

---

---

# LITTMAN KROOKS

---

---

LLP

www.lklp.com

## *SPACs – Specified Purpose Acquisition Companies*

By



**Mitchell C. Littman**  
[mlittman@lklp.com](mailto:mlittman@lklp.com)



**Emily C. Lewis**  
[elewis@lklp.com](mailto:elewis@lklp.com)

*To be Published in Marcum & Kliegman's M&K SEC Insights Q3 2005*

---

### **The Wide World of SPACs**

Specified Purpose Acquisition Companies, also known as SPACs, have recently taken the securities world by storm as the latest vehicle to launch small but promising private companies into the public sector via initial public offerings or “IPOs.” Due in part to the protection provided investors and the increased interest in hedge funds, SPACs are increasingly becoming the structure of choice for investors in making public offerings.

A SPAC is a blank check company, or newly-formed company without any business operations, formed for the purpose of implementing a merger, asset acquisition or similar business combination. This structure provides the target company with immediate capital raised through an IPO, an advantage over the more typical reverse merger transaction.

Although not all SPAC IPOs share the same structure, many SPAC offerings have common characteristics. SPAC securities are generally offered in units, usually consisting of one share of common stock and one or two warrants, at an offering price of \$6.00 to \$8.00 per unit. Each warrant is then exercisable beginning on the later of the completion of a business combination by the SPAC and one year after the date of the prospectus, and ending four years after the date of the prospectus. If the SPAC's common stock is trading at a substantial premium (approximately 140%) per share or higher for 20 trading days within a 30 day trading period, the warrants are redeemable for \$0.01 per warrant when first exercisable. In some offerings, the managing underwriter may receive a warrant solicitation fee for the solicitation of warrant redemptions.

Eight to fifteen percent of the proceeds from the offering are used to cover the underwriters' discount, expenses of the offering and for working capital purposes, including expenses in connection with a business combination, while the remainder is

deposited in trust. Those funds held in the trust are invested exclusively in short-term government securities. They are released upon the earlier of the completion of a business combination or the liquidation of the SPAC. Once the SPAC is declared effective, a Current Report on Form 8-K is filed to report the proceeds of the IPO on an audited balance sheet.

In order for a SPAC to acquire a target company, a majority of the holders of shares of common stock held by the public stockholders of the target company must approve the business combination with the SPAC, even if such approval would not otherwise be required by applicable corporate law. Those who vote against it have the right to convert their common stock into a pro rata share of the proceeds of the offering that were deposited into a trust account.

If a business combination does not occur within 18 months after the closing of the IPO, the entire trust account, including interest, along with any remaining net assets of the SPAC is then distributed to the public stockholders. This time period may be extended to 24 months if a letter of intent or agreement to enter into a business combination is executed within such 18 month period.

While in some SPAC IPOs, pre-IPO stockholders may enter into a lock-up arrangement lasting until six months after the completion of a business combination, most escrow their shares for three years. These shares may be released if the SPAC is liquidated or, if after the completion of a business combination, the SPAC enters into a transaction in which the shares of all of its common stockholders are exchanged for shares of the target company.

SPAC securities may be traded in a variety of ways once an offering is complete. While most SPACs have been listed on the OTC Bulletin Board, certain recent SPACs have been approved for listing on the AMEX if they otherwise satisfy AMEX standards, which focus on factors such as the background of management and the specificity of the purpose of the SPAC. Although SPACs may not be listed on the NYSE or NASDAQ until after the completion of a business combination, once such combination is completed, SPACs may be listed upon the satisfaction of certain criteria in a limited number of states.

### **A Look Back – The History of SPACs**

The recent surge in SPAC offerings is not an entirely recent phenomenon. In fact, blank check companies have been around for several years, mostly operating under Rule 419 of the Securities Act of 1933 and the Penny Stock Reform Act of 1990. These provisions gave investors certain protections, including the depositing of gross IPO proceeds into an escrow account or a separate bank account established by a registered broker-dealer until after the business combination was completed.

However, recent SPAC deals are exempt from Rule 419 because SPAC units sell at \$6.00 each, rather than \$5.00 or less and because, after their IPOs, SPACs have more than \$5 million in net tangible assets. Another difference between SPAC offerings and those under Rule 419 is the timing of when units may become available for trade. Units under a SPAC offering may commence trading on or promptly after the date of the prospectus. However, under a Rule 419 offering, no trading is permitted until after the completion of a business combination.

Although SPAC IPOs and securities offerings under Rule 419 differ in some respects, both structures ultimately focus on the protection of the investors. In both types of offerings, the proceeds are deposited into an account, whether a trust, escrow or separate bank account, and if a business combination does not occur within a specified amount of time, the money is returned to the investors. Proceeds of SPAC offerings may only be invested in U.S. "government securities," while proceeds under a Rule 419 offering can be invested in specified securities, such as a money market fund meeting conditions of the Investment Company Act of 1940 or in securities that are direct obligations of or are guaranteed by, the United States.

Another protection offered by SPAC offerings is that the initial target business acquired must have a fair market value equal to 80% of the SPAC's net assets at the time of the acquisition. Offerings under Rule 419 share a similar protection, restricting acquisition of a target business unless the fair value of the business or net assets to be acquired represents at least 80% of the maximum offering proceeds.

### **Worthy Investment?**

When considering whether to acquire a target business through a SPAC offering, it is also important to know the risks involved in such an undertaking. The management team typically purchases at least 20% of shares of the SPAC for nominal consideration. They may need to be willing and able to not only provide start up and offering expenses for the SPAC, but also provide office space and administrative services. The management team may have to reimburse IPO investors if creditors come after the money deposited into the trust account. They may also have to agree to purchase a certain amount of warrants in the public market at certain price levels after the completion of the IPO.

Because of these obligations, SPACs require individuals who have previously succeeded in building a company from the ground up. SPACs typically employ principals from thriving private equity firms, successful investment bankers, former executives and those who have a sufficient wealth to meet the financial obligations SPAC offerings require. Individuals with these backgrounds can withstand the possible risk of failure that accompanies SPAC offerings.

Finally, investors seeking to participate in the newest offerings must also be aware of their risks. There may be limited liquidity for SPAC securities in the secondary market. Investor may lose that eight to fifteen percent of their initial investment if their shares are converted into interest in the trust account. Additionally, the SPAC management team may operate the SPAC in a certain manner that may result in creditors attacking the money deposited in the trust. On top of all of these risks, once the business combination is complete, the investor then faces all of the risks of an investment in a typical IPO.

### **Will There Be Calm After The Storm?**

Despite these risks, investors are increasingly relying on SPACs as the structure of choice in offering investments. This surge is partly attributable to the increased interest in hedge funds. SPACs and hedge funds work well together in offering investment protection. SPACs enable hedge funds to demonstrate to their investors that they are more fully invested in securities and are not maintaining excess cash. SPACs also provide hedge funds with flexibility when deciding whether to continue to own SPAC shares after a business combination. On the flip side, if investors do not wish to keep their shares, SPACs offer hedge fund investors downside protection.

A quick glance at statistics illustrates just how popular SPACs have become in the past few years. Since January 2004, 16 SPACs have raised over \$486 million through IPOs. Between February and June of 2005, 25 more SPACs filed registration statements with the SEC for IPOs. The offering size of such offerings has ranged from \$21 million to \$201 million.

Based on this information, the offering of securities through SPACs shows no present signs of slowing down. As long as qualified management teams remain interested in this type of offering and hedge funds continue to support SPACs as an investment structure, the future of SPACs looks bright as a favored vehicle in the offering of securities.

\* \* \*