Special Purpose Acquisition Corporations: Specs to Consider When Structuring Your SPAC – Part I

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A special purpose acquisition corporation, commonly known as a "SPAC," and formally a "development stage company," is a corporation formed for the purpose of raising capital through an initial public offering ("IPO") of its securities, in order to fund an acquisition of an existing operating company or companies. Though the SPAC itself has no business operations, investors entrust an experienced founding management team to seek out and consummate a value-building acquisition of an operating business, often in a particular industry, sector or geographical area. The IPO's proceeds can also provide the target company with immediate capital, an advantage over other more traditional structures.

Several notable patterns in the structuring of SPAC deals have emerged from the recent spate of SPAC offerings. This article will briefly describe these structural elements and trends and suggest considerations for potential issuers and their counsel when planning for, structuring and executing a SPAC offering. Part I of this two-part article will provide an overview of the evolution and structure of SPACs. Part II will address several current salient issues confronted by SPACs, including officer compensation, the decision whether to list on an exchange and the benefits and challenges of overseas offerings.

Background

A SPAC is similar to a "blank check company", because the basic concept of a blank check company – to complete a business combination with an unidentified target business – is the same for both types of development stage companies. The crucial difference for a SPAC, however, is that it is not deemed a "blank check company" for purposes of Rule 419 under the Securities Act. Rule 419 imposes certain obligations and restrictions upon any issuer deemed to be a "blank check company," defined therein as (i) a development stage company that has no specific business plan or purpose or that has indicated that its business plan is to engage in a merger or acquisition with an unidentified company or companies… and (ii) is issuing "penny stock." An issuer will not be deemed to issue penny stock if it has a minimum of $5 million of net tangible assets immediately following its IPO.[1] Although SPACs are not blank check companies because they are not penny stock issuers, many practitioners and commentators continue to refer to them as blank check companies.

Due in part to certain protections afforded investors and the increased flexibility in their operations, SPACs have recently reemerged on the IPO market in large numbers: both the deal size and prevalence of SPAC offerings among IPOs have increased dramatically in the last year. Development stage companies are not new: "blind pools" have existed for years, and the late 1980s and early 1990s were a heyday, with approximately 2,700 development stage offerings raising almost $9.6 billion between 1987 and 1990.[2] A hiatus in activity beginning in 1995 lasted eight years, partly as a result of an overheated IPO market that put SPACs at a competitive disadvantage.[3] The early companies often suffered from negative perceptions in the financial and investment community, because lax disclosure requirements for development stage companies led to abuse. However, the earlier development stage offering model has been retooled and refined to improve investor protection together with potentially high investment returns. Additionally, the recent participation of established underwriters in SPACs has helped to promote the acceptance of SPACs in the financial and investment community.

SPACs are becoming increasingly popular. In 2005, more than 60 SPACs filed registration statements for IPOs, compared with just 14 filings in 2004. In fact, SPACs comprised almost 22% of the total number of IPO registrants in 2005.[4] Most SPACs provide in their charters that the company must consummate a business combination no later than 18 to 24 months after completion of the IPO. Of 41 SPACs that began publicly trading in 2004 and 2005, 25 have announced proposed business combinations, several of which have already been consummated.[5]

New SPACs and SPAC business combination activity during the first half of 2006 was considerable. From January 1, 2006 through June 30, 2006, 20 SPACs filed registration statements and 24 SPACs successfully went public. Of the 24 SPACs whose securities began publicly trading in the first half of 2006, one, Highbury Financial, has already announced a proposed business combination.

The size of SPAC offerings has also been on the increase. In 2005, approximately one-third of new SPAC filings sought to raise under $50 million, slightly more than one-third sought to raise between $50 million and $100 million, and just under one-third sought to raise $100 million or more. Of SPAC offerings that were filed during the first half of 2006, 25% have sought to raise under $50 million, 25% have sought to raise between $50 million and $100 million and 50% have sought to raise $100 million or more. Of the 10 SPAC filings in the first half of 2006 seeking to raise $100 million or more, 7 are seeking over $150 million, with the largest SPAC seeking $300 million. The two largest deals to begin trading in 2006 each registered offerings of $150 million.

A SPAC Is Born

Before a SPAC files a Form S-1 registration statement and completes its IPO, it will typically begin as a corporation formed by a small group of industry executives or sophisticated investors ("Founding Stockholders"). The Founding Stockholders purchase the company's common stock for nominal consideration and generally retain, after completion of the IPO, 20% of the SPAC's common equity, although this percentage is less if the underwriters' over-allotment option is exercised. Some or all of the Founding Stockholders also serve as the SPAC management team that will search for prospective target operating companies.

Registration Statement And Structure

The Registration Statement should describe the target sector in which the SPAC intends to acquire operating companies, as well as any objective criteria that management intends to consider in evaluating prospective target operating companies. The Registration Statement should also set forth a description of the offering, the securities to be offered in the IPO, biographies of management of the SPAC and other relevant information.

In a typical SPAC, the securities are offered in units, at a set public offering price of either $6.00 or $8.00 per unit, consisting of one share of common stock and one or two warrants respectively, exercisable for the purchase of additional common stock at a set price that reflects a discount off the IPO price for the units. There has been a recent trend toward $8.00 unit offerings. Each warrant may be exercised on the later of (i) consummation of an acquisition or (ii) one year after the date of the prospectus, typically expiring four years after the date of the prospectus. If the SPAC's common stock trades at a substantial premium for 20 trading days within a 30-day trading period, the warrants are redeemable for $0.01 per warrant at any time after the warrants become exercisable. Depending on whether and when the underwriters exercise their over-allotment option, the common stock and warrants will begin to trade separately.

Offering Proceeds Placed In Trust

As an essential investor protection in a SPAC, a large percentage of the IPO proceeds, net of a portion of the underwriters' compensation, but not of other offering expenses, is deposited into a trust account where the funds are invested exclusively in short-term government securities. Meanwhile, Rule 419 requires a deposit of 90% of the offering proceeds, net of underwriters' compensation, but not of other offering expenses. Therefore, SPACs sometimes historically placed a lower percentage of the offering proceeds in trust than blank check companies. However, as discussed below, many of the recent SPACs place greater than 94% in trust. These funds are released in connection with the consummation of an acquisition. If no business combination is completed within 18 to 24 months, the SPAC must be dissolved, in which case the trust fund plus any other remaining SPAC assets are, subject to limited exceptions, distributed to public investors. This deadline for completing a business combination may be extended from 18 to 24 months if a letter of intent or agreement to enter into a business combination is executed within such 18-month period. Conversely, under Rule 419, if an acquisition has not been consummated within 18 months after the registration statement effective date, the funds held in trust must be returned to investors. In this way, the SPAC structure increases the likelihood of a business combination being completed.

During the beginning of the recent SPAC resurgence, in 2004 and the first half of 2005, SPACs frequently placed approximately 95% of the offering proceeds (net of the underwriters' compensation and expenses but not of other offering expenses) in trust.[6] In 2006, a trend has developed towards placing 100% of the offering proceeds (net of underwriters' compensation and expenses but not of other offering expenses) in trust.[7] SPACs that place such 100% into a trust account raise the necessary funds for their other offering expenses and the expenses incurred in connection with identifying and evaluating a target business through private placements to, and borrowings from, the Founding Stockholders. Additionally, the total percentage of the gross offering proceeds has been increasing as a result of a trend towards placing a portion of the underwriters' compensation in trust as deferred compensation.

Use Of Interest From Trust To Fund Expenses

Any remaining proceeds from the offering not held in trust are used to cover expenses of the offering and for working capital purposes, including expenses in connection with a business combination. In most SPACs, the interest earned by the funds in the trust account has been off-limits to management. However, as the percentage of proceeds desposited in a trust has increased, some recent SPAC offerings have made a portion of the interest on the escrowed funds available to management to fund expenses prior to a business combination.

Structural And Other Requirements

In order for a SPAC to consummate a business combination, the target business must have a fair market value representing at least 80% of the SPAC's net assets (excluding deferred underwriters' discounts and commissions held in trust) after the time of acquisition. By contrast, Rule 419 restricts a blank check company from acquiring a target business unless the fair value of such business is equal to at least 80% of the maximum offering proceeds. Therefore, SPACs may acquire target businesses with a lower purchase price than what would be required under Rule 419, perhaps increasing the likelihood that a business combination will be consummated, while still protecting investors by guaranteeing that the value of the target company will represent a large percentage of the offering proceeds.

The terms of a typical SPAC offering allow stockholders to vote on a proposed business combination, even though such approval may not be required under state law. The SPAC will send each investor a proxy statement as required by the SEC, and any investor who votes against the business combination and affirmatively declares his or her election to convert his or her shares will have the right to receive his or her pro rata share of the trust account in accordance with the procedures disclosed in the prospectus. However, an objecting stockholder who does not follow such procedures or take any action will lose his or her right to the return of the funds, unless the matter is voted down by the other stockholders and the business combination is not consummated. Conversely, Rule 419 requires that an investor take action to notify the blank check company of his or her election to remain an investor and, if an investor does not do so, the investor's pro rata share of the funds held in escrow or trust would be automatically returned to the investor. Additionally, under Rule 419, unless a sufficient number of investors elect to remain investors, the entire escrow fund must be returned to all investors and the issuer's securities will never become publicly traded.

Upon effectiveness, a SPAC also becomes subject to the numerous SEC requirements applicable to public companies, including periodic reporting, corporate governance requirements, proxy solicitation rules, and Section 16 of the Securities Exchange Act regarding insider trading.

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[1] *Rule 3a51-1(g)(3) under the Securities Exchange Act of 1934 provides that net tangible assets must be demonstrated by financial statements dated less than fifteen months prior to the date of the transaction that the broker or dealer has reviewed and has a reasonable basis for believing are accurate in relation to the transaction date. SPACs satisfy this requirement by filing their financial statements on a Current Report on Form 8-K promptly after completion of the IPO.*

Some practitioners and commentators have suggested that an issuer also may not offer securities for $5.00 or less if it seeks to avoid issuing "penny stock" for purposes of Rule 419. However, Rule 3a51-1(d), which allows an issuer to avoid being a penny stock issuer if it offers securities for greater than $5.00, is an alternative to Rule 3a51-1(d), rather than an additional requirement, but is expressly unavailable to development stage companies.

[2] *Bruce Rader & Shane de Burca, "SPACs: A Sound Investment or Blind Leap of Faith?", Insights: The Corporate and Securities Law Advisor, Jan. 2006 v20, at 2.*

[3] *Remarks of David Nussbaum, Special Purpose Acquisition Company (SPAC) Call, Integrated Corporate Relations (Jan. 30, 2006).*

[4] *Mitchell Littman, David Buzkin & Michael Rapp, "Starting a Blank Check Company: The Must-Know Legal & Regulatory Issues Involved with Forming a SPAC," Private Equity Analyst Virtual Seminar, October 27, 2005, at 7.*

[5] *Statistics regarding SPAC activity in 2005 and 2006 are based upon a review of registration statements, proxies and current reports filed with the SEC. Unless otherwise stated, deal size numbers assume no exercise of the underwriters' over-allotment option.*

[6] *Of 10 SPACs that began trading between January 1, 2004 and April 15, 2005 that we sampled, 8 placed between 94% and 96% of the offering proceeds, net only of underwriters' compensation and expenses, in trust. The other two sampled SPACs placed an even greater percentage in trust.*

[7] *We examined 10 of the 20 SPACs that have filed registration statements in the first half of 2006, including 5 of the 11 SPACs that filed between May 1, 2006 and July 6, 2006. In each filing, the issuer planned to place at least 99% of the offering proceeds, net of underwriters' compensation and expenses, in trust.*

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