BuchalterNemer
A Professional Law Corporation

Special Purpose Acquisition Companies

Mark Bonenfant, Esq.

Special Purpose Acquisition Companies (commonly called "SPACs") have emerged as a popular alternative acquisition vehicle. A SPAC is a corporation formed to fund the acquisition of and provide capital to an existing operating company or companies by raising capital through an initial public offering ("IPO") of its securities in the public equity markets.

The volume of SPACs has been driven, in part, by the interest of private equity funds and the more recent involvement of larger investment banks, including Citigroup, Merrill Lynch and Deutsch Bank Securities, among others. Private equity funds participate in SPACs because they provide access to an alternative pool of capital for acquisitions that SPACs have traditionally sought with institutional-based private equity funds.

SPACs are similar to commonly referred "blank check companies" that are subject to specific obligations and restrictions as a result of Securities and Exchange Commission ("SEC") Rule 419 of the Securities Act of 1933 ("1933 Act"). Blank check companies like SPAC's are both formed to complete a business combination with an unidentified target company. But the restrictions placed on "blank check companies," make them less attractive than more traditional vehicles for accumulating capital. SPACs are structured to fall outside SEC Rule 419.

Forming the SPAC

SPACs are generally formed by a group of persons experienced in an identified industry and a small number of sophisticated investors. These founders contribute nominal capital for 100 percent 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. After the SPAC completes its IPO, the founders will retain approximately 20 percent of the SPAC equity. Some of the founders will form the management team. The management team may not necessarily have private equity experience, but has an industry-specific track record. As initially formed, the SPAC has no business operations. Rather, the initial business plan directs an experienced management team to seek and to consummate one or more acquisitions in a specific market sector. SPACs have targeted various industries including technology, healthcare, advertising and regional banks. Members of the management do not receive salaries. Their 20 percent equity interest is their key economic reward, but they are usually reimbursed for out-of-pocket expenses. Certain members of the management team may be offered employment contracts after the completion of an acquisition.

SPAC Initial Public Offering

Shortly following its formation, the SPAC will file a registration statement with the SEC to register its securities for an IPO. The SEC has detailed rules for registration statements in general, and the SEC takes a particular interest in the review of SPAC filings. Historically, the SE C 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 careful review of the structural elements and features of SPAC offerings including provisions that create potential conflicts of interests. As the number of SPAC IPO filings have increased over the last three years, the SEC review process has become longer and more challenging. SPAC managements refrain from looking for prospective acquisition targets until the IPO is completed, because once a SPAC identifies a target prior to filing the registration statement, then the SE C requires the SPAC to disclose significant information about the target even though the SPAC and target may not ultimately consummate a transaction.

The SPAC securities are typically structured as units with each unit consisting of one share of common stock and one or two warrants, respectively. The warrant component is exercisable for the purchase of additional common stock at an exercise price that reflects a discount from the IPO price to the public for the common stock. Each warrant is exercisable on the later of consummation of an acquisition or one year after the date of the IPO and, typically, will expire on the fourth anniversary of the IPO. The SPAC may redeem the warrants if the underlying common stock trades at a substantial premium over the IPO price during a prescribed 30-day trading window. After completion of the IPO, the units trade and three months thereafter, the common stock and warrants also begin to trade separately. The securities are traded either on the Over-the-Counter Bulletin Board Exchange (commonly referred to as the "OTC-BB"), or the American Stock Exchange. The warrant component is used as a hedging vehicle and may end up being traded more actively than the common stock. Many hedge

funds sell off the warrants or the common stock shortly after the IPO for a shortterm return on their investment.

Structuring the SPAC
Notwithstanding a structure that is exempt from the obligations and requirements of SE C Rule 419 for "blank check companies," most SPACs take on a structure that looks to Rule 419 for many of its features. In part, this has been in response to the investment community desire for better investor protections and to ease SEC concerns about SPACs. The significant structural terms generally found in SPAC organizational documents and the IPO materials (including the underwriting agreement) include the following:

Escrow for Proceeds. A significant portion of the IPO proceeds, net of the underwriters' compensation are placed in an escrow account. The proceeds are released upon the earlier of (i) the consummation of an acquisition approved by shareholders, or (ii) liquidation of the SPAC in the event no acquisition is consummated before the prescribed expiration period. The remaining offering proceeds are used for operating expenses. Escrow proceeds may be invested, but the investments must be structured to avoid triggering compliance with the Investment Company Act of 1940. Interest income from the escrow may also be released to the SPAC for additional working capital.

Target Fair Value. The business acquired by the SPAC must have a fair value in excess of 80 percent of the SPAC's net assets. Remaining assets not used for the acquisition are available for working capital for the target business and reimbursement of SPAC operating expenses.

Shareholder Approval. SPAC shareholders must approve the proposed acquisition by at least a majority of shares of common stock issued in the IPO (even if applicable state law does not require such approval). To obtain the requisite vote, the SPAC must file a proxy statement with the SEC. The SEC disclosure rules for the proxy statement are extensive, and require audited financial statements of the target and proforma financial statements reflecting the effect of the transaction on the SPAC. The SEC will review the proxy statement and, similar to its review of the IPO registration statement, the process will be thorough and time consuming.

Dissenting Shareholders Conversion Rights. Shareholders who vote against a proposed acquisition otherwise approved by the requisite vote of shareholders are usually given the right to convert their shares of common stock into a right to receive in cash a pro rata portion of the SPAC's escrowed funds.

Transaction Expiration Date. SPACs generally agree to complete a business combination within 18 months from the date of the IPO, or within 24 months of entering to a letter of intent or definitive agreement with a target (assuming such letter of intent or definitive agreement was entered into within 18 months of the IPO).

Forced Liquidation. If the SPAC does not consummate an acquisition transaction before the expiration date, it will be required to liquidate and distribute the escrowed funds pro rata to its shareholders, providing downside protection to investors.

Other Issues for Negotiation
In addition to the typical structural terms discussed above, SPACs must consider and negotiate a number of other matters. Some of the more important items for negotiation include the SPAC private placement that follows initial formation, purchase options for the underwriter (these are in addition to customary underwriter over-allotment options), lock-up agreements for the founders, shareholder investment agreements, deferral of underwriter's commissions, underwriter warrants, and registration rights agreements for founder shares.

SEC Reporting Company and Stock Exchange Requirements
After the SPAC completes its IPO, it becomes subject to the various reporting requirements of the Securities Exchange Act of 1934. SPACs that choose listing on the America Stock Exchange are required to comply with its listing standards, including maintaining an independent audit committee.

Analysis
The SPAC structure offers advantages for both the SPAC shareholders and the target company. SPAC shareholders invest in an investment vehicle with a very short time horizon during which 90 percent of their capital is escrowed earning interest until management produces an acquisition opportunity. The shareholders get a "look-see" at potential deals and if the shareholders do not like a proposed deal or the two-year period elapses, the shareholders get approximately 92 percent to 95 percent of their investment returned.

SPAC shareholders have a trading market for their common stock and warrants. The unit combination allows shareholders to hedge their investment. When the SPAC announces a deal, the SPAC stock price tends to move up and in most cases shareholders can sell their stock for 100 percent of their investment while holding the warrants to see if the deal actually is completed. But, there are several disadvantages to a SPAC structure. The SPAC will compete for acquisitions with financial and strategic buyers who may be able to move faster to complete a deal, and the two-year limit may impose artificial

BuchalterNemer
A Professional Law Corporation

pressures on pricing and completing a deal. The SPAC warrants create a market overhang that could depress stock values. Finally, management receives 20 percent of the SPAC equity to find a deal, diluting the public shareholders.

Target companies may be attracted to a SPAC for several reasons. A SPAC offers an alternative structure to a firm commitment initial public offering. In today's markets, underwriters will not generally complete a traditional IPO unless the target company is of sufficient size, and unlike the late 1990s, underwriters are completing very few "emerging growth IPO's." For small companies looking to go public, a SPAC offers an opportunity more favorable than the typical "shell" reverse merger. The SPAC comes with significant capital, an existing trading market with a broad shareholder base, no prior negative history and an experienced management team.

Mark Bonenfant is a Shareholder in the Los Angeles office. He can be reached at (213) 891-5020 or by email at mbonenfant@buchalter.com.