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SPACs: A Primer

Overview

A special purpose acquisition company, or SPAC, is a publicly traded "blank check" company, formed for the purpose of effecting a business combination with an unidentified operating business. Essentially, a management team raises funds through an initial public offering, or IPO, and then seeks out a transaction with a viable operating company.

The first SPAC was completed in the mid-1990s, but the demand for SPACs disappeared quickly because of the strong IPO market. The SPAC market re-emerged in 2003 and has become more than just a niche market in the past couple of years. Many SPACs are listed on the American Stock Exchange, and, recently, both the New York Stock Exchange and The Nasdaq Stock Market have announced new rules to permit the listing of SPACs. Investment banks such as Citigroup; Deutsche Bank; and UBS Securities are underwriting SPACs, and, in December 2007, Liberty Acquisition Holdings Corp. completed the first $1 billion SPAC IPO.

Chief among the SPAC's characteristics that distinguish it from a traditional blind pool are its public stockholder protections. The most important of these protections are the rights given to such stockholders (a) to vote on each business combination proposed for the SPAC, until one has been approved by the public stockholders and consummated, and (b) to elect, at the time they place their vote, if they are voting against the proposed transaction, to have their stock converted into their proportionate share of the proceeds held in the SPAC's trust account (described below) concurrently with the closing of the transaction.

Similar to a private equity fund, a SPAC is typically managed by an experienced management team and group of advisors. SPAC management teams generally have experience completing acquisitions, investing in private equity and/or managing companies or expertise within a specific industry (from which the SPAC will seek its business combination targets).

Economics

In typical SPAC offerings, the SPAC sells units to the public, consisting of one share of common stock and one common stock warrant. Each warrant entitles the holder to purchase one share of stock at a price that has been set at a discount to the price of the public unit. The warrant typically becomes exercisable upon the later of (a) the SPAC's completion of its initial business combination or (b) the first anniversary of its IPO.

Prior to the IPO, in most cases when the SPAC's corporate entity is first formed, the SPAC's insiders (its officers, directors and advisors and their affiliates) generally purchase, for a nominal sum (typically $25,000), such number of shares of stock as will equal 20% of the SPAC's total outstanding shares immediately following the IPO. For example, if the SPAC plans on selling 10,000,000 shares of its stock in the IPO at an offering price of $10.00 per share (a $100 million IPO), the insiders will purchase 2,500,000 shares, representing 20% of the 12,500,000 shares that will be outstanding after the IPO, for $25,000. As a result, upon completion of the IPO, they will own $25 million worth of stock, based on the initial public offering price. However, as discussed below, they will be prohibited from selling any of that stock at least until the SPAC completes a business combination approved by the public stockholders.

Substantially all of the proceeds of the SPAC's IPO are placed in a trust account for the benefit of the public stockholders. Historically, 85% to 90% of the gross proceeds were placed in the trust account and no withdrawals from the account were permit-

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ted prior to the SPAC's initial business combination. Currently, in response to market demand, SPACs are placing 99% to 100% of the gross proceeds from their IPOs in the trust account (often, only $50,000 to $100,000 of the IPO proceeds are being retained by the SPAC outside of the trust). SPACs have been able to accomplish this and still have sufficient monies to pay their IPO expenses and fund their pre-combination operations as a result of the following measures:

- a portion of the interest earned on the trust account may now be withdrawn from the account to pay some of the SPAC's working capital expenses and taxes prior to its initial business combination;
- the SPAC's insiders are now, in addition to their share purchases discussed above, making more substantial investments in the SPAC at the time of the IPO, through a simultaneous purchase of warrants or units (typically for a purchase price equal to 3% to 5% of the IPO's gross proceeds, which, in our prior example, means an investment of between $3 million and $5 million); and
- the underwriters of the IPO are deferring a portion (often as much as half) of their fees until the SPAC completes its initial business combination.

The insiders' purchase of warrants or units not only increases the dollar amount that can be placed in trust for the benefit of the public stockholders (because the IPO expenses, including the non-deferred portion of the underwriters' compensation, can be paid from the funds obtained from such purchase), it also provides funds for the SPAC to use while seeking a prospective target business and gives greater comfort to the public stockholders by further aligning management's interests with their interests. Since the deferred portion of the underwriters' compensation is only paid to the underwriters if the SPAC completes a business combination, such deferral increases the amount available for distribution to the public stockholders if a business combination is not completed (see below).

The insider stockholders do not have the liquidation benefits that are available to the SPAC's public stockholders. Unlike the public stockholders, who may trade their shares in the public market, insiders are prohibited from selling their securities until at least the completion of the SPAC's initial business combination. Further, if no such transaction is completed within the time period designated (see "The Business Combination" below), causing the liquidation of the trust account, the insiders are not permitted to participate with the public stockholders in such liquidation and their shares and warrants (or units) become worthless.

None of the insiders or their affiliates receives any payments for services rendered by them to the SPAC (including salaries or finder's fees), or otherwise, prior to or in connection with the SPAC's initial business combination, other than the nominal payment for office space and related services (generally $7,500 a month) that is typically made to an entity affiliated with the insiders.

The Business Combination

A SPAC has a limited time period in which to complete its initial business combination. That period may be as short as 18 months to enter into a letter of intent or definitive agreement for a proposed business combination, with an additional six months to complete the transaction, and as long as 36 months to complete a business combination. If a business combination is not completed within the prescribed time period, the trust account is liquidated. This may require stockholder approval depending on the structure and governing law.

In addition to applicable stockholder approval requirements imposed by the laws of the jurisdiction in which the SPAC is incorporated, additional requirements are imposed upon the SPAC with respect to its completion of a business combination through its charter documents and contractually in the underwriting agreement. Generally, the target company must have a fair value equal to at least 80% of the SPAC's net assets. This does not mean that 80% of the funds in the trust account must be used by the SPAC to pay for the business combination; it is merely a requirement for the minimum value of the target business to be acquired. The SPAC may pay the sellers with cash from the trust account, with monies raised in equity and/or debt financings or with stock, or any combination of the foregoing.

The business combination must be approved by a majority of the shares actually voted by the public stockholders. Often the insiders typically are required to vote in accordance with the vote of the public stockholders so as not to influence the vote. In addition, public stockholders receive a second chance to decide whether or not to maintain their investment in the SPAC at the time the vote for the business combination is taken. Any public stockholder that votes against the business combination may elect at the time of such vote to have its shares converted into its pro rata portion of the proceeds held in the trust account when and if the proposed combination is actually completed. However, if public stockholders holding a number of shares in excess of a specified percentage of the SPAC's public shares elect to exercise their conversion rights, the SPAC is not permitted to proceed with that particular business combination. Historically, a SPAC could not proceed with a business combination if

holders of at least 20% of the public shares exercised their conversion rights. A 30% threshold has become more typical, and for some SPACs, the percentage is as high as 40%. What this means is that, if public stockholders holding 30% of the public shares both vote against the combination and exercise their conversion rights, the SPAC cannot complete the business combination even if public stockholders holding a majority of the public shares have voted in its favor. On the other hand, if holders of less than 30% of the public shares exercise their conversion rights, a majority of the SPAC's shares are voted in favor of the combination and all of the other conditions to the business combination are met, then the transaction may proceed. Upon its completion, the public stockholders that exercised their conversion rights will receive the portion of the funds held in the trust account relating to their shares and their shares will be cancelled.

A SPAC must solicit its public stockholders' approval of the business combination through the proxy statement process. This process is lengthy. The Securities and Exchange Commission, or SEC, will review and comment on the proxy statement, often creating a period of 120 days or more between the initial filing of the preliminary proxy statement with the SEC and the mailing of the definitive proxy statement to the SPAC's stockholders. If, however, the SPAC is a "foreign private issuer" under the federal securities laws, the stockholder approval process is greatly reduced because filing and review of the proxy statement with and by the SEC is not required. However, SPACs generally commit to solicit their stockholders' votes through a proxy statement containing the information required by the SEC for U.S. public entities, even though such proxy statement may not be required under our federal securities laws.

Concurrently, with the completion of the business combination, the funds held in the trust account, less any funds used to satisfy public stockholder conversion rights, are released to the SPAC. As discussed earlier, some of the funds may be used to pay all or a portion of the SPAC's purchase of the acquired business. In connection with the stockholder approval of the business combination, the public stockholders are usually requested to approve changes to the SPAC's charter documents so the provisions specific to the SPAC will cease upon the consummation of the transaction. These provisions typically may only be amended in connection with a business combination as a further protection for the public stockholders.

From the point of view of a target operating business–the SPAC's potential business combination partner–SPACs have much to offer. A SPAC can be a very attractive merger candidate for the owners of a private company willing to continue to maintain an equity position in the post-combination company. Rather than "cashing out" in an all cash sale, the target company is merged with, or acquired by, the SPAC in a transaction similar to a reverse merger with a public "shell." Except that a SPAC is not your ordinary shell; it is an exceedingly clean shell. It has never had an operating business so there are no potential "skeletons in its closet" to concern the target. In addition, unlike most shell companies, a SPAC has plenty of cash that can be used for the post-combination company's working capital or set aside as a "war chest" to fund future acquisitions. A portion of the SPAC's cash is sometimes used to pay a portion of the acquisition price, allowing the target's stockholders to take some money off the table at the time of the business combination. Members of the target company's management are also more assured of keeping their management roles following a merger with a SPAC than they would be if their company were to be acquired by one of its own competitors, as a competitor would likely seek to consolidate the target's management with its own personnel. Because of the current credit crisis many buyers are finding it more difficult, if not impossible, to finance acquisitions. As a result, a business combination with a SPAC may become an even more attractive alternative. ■

Brad L. Shiffman

Save the date

SPACs Boston

March 18th • The Four Seasons, Boston

Brad L. Shiffman will be presenting the Legal Panel recap at SPACs Boston

Topics presented at SPACs Boston will include:

- The state of the SPAC–going mainstream
- SPAC vs. IPO–what are the advantages for a management team to choose a SPAC?
- Finding targets–choosing the right deals, what are investors looking for?
- M&A issues–how do you value SPAC stock consideration? What are differences between a SPAC and a typical M&A?
- Getting the vote / securities law concerns

For more information, see **www.blankrome.com/SPACs** or contact Brad L. Shiffman at bshiffman@blankrome.com.