0 | 36.0 | 18.0 |
| Conversion threshold | 27.2% | 30.0% | 40.0% | 20.0% |
| % held in trust | 96.3% | 98.0% | 110.1% | 82.8% |

The "conversion threshold" in Table 1 is a measure of the power of SPAC investors to veto a specific combination proposed by managers.[338] If more than the given threshold votes to reject the deal and receive their share of the trust account back, then the acquisition will not occur.[339] The conversion threshold thus functions as a supermajority approval requirement, and is a key investor protection present in SPACs and absent in traditional private equity.[340] Table 1 demonstrates that for this sample, which ends in 2008, the minimum conversion threshold is 20% and the maximum is 40%.

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[337] *Compare* Riemer, *supra* note 45, at 946 n.98 ("While a two-year limit was (and remains) typical, because SPACs are not bound by a statutory time limit, management may institute a longer or shorter limit at its discretion. Second-generation SPACs generally require that a letter of intent to conduct a business combination be filed within eighteen months of the IPO and that the combination be completed within twenty-four months."), *with supra* notes 101, 134 and accompanying text (explaining the average ten-year lifespan of a private equity investment).

[338] *See supra* notes 43-44 and accompanying text.

[339] *See supra* notes 43-44 and accompanying text.

[340] *Compare supra* notes 43-44 and accompanying text (explaining a SPAC's "conversion threshold"), *with supra* notes 88, 137 and accompanying text (explaining the limited voice investors have in traditional private equity investments).

As Part VII of this Article will detail, we have preliminary data on more recent, so-called "Third Generation" SPACs, which employ a much higher conversion threshold, effectively eliminating investor voice.

Finally, the "% held in trust" in Table 1 refers to the amount of the IPO proceeds that are held in an escrowed trust account, and may not be released until the conclusion of the acquisition. It is the placement of funds in trust that provides investors with the assurance that they can receive most of their money back if the SPAC sponsors fail to find or complete a deal, or if the investor wishes to opt out of it.[341] Table 1 shows that the range of the amount held in trust is 82.8% to 110%.[342]

Figure 2 below shows the outcomes of SPACs over time. As seen by the thick dark line, the two largest peaks in SPAC S-1 filings occurred in 2005 and in the latter half of 2007 and the first half of 2008. Notably, the success rate of the SPAC formed in these two different periods is highly dissimilar. As seen in Figure 2, at the 2005 peak SPACs that completed both an IPO and an acquisition comprised the highest number of transactions, followed second by transactions that completed an IPO but not an acquisition, and trailed by transactions that did not complete an IPO. In contrast, in the 2007/2008 peak the greatest number of transactions, by far, involved SPACs with withdrawn S-1s. As demonstrated in Figure 2, some SPACs successfully acquired targets in 2007, but starting at the beginning of 2008, every proposed SPAC IPO was withdrawn. However, the graph does reveal the more recent resurgence in SPAC activity to levels similar to late 2003 and 2004.

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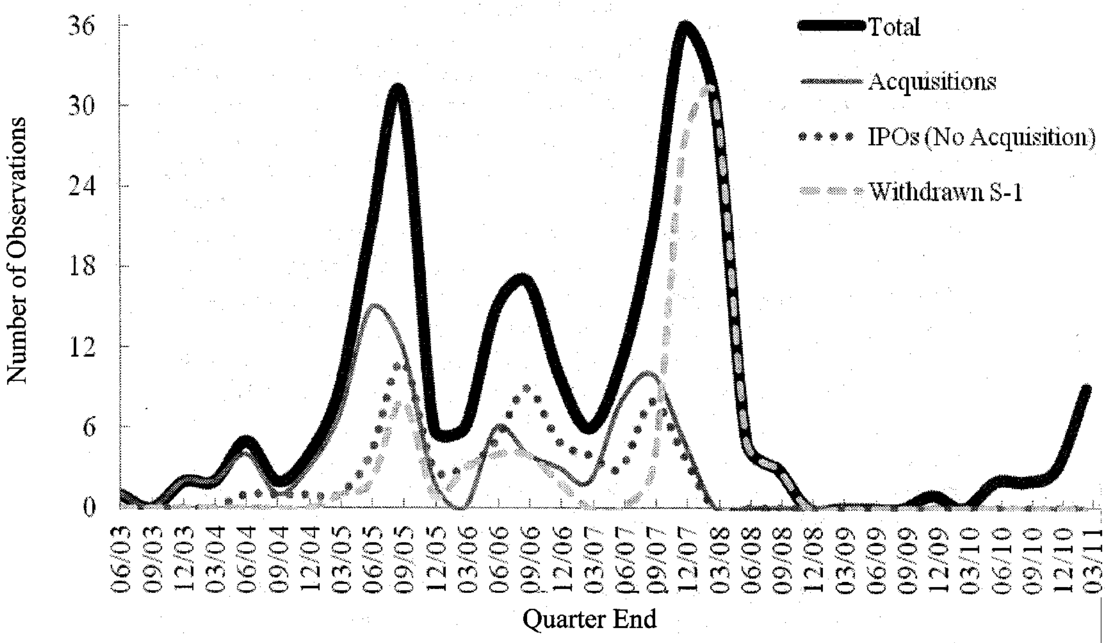
[341] *See, e.g.*, *supra* notes 174, 177, 180-82 and accompanying text (explaining the classic protection features of a SPAC).

[342] "% held in trust" is the amount actually held in the trust account divided by the total amount raised in the IPO. So if the amount paid by the sponsors for private placement shares or warrants exceeds the amount spent on offering costs and other miscellany, the number can exceed 100%.

Figure 2. SPAC Experience by Quarter




## VI. SHARED CONTRACTUAL STRATEGIES

This Part focuses on the investor protection strategies that SPACs borrow from traditional private equity. These strategies highlight the basic structural similarities between SPACs and their private equity cousins, and will ultimately allow us to appreciate the magnitude of SPACs' departures from the traditional private equity template in the areas of voice and exit.

### A. *Managerial Compensation: A Story of Convergence*

#### 1. The Magic 20

Venture capital managers receive 20% of any realized gains from the sale or IPO of portfolio companies, known as carried interest.[343] More than 50% of venture capital firms also charge an annual 2.5% management fee.[344] Although venture capital fund managers make a modest salary and bonus, the carried interest makes up the lion's share of their compensation.[345] Buyout fund managers follow a similar pattern, with managers receiving 20% of the profit.[346] They also charge investors a management fee of around 2%.[347] In addition, buyout funds also charge their portfolio companies management fees.[348]

The literature emphasizes the important role this compensation structure plays in constraining agency costs.[349] In the venture capital context, Professor Ron J. Gilson calls it "the front line response to the potential for agency costs resulting from allocating to the GP the control necessary to apply its skill and expertise on behalf of the investors."[350] In buyout funds, Professor Victor Fleischer observes:

> The carried interest thus provides the most powerful incentive to work hard. A large carry is one of the hallmarks of a private equity fund, and is considered essential to attracting talented managers. While private equity managers could live well on their base salaries alone, they would not be truly rich. Only the compensation of the carried interest of a successful fund can do

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[343] *See* Fleischer, *supra* note 38, at 8.

[344] *See supra* note 107 and accompanying text.

[345] *See* Sahlman, *supra* note 9, at 495 ("[T]he carried interest component of compensation is large in relation to other components."); *see also* Gompers & Lerner, *Analysis of Compensation*, *supra* note 9, at 6 (conducting an empirical study that found management fees of 1.5% to 3% and a large concentration of carry at 20%).

[346] *See supra* note 142 and accompanying text.

[347] *See supra* note 141 and accompanying text.

[348] *See* Kaplan & Strömberg, *supra* note 73, at 124.

[349] *See, e.g.*, Gilson, *supra* note 88, at 1089 (stating that venture fund compensation is the way for investors to keep management in line); Fleischer, *supra* note 100, at 97 (explaining that private equity managers can earn a salary anywhere, and that the funds' potential profits are what keep them committed).

[350] Gilson, *supra* note 88, at 1089.

> that, and it is the prodigious carry of successful private equity funds that lures professionals away from investment banks, commercial banks, and other investment management companies.[351]

As originally conceived, SPAC sponsors, like traditional private equity managers, received around 20% of the venture's profits.[352] This result was achieved by permitting those sponsors to buy a significant percentage of the SPAC shares, almost uniformly 20%, at a nominal amount.[353] In 211 of the 260 companies observed in Figure 3 below, sponsors received exactly 20% of the company in the form of pre-IPO share sales. As can be seen in the chart, 224 firms' sponsors received between 20.0% and 20.9%. Eleven firms received 16-19.9%, and another 8 firms received 21%-24.9%. These sponsor shares were placed in escrow, and released only upon the completion of the acquisition.[354] Thus, if the SPAC failed to find a suitable target or to gain approval of a proposed acquisition, sponsors did not receive a share of the trust account upon liquidation.[355] In addition, these shares had generally to be voted with the majority of shares held by public shareholders—in other words, the SPAC sponsors had to vote their stock in accordance with the public shareholders' wishes.[356] While it is hard to see how SPACs could be structured without this sponsor share escrow (because without the escrow the sponsors would immediately claim a sizeable share of the funds raised in the initial public offering), the escrowing of sponsor shares strongly motivates the sponsors to pursue a business combination at all costs.[357] Liquidation means that the sponsors

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[351]Fleischer, *supra* note 100, at 97.

[352]*See supra* notes 179-81 and accompanying text.

[353]*See, e.g.*, *supra* notes 179-81 and accompanying text (explaining how the system of SPAC sponsors buying shares in themselves works); *see also* Bank St. Telecom Funding Corp., Form S-1, *supra* note 185, at 16 (stating that post-acquisition, the sponsors will "collectively own approximately 20% of [the] issued and outstanding shares of common stock . . . .").

[354]*See supra* notes 179-82 and accompanying text.

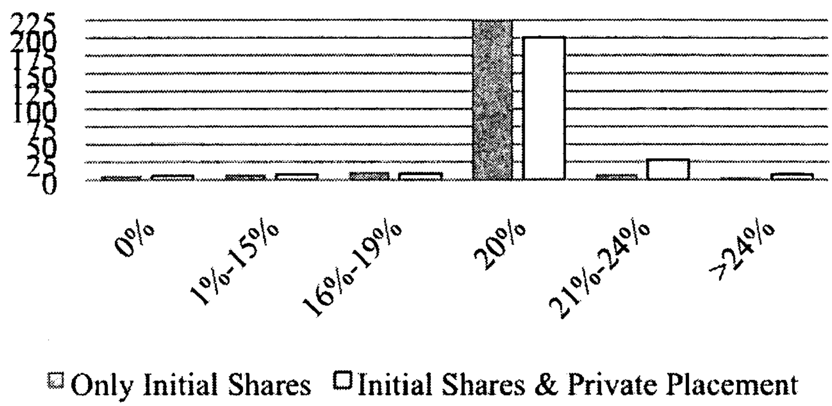
[355]*See supra* notes 179-82 and accompanying text.

[356]*See, e.g.* Michael A. Pittinger & Cara M. Grisin, *When SPACs Attack: The Role of Special Purpose Acquisition Companies in the M&A Market*, 12 DEAL POINTS: THE NEWSLETTER OF THE COMM. ON NEGOTIATED ACQUISITIONS, Fall 2007, at 4 n. 14 *available at* http://potteranderson.com/uploads/90/doc/Deal%20Points%20-%20Fall%202007%20issue%20SPAC%20article.pdf ("To ensure that any applicable stockholder vote requirements of the jurisdiction of organization are also satisfied, the founders typically agree to vote in favor of the proposed business combination or to vote their shares in accordance with the vote of the IPO shares.").

[357]*See supra* notes 179-82 and accompanying text; *see also* Roger Ehrenberg, *Does SPAC Spell Scam?*, SEEKING ALPHA (May 18, 2008), http://seekingalpha.com/article/77687-does-spac-

receive nothing; indeed, if a private placement occurred, the sponsors would be out of pocket for the SPAC expenses.[358]

Figure 3.




Strikingly, the managers of each type of fund expect to make the bulk of their money from their claim to 20% of the profits of the venture.[359] Below the surface, however, venture and private equity funds' managerial compensation have much more in common with each other than with SPACs. While they expect to reap most profits from carried interest (which, controversially, is taxed at the preferential capital gains rate),[360] they also claim salaries and management fees.[361] SPAC managers, in contrast, receive nothing unless and until a deal is consummated.[362]

However, SPAC sponsors receive their 20%—or at least, their shares are released from escrow and are thus liquid—upon acquisition.[363] In

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spell-scam ("SPAC sponsors . . . are all about getting the deal done, since the clock is always ticking on deploying their funds before they have to be returned to investors.").

[358] *See supra* notes 179-82 and accompanying text; *see also* Bonenfant, *supra* note 194 ("[F]ounders contribute nominal capital for 100% of the SPAC capital stock. After the initial capitalization, the founders and other sophisticated investors participate in a private placement to purchase SPAC securities. The proceeds of the private placement provide working capital to carry the SPAC through its IPO, and fund operating expenses until an acquisition is consummated.").

[359] *See supra* notes 108, 142, 179-86 and accompanying text.

[360] *See supra* note 109 and accompanying text.

[361] *See supra* notes 108, 142 and accompanying text.

[362] *See supra* note 182 and accompanying text.

[363] *See supra* notes 179-82. However, the sponsors' shares are subject to lock-ups. *See supra* note 196 and accompanying text.

contrast, VC and private equity managers receive money, not upon investment of the fund's assets in the portfolio company, but rather upon realization of profit (*i.e.* upon sale or IPO of that company).[364] So while of course managers of all three entities are motivated to pursue acquisitions, only SPAC sponsors are rewarded for the mere fact of acquisition.[365] Indeed, a common risk factor in SPAC prospectuses warns investors:

> [T]he [officers' and directors'] shares acquired prior to this offering, as well as the sponsors' warrants and any warrants purchased by our officers or directors in the aftermarket, will be worthless if we do not consummate our initial business combination. The personal and financial interests of our directors and officers may influence their motivation in timely identifying and selecting a target business and completing a business combination. Consequently, our directors' and officers' discretion in identifying and selecting a suitable target business may result in a conflict of interest when determining whether the terms, conditions and timing of a particular business combination are appropriate and in our stockholders' best interest.[366]

Interestingly, modern SPACs have reduced or delayed the sponsor's ability to realize all of the "Magic 20" upon acquisition.[367] For example, a recent SPAC provided that transfer restrictions limiting the ability of the sponsors to sell shares would lapse as certain milestones were reached: 20% upon acquisition, 20% after the closing price of the stock was over $12.00, and additional 20% increments when it reached $13.50, $15.00, and $17.00.[368] This conditioning of compensation on profit, rather than on

[364]*See* Gilson, *supra* note 88, at 1089. Clawbacks delay the GP's payout, or hold it back, until total performance is known. *Id.*

[365]*See* Ehrenberg, *supra* note 357.

[366]Hyde Park Acquisition Corp. II, Amendment No. 1 to Registration Statement (Form S-1/A), at 31 (June 10, 2011).

[367]Stuart Neuhauser, *Assessing the Resurgence of SPACs in the 2011 IPO Market*, IPO VITAL SIGNS (June 17, 2011), http://www.ipovitalsigns.com/PressReleases/6_20_11_Article.htm ("In addition, Generation III SPACs have either reduced the sponsor's ownership in the vehicle or provided for tranching/forfeiture of such interests based upon stock appreciation of the SPAC post business combination.").

[368]Empeiria Acquisition Corp., Amendment No. 4 to Registration Statement (Form S-1/A), at 6 (May 24, 2011).

investment, makes recent SPACs look even more like their private equity cousins.

### 2. "Skin in the Game"

The incentives of the SPAC sponsor are of critical importance. Initially sponsors put up little of their own money, but now they often purchase additional shares or warrants through a private placement[369] around the time of the offering, in the offering itself, or in the secondary market.[370] These purchases supplement the amount the sponsors have put at risk in the SPAC and increase their "skin in the game."[371]

Private placements also allow the SPAC to promise investors that close to 100% of the proceeds will remain in trust, as the private placement funds, rather than the offering proceeds, are used to pay the SPAC's operating expenses.[372] Sometimes these later-acquired sponsor shares carry with them no voting restrictions and allow for participation without restriction in any liquidation event.[373] In other cases, private placements are subject to escrow and other restrictions.[374] As seen in Table 2 below, the average (median) amount invested by the managers of the firms observed in a private placement was \$3.3 (\$2.5) million. This amount represents about 2.5% of the total amount of proposed proceeds. In addition, there were fifty-five SPACs, most of which were formed before 2006, for which there was no private placement at all.

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[369] In a private placement, securities are sold to a small number of investors to raise capital without a public offering. *Private Placement*, NASDAQ, http://www.nasdaq.com/investing/glossary/p/private-placement.

[370] *See* Ellenoff Grossman & Schole LLP, *"SPAC" Special Purpose Acquisition Corporation*, www.egsllp.com/SPACPPP.ppt (characterizing "[c]oncurrent [p]rivate [p]lacement/[s]ponsor [l]oans" as a "historical trend").

[371] *See id.*; Telephone Interview with Doug Ellenoff, Member of Ellenoff Grossman & Schole LLP (Mar. 4, 2011); *see also* Riemer, *supra* note 45, at 959 (describing how traditional money invested by SPAC sponsors constitutes "skin in the game").

[372] *See* Bonenfant, *supra* note 194.

[373] *See* Neuhauser, *supra* note 367 (stating that one of the objectives of newly developed SPACs is to "align[] the equity interests of the sponsor with investors and target businesses").

[374] *See, e.g.*, Catalytic Capital Inv. Corp., Registration Statement (Form S-1), at 2 (Mar. 24, 2006).

TABLE 2. STATISTICS FOR 270 PROPOSED SPACS THAT FILED AN S-1 FROM 2003 TO 2011

| | Mean | Median | Maximum | Minimum |
|---|---|---|---|---|
| Proposed IPO Proceeds ($mil) | $141.1 | $100.0 | $900.0 | $12.5 |
| Private Placement ($mil) | $3.3 | $2.5 | $35.0 | $0.0 |
| -2003 to 2005 (83 observations) | $0.8 | $0.0 | $11.3 | $0.0 |
| -2006 to 2011 (177 observations) | $4.6 | $3.8 | $35.0 | $0.0 |
| Private Placement / Prop. IPO Proceeds | 2.5% | 2.5% | 9.7% | 0.0% |
| -2003 to 2005 (83 observations) | 1.2% | 0.0% | 9.1% | 0.0% |
| -2006 to 2011 (177 observations) | 3.1% | 2.9% | 9.7% | 0.0% |

Indeed, as the SPAC form evolved, sponsors were expected to put more and more of their own money at risk (in the form of private placements), setting themselves up for substantial losses if no acquisition occurred.[375] In the interviews we conducted, we heard two explanations for the marked increase in private placements. The first is the "skin in the game" explanation: in the early years, successful SPAC sponsors received 20% of companies without risking much, and the consensus was that the market demanded more of a show of commitment from the managers.[376] The second explanation discounted the "skin in the game" theory, suggesting instead that the market's true concern was with pursuing shareholder protection through ever-larger escrow accounts.[377] The SPAC model is easily

[375] *See* Barker & Hedin, *supra* note 43, at 38 ("More recent deals are placing between 95-100% in trust (net of underwriters' compensation and expenses but not of other offering expenses). SPACs that place 100% into the trust account raise the necessary funds for their offering expenses and other expenses incurred in connection with identifying and evaluating a target business through private placements to, and borrowings from, the founding stockholders or sponsors.") (footnote omitted).

[376] *See* Telephone Interview with Doug Ellenoff, *supra* note 371.

[377] *See id.*

mimicked; the largely generic filings are publicly available,[378] and the company itself is merely an empty shell.[379] The primary way for a SPAC to distinguish itself from the rapidly multiplying number of competitors was to offer investors more of their money back if no acquisition occurred or if they exercised their opt-out rights.[380] This explanation correlates with the trend we discuss in Part VII, pursuant to which the SPAC trusts retained ever-higher percentages of the public offering proceeds.[381] Increasing amounts held in trust decreased the amount of offering proceeds available to run the SPAC.[382] Operating money had to come from somewhere else, and the SPACs' sponsors were the obvious choice.[383]

Whatever the reason, SPAC sponsors now commit their own money to the fund, an average of 2.5% of the IPO proceeds.[384] While a comparison to traditional private equity would be revealing, we have found little hard data on the amount that buyout and venture GPs invest in their own funds. Estimates range from 1%-5% of the capital of the fund.[385] The authors of one treatise recommend, as a minimum general partner investment, the lesser of 0.2% of total capital commitments and $500,000.[386] This may, however, be only a minimum.[387] For "marketing purposes"—to ensure an alignment of interests with investors—managers may be expected to contribute more capital to the fund.[388] One source reports that the mean contribution by

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[378] *See supra* note 323 for an explanation of EDGAR, the SEC's electronic filing system.

[379] *See supra* notes 172, 175-76 and accompanying text.

[380] *See* Wittlin & Ferris, *supra* note 241, at 2 (explaining the traditional SPAC structure).

[381] *See* M. Ridgway Barker & Michael L. Pflaum, *Exchanges for Listing SPACs – A Shifting Landscape*, THE METRO. CORP. COUNSEL 5, 5 (Jan. 2009), *available at* http://www.metrocorpcounsel.com/pdf/2009/January/05.pdf (stating that pursuant to new NYSE and NASDAQ rules, at least 90% of what is earned in the IPO must go into the trust account).

[382] *See* Barker & Hedin, *supra* note 43, at 38.

[383] *See id.*

[384] *See supra* Table 2.

[385] Fleischer, *supra* note 38, at 8; *see also* Karl S. Okamoto, *After the Bailout: Regulating Systemic Moral Hazard*, 57 UCLA L. Rev. 183, 229 (2009) ("[I]t is common for investors in hedge funds or private equity partnerships to insist that the managers themselves place a meaningful percentage of their own net worth at risk alongside the investors' money.").

[386] STEPHANIE BRESLOW & PHYLLIS SCHWARTZ, PRIVATE EQUITY FUNDS: FORMATION AND OPERATION § 2:5.3, at 2-28 (Practicing Law Inst., 1st ed. 2009). Tax reasons partly explain the requirement of GP investment. *Id.*; *see also* Fleischer, *supra* note 100, at 82 ("The GP also contributes about 1% of the capital to the fund. This amount, which is largely an artifact of tax history, is small in comparison to the carry and generally has a negligible effect on incentives.") (footnote omitted).

[387] BRESLOW, *supra* note 386, § 2:5.3[B], at 2-29.

[388] *Id.*

general partners was 3.25% for buyout funds and 2.1% for venture capital funds.[389]

Much remains unclear about the extent and reasons for managers' investment in the funds they oversee. What *is* clear is that the norm in traditional private equity is for managers to have some stake in the firm.[390] SPACs initially deviated from this pattern, but quickly conformed to it.[391] As Part VIII of this Article discusses, some commentators view managerial investment in traditional private equity as a mere "artifact of tax history."[392] But evidence that SPAC founders experienced evolutionary pressure to put up their own money, coupled with the move to condition the distribution of escrowed shares to the founders on performance goals, suggests that "skin in the game" might actually be significant in traditional private equity as well.[393]

## B. *Time Limit*

SPACs share with venture capital and private-equity firms the characteristic of a built-in fund life.[394] Venture funds are usually ten years in length, although they can be extended for up to three years, usually in one-year increments.[395] Private equity funds follow this pattern.[396] "[P]artners are automatically cashed out of the fund on expiration of the fund's limited term . . . ."[397] Sahlman calls the limited life of a VC fund "the ultimate tool for aligning the interests of the agent and principal . . . ."[398] "[T]he venture capitalist cannot keep the money forever," and knows he will be called to account at a certain date.[399]

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[389]Robert C. Illig, *Hedge Funds: The Missing Link in Executive Pay Reform*, 28 BANKING & FIN. SERVS. POL'Y REP. 10, 11 n.7 (2009) (citations omitted).

[390]*See supra* notes 385-89 and accompanying text.

[391]*See supra* note 370 and accompanying text.

[392]*See* Fleischer, *supra* note 100, at 82.

[393]*See supra* BRESLOW, *supra* note 386, § 2:5.3[B] ("[I]t is typically viewed as acceptable and even as *desirable* that a portion of the sponsor commitments come from other employees who will be actively involved in managing the funds.") (emphasis added).

[394]*See supra* note 337 and accompanying text.

[395]Sahlman, *supra* note 9, at 490.

[396]*See* Kaplan & Strömberg, *supra* note 73, at 123.

[397]Ribstein, *supra* note 150, at 299.

[398]Sahlman, *supra* note 9, at 501.

[399]*See id.* at 494, 501 ("The possibility that the interests of general and limited partners will diverge over time is addressed directly by limiting the lifespan on the venture-capital partnership. The ability to withdraw funding support is the ultimate tool for aligning the interests of the agent and principal in this organizational form, and is reinforced by the existence of the scale or scope

While SPACs also employ a fixed life, their life span is much shorter than that of the ten-year private equity fund.[400] Typically SPACs have an initial time limit, originally eighteen months—exactly paralleling the requirements of Rule 419.[401] As with venture capital and private equity funds, SPAC structures sometimes allow for an extension of the original time period (usually by six months) if a letter of intent with a target company is signed.[402] Counting the extension period, most SPACs impose a limit of two years on completing an acquisition.[403]

The variation in SPAC shelf life, as seen in Table 3 below, is striking. When the NYSE and NASDAQ began listing SPACs in 2008, they permitted a maximum of thirty-six months for a combination, which is the maximum we observed in our sample.[404] The minimum time permitted we observed is eighteen months, and the average allowed for a preliminary acquisition agreement to be reached was twenty-five months.[405] For our sample's thirty Third Generation SPACs (those SPACs with an initial S-1 filed from 2009-2011) the range is from fifteen to twenty-three months to complete an acquisition.[406] It thus appears that, unlike in the venture capital and private-equity context, no industry norm has emerged for SPAC duration.[407]

We posit that this lack of uniformity may be because the time limit constraint necessarily functions differently in the SPAC, where ownership is liquid, than in the private venture or buyout fund. For traditional investment funds, a fund's expiration date functions both to discipline managers and to provide liquidity to investors.[408] SPACs separate these functions. Public trading of SPAC shares guarantees a measure of liquidity.[409] SPACs

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economies and learning-curve effects.").

[400] *See supra* note 337 and accompanying text.

[401] *See* Derek K. Heyman, *From Blank Check to SPAC: The Regulator's Response to the Market, and the Market's Response to the Regulation*, 2 ENTREPRENEURIAL BUS. L.J. 531, 542 (2007) (explaining the timing similarities between Rule 419 and a typical SPAC).

[402] *See, e.g.*, Riemer, *supra* note 45, at 946 n.98 (explaining the normal time constraints on a SPAC).

[403] *See, e.g.*, *id.*

[404] *Client Alert: Nasdaq Joins NYSE and AMEX in Allowing Listing of Special Purpose Acquisition Companies (SPACs)*, Chadbourne & Parke LLP, (Aug. 20, 2008), http://www.chadbourne.com/clientalerts/2008/specialacquisition/.

[405] *See infra* Table 4.

[406] *See infra* Table 4.

[407] *See supra* notes 101, 134 and accompanying text.

[408] *See* Kaplan & Strömberg, *supra* note 73, at 123 (explaining how and why management divides up the ten year period in LBOs).

[409] *See* Heyman, *supra* note 401, at 543 (stating that SPACs now being listed on exchanges "increases their liquidity and access to capital . . . .").

generally trade at a slight premium to their share of the trust account, reflecting the option value that SPACs provide regarding future acquisitions.[410]

However, the SPAC model does require some kind of expiration date.[411] The time constraints associated with SPACs limit the amount of time managers have the trust account at their disposal.[412] Without them, investors might worry that managers will simply sit on the money indefinitely; a limited lifespan thus increases the value of the trust fund to investors.[413]

### C. *Concentration Limits*

Traditional private equity funds place limits on the amount that may be committed to any one acquisition, *i.e.*, on the amount that can be invested in a single company.[414] This contractual constraint prevents a fund from being overexposed to any one company.[415] What investors look for from these funds is a portfolio—a bench or lineup of companies.[416] It is understood that some companies will underperform, but ideally there will be one or two "home runs" that generate outsized returns that help produce the overall 20%-30%[417] return for which managers of these entities aim. Some may even specify certain percentages of asset classes the fund must hold.[418]

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[410]*See* Barker & Hedin, *supra* note 41, at 6 (stating that "the SPAC's common stock trades at a substantial premium . . . .").

[411]*See supra* note 404 and accompanying text.

[412]*See* Riemer, *supra* note 45, at 946 n.98 (citations omitted).

[413]*See id.* (describing the timeline of SPACs).

[414]Sahlman, *supra* note 9, at 496-99; Gompers & Lerner, *The Use of Covenants*, *supra* note 160, at 480.

[415]*See* Gompers & Lerner, *The Use of Covenants*, *supra* note 160, at 480 ("These provisions are intended to ensure that the general partners do not attempt to salvage an investment in a poorly performing firm by investing significant resources in follow-on funding.").

[416]*See supra* notes 102-03 (explaining "portfolio companies").

[417]*See* Edward Wolkowitz et al., *Debtor-in-Possession Financing in Mega-Cases: Transcript of Proceedings*, 39 SW. U. L. REV. 643, 669 (2010); *see also* Sandra Bosela, *Valuation – Spreadsheet or Napkin?*, 2005 J. BUS. VALUATION 229, 232 (2005) ("Historically, 25 to 30 percent was a common hurdle or target IRR for private equity investors.").

[418]Gompers & Lerner, *The Use of Covenants*, *supra* note 160, at 483.

TABLE 3. STATISTICS FOR 86 SPACS THAT COMPLETED AN ACQUISITION

| | Mean | Median | Max. | Min. |
|---|---|---|---|---|
| IPO proceeds ($mil) | $124.0 | $60.0 | $900.0 | $15.8 |
| Value of combination ($mil) | $254.0 | $128.4 | $3,403.4 | $13.0 |
| Value of comb. / IPO proceeds | 252.4% | 181.1% | 1,3507.7% | 13.0% |

SPACs, in contrast, are one-shot deals. In a traditional SPAC, any business combination must have a fair market value of at least 80% of the trust value.[419] This provision restricts the sponsors from being able to access the trust account for anything less than a substantial business combination (and also mirrors a Rule 419 requirement).[420] In Table 3 above, we show statistics on eighty-six of the eighty-seven transactions observed in which the SPAC was able to successfully acquire a target. As can be seen, the average amount paid for the acquisition is $254 million and the range of acquisition size is vast, especially in comparison to the range of IPO proceeds, from a minimum of $13.0 million to a maximum of $3.4 billion. Furthermore, the average value of the acquisition, scaled by the value of the IPO proceeds of 252%, exceeds the bar of 80% significantly.[421] However, Table 3 does show that about 10% of the acquisitions do not exceed the 80% hurdle. This is primarily for two reasons. First, we measured only the initial acquisition made. Second, our sample contained instances of SPACs renegotiating the SPAC's terms with shareholders, which we found lead to a partial liquidation of funds and thus a lower proceeds amount.

Although restrictions on the amount that may be committed in SPACs are the polar opposite to those in traditional private equity (*i.e.*, SPACs require commitment to one transaction, whereas venture and buyout funds require multiple investments), the restrictions are cut from the same cloth.[422]

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[419]*See, e.g.*, Davidoff, *supra* note 4, at 225.

[420]*See, e.g.*, Riemer, *supra* note 45, at 942 (stating that Rule 419 maintained an 80% rule as well).

[421]*See supra* note 420 and accompanying text.

[422]Davidoff, *supra* note 4, at 238 ("A SPAC has similar suboptimal risk-bearing characteristics vis-à-vis the private equity fund investment for which it ostensibly substitutes. A purchase of SPAC securities is typically an investment in a single, to-be-determined acquisition.") (footnote omitted).

In each case, the contractual limitation helps ensure that the managers honor the governing principle of the investment.[423] In the case of traditional private equity, the goal is investment in multiple private companies.[424] In the case of SPACs, it is investment in a single company.[425] Each form places contractual limits on investment amounts in order to achieve its specified end.[426]

### D. *Reporting of Information*

As private firms offering only to accredited investors, venture and private equity funds are exempt from the mandatory disclosure requirements of the Securities Act and the Exchange Act.[427] Buyout and VC investors nonetheless usually have contractual rights to receive periodic reports from their managers, in the form of fund-level financial statements.[428] Venture investors have annual meetings with the GPs and sometimes with the management of key portfolio companies.[429] They may receive written information on portfolio companies as well, at the discretion of the GP.[430]

As holders of publicly traded securities, SPAC investors receive the periodic reports required by the 1934 Act: annual reports, quarterly reports, proxy statements, and 8-Ks whenever material changes in the company occur.[431] However, this level of transparency is not as great as first impressions may suggest. SPACs' public filings are generally boilerplate; indeed, a main attraction of the form is that, because the company is a "shell," there is little of substance to disclose in the initial prospectus.[432] Once a firm is public, its quarterly and annual reports do little more than

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[423]*See id.* at 225.
[424]*Id.* at 189.
[425]*Id.* at 225.
[426]*See* Davidoff, *supra* note 4, at 225.
[427]Spindler, *supra* note 133, at 311.
[428]*See id.* at 327-28 (explaining the usual types of information private investors receive).
[429]Sahlman, *supra* note 9, at 492.
[430]*See* Spindler, *supra* note 133, at 327.
[431]*See* Riemer, *supra* note 45, at 963 ("SPACs must issue all reports and disclosures required of public companies, and they must also comply with the disclosure requirements of the exchanges on which they trade."); *see also* Bonenfant, *supra* note 194 (listing the SEC rules that SPACs must follow).
[432]*See SEC Restricts SPAC Managers' Warrant Purchases*, THE REVERSE MERGER REPORT, 14-15 (2005), http://www.littmankrooks.com/wp-content/uploads/2010/11/SEC-Restricts-SPAC-Managers-Warrant-Purchases.pdf.

disclose the interest earned by the trust account.[433] The SPAC files an 8-K to announce an acquisition target,[434] but until that announcement the SPAC investor is generally about as informed as her counterpart in a venture or buyout fund.[435]

### E. *Reputation and Serial Funds*

While the shelf life of an individual fund or SPAC is limited, successful managers in all three forms often create multiple funds within a family to leverage past successes and reap the benefits that accrue to repeat players.[436]

In their brief history, SPACs have been organized so close on each others' heels that the reputational value seems limited.[437] But we do see serial SPAC sponsors who tout their past successes.[438] For example, after Aldabra Acquisition Corporation successfully acquired the Great Lakes Dredge & Dock Corp., the same sponsors organized Aldabra 2 Acquisition Corp., Aldabra 3 Acquisition Corp., and Aldabra 4 Acquisition Corp.[439] It remains to be seen whether repeat SPAC sponsors will develop the reputational capital we posit is so crucial in traditional private equity.[440]

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[433]*See, e.g.*, Hicks Acquisition Co. II, Inc., Quarterly Report (Form 10-Q), at 7 (May 7, 2012) ("The Company has not generated any revenues, other than interest income earned on the proceeds held in the trust account established in connection with the Offering.").

[434]*See* Bonenfant, *supra* note 194.

[435]*See SEC Restricts SPAC Managers' Warrant Purchases*, *supra* note 432, at 15 ("SPACs regularly say in SEC filings before their public offerings that they have yet to find a company that they would like to acquire. That's because it would be more difficult for a SPAC to go public if it found an acquisition target first. The SPACs' filings with the SEC would then have to include detailed disclosures about the target company's business and finances.").

[436]*See* Riemer, *supra* note 45, at 958 n.182 (citation omitted) (quoting one equity manager as stating that "when a bank is evaluating a SPAC, 'management is almost as important as the type of structure used'").

[437]*See supra* notes 34-35 and accompanying text.

[438]*See* Riemer, *supra* note 45, at 958 n.182.

[439]*See* Aldabra 4 Acquisition Corp., Registration Statement (Form S-1) (Dec. 31, 2007); Aldabra Acquisition Corp., Amendment No. 2 to Registration Statement (Form S-4) (Nov. 8, 2006) (offering the merger of Great Lakes Dredge & Dock Holdings Corp.).

[440]*See supra* notes 18, 22-25 (explaining the importance of reputation in traditional private equity).

### F. *Conflicts of Interest*

One final difference between SPACs and traditional private equity merits attention before we move to the larger questions of voice and exit. Venture and buyout fund investors commonly use contractual constraints to mitigate managers' conflicts of interest.[441] In particular, venture funds place limitations on GPs' abilities to invest their own money in portfolio companies.[442] This limitation makes sense because "[i]f general partners invest in selected firms, they may devote excessive time to these firms and may not terminate funding if the firms encounter difficulties."[443] Other contractual provisions, such as restrictions on outside activities and requirements that GPs spend substantially all of their time managing the fund, ensure that managers do not shirk their responsibilities.[444] VCs also limit co-investments with earlier funds of the same family to ensure that a later fund is not propping up the poor choices of an earlier fund.[445]

In contrast, the original SPAC template specifies that management will not devote much time to running the SPAC.[446] SPACs disclose upfront to investors that conflicts are possible, and even likely, in light of these arrangements.[447] Consider, for example, the following language appearing in Bank St. Telecom Funding Corp.'s S-1:

> Our officers and directors are currently and may in the future become affiliated with entities, including other "blank check" companies, engaged in business activities similar to those intended to be conducted by us. . . . Our officers and directors may become aware of business opportunities that may be appropriate for presentation to us as well as the other entities with which they are or may be affiliated. . . . Accordingly, they

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[441] *See* Gompers & Lerner, *The Use of Covenants*, *supra* note 160, at 481-84 (describing the clashes that can exist between general partners and limited partners).

[442] *See id.* at 481.

[443] *Id.*

[444] *See, e.g.*, *id.* at 482 (explaining how investors may take care of conflicted management problems); *see also* Sahlman, *supra* note 9, at 492-93 (listing some common restrictions in management contracts). Such restrictions often apply for the first few years of the fund or until a set percentage of the funds has been invested. Gompers & Lerner, *The Use of Covenants*, *supra* note 160, at 482.

[445] Gompers & Lerner, *The Use of Covenants*, *supra* note 160, at 480-81.

[446] *See supra* note 184 and accompanying text.

[447] *See, e.g.*, Bank St. Telecom Funding Corp., Form S-1, *supra* note 185, at 12 (stating outright that conflicts are possible).

> may have conflicts of interests in determining to which entity a particular business opportunity may be presented. We cannot assure you that these conflicts will be resolved in our favor.[448]

HCM's S-1 states that "[o]ur officers and directors may tend to favor potential initial business combinations with target businesses that offer to reimburse any expenses that we did not have the funds to reimburse ourselves."[449] Consider also the following language appearing on Alpha Security Group's S-1:

> Since our directors own shares of our common stock which will be released from escrow only in certain limited situations, our board may have a conflict of interest in determining whether a particular target business is appropriate to effect a business combination. The personal and financial interests of our directors and officers may influence their motivation in identifying and selecting a target business and completing a business combination timely.[450]

The difference in strategy is striking. In traditional private equity firms, conflicts are painstakingly circumscribed. In the SPAC context, conflicts are cheerfully acknowledged. The investor is informed of their existence and warned to proceed at her own risk.[451] The manager may slack off or make decisions for his personal interest.[452]

To the extent the SPAC model works, it must be because other investor protections—the trust account, the liquidity provided by the public market, SEC regulation, etc.—counteract the contractual freedom of

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[448] *Id.*; *see also* Alpha Sec. Grp. Corp., Form S-1, *supra* note 184, at 13-14 (stating similar language).

[449] HCM Acquisition Co., Form S-1, *supra* note 186, at 86.

[450] Alpha Sec. Grp. Corp., Form S-1, *supra* note 184, at 48.

[451] *See supra* notes 446-50 and accompanying text.

[452] *See supra* notes 446-50 and accompanying text. There are hints, in the last quarter of 2011, that this tolerance of conflicts of interest might be changing. *See, e.g.*, Chart Acquisition Corp., Registration Statement (Form S-1), at 4 (Oct. 13, 2011) ("[O]ur officers and directors have agreed not to participate in the formation of, or become an officer or director of, any blank check company until we have entered into a definitive agreement regarding our initial business combination or we have failed to complete our initial business combination within 21 months from the date of this prospectus."); HBC Acquisition Corp., Registration Statement (Form S-1), at 5 (Sept. 6, 2011) (stating similar language); ROI Acquisition Corp., Registration Statement (Form S-1), at 7 (Oct. 14, 2011) (stating similar language).

managers to act in their own interest. We now turn to the two chief protections for SPAC investors: voice and exit.

## VII. EVOLUTION IN INNOVATION: VOICE AND EXIT IN SPACS

Beyond the investor protections detailed in Part VI of this Article, there are two obvious mechanisms for disciplining managers: (1) giving investors a say on the investment,[453] and (2) allowing investors to commit capital in stages—*i.e.*, to withhold a portion of the investment if the managers underperform,[454] and exit if the going gets rough.[455] These mechanisms are conspicuously absent from traditional private equity contract designs.[456] Fund investors have no real voice in managing the funds they own.[457] And, while staged investments—a form of exit where initial capital commitments are only partially funded up front—are the norm, funds punish cold-footed investors by diluting their positions.[458] In addition, the reputational costs of defaulting on a capital call are high—investors who renege on their commitments might find themselves frozen out of future funds.[459]

In contrast, SPAC entrepreneurs broke the private equity mold by allowing their investors both voice and exit. As to voice, shareholders had a formal vote on a proposed acquisition and a second de facto vote via the conversion threshold.[460] And SPAC investors enjoyed not only the liquidity

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[453]*See supra* note 188 and accompanying text (discussing the SPAC shareholders' voting rights).

[454]*See* Douglas S. Ellenoff, *Generation III—The New Mechanics of SPACs*, ELLENOFF GROSSMAN & SCHOLE LLP, 11 (2010), http://www.egsllp.com/DSESPACArticle.pdf (describing a SPAC's "redemption threshold").

[455]*See supra* note 177 (discussing the SPAC shareholders' rights to receive their money back if they vote against the acquisition); *see also* Riemer, *supra* note 45, at 960 ("[T]he worst-case scenario for SPAC investors is that they are refunded the portion of their initial investment that had been accruing interest in escrow, instead of the more dramatic potential returns of a merger.").

[456]*See supra* notes 87-88, 137 and accompanying text (stating that investors in venture and LBO funds have limited rights).

[457]*See supra* notes 87-88, 137.

[458]*See, e.g.*, Stephen Harris, *Overlooking Private Equity Partnerships Can Be Costly Mistake Secondary Market Offers Liquidity for Limited Partners*, TURNAROUND MGMT. ASS'N (Nov. 1, 2006), http://www.turnaround.org/Publications/Articles.aspx?objectID=6735 ("Once a limited partner makes a commitment to a fund, it cannot withdraw or otherwise discontinue its participation without incurring onerous penalties.").

[459]*See, e.g.*, David Rosenberg, *The Two "Cycles" of Venture Capital*, 28 J. CORP. L. 419, 421 (2003) (describing how both GPs and LPs are incentivized to avoid developing a negative reputation).

[460]*See, e.g.*, Riemer, *supra* note 45, at 954-55 ("Unless a majority of investors affirmatively

of publicly traded stock, but also the guarantee of 85% of their initial investment if they held until acquisition or dissolution.[461] These powerful investor protections made the investment vehicle attractive to initial investors, but turned out to make it much harder to get a deal done (*i.e.*, to actually acquire a target).[462] Without reputational constraints limiting investor opportunism, SPAC managers found themselves vulnerable to holdup.[463]

To orient readers, we remind them of some key historical dates. From the beginning of the second wave of SPACs in May 2003, SPACs grew steadily in number until July 1, 2005, when AMEX began to list them on its exchange.[464] The form then exploded, with sixty-seven S-1s filed leading to fifty-five IPOs in 2005, forty-seven S-1s and thirty-five IPOs in 2006, and seventy-four S-1s leading to forty-four IPOs in 2007.[465] The NYSE and NASDAQ allowed SPACs to list in 2008, but the financial crisis meant that very few SPACS were formed after the second quarter of 2008, and fewer still went public.[466]

In the post-crisis period, SPACs have reemerged from dormancy.[467] These new SPACs have developed significantly different provisions to respond to the problems of hedge fund vote gaming and greenmailing.[468] One SPAC, 57th Street General Acquisition Corporation, went public in 2009, and in May 2011 it acquired Crumbs Holdings LLC, a New York-based gourmet cupcake seller.[469] Seven other SPACS went public in 2010

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approve a combination, and less than twenty percent of investors vote against the combination, the fund is dissolved and investors are entitled to a pro rata share of the escrow account.").

[461] *See id.* at 945 & n.96 (stating that 85-95% was the amount in trust); *id.* at 954-55 (stating how the investor's input determines the outcome of the SPAC).

[462] Neuhauser, *supra* note 367 ("One of the main impediments in consummating SPACquisitions in 2008/09 was the redemption threshold which provided that a business combination could not proceed unless a majority of the public shareholders approved a deal and that no more than 30% (or some other specified %) of the public shareholders requested their capital returned.").

[463] *See supra* notes 62, 190 and accompanying text.

[464] *See supra* notes 235-38 and accompanying text.

[465] *See supra* note 239 and accompanying text; *infra* Table 4.

[466] *See supra* notes 240-42 and accompanying text.

[467] *See supra* note 243 and accompanying text.

[468] *See supra* note 207 (discussing the "greenmailing" problem); Neuhauser, *supra* note 367 (describing how modern SPACs are evolving); *see also* Friedmann & Larson, *supra* note 62 ("While conventional IPO investors eschewed SPAC offerings, many hedge funds sought out SPAC investments. These hedge funds appear to have been attracted to SPACs by the opportunity to profit on their investments through arbitrage trading strategies, rather than a buy and hold approach.").

[469] 57th Street General Acquisition Corp., Owner of Crumbs Holdings LLC, Announces Changes to Its Ticker Symbols, CRUMBS BAKE SHOP (May 10, 2011), http://investors.crumbs.com/

(and twenty-two in 2011), but it is too soon to tell if they will complete acquisitions.[470] We include the characteristics of this third generation of SPACs[471] in Table 4 below, but (with the exception of 57th Street) these SPACs have emerged too recently for us to provide data on outcomes.

The public nature of SPACs allows us to track at a granular level SPACs' grand experiment in giving public investors voice and exit.[472] Outside the sheltered confines of traditional private equity, the market provided continuous feedback into which features of the SPAC contract design worked – and which did not.[473]

TABLE 4. MEAN CHARACTERISTICS OF SPACS BY YEAR PRELIMINARY PROSPECTUS IS FILED

| | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 |
|---|---|---|---|---|---|---|---|---|---|
| IPO proceeds ($mil) | $22 | $39 | $76 | $104 | $238 | $181 | $50 | $78 | $92 |
| Unit price | $6.00 | $6.32 | $7.17 | $7.74 | $9.55 | $9.74 | $10.00 | $8.57 | $10.00 |
| Warrant strike price | $5.00 | $5.00 | $5.34 | $5.80 | $6.68 | $7.18 | $11.50 | $9.56 | $10.89 |
| Strike prc. > Unit prc. | 0% | 0% | 0% | 0% | 0% | 0% | 100% | 71% | 78% |
| Months for combo | 24.0 | 23.1 | 23.5 | 24.0 | 26.8 | 28.9 | 15.0 | 21.4 | 23.0 |
| Conversion threshold | 20.0% | 20.0% | 20.7% | 23.9% | 32.5% | 35.1% | 88.0% | 63.3% | 74.4% |
| % in trust | 85.0% | 86.2% | 93.2% | 97.7% | 99% | 99% | 100% | 97.2% | 100% |
| Pvt. place./ IPO prcds. | 0% | 0% | 1.4% | 3.2% | 3.1% | 3.0% | 3.7% | 3.0% | 4.3% |
| % listed on OTC | 100% | 100% | 68.7% | 31.9% | 14.9% | 12.8% | 100% | 85.7% | 77.8% |
| No IPO | 0.0% | 0.0% | 17.9% | 25.5% | 40.5% | 100% | - | - | - |
| IPO, no acquisition | 0.0% | 23.1% | 28.4% | 46.8% | 25.7% | 0.0% | - | - | - |
| Acquisition | 100% | 76.9% | 53.7% | 27.7% | 33.8% | 0.0% | - | - | - |
| N | 3 | 13 | 67 | 47 | 74 | 39 | 1 | 7 | 22 |
| Total other IPOs[474] | 62 | 174 | 160 | 157 | 160 | 21 | 41 | 96 | NA |

releasedetail.cfm?ReleaseID=575644.

[470] *See infra* Table 4.

[471] *See* Neuhauser, *supra* note 367 (referring to modern SPACs as "Generation III SPACs").

[472] *See id.* (stating that "the resurgence [of SPACs] is due to the *new structure* of Generation III SPACs first introduced in May 2010 with 57th Street Acquisition Corp's IPO . . . .") (emphasis added).

[473] *See id.*

[474] Jay Ritter provides data on non-SPAC IPOs. He includes only IPOs with an offer price of $5.00 or more; excluding ADRs, unit offerings (thus excluding all firms in our sample), closed-end funds, REITs, partnerships, banks, S&Ls, and stocks not listed on CRSP. Jay R. Ritter, *Initial Public Offerings: Tables Updated Through 2010*, 1-2 (Jan. 27, 2011), http://bear.warrington.ufl.edu/ritter/IPOs2010Statistics111.pdf.

## A. *Voice*

Venture investors have little say over the individual investment choices of fund managers.[475] Some funds establish advisory boards, which may have limited partner representation.[476] Still, Professor Ronald J. Gilson terms these boards "largely inconsequential."[477] The GP has "virtually complete control."[478]

The same is true in buyout funds. Indeed "[t]he reason for choosing the limited partnership form is principally to limit the control rights that limited partners will have over the partnership."[479] Investors in the buyout fund usually do not have much voting power.[480] These investors typically lack even the right to replace poorly performing managers.[481] In the few cases when an LP has control rights, she might have a "general reluctance" to exercise them.[482] As Spindler explains, "[m]any of the investors are repeat players, such as funds-of-funds, insurance companies, pensions, and other institutional investors, and do not want to acquire reputations as troublemakers, which would deny them investment opportunities in the future."[483]

In contrast, early SPACs provided robust control rights to investors. First, these SPACs required a majority of shareholders to approve the proposed acquisition in order for the acquisition to go through.[484] Second, even if a majority of shareholders approved the transaction, individual shareholders who voted against it could exercise their right to receive their pro rata portion of the escrowed funds if the combination occurred (a "put right" or "right of rescission").[485] This redemption right translated into a

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[475]*See, e.g.*, Gilson, *supra* note 88, at 1088 ("Most important, the investors are prohibited from insisting on an approval right of the GP's investment decisions.").

[476]*See id.*

[477]*Id.*

[478]*Id.*

[479]Spindler, *supra* note 133, at 328.

[480]Ribstein, *supra* note 150, at 299.

[481]*See* Spindler, *supra* note 133, at 328-29 ("[T]he limited partner has very little control over what that capital is used for and usually very little right to replace management—or other such remedies—subsequent to poor performance."). Private equity limited partners can step in, however, "upon some fairly major event, such as the departure of key management personnel of the general partner or the bad actions of the general partner." *Id.* at 329.

[482]*Id.* at 330.

[483]*Id.*

[484]*See* Riemer, *supra* note 45, at 961-62.

[485]*See, e.g.*, *id.* at 945-46, 961 (noting a SPAC investor's "right of rescission" after the acquisition is announced).

secondary veto power because most SPACs specified that if a given percentage of shares (the "conversion threshold") voted to redeem their shares from the trust account, the acquisition would not go forward[486]—effectively imposing a supermajority approval requirement.[487]

Most early SPACs hewed to a 20% conversion threshold.[488] Looking at Table 1 above, the lowest threshold observed was 20%; but within our sample, 110 SPACs used this threshold. Notably, each of these 110 entities was formed prior to February of 2007.[489] Table 1 shows that that the median conversion threshold for all entities, including those formed in later years, is 30%. The NYSE and NASDAQ both require that the threshold be no more than 40%.[490] The average conversion threshold in our sample in Table 1 above is 27.2%. As seen in Table 4 above, the mean conversion threshold did not rise above 30% until 2007; and not until 2009 was the average above 50%.

Why have these changes occurred? These shareholder approval provisions were important in convincing the SEC to allow SPACs to go public,[491] but they created an unintended consequence: a holdout right.[492] During the recent financial crisis, investors became desperate for havens in which to invest their money.[493] SPACs' trust funds provided a safe harbor

[486]*See supra* note 43 and accompanying text (explaining the investor's "conversion right").

[487]*See* Joe Barbeau et al., *Deal-Breakers*, DAILY J.: FOCUS COLUMN 7 (2009), *available at* http://www.gibsondunn.com/publications/pages/Deal-Breakers.aspx (identifying the "difficulty [in] getting supermajority approval (usually, 80 percent is required)" as a problem inherent in SPACs).

[488]*See* Riemer, *supra* note 45, at 954-55.

[489]*See, e.g.*, Pantheon China Acquisition Corp., Registration Statement (Form S-1), at 7 (Aug. 14, 2006) ("We will proceed with a business combination only if (i) a majority of the shares of common stock voted by the public stockholders are voted in favor of the business combination and (ii) public stockholders owning less than 20% of the shares sold in this offering exercise their conversion rights . . . .").

[490]Barker & Pflaum, *supra* note 381, at 5.

[491]*See* Bonenfant, *supra* note 194 ("Historically, the SEC has been concerned about development stage company filings as evidenced by the adoption of Rule 419. This concern is also reflected in the SEC's review of the structural elements and features of SPAC offerings.").

[492]*See supra* note 62 and accompanying text.

[493]*See* Harvey Jones, *No Guaranteed Safety in Financial Safe Havens*, THE NAT'L (May 5, 2012), http://www.thenational.ae/lifestyle/person-finance/no-guaranteed-safety-in-financial-safe-havens ("In these troubled times, safety first is the motto for many investors. Nobody wants to lose all their money in another banking, property, stock market or currency crash. Yet the world is running out of safe havens."). Readers may remember that even money market funds began to seem risky. After the oldest money market in the United States, the Reserve Primary Fund, "broke the buck" (*i.e.*, cut its share price to below $1.00), the Treasury Department stepped in to backstop these investments. Saule T. Omarova, *From Gramm-Leach-Bliley to Dodd-Frank: The Unfulfilled Promise of Section 23A of the Federal Reserve Act*, 89 N.C. L. REV. 1683, 1740-41 (2011).

that made SPACs an increasingly attractive investment, regardless whether an acquisition took place.[494] Indeed, it was around this time that reports of "greenmailing" emerged, as hedge funds realized that they could use the power of withholding approval votes to gain concessions from SPAC managers eager to close a deal.[495] The business form then all but disappeared.[496] Not a single SPAC IPO occurred in all of 2008.[497]

In more recent years, SPACs have recreated themselves and reemerged, addressing the problem of shareholder voice by taking it away.[498] 57th Street General Acquisition Corp., ("57th Street"), the first of these new generation SPACs,[499] provides a good example of the changing nature of SPACs. The prospectus for 57th Street has no requirement of shareholder approval by vote.[500] Instead, it employs a tender offer mechanism, offering to buy shares back from shareholders unhappy with the proposed transaction.[501] The tender offer removes the holdup value from would-be hedge-fund arbitrageurs; they can no longer threaten a negative vote to gain consideration from the SPAC.[502] If they want to cash out, they must put up their shares.[503] 57th Street retains the conversion threshold concept, but the level is high: the holders of more than 88% of shares must tender their shares

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[494]*See The Cauldron: Healthcare Costs, Pension Funds, LBOs, SPACs and PIKs*, THE ECON. POPULIST, http://www.economicpopulist.org/content/cauldron-healthcare-costs-pension-funds-lbos-spacs-and-piks ("The recent popularity of SPACs, which are a controversial investment class due to their high risk characteristics, . . . appears due almost wholly to investor demand for 'private equity-type' investment.").

[495]*See, e.g.*, Jonathan Keehner, *For Blank-Check IPOs, Popularity Comes At a Price*, REUTERS (Feb. 25, 2008), http://www.reuters.com/assets/print?aid=USN2465188420080225 (discussing the issue of "activist investors" in SPACs completing acquisitions).

[496]*See supra* note 241 and accompanying text.

[497]*See supra* note 242 and accompanying text.

[498]*See* Neuhauser, *supra* note 367 (stating that modern SPACs have "do[ne] away with the shareholder approval process").

[499]*See supra* note 472.

[500]*See* 57th St. Gen. Acquisition Corp., Form S-1, *supra* note 333, at 58.

[501]*Id.* ("Unless otherwise required by law, our stockholders will not have the opportunity to vote on our business transaction. In the event we are required to seek stockholder approval in connection with our initial business transaction, we will send each stockholder a proxy statement containing information required by the SEC.").

[502]*See* Order, *supra* note 190, 2010 WL 5301044, at *5-*6 (ruling that SPACs may pursue the tender offer route if they wish).

[503]*See* 57th St. Gen. Acquisition Corp, Form S-1, *supra* note 333, at 58 ("[A] stockholder who follows the procedures described in the proxy statement will be given the right to put his shares of common stock to us for a pro rata share of the trust account."). Note that the initial mechanism described was a "put right," but the SEC required 57th Street to conduct a tender offer. *See id.*

in order for the business combination to fail.[504] If fewer than the 88% threshold amount of shareholders tender their shares, the deal goes through.[505] Furthermore, 57th Street included a "bulldog provision,"[506] restricting the right to tender shares to holders of less than 10% of the shares.[507] The S-1 observed:

> We believe this restriction will discourage stockholders from accumulating large blocks of shares, and subsequent attempts by such holders to use their put right as a means to force us or our management to purchase their shares at a significant premium to the then current market price or on other undesirable terms.[508]

Our data show this evolution. As seen in Table 4 above, in the post-2007 period, the lowest average conversion threshold is 63.3% in 2010, with the highest conversion threshold set at 88% for the lone SPAC of 2009 we observed. This change has shifted power over acquisition decisions to SPAC managers in a dramatic way.[509] We argue in Part VIII of this Article that this loss of the vote occurred because the vote became more trouble than it was worth to shareholders, given the other protections SPACs afforded their investment. The next section explains why.

### B. *Exit*

Exit refers to the ability to get out of an investment that has gone sour.[510] Venture and buyout funds provide their investors with limited exit rights—or at least, the right to limit their losses by staging their investments.[511] However, exercising the right not to contribute further can

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[504]57th St. Gen. Acquisition Corp, Form S-1, *supra* note 333, at 52.

[505]*See id.*

[506]This term is coined after Bulldog Investors. *See* Ted Wallace, *Hedge Fund Activism Extends to SPACs*, HARV. LAW SCH. F. ON CORP. GOVERNANCE AND FIN. REG. (Feb. 1, 2009, 10:03 AM), http://blogs.law.harvard.edu/corpgov/2009/02/01/hedge-fund-activism-extends-to-spacs/#more-840 ("[M]any SPACs now incorporate a 'bulldog' provision – preventing any investor (or group) from holding more than 10% of the shell company to exercise conversion rights (and thus force the scuttle of an already-approved merger).").

[507]*See* 57th St. Gen. Acquisition Corp, Form S-1, *supra* note 333, at 11.

[508]*Id.*

[509]*See supra* notes 498-508 and accompanying text.

[510]*See* HIRSCHMAN, *supra* note 56, at 4.

[511]*See* Litvak, *Governance Through Exit*, *supra* note 9, at 772-73 (stating that venture

be costly.[512] Professor Kate Litvak has documented the punitive dilution that funds impose for failure to invest more.[513] In addition, the reputational costs of failing to meet capital calls is often steep because investors tend to be repeat players who can be cut out of later transactions.[514] In short, the hold-back right in traditional private equity imposes some discipline upon poorly performing managers, but it is a weak right at best.[515]

In contrast to traditional private equity, SPACs provide investors a highly meaningful form of exit. SPACs characteristically agree to hold 90% or more of the offering proceeds in escrow, as Rule 419 requires.[516] These funds in turn cannot be used for the company's day-to-day operations (although the interest earned thereon may be),[517] and must be invested in government obligations or treasury securities.[518] To protect the trust value, SPACs generally obtain waivers from vendors and targets on any claims to the escrowed funds.[519] As seen in Table 1 above, the percent held in trust ranges from a low of 82.8% to a high of 110%, with a mean and median of 96.3% and 98%, respectively. Most of these percentages exceed those required by the AMEX (which requires that at least 85% of the funds be placed in escrow)[520] and the NASDAQ and NYSE (which set a 90% threshold).[521] If the SPAC fails to locate a target and gain shareholder approval for that target's acquisition, then each shareholder receives a pro

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capitalist can stage their investments).

[512] *See id.* (stating that a venture capitalist investor's default may be unwise).

[513] *See id.* at 808-09 (explaining the factors that correlate with "weaker investor walkaway rights").

[514] *See* Victor Fleischer, *Fickle Investors, Reputation, and the Clientele Effect in Venture Capital Funds*, 40 WILLAMETTE L. REV. 813, 817 (2004).

[515] *See id.* We can find little data on whether buyout funds also stage investments and impose similar punishments on investors who fail to meet capital calls, but several sources indicate that this is the case. *See, e.g.*, Spindler, *supra* note 133, at 330 ("[E]ven where some degree of control exists, there appears to be a general reluctance to exert control rights.").

[516] Sjostrom, *supra* note 1, at 758.

[517] *See, e.g.*, HCM Acquisition Co., Form S-1, *supra* note 186, at 79 (noting that interest income may be used to pay income taxes and up to $3 million can fund working capital requirements).

[518] 17 C.F.R. §§ 230.419(b)(2)(i)-(iv) (2011).

[519] William H. Hinman, Jr., *Special Purpose Acquisition Corporations*, *in* SPECIAL PURPOSE ACQUISITION CORPORATIONS, at 510 (PLI Corp. Law & Practice Course Handbook Series, No. 14864, 2008); *see also* Bank St. Telecom Funding Corp., Form S-1, *supra* note 185, at 9.

[520] Mark Cecil, *State Attorneys General: Set to Attack SPACs*, MERGERS & ACQUISITIONS REPORT, at 1 (Aug. 22, 2005).

[521] Camille Formosa et al., *SPACs 2.0: New SPAC Rules Changes Approved By NASDAQ And NYSE AMEX And New Market Features Make SPACs A More Attractive Investment Vehicle In 2011*, MARTINDALE.COM (Mar. 21, 2011), http://www.martindale.com/securities-law/article_Sheppard-Mullin-Richter-Hampton-LLP_1258884.htm.

rata share of these escrowed funds.[522] Thus, the more funds that a SPAC can hold in trust, the more attractive a SPAC will become to an investor—the higher the percentage in trust, the less risk to the investment.[523] As demonstrated in Table 4 above, this avoidance of loss makes the (unreported) standard deviation of 4.5% a non-trivial amount of variation when viewed as a percentage loss over a 24-month period. As the table shows, there is an increase in the average percent of proceeds kept in the trust account, rising in a linear fashion from a low of 85% in 2003 to an average of 99% in 2007 and 2008. In 2009 and 2011 the average is 100%, while it is 97.2% in 2010.

This average percent of the proceeds from the IPO increases due to two sources of cash. The first is private placements of warrants by managers, which was discussed in Part VI.A of this Article—the "skin in the game."[524] In Table 4 above, we show that these private placements began to appear in SPAC offerings in 2005 and now represent a relatively small, but growing, proportion of proposed IPO proceeds, ranging from a low of 1.4% in 2005 to a high of 4.3% in 2011. Second, SPAC underwriters began offering to defer a portion of their compensation until the hoped-for acquisition actually closed.[525] Underwriters are generally quite resistant to negotiating down this portion of their compensation—the so-called "discount" at which they buy the shares from the corporation before selling them to the public at full price.[526] In future work we will explore the implications of the banks' willingness to defer this typically fixed portion of underwriter compensation.

As the SPAC evolved, the trust account became more and more important.[527] The ability to offer investors an increasingly "cheap look" at an investment, if not an entirely "free look," apparently outweighed the loss of

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[522] *See* Riemer, *supra* note 45, at 954-55.

[523] *See* Barker & Hedin, *supra* note 43, at 38.

[524] *See supra* Part VI.A.2.

[525] Heyman, *supra* note 401, at 546.

[526] *See* Riemer, *supra* note 45, at 954 n.162 ("An investor's pro rata share is equal to the total amount of funds held in escrow, plus any interest earned, *less any amount held in escrow representing a portion of the underwriter's discount*. . . .") (emphasis added); Andres Rueda, *The Hot IPO Phenomenon and the Great Internet Bust*, 7 FORDHAM J. CORP. & FIN. L. 21, 30-31 (2001) ("[U]nder the cartel-like price structure that prevailed among the half-dozen or so market players that dominated investment banking during the Internet boom, the usual fee was a flat, non-negotiable seven percent underwriter's discount.").

[527] *See* Neuhauser, *supra* note 367 (stating that in modern SPACs, "from the investor point of view, all of the funds continue to be protected in a trust account and they continue to be provided with the right to a return of their capital").

protections afforded by shareholder voting rights.[528] From the firm's perspective, the trust account provides a pool of collective capital that serves as currency for an acquisition and a check on managerial discretion.[529] SPACs generally finance their acquisitions using a combination of the unclaimed capital in the trust account and newly issued stock.[530] Even in Third Generation SPACs, where the conversion threshold is high, if too many SPAC shareholders tender their shares, then the scant equity available for the deal might well make targets reluctant to go through with the acquisition.[531] The threat of this reluctance will, in turn, discipline fund managers to pursue those deals built around maximizing shareholder returns.[532]

In sum, SPAC entrepreneurs enticed would-be investors by offering voice and exit, two notable deviations from the traditional private equity contract design. The voice experiment fell prey to investor opportunism; unconstrained by reputation, empowered investors quickly morphed into holdup artists.[533] Exit, however, proved to be a valuable constraint on managers by giving unhappy investors the right to walk away.[534]

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[528] *See id.*; *see also* Dennis Dick, *Can the J-Shaped Liquidity Curve Write a Prescription?*, CFA MAGAZINE, 28 (Sept.-Oct. 2011), *available at* http://premarketinfo.com/in-the-media/ (discussing a general "cheap look"). The trust account can fruitfully be viewed in a number of ways. From the perspective of the individual investor, it creates a kind of option on a subsequent, yet-to-be-determined acquisition. *See* Neuhauser, *supra* note 367. The option takes an unusual form, in that the full purchase price is paid up front: what the initial investor buys is a robust option to abandon the investment, that is, to receive almost all her money back if she dislikes the acquisition the SPAC management proposes. *See* Riemer, *supra* note 45, at 954 & n.162, 955 (explaining what the dissenting investor receives). Looked at in this way, for the purchase of a SPAC with a unit price of $10.00 and a trust value of $9.75, $0.25 is the price for the option to abandon the investment. *See* Tim Jenkinson & Miguel Sousa, *Why SPAC Investors Should Listen to the Market*, at *10 (February 12, 2009), *available at* http://ssrn.com/abstract=1331383. But SPAC shares are traded publicly, and as such present daily opportunities to sell—in that sense, the option to abandon is inherent in being publicly listed. *See id.*

[529] *See* Order, *supra* note 190, 2010 WL 5301044, at *3 ("[S]PACs often use stock as consideration for the business combination and cash in the trust account is used to redeem shareholders and possibly finance the operation of the target.").

[530] *See id.*

[531] *See* Wittlin & Ferris, *supra* note 241, at 4 ("Some SPAC targets, however, may not wish to close a transaction with a SPAC that has substantially less cash than originally anticipated, even if the ownership percentage of the SPAC's shares by the target's stockholders is increased to reflect the reduced amount of cash in the SPAC.").

[532] *See id.*

[533] *See supra* notes 485-88, 495 and accompanying text.

[534] *See supra* note 528 and accompanying text.

### C. *The Case of EarlyBirdCapital, Inc.*[535]

Before we move to consider the implications of the changes in contractual design that we see in SPACs, we must consider one question: does the change we observe in SPAC structure result from the entry of new investment banks, bringing with them idiosyncratic innovations to SPAC structures, or is it a more widespread change in the way that SPACs are structured in response to competitive pressures? The answer to this question is important; if the change is due to new entrants, then any argument that SPAC structure has evolved for particular reasons (*i.e.*, problems of hedge fund vote gaming and "greenmailing")[536] is weak. New, innovative SPACs might exist side by side with old-style SPACs, resulting in an aggregate of data and creating the illusion of evolution from mere multiplicity. However, if we observe the structure of SPACs changing for a particular underwriter over time, then the argument for this change being attributable to general evolution, instead of mere diversity of industry, becomes more convincing.

In Table 5 below, we examine the characteristics of SPACs in which the lead underwriter is EarlyBirdCapital—the innovator, and second most prolific lead underwriter, of SPACs in our sample period.[537] Most of the characteristics of EarlyBirdCapital's deals exhibit the same shift as the general SPAC population.[538] For example, as seen from the table, the conversion threshold for EarlyBirdCapital transactions remained at or near 20% until 2007 and 2008, when it doubled to 40%. In the three transactions after this period, in 2010 and 2011, the conversion threshold increased to 80% and 90%, respectively.

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[535]The SPAC is actually a trademark of EarlyBirdCapital, Inc. *See SPAC*, EARLYBIRDCAPITAL, http://www.earlybirdcapital.com/spacs.html (last visited Sept 14, 2012).

[536]*See supra* note 495 and accompanying text.

[537]*See ICR To Host Conference Call To Discuss Special Purpose Acquisition Companies*, BUSINESSWIRE (Jan. 30, 2006) [hereinafter *ICR to Host*], http://www.businesswire.com/news/home/20060130005545/en/ICR-Host-Conference-Call-Discuss-Special-Purpose (stating that the SPAC is "a trademark of EarlyBirdCapital Inc.").

[538]*Compare supra* Table 4 (presenting characteristics of general SPACs) *with infra* Table 5 (presenting characteristics of EarlyBirdCapital, Inc. specifically).

TABLE 5. MEAN SPAC CHARACTERISTICS WHEN EARLYBIRDCAPITAL, INC. IS LEAD UNDERWRITER

| | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 |
|---|---|---|---|---|---|---|---|---|---|
| IPO proceeds ($mil) | $21.0 | $27.4 | $41.2 | $41.1 | $66.3 | $49.0 | - | $44.3 | $50.0 |
| Unit price | $6.0 | $6.0 | $6.0 | $6.6 | $8.0 | $8.0 | - | $6.0 | $10.0 |
| Warrant strike price | $5.0 | $5.0 | $5.0 | $5.0 | $5.4 | $6.0 | - | $6.0 | $7.5 |
| Strike prc. > Unit prc. | 0% | 0% | 0% | 0% | 0% | 0% | - | 50% | 0% |
| Months for combo | 24 | 24 | 24 | 24 | 27 | 30 | - | 22.5 | 24 |
| Conversion threshold | 20% | 20% | 20% | 23% | 40% | 40% | - | 80% | 90% |
| % in trust | 85% | 85.8% | 87.7% | 95.2% | 99.3% | 97.2% | - | 97.7% | 101% |
| Pvt. place./IPO prcds. | 0% | 0% | 0.3% | 3.9% | 4.5% | 2.1% | - | 2.4% | 6.2% |
| % listed on the OTC | 100% | 100% | 88.9% | 100% | 75.0% | 100% | - | 50% | 0% |
| N | 2 | 7 | 9 | 7 | 4 | 2 | 0 | 2 | 1 |

In addition, as the statistics suggest, the ability to offer investors a relatively riskless investment with significant upside potential became more important in EarlyBirdCapital transactions, just as it gained in importance in the full sample of SPACs, as shown in Table 4 above. As seen in Table 5, the percent held in trust increased each year from 85% in 2003 to 99.3% in 2007 and again from 97.2% in 2008 to 101% in 2011. As suggested above, these increases came alongside increased participation by managers in the form of private placements,[539] which Table 5 shows first appeared in the EarlyBird transactions in 2005. Also noticeable from the data is that the percent of the private placement amount relative to the amount of IPO proceeds increased over time: moving from 0% to 4.5% from 2003 to 2007, and from 2.1% to 6.2% from 2008 to 2011.

On the whole, the characteristics of the SPACs underwritten by EarlyBird in Table 5 change in the same manner as that of the general population of SPACs in Table 4. This pattern for EarlyBird is consistent with the changing of SPAC structure to eliminate the vote and increase the percentage held in trust.[540] Therefore, we conclude that the pattern we see of emphasizing exit and discounting voice is an industry-wide phenomenon.

Of additional importance is the lack of speed with which EarlyBird modified its SPAC structures, which suggests that SPACs' structural evolution was driven, in part, through competition.[541] Though EarlyBird

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[539] *See supra* notes 369-71 and accompanying text.

[540] *See supra* Part VII.A-B.

[541] *See ICR to Host*, *supra* note 537 ("While EarlyBirdCapital was the early leader in

introduced the SPAC structure, it was slow to change.[542] EarlyBird was the lead underwriter for five of the first six, and fourteen of the first thirty, SPACs.[543] However, it was the third underwriter to list its SPAC on a more prominent exchange than the OTC and did not do so until its thirteenth transaction.[544] Only after fourteen transactions by other underwriters with conversion thresholds greater than 20% did EarlyBird underwrite an IPO with a conversion threshold in this higher range.[545] Only after twenty-seven transactions by other underwriters with trust accounts greater than 90% did EarlyBird follow suit—it was its eighteenth SPAC in our sample period.[546] Last, it was the twelfth firm to underwrite a SPAC in which there was a private placement of shares.[547] Thus, one can reasonably conclude that competition for the underwriting services to SPACs, and the associated fees, is a primary driver of the observed changes in SPAC structure. The initial innovator changed the features of its original template in response to outside pressures.[548] We plan to focus future work on the insights SPACs provide on the role of the underwriter in the public offering.

## VIII. IMPLICATIONS: REPUTATION, VOICE, AND EXIT

SPAC entrepreneurs had a revolutionary idea. They took the delicately balanced, emphatically private, financial contract between private equity investor and manager and transplanted it to the public market. This radical move promised new opportunities for all. Fund managers who either chafed in the confines of the traditional private equity fund structure or who had a limited track record would be free to pursue their own deals, unfettered by the demands of established private equity funds.[549] The general public would finally get a chance to invest in funds that take private companies public.[550] Lastly, targets would have a cheaper method to access the capital markets.[551]

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brining SPACs to market, many other investment banks . . . have recently priced deals.").

[542] *See id.* (detailing the history of SPACs).

[543] *See id.* ("In 1993 and 1994 Early[B]ird Capital[] took 13 SPACs public, only one of which was liquidated."); *see also Completed SPAC Offerings*, EARLYBIRDCAPITAL, http://www.earlybirdcapital.com/offerings.html (listing post-2003 SPACs).

[544] *See supra* Table 5.

[545] *See supra* Table 5.

[546] *See supra* Table 5.

[547] *See supra* Table 5.

[548] *See supra* Table 5, note 541 and accompanying text.

[549] *See supra* note 204 and accompanying text.

[550] *See supra* note 203 and accompanying text.

[551] *See supra* note 205 and accompanying text.

Things didn't work out as expected. We argue in this Part that reputation was the vital private equity ingredient SPACs could not recreate in the public market. The "one-shot deal" nature of the SPAC removed the reputational constraint on fund managers, and the public nature of the markets eliminated the reputational constraint on investors.[552] The financial contract was forced to develop substitutes for reputation;[553] it remains to be seen how successful these substitutes will prove.

Finally, we explore what light SPACs shed on the relationship between voice and exit. Hirschman posited in 1970 that the easier the ability to exit, the less likely that the power of voice will be exercised.[554] Recent literature suggests that, although conventional wisdom is that voting in the typical corporation is of little value, voting in mutual funds may be even less effective because exit is relatively easier.[555] The elimination of the SPAC acquisition vote contributes empirical evidence to support the claim that shareholders are indifferent to a vote if the exit is cheap enough.

First we turn to the role of reputation. Thus far, we have focused, by design, on the investor/fund contract. This focus has given us a somewhat distorted perspective because prospective private equity investors are focused on the probability of success on the fund, which ultimately depends on the success of the underlying portfolio.[556] As Part II discussed, Ron Gilson describes the crucial role of reputation in the "braided" relationships between investor/fund and fund/portfolio-company.[557] Funds do not exploit the companies they invest in because if traditional funds act opportunistically, they will not be able to make further investments and, ultimately, will not be able to raise subsequent funds.[558] Because private equity companies' business model hinges on raising multiple funds and capitalizing on scale and scope economies, reputation matters.[559]

SPACs are new—the first SPAC sponsors had no reputation, at least regarding this new form.[560] Moreover, SPACs are one-shot, especially

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[552]*See supra* notes 33-35 and accompanying text.

[553]*See supra* notes 33-35 and accompanying text; Neuhauser, *supra* note 367.

[554]*See* HIRSCHMAN, *supra* note 56, at 34.

[555]*See* Morley & Curtis, *supra* note 61, at 89-90.

[556]*See supra* notes 151-61 and accompanying text.

[557]*See supra* notes 152-53.

[558]Gilson, *supra* note 88, at 1092.

[559]*See supra* Part II.C.

[560]*See* Karen Richardson & Peter Lattman, *Financiers Now Say 'Trust Us' Like the Blank-Check Companies of Yore, SPAC Investors Are Asked to Buy In – on Faith*, THE WALL STREET J., 2 Feb. 1, 2007, *available at* http://www.ladenburg.com/uploads/LTS%2002-01-07.pdf (stating that investors use a strategy called "bet on the jockey," in which everything hinges on the identity of the

compared to traditional private equity, and so reputation does not constrain managers.[561] While return SPAC entrepreneurs do exist, when each SPAC is launched there is no expectation of a follow-up by the same managers.[562] Prospective target companies have little reputational capital to rely upon when considering whether to consent to acquisition by a SPAC.[563] A revealing sign of the importance of reputation is that, after the first wave of SPACs, prospectuses were quick to inform investors when their managers had successfully led SPACs in the past, as opposed to simply relying on past business success.[564]

We interpret the evolution in SPAC managerial compensation as a response to the need for a substitute for reputational capital. One striking takeaway from our data is the extent to which the original SPAC template hewed to the "magic 20%" compensation for managers: 211 of our 260 SPACs, or 81% of our sample, receive exactly 20% of the corporation, and 19 more are within 5% of that number.[565] This marked clustering around 20% indicates that the SPAC sponsors aspire to be like their traditional private equity cousins, and expect to be compensated accordingly.[566] Particularly since they are not charging a 2% management fee to investors,[567] the 20% incentive, analogous to private equity's "carry,"[568] seemed vital at the outset.

And yet 20% awarded solely for a single acquisition proved overly generous for the market. As discussed below, the market evolved in two ways: first, it required the managers to stump up the "skin in the game" they originally left out. Second, it has begun to condition the managerial 20% on more concrete performance.

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managers because nothing is known about actual SPAC).

[561]*See* Thompson, *supra* note 33, at 12-13 ("[U]nlike private equity managers, SPAC sponsors are not necessarily going back to investors to raise funds again. Sponsors infrequently express the intent to maintain an active role in the acquired firm, and have the easy option of returning full time to the outside employment that they have maintained throughout their tenure with the SPAC.").

[562]*See id.*

[563]*See* Heyman, *supra* note 401, at 533-34 (stating that under the "bet on the jockey" theory, "high profile names that are likely to attract investment" are really the only thing the SPAC has going for it).

[564]*See, e.g.*, Aldabra 4 Acquisition Corp., Form S-1, *supra* note 439, at 70 ("Each of our executive officers and certain of our directors has been involved in other blank check companies.").

[565]*See supra* Part VI.A.1.

[566]*See, e.g.*, Sahlman, *supra* note 9, at 491 (stating that in venture capital funds, 20% is the norm).

[567]*See, e.g.*, Riemer, *supra* note 45, at 959 (citation omitted) ("SPAC managers do not receive salaried compensation or management fee.").

[568]*See supra* notes 105-13 and accompanying text.

Beginning with the "skin in the game," at first the SPAC sponsors only paid a nominal amount for their 20% interest.[569] Perhaps they, like some scholars, viewed the 1% managerial investment in venture capital and LBO funds to be an "artifact of tax history,"[570] and therefore dispensable. In contrast, now the sponsors invest significant capital, which they forfeit if a business combination does not materialize.[571] The SPAC sponsors now pay for the funds' operating expenses, allowing the trust account to grow to ever higher levels.[572] In effect, they are now posting a bond as to their own performance; exposed to a downside risk, they reassure investors that they too have personal assets at stake.[573]

As discussed, there is some debate as to the importance of skin in the game in the traditional private equity contract.[574] In SPACs it is vital. SPAC managers risk their reputations to some degree, but because they are one-shot transactions, investors cannot rely on the built-up reputational capital of prior funds and other funds from the same company.[575] A manager's personal investment thus became a bond, ensuring that the promoters risked losing something of real value.[576] This reassurance matters both to SPAC investors and to targets.

Another recent SPAC development, the imposition of performance hurdles, similarly substitutes for reputation. The founders of the newest SPACs will forfeit their shares unless the stock price attains certain preset levels.[577] Thus, the managers receive their full 20%, not when the target is

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[569]*See, e.g.*, Riemer, *supra* note 45, at 959 (discussing management compensation within the SPAC).

[570]Fleischer, *supra* note 100, at 82 n.25 ("Before the check-the-box rules, a 1% capital interest was necessary to help ensure partnership classification for tax purposes."); *see also* Sahlman, *supra* note 9, at 488 ("Typically, the general partners provide only a small proportion (about 1%) of the capital raised by a given fund.").

[571]*See, e.g.*, SCG Fin. Acquisition Corp., Amendment No. 3 to Registration Statement (Form S-1/A), at 37 (Apr. 1, 2011) ("[O]ur sponsor has committed to purchase an aggregate of 4,666,667 sponsor warrants, each exercisable for one share of our common stock at $11.50 per share, for a purchase price of $3.5 million, or $0.75 per warrant, that will also be worthless if we do not consummate a business combination."); *see also* Wittlin & Ferris, *supra* note 241, at 3.

[572]*See* Barker & Hedin, *supra* note 43, at 38 ("Approximately 85-100% of the proceeds raised in the IPO are held in trust to be used to fund the initial business combination. Earlier deals tended to put 85% in trust. More recent deals are placing between 95-100% in trust . . . .").

[573]*See id.* ("By placing a greater amount in trust, deals are providing greater protection for investors, coupled with greater risk for insiders and underwriters.").

[574]*See supra* note 570 and accompanying text.

[575]*See supra* notes 560, 563 and accompanying text.

[576]*See* Barker & Hedin, *supra* note 43, at 38.

[577]*See, e.g.*, Chart Acquisition Corp., Form S-1, *supra* note 452, at 6 ("A number of founder shares in an amount equal to 2.5% of our shares of common stock issued and outstanding

acquired, but when the public corporation proves its worth in the market.[578] Like "skin in the game," performance hurdles reassure both investors and targets that the SPAC promoter is committed for the long haul.[579] We are no longer in the world of the "magic 20." While the manager earns some of his 20% upon acquisition, 5% in the most recent SPACs is conditioned on the investment actually proving profitable to all parties.[580]

Just as investors and targets felt the loss of traditional private equity's reputational constraints on SPAC managers, so too did SPAC managers suffer from the lack of reputational constraints on investor opportunism in the new form.[581] In the first generation of SPACs, shareholders could voice their objections to an acquisition via vote, and they could also walk away, even from an approved acquisition, while still receiving the bulk of their investment back from the SPAC trust account.[582] While these rights may have seemed good in theory, in practice they were redundant because of all of the other protections of a SPAC (*i.e.* the short timeline, the 80% in the trust account requirement).[583] Worse yet, rather than being a "belt" to the "suspenders" protection of the trust account, the shareholder vote became a noose around the SPAC manager's neck. As we saw, the initial supermajority vote, with a 20% conversion threshold, created the possibility for strategic behavior on the part of shareholders.[584]

The conversion threshold creates a moral hazard problem for the SPAC investor analogous to the traditional private equity investor's ability to renege on capital commitments.[585] Remember, as Part II of this Article described, private equity investment involved only a limited capital outlay at the beginning.[586] Opportunistic investors might be tempted to treat their commitment like an option and not respond to future capital calls.[587]

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after expiration of the underwriters' overallotment option (excluding the placement shares) are subject to forfeiture by our sponsor in the event the last sales price of our stock does not equal or exceed $11.50 per share . . . ."); ROI Acquisition Corp., Form S-1, *supra* note 452, at 9 (stating similar language).

[578] *See* Chart Acquisition Corp., Form S-1, *supra* note 452, at 6.

[579] *See* Barker & Hedin, *supra* note 43, at 38.

[580] *See, e.g.*, Chart Acquisition Corp., Form S-1, *supra* note 452, at 6 (stating that 2.5% is conditioned on one price, and another 2.5% is conditioned on a higher price).

[581] *See supra* note 34 and accompanying text.

[582] Riemer, *supra* note 45, at 954-55, 960.

[583] *See id.* at 953-55 (listing the available protections in a SPAC).

[584] *See* Order, *supra* note 190, 2010 WL 5301044, at *5-*7 (discussing the problem of "greenmailing").

[585] *See, e.g.*, *supra* notes 21-22, 24-25 and accompanying text (describing the reputational constraints on private equity funds).

[586] *See, e.g.*, *supra* note 21 (detailing how staged investments work).

[587] *See, e.g.*, *id.* (describing how private investors might renege on their promises).

As discussed above in Part II of this Article, reputational considerations constrain such opportunism on the part of investors. As would-be repeat players, accredited investors will fulfill their promises because they fear being shut out of subsequent investment opportunities.[588]

SPAC investors have no such scruples. Because SPACs trade in the open market, SPAC managers have no control over the identity of their investors.[589] Initially, they felt free to extort SPAC managers with their new supermajority power.[590] To address the reputational deficit, SPAC sponsors developed tactics like "bulldog"[591] provisions that limit stockholders from voting or converting more than 10% of their stock.[592] Further, they raised the conversion threshold,[593] effectively eliminating the majority vote entirely.[594] We argue that these moves are adaptive responses to the lack of reputational constraints in the public markets, and that they reinforce the importance of investor reputation in traditional private equity. Bereft of the reputational constraint on investor opportunism, SPAC managers quickly learned to be more sparing in granting investor rights.[595]

Besides casting light on the importance of reputation in private equity contract design, SPACs' evolution allows for insights into the relative strengths of two classic strategies to mitigate agency costs: voice and exit.[596]

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[588] *See, e.g.*, *supra* notes 22, 24-25 (explaining that problems can occur for private equity investors who renege).

[589] *See* Davidoff, *supra* note 4, at 227-28 ("[T]he SPAC phenomenon has been publicly attributed and promoted as a private equity substitute, one the public can now freely access."). Therefore, because the SPAC does not handpick its investors, such investors are not concerned with maintaining a good reputation amongst SPAC managers. *See* Sjostrom, *supra* note 1, at 756; Davidoff, *supra* note 4, at 227-28.

[590] *See* Order, *supra* note 190, 2010 WL 5301044, at *5-*7 (describing "greenmailing").

[591] *See supra* note 506 (defining a "bulldog provision").

[592] *See, e.g.*, China Res. Dev. Inc., Registration Statement (Form S-1), at 12 (Jan. 14, 2011).

[593] *See, e.g.*, *supra* note 504 and accompanying text (discussing 57th St.'s new, high conversion threshold).

[594] *See, e.g.*, Wittlin & Ferris, *supra* note 241 ("The key structural modification [to the SPAC], . . . is the elimination of the stockholder vote requirement for a proposed acquisition.").

[595] *See, e.g.*, Neuhauser, *supra* note 367 ("[T]he elimination of the shareholder vote was a huge step in the right direction.").

[596] Albert Hirschman offers the classic description of two prominent strategies in EXIT, VOICE, AND LOYALTY, where he describes the choice confronting a consumer: to voice complaints or to stop using the product. *See generally* HIRSCHMAN, *supra* note 56, at 4. Hirschman's insight has often been cited in corporate scholarship to describe the choices confronting shareholders and plaintiffs in a securities class. *See, e.g.*, John C. Coffee, Jr., *Litigation Governance: Taking Accountability Seriously*, 110 COLUM. L. REV. 288, 293 n.11 (2010) (noting that Hirschman coined the terms "exit" and "voice" to describe "rival strategies for influencing large organizations"). But, as the foregoing discussion makes clear, principals do not confront a binary choice of voice and exit when seeking protection from agency costs: they are but

We have seen the holdout (*i.e.* "greenmailing") problems discussed above, which a supermajority vote creates. But if granting shareholders a vote on an acquisition remained important in competing for the dollars of potential investors, SPAC sponsors could still have easily offered investors a conversion threshold of 50%—that is, a simple majority vote. The sponsors of latter-day SPACs, however, denied their investors any approval vote at all—at least as a matter of right.[597] From Table 4 above, we see that the de facto veto provided by the conversion threshold has moved up to an average of 75.2% in the most recent SPACs.

The SPACs' shift from promising a supermajority vote to promising no vote at all may seem surprising. If the vote had value, it certainly would have been retained because of the presence of a highly competitive market.[598] SPACs contain a limited number of built-in characteristics, and so can compete only based in particular on the identity of their managers[599] and the particular level of investor protections they offer.[600] Because the SPAC marketplace is an arena of survival of the fittest, we surmise investors truly do not attach importance to the vote, given their willingness to accept the tender offer instead.[601]

The reason that SPACs eliminated initially robust voting rights is clear from the data: the trust account has taken their place as the primary protection mechanism for SPAC investors.[602] Ever-increasing amounts have been put into trust, from 85% to amounts approaching (or even greater than)

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two of many strategies principals can use.

[597]*See* SCG Fin. Acquisition Corp., Form S-1/A, *supra* note 571, at 20. SCG Financial Acquisition Corp. stated that it would not offer the vote option at all, unless required by law or deemed advisable by the sponsors. *Id.* If a vote occurred, a simple majority would be enough to approve the acquisition. *See id.* What is important is that the vote is no longer a promised protection; instead it is a mere possibility, available only at the discretion of the managers. *Id.*

[598]*See ICR to Host*, *supra* note 537 (listing some of players in the industry).

[599]*See supra* notes 562-65 and accompanying text (explaining the "bet on the jockey" theory).

[600]*See* Heyman, *supra* note 401, at 540 (stating that SPACs "have enough wiggle room to alter the structure in ways that make it attractive to investors").

[601]*See, e.g.*, *supra* note 208 and accompanying text (stating that the tender offer is an alternative to voting). The initial SPAC template was negotiated not just between SPAC promoters and investors. The SEC was a necessary intermediary—if the promoters could not convince the SEC regulators that the offering was fair to investors, it would not go forward. *See* Order, *supra* note 190, 2010 WL 5301044, at *5-*7 (showing the SEC's concern for shareholder protection in the SPAC context); *see also* Heyman, *supra* note 401, at 540 ("[T]he SEC does not perceive [SPACs] as a scam in need of being caught within a wider or more tightly woven regulatory net."). This accounts for the "belt and suspenders" style investor protections that characterize the early SPACs. *See, e.g.*, Riemer, *supra* note 45, at 954-55 (stating these protections)

[602]*See supra* Part VII.B.

100%.[603] Furthermore, SPACs have often obtained guarantees from their investment banks[604] or sponsors[605] to ensure that the trust account would be safe from third-party claims.[606] Put simply, the trust account is nearly as good as gold; until an acquisition occurs, it offers the shareholder a means of withdrawing from the venture at a cost no more than de minimis.[607] With such robust exit rights, the vote is a mere superfluity.[608] Granting it only subjects the sponsors, and the entity as a whole, to unnecessary risks of mounting transaction costs and delay.[609]

The complete elimination of the SPAC vote deepens our understanding of shareholder votes in other contexts. In order for a vote to be effective, the voters must be able to separately or collectively monitor their agent, agree on a proposed course of action, and coordinate a

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[603] *See supra* notes 520-23 and accompanying text (discussing the high percentages of capital that must be in trust account).

[604] *See, e.g.*, Sapphire Indus. Corp., Amendment No. 3 to Registration Statement (Form S-1/A), at 24 (Dec. 28, 2007), stating:

> While we will seek to have all vendors and service providers (which would include any third parties we engaged to assist us in any way in connection with our search for a target business or businesses) and prospective target businesses execute agreements with us waiving any right, title, interest or claim of any kind they may have in or to any monies held in the trust account, there is no guarantee that they will execute such agreements. Nor is there any guarantee that, even if such entities execute such agreements with us, they will not seek recourse against the trust account or that a court would not conclude that such agreements are not legally enforceable. Lazard has agreed to have personal liability to ensure that the proceeds in the trust account are not reduced by the claims of target businesses or claims of vendors or other entities that are owed money by us for services rendered or contracted for or products sold to us. However, it may not be able to satisfy those obligations, if it is required to do so. Furthermore, Lazard will not have any personal liability as to any claimed amounts owed to a third party who executed a waiver (including a prospective target business or businesses).

[605] *See, e.g.*, China Res. Dev. Inc., Amendment No. 6 to Registration Statement (Form S-1/A), at 16 (June 2, 2011) ("Robin Lee has contractually agreed that, if we liquidate prior to the consummation of a business combination, he will be personally liable to ensure that the proceeds in the trust account are not reduced by the claims of target businesses or claims of vendors or other entities that are owed money by us for services rendered or contracted for or products sold to us.").

[606] *See supra* note 519 and accompanying text.

[607] *See* Riemer, *supra* note 45, at 960 (discussing pre-2008 SPACs, but emphasizing the still accurate point that investors have little to lose).

[608] *See supra* Part VII.B.

[609] *See* Wittlin & Ferris, *supra* note 241, at 2-3 ("The combination of hedge funds starved for cash and hedge funds with a 'yield to trust' strategy made obtaining stockholder approval of acquisitions extremely difficult for SPACs. Uncertainty regarding the outcome of the stockholder vote discouraged potential acquisition targets from pursing discussions with SPACs.").

response.[610] The costs of collective action are low when there are a limited number of decision makers.[611] Public corporations, in contrast, feature countless shareholders who confront a classic collective action problem.[612] As many corporate scholars have noted, public corporation shareholders face problems of incentive and effectiveness when trying to use their voting power to discipline agents.[613] The difficulty is so great that today's conventional wisdom is that shareholders should follow the "Wall Street Rule" and exit, rather than exercise their voice at all.[614]

A recent theory of voting in mutual funds proposed by John Morley and Quinn Curtis has complicated the notion of exit and the "Wall Street Rule." Morley and Curtis argue that exit is easier in mutual funds than in publicly traded corporations, and that therefore mutual fund shareholders have less incentive to make use of the vote than do their public corporation counterparts.[615] That is, whatever limited value the shareholder vote has in a public corporation, it will have even *less* importance in a mutual fund, which is in effect even more liquid than a public corporation because it trades on asset value, rather than on an expectation of future cash flows.[616]

Morley and Curtis offer theoretical arguments as to why voting mutual fund shareholders, with their robust exit right, are relatively less likely to make use of the vote.[617] SPACs' elimination of the acquisition vote offers empirical proof of their claim that stronger exit rights lessen the importance of a vote.[618] We present actual data indicating that a stronger exit right

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[610]*See* Stephen J. Choi & Jill E. Fisch, *How to Fix Wall Street: A Voucher Financing Proposal for Securities Intermediaries*, 113 Yale L.J. 269, 271 (2003) ("The dispersed shareholder body is poorly positioned to engage in effective collective action; the costs of monitoring management or leading a proxy contest typically far outweigh the benefits to an individual shareholder. As a result, shareholder collective action is rare, even though it may benefit shareholders as a group.").

[611]John Armour et al., *Agency Problems, Legal Strategies, and Enforcement*, 4 (European Corp. Governance Inst., Law Working Paper No. 135, 2009), *available at* http://ssrn.com/abstract=1436555 ("Multiple principals will face *coordination costs*, which will inhibit their ability to engage in collective action.").

[612]*See* Choi & Fisch, *supra* 610, at 271.

[613]Beginning at least as far back as Berle and Means in 1932. ADOLF A. BERLE & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 252 (Harcourt, Brace & World, Inc. rev. ed. 1968) (1932).

[614]Robert B. Thompson & Paul H. Edelman, *Corporate Voting*, 62 VAND. L. REV. 129, 130 (2009).

[615]Morley & Curtis, *supra* note 61, at 89-90.

[616]*Id.* at 84.

[617]*See id.* at 89-90.

[618]*See supra* Part VII.B.

correlates to less shareholder interest in a vote.[619] Thus the SPAC story, important in its own right, also offers insight into larger questions of contract design.

## IX. CONCLUSION

The story of SPACs is a story of legal innovation. This Article has provided the first detailed picture of how SPACs have changed over time. Using an original dataset, we documented the contours of this exciting new corporate form. The SPAC story has importance in its own right. We traced it in detail, describing how SPACs attempted to reshape the private equity mold to the public market. SPACs borrowed much from the private equity contract, most notably by using incentive compensation to align managers' interest with those of shareholders, and imposing a time limit on managers' use of funds.

SPAC's original contract design proved to be flawed because SPAC entrepreneurs miscalculated the importance of reputation. Without the potent reputational constraints the clubby world of private equity afforded, managers could no longer claim an unfettered 20% of the profits or omit for long the 1% "skin in the game" that traditional private equity managers contribute. Correspondingly, opportunistic hedge funds were free to extort concessions from SPAC managers, unhampered by the fear that they were risking a chance at future investments. The SPAC form evolved to respond to this danger, but then went one step further and largely eliminated the vote on an acquisition. This development contributes to recent literature by deepening our understanding of the relationship between voice and exit. The SPAC experience highlights that some exits are cheaper than others and suggests that, if the exit is easy enough, a vote may not matter at all.

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[619] *See supra* Tables 1-4.