In Practice

Authors Jeremy Green and Robert Parent

SPAC-linked margin loans

The recent increase in the use of special purpose acquisition companies (SPACs) has been generating much discussion in the press, the finance industry and among lawyers and regulators. The trend began in the US and is spreading across the globe, with securities exchanges in a number of jurisdictions competing to position themselves as an alternative listing venue of choice for SPACs. In this In Practice article, the authors consider their structure and risk profile and whether the securities that they issue have the potential to be a new asset class for margin lenders.

A SPAC is a shell company formed to raise capital through an initial public offering of securities (IPO) for the purpose of completing a "business combination transaction" (ie an acquisition, merger, or demerger) with an existing private company in order to take that private company public. The unique structural features of a SPAC[1] and the securities they issue provide an interesting and potentially attractive asset class for participants in the margin lending market.

A SPAC typically issues three types of securities to the public: units, redeemable shares, and warrants, each of which has its own "ticker" and is tradeable. However, only the units (each of which is, essentially, a stapled security representing an entitlement to a single share and a fraction of a warrant) are tradeable by holders, commonly for an initial period of 45-52 days. At the end of that initial period, subject to certain conditions, holders are entitled to apply to separate their shares and warrants to allow for those shares and warrants to become independently tradeable.

The units are typically issued at US$10 per unit and the cash proceeds are deposited into a segregated trust account that neither the SPAC nor its sponsor can access until either the funds are required for a business combination transaction or to fund redemptions. Within two years, the SPAC must use those proceeds to enter into a business combination transaction that falls within the description contained in the SPAC's registration statement. If a business combination transaction is not entered into within the two-year period, the SPAC will be liquidated and the balance of the trust account applied to redeem its securities. If the SPAC identifies a target for a business combination transaction, the SPAC will announce the proposed transaction and investors have the right (exercisable during a prescribed period prior to the completion of the proposed transaction) to have their securities redeemed upon completion of the proposed transaction using the issuance proceeds (plus interest earned on it) held in the trust account.

Investors in a SPAC have essentially invested in a company that has a single asset – ie a segregated, blocked bank account with a balance approximately equal to the aggregate amount of money needed to redeem the SPAC's securities at their issue price. As a consequence, prior to a SPAC announcing or entering into a business combination transaction, provided that the original balance of the trust account remains intact, the units (and/or shares) issued by a SPAC ought to trade at or about (or, at least, not significantly below) the issue price, reflecting the fact that investors can expect to be able to have their shares redeemed at or about the initial issuance price.

Consequently, a SPAC's units and/or shares present a unique and altogether different risk profile for a margin lender. Typically, the primary risk to a lender providing a margin loan is a sudden and significant fall in the price of securities pledged to secure the loan. However, considering the structural features of a SPAC's units and/or shares as described above, the risk of such a fall ought to be very low, at least prior to the SPAC announcing or entering into a business combination transaction.

This different risk profile means even in the absence of a liquid market to hedge the market risk, the customary contractual protections provided to a margin lender – namely, relatively modest loan-to-valuation ratios and share price-based margin provisions – are less important,[2] provided the lender ensures the loan must be repaid in full prior to the SPAC entering into a business combination transaction and the pledge is enforceable. This requirement ensures that, in the event the borrower does not repay the loan when due, the lender has sufficient time to enforce the pledge – either by exercising the borrower's right to redeem the securities at or about the issuance price or by selling the shares pursuant to its power of sale.

The suitability of such a loan ultimately rests upon preserving the sanctity of the trust account and assessing the risk of the balance being depleted, for example, through fraud on the part of the SPAC or its sponsor, by third-party claims of the SPAC's vendors, services providers or prospective targets, or upon the insolvency of the bank in which that account is held. Mitigating these risks requires thoughtful analysis and structuring, but the appearance of the first of these margin loans in the market suggests these risks are not unmanageable. ■

1 This article is concerned with the structural features of a SPAC whose securities are listed on an exchange in the US.

2 Although, there may be regulatory limitations on the potential for very high loan-to-valuation ratios being used.

Biog box

Jeremy Green is a partner, and Robert Parent is an associate, in the London office of Latham & Watkins and are members of the firm's Corporate Department, Financial Institutions Group, and the Capital Markets, Derivatives, and Structured Finance Practices. Email: jeremy.green@lw.com and robert.parent@lw.com