DEAL POINTS

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**WHEN SPACS ATTACK:
THE ROLE OF SPECIAL PURPOSE ACQUISITION COMPANIES IN THE M&A MARKET**

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Introduction

Special purpose acquisition companies, or SPACs, are publicly traded shell companies that allow their sponsors to raise capital through an initial public offering for use in seeking to acquire an operating company within a fixed time frame. As such, they are a form of "blind pool" without an operating business or revenues. So called "blind pools" and "blank check" companies have a history of being associated with misuse and abuse, but in the past several years SPACs have managed to overcome many of those negative associations and have been steadily on the rise – increasing in both number and size. According to one source, SPACs have filed to raise more than $7 billion in 2007, a 139% increase over 2006, and SPACs accounted for a quarter of all IPOs in the first half of 2007.[2] Although investments in SPACs are subject to many unique risks, the advantages of the SPAC structure tend to appeal to certain sophisticated investors, particularly hedge funds. As the number of SPACs and the funds they are raising continue to increase, SPACs are likely to maintain their growing presence in the M&A landscape.

General Overview of SPAC Formation and Structure

A SPAC is a corporation formed by a small group of sophisticated investors, or sponsors.[3] The sponsors are often experienced managers with successful investment or operational track records. They initially hold 100% of the SPAC's common stock and also serve as the SPAC's management team during the IPO stage and the SPAC's subsequent search for acquisition candidates.

Most SPACs are formed to pursue an acquisition in a particular industry or market

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[2] *See The Best of Our Blogs, Surge Seen in Blank-Check Offerings*, The Daily Deal (Friday, September 21, 2007) (citing statistics according to American Growth Capital).

[3] Many SPACs are organized under the laws of Delaware or other states. There has been a recent trend, however, toward organizing SPACs under the laws of the Cayman Islands, particularly where the SPAC will be listed on London's Alternative Investment Market. *See* Kevin Butler & Richard Fear, *Cayman Islands*, THELAWYER.COM, June 25, 2007, *available at* http://www.thelawyer.com.

segment[4] or in a particular geographic region,5 although some SPACs have opted not to focus on acquisitions in a particular sector or region. The capital needed for a SPAC to pursue an acquisition is raised through an initial public offering of units, most often consisting of one share of common stock and one or two warrants. SPAC IPO prices have been remarkably uniform, generally at $6 or $8 per unit. A recent trend in larger offerings, however, is to offer units at $10, with units consisting of one share of common stock and one warrant.[6] SPACs typically raise anywhere from $30 million to $120 million through their IPOs, but some recent SPACs have raised significantly more. Units normally trade publicly for a period of time following the IPO, with common stock and warrants beginning to trade separately once the SPAC has filed a form 8-K with audited financial statements.

SPAC securities frequently trade on the Over-the-Counter Bulletin Board ("OTC-BB"), although many SPACs have chosen to be listed on the American Stock Exchange ("AMEX") since the AMEX began accepting applications for listings of SPACs in 2005.[7] AMEX, however, generally subjects SPACs to more intense scrutiny than other potential listings.[8] Other exchanges have been more skeptical of SPAC listings. Nasdaq, for instance, has expressed a concern that SPAC securities might end up in the hands of unsophisticated investors who are unable to appropriately assess the unique risks.[9] Accordingly, it has declined to list SPACs until they have completed an acquisition and become operational.[10] The New York Stock Exchange ("NYSE") has expressed similar views.[11] Several international exchanges will list SPACs, including London's Alternative Investment Market ("AIM"), a stock exchange for small capitalization listings.[12]

A key feature of a SPAC is that a certain percentage, generally above 90%, of its IPO proceeds will be placed in an escrow or trust, pending an acquisition or the liquidation of the SPAC. A SPAC's certificate of incorporation fixes a limited time frame for the SPAC to identify an acquisition target and close an acquisition. Typically, the SPAC will have 18 months from the consummation of its IPO to close an acquisition, which time is extended to

[4] *See* Cynthia Krus, *The SPAC Phenomenon: A Discussion of the Background, Structure and Recent Developments Involving Special Purpose Acquisition Companies*, MONDAQ, June 24, 2006, *available at* 2006 WL 12741981 [hereinafter Krus] (listing as examples technology, shipping, mining, advertising, regional banking, and healthcare).

[5] China has been a particular focus of SPACs. *See* M. Ridgeway Barker & Randi-Jean G. Hedin, *SPACs: A Focus on China*, THE METROPOLITAN CORP. COUNSEL, Dec. 2006, at 63.

[6] M. Ridgeway Barker & Randi-Jean G. Hedin, *SPACs – Continuing to Grow and* Evolve, The Metropolitan Corp. Counsel, June 2008 [hereinafter Barker].

[7] *See* Krus, *supra.*

[8] *Id.*

[9] *See* Helen Avery, *Spac Spat Probe Hits Wall of Silence*, EUROMONEY, June 1, 2006, *available at* 2006 WLNR 12308725.

[10] *Id.*

[11] *Id.*

[12] *See* Colleen Marie O'Connor, *Spacs Take Flight on London's AIM, Greater Flexibility, Speed to Market Lures US Concept Overseas*, ASSET SECURITIZATION REPORT, November 7, 2005, *available at* 2005 WLNR 23205820.

24 months if the SPAC enters into a letter of intent or definitive agreement within the first 18 months. More recently, some SPACs have opted for the greater flexibility of a longer acquisition period. If a SPAC has not closed an acquisition within the fixed time frame, it will be liquidated and the escrowed IPO proceeds will be distributed *pro rata* to holders of IPO shares.

The IPO proceeds that are not held in escrow are typically available, along with capital invested by the sponsors, for the SPAC to use in connection with its search for acquisition candidates and to pay its general operating expenses pending its completion of a business combination, including expenses relating to ongoing compliance with reporting obligations under federal securities laws.[13] The SPACs registration statement usually details the uses of proceeds not held in escrow.

Once a SPAC has reached agreement to acquire an operating company, the acquisition must be submitted for stockholder approval. SPAC certificates of incorporation typically require that any business combination be approved by a majority of the shares of common stock issued in connection with the IPO, even if no stockholder vote on the particular form of business combination is required under the law of the SPAC's jurisdiction of organization. In connection with stockholder approval, the SPAC must prepare and file preliminary proxy materials with the SEC. Review of preliminary proxy materials by the SEC staff often takes considerable time and involves several rounds of comments due to the enhanced scrutiny that the SEC staff tends to apply to proposed business combinations involving SPACs.

A SPAC's organizational documents will also permit any holders of IPO shares who vote against the business combination to "convert" their shares into a *pro rata* interest in the escrowed IPO funds, even if the business combination is approved. If a specified percentage (typically 20% to 30%) of the IPO shares have exercised such "conversion" rights, however, the business combination will not be completed, and the SPAC will be liquidated and the escrowed IPO funds distributed. If a proposed business combination receives the requisite stockholder vote and "conversion" rights have been exercised by the holders of fewer than the specified percentage of IPO shares, then the escrowed IPO funds will be released to the SPAC to be used in completing the business combination.

SPAC Structural and Investor Protection Features

SPACs have a number of structural features designed to enhance investor protection and to make the SPAC a more attractive investment opportunity. Those features, some of which have been mentioned above, typically include:

- A requirement that a certain percentage of the SPAC's IPO proceeds be placed in escrow with a third party trustee until either the consummation of a business combination or the SPAC's liquidation. The percentage of funds ordinarily placed in escrow has steadily increased over the past few years and is now

[13] *See* Steven Boehm, Cynthia Krus, Christopher Zochowski & John Mahon, *A Primer on SPACs: An Explanation of the Purpose, Structure and Current Issues Affecting Special Purpose Acquisition Companies*, MONDAQ, Aug. 11, 2005, *available at* 2005 WLNR 12708051 [hereinafter Boehm].

typically in the 95% to 100% range, with many recent SPACs escrowing more than 98% of their IPO proceeds. As a way to increase the IPO funds available to be escrowed, it is increasingly common for underwriters to agree to defer a portion of their compensation until consummation of a business combination.

- A requirement that the SPAC consummate a business combination within 18 months of its IPO, or 24 months if the SPAC enters into a letter of intent, definitive agreement, or agreement in principle with a target company within 18 months of the IPO.

- A requirement that the SPAC acquire, in a single business combination, one or more operating companies with a combined fair market value in excess of 80% of the SPAC's net assets at the time of the acquisition.

- A requirement that a majority of the shares of common stock issued in connection with the SPAC's IPO approve a business combination, whether or not such a vote is required under the law of the SPAC's jurisdiction of organization.[14]

- A right of holders of IPO shares who do not vote in favor of an otherwise approved business combination to "convert" their shares into a *pro rata* share of the escrowed IPO funds.[15]

- A prohibition on the SPAC's consummating a business combination if holders of a specified percentage or more of IPO shares elect to exercise their "conversion" rights. The specified percentage has typically been 20% but has been as high as 30% to 40% for some recent SPACs.

- A requirement that if the SPAC fails to complete a business combination within the time specified, it must liquidate[16] and distribute a *pro rata* share of its escrowed IPO proceeds to holders of shares issued in the IPO (the sponsors receiving no escrow distributions for their pre-IPO shares).

- Lock-up agreements for the sponsors pursuant to which they agree to retain their ownership until some time after a business combination.

- Warrant purchase commitment agreements requiring the sponsors to purchase warrants in the public market or directly from the SPAC in order to

[14] 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.

[15] For SPACs organized under Delaware law, this "conversion" right, sometimes called an "opt out" right, would technically be a redemption of shares and would be subject to statutory limitations on redemption, including the existence of legally available funds from which to redeem the shares. 8 *Del. C.* §160.

[16] If a SPAC is organized under Delaware law, it must comply with Delaware's dissolution and winding-up requirements, including a stockholder vote to authorize dissolution, notwithstanding any provision of the certificate of incorporation that purports to trigger dissolution automatically. *See* 8 *Del. C.* § 275.

further align their interests with those of other investors. The warrants are also subject to a lock-up period.

Certain of the foregoing structural features and protections are designed to track restrictions imposed by Rule 419 ("Rule 419") of the general rules and regulations promulgated under the Securities Act of 1933, as amended (the "Securities Act"). Technically, a SPAC does not meet the definition of a "blank check" company to which Rule 419 is applicable, so long as the SPAC files a Form 8-K promptly after consummation of its IPO indicating that its net assets are in excess of $5 million.[17] Nonetheless, to satisfy market expectations and, no doubt, also to lessen the degree of SEC scrutiny, SPACs tend to follow many of the requirements of Rule 419.[18] More recently, some SPACs have opted to implement Rule 419-type features, but with modifications, for example, by increasing the period of time in which a business combination must be consummated or by increasing the percentage of IPO shares for which "conversion" rights must be exercised to prohibit consummation of a business combination, notwithstanding stockholder approval.

Benefits and Pitfalls for SPAC Investors

Investment in a SPAC offers many of the advantages of investing in a private equity fund, while also offering the liquidity of a public market and a "conversion" or "opt out" right if the investor is dissatisfied with the particular business combination. Investment in a SPAC also involves limited downside because a significant portion of the funds raised in the IPO is placed in escrow. An investor's upside, on the other hand, is potentially significant. Management teams are typically experienced individuals with a proven track record, thus enhancing the prospect that the SPAC will find an appropriate acquisition target.

Aside from the sponsors, hedge funds tend to be the primary investors in SPACs.[19] Hedge funds are attracted to SPAC offerings because they allow the hedge fund to consider its funds fully invested, but also offer the liquidity of a public market and give the fund an "opt out" right when a target acquisition is identified.[20] In addition to the inherent limitation on downside risk, the structure of a SPAC and its securities also offers opportunities to implement complex arbitrage strategies. Investors may own units, common stock, or warrants, separately or in any combination, thus allowing funds to implement investment strategies to hedge and mitigate risk.

[17] Specifically, Rule 419 excludes from its requirements any issuers whose outstanding shares are not deemed to be "penny stock." 17 C.F.R. § 230.419(a)(2)(ii). According to Rule 3a51-1 under the Securities Exchange Act of 1934 ("Exchange Act"), the definition of "penny stock" does not include issuers with less than three years of operations who have a minimum of $5 million in assets. 17 C.F.R. § 240.3a51-1. Thus, so long as a SPAC has in excess of $5 million in net assets following its IPO, the SPAC's securities do not meet the definition of penny stocks and the SPAC does not qualify as a "blank check" company. *See* Krus, *supra*.

[18] *See* Krus, *supra*; Bruce Rader & Shane de Burca, *SPACs: A Sound Investment or Blind Leap of Faith?*¸ Insights, Jan. 2006, at 4-5 [hereinafter "Rader"].

[19] *See generally* Vyvyan Tenorio, *Pow! SPAC! Boom!*, DAILY DEAL, May 26, 2006, *available at* 2006 WLNR 9038125; Rader, *supra*, at 4-5.

[20] Rader, *supra* note 2, at 4-5.

Of course, SPAC investors also face significant risks, particularly because a SPAC is not an operating company, has no revenues, and has not even identified a particular target or targets at the time of the IPO. As such, investing in a SPAC has been characterized as a "blind leap of faith."[21] If a business combination is not consummated within the required period, an investor faces a potential loss of a portion of its initial investment, with the size of the loss depending upon the percentage of IPO proceeds that were placed in escrow. That loss may be more if management incurs additional liability that cannot be satisfied from non-escrowed funds.[22]

Practical Issues Facing SPACs

SPACs face numerous practical issues in carrying out their IPO and their day-to-day activities, as well as in seeking a suitable acquisition candidate and negotiating an acquisition. The following is a list of some of the common issues SPACs confront:

- SPAC filings with the SEC, both at the IPO stage and the proxy solicitation/business combination stage, have generated significant interest on the part of the SEC staff, which has expressed concerns with many SPAC structural issues, as well as potential sponsor conflicts of interest. As a result, it may be more time consuming and costly to prepare and clear registration and proxy statements for a SPAC than for other public companies.
- As a public company, a SPAC is subject to reporting requirements under the federal securities laws, including compliance with the Sarbanes-Oxley Act of 2002. If listed on an exchange, a SPAC must also comply with the exchange's listing requirements. Compliance with reporting and listing requirements can be time consuming and costly.
- SPACs that trade on the OTC-BB are subject to state blue-sky laws, and their securities may not be sold in many jurisdictions.[23] Moreover, registering a SPAC IPO under state blue-sky laws can be challenging.[24]
- SPACs have a limited time frame in which to identify potential acquisition candidates, conduct due diligence, select a target, and negotiate a definitive agreement. Accomplishing all that within the fixed time frame is often made more difficult by limitations on the target's industry or the geographic region in which it operates, as well as by the requirement that the target's fair market value exceed 80% of the SPAC's net assets. If a deal is not consummated within the specified time frame, the SPAC's organizational documents require that it be dissolved and that the IPO proceeds be distributed to stockholders.[25] The fixed time frame

[21] Barker, *supra*.

[22] Rader, *supra*, at 4-5.

[23] *Id*. at 3.

[24] William F. Griffin & Andrew D. Myers, *Paint it SPAC*, DAILY DEAL, Oct. 23, 2006, *available at* 2006 WLNR 18294684.

[25] A number of SPACs have elected to seek an extension of the acquisition period by obtaining a stockholder vote to amend their certificates of

not only puts added pressure on management, but may make some targets less interested in being acquired by a SPAC and may give those targets that are interested additional leverage to negotiate a favorable deal.

- The requirement that a business combination be approved by the holders of IPO shares and the availability of "conversion" rights for dissatisfied stockholders give rise to additional issues:
  - Preparing proxy solicitation materials for stockholder approval of a business combination, as discussed above, can be a lengthy and costly process, especially in view of the often stringent SEC review process. Where a SPAC has taken a considerable amount of time to identify an acquisition candidate and negotiate a business combination, additional delays arising from the SEC review process can sometimes cause the SPAC to run up against the 18 month/24 month window for completing the acquisition.
  - The availability of voting and "conversion" rights also gives rise to arbitrage opportunities, particularly where a SPAC's shares are trading near or below the *pro rata* amounts held in escrow. Such opportunities can be particularly problematic in view of the prohibition on consummating a business combination if holders of a specified percentage of IPO shares have exercised "conversion" rights. In some instances, stockholders have even been accused of using the threat of "conversion" to carry out greenmail.[26]

Practical Issues Facing Target Companies Seeking to be Acquired by a SPAC

An acquisition by a SPAC can offer significant benefits for a target company, including providing access to additional capital and the opportunity to become a public company without the cost and burden of going through the IPO registration process. Target companies nonetheless face unique issues when negotiating and seeking to consummate an acquisition by a SPAC:

- The limited time frame available for a SPAC to consummate an acquisition may in some cases give a target a bit more leverage to negotiate a favorable deal, but the time pressures resulting from a SPAC's unique structure can also impose additional burden and expense on a target that might not be present in the context of another type of acquisition.

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incorporation. Seeking an extension may pose additional issues with respect to whether such an amendment is permissible under the certificate of incorporation and applicable law, the vote required for such an amendment, the appropriate treatment of stockholders who vote against an extension, and whether obtaining an extension could give rise to disclosure claims based on statements made in the SPAC's registration statement/prospectus.

[26] *See* Meghan Leerskov, *PharmAthene Merger Validated Despite Greenmail Maneuvers*, The Reverse Merger Report (Sept. 13, 2007).

- A SPAC's limited window period for consummating an acquisition also gives rise to execution risk for the target. Absent a stockholder vote in favor of an extension of the acquisition period, if a business combination is not consummated prior to the expiration of the acquisition period, the SPAC must dissolve and is not permitted to close, even if it has a signed deal in place.

- For a number of reasons, including the requirement that a SPAC's stockholders approve any business combination and the resulting need for a proxy statement subject to the SEC review process, SPAC deals often take longer to close than other types of acquisitions. Such delays further enhance consummation risk.

- The requirement that a business combination be approved by the holders of a SPAC's IPO shares and the availability of "conversion" rights for dissatisfied SPAC stockholders – as well as the resulting arbitrage and greenmail opportunities created thereby – also increase consummation risk.

- Notwithstanding the additional delay and inherent risks associated with a SPAC deal, a target company's ability to negotiate for meaningful deal protection in the form of a reverse termination fee and/or expense reimbursement is limited. SPACs ordinarily have limited funds available from which to pay such fees and expenses, given that the bulk of IPO proceeds are tied up in escrow. When targets have been successful in negotiating break up fees from SPACs, they have typically been far lower than market.

- As discussed above, the opportunity to become a public company through acquisition by a SPAC is often viewed as an advantage from the perspective of the target. But becoming a public company also may have disadvantages such as the additional costs and burden of complying with requirements under federal securities law, including the Sarbanes-Oxley Act, and applicable listing requirements.

Conclusion

SPACs are becoming an increasingly popular alternative investment vehicle, both in the United States and abroad. While SPACs offer unique benefits to their sponsors and investors, they also pose unique risks to sponsors, investors, and target companies and give rise to a host of distinct practical hurdles. As the presence of SPACs in the M&A landscape grows, M&A practitioners should be cognizant of both the benefits and potential pitfalls surrounding SPACs and acquisition transactions involving SPACs.

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