

The Wide World of SPACs

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SPECIFIED PURPOSE ACQUISITION

COMPANIES, or SPACs, are a relatively new method to launch small but promising private companies into the public sector through initial public offerings ("IPOs"). Due partly to certain protection provided to investors, SPACs have increasingly become the structure of choice 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.

Many SPAC offerings share 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 expiring four years after the date of the prospectus. If the SPAC's common stock is trading at a substantial premium for a specified period, the warrants are redeemable for \$0.01 per warrant when first exercisable.

Eight to fifteen percent of the offering proceeds are used to cover the underwriters' discount, offering expenses and for working capital purposes, while the remainder is deposited in trust. Those funds are invested exclusively in short-term government securities. They are not released until 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 SPAC's shareholders 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 the trust account. Typically, a business combination will not proceed even with majority approval if at

least 20% or more of the public shareholders exercise their conversion rights.

If a business combination does not occur within 18 months after the closing of the IPO, the entire trust account 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 a transaction is entered into in which the shares of all of its common shareholders are exchanged for shares of the target company.

SPAC securities may be traded in a variety of ways after an offering. While most SPACs have been listed on the OTC Bulletin Board, certain recent SPACs have been approved for listing on the AMEX if the SPAC meets certain criteria based on an enhanced due diligence review. Such review examines the suitability of the investment, focusing on the underwriter's sales practice and regulatory history. In addition, AMEX has indicated that the SPAC must have at least \$65 million in gross IPO proceeds.

A Look Back: The Brief 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 or separate bank account established by a registered broker-dealer until after a completed business combination.

However, recent SPAC deals are exempt from

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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 or more in net tangible assets. Another difference between the two offerings is that 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 business combination is complete. Additionally,

proceeds of SPAC offerings may only be invested in U.S. "government securities" while proceeds under Rule 419 can be invested in specified securities, such as certain money market funds or securities guaranteed by the United States.

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 a trust or similar account, and if a business combination does not occur within a specified amount of time, the money is returned to investors. 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?

Despite the protections, SPAC offerings also involve risks. The management team typically purchases at least 20% of shares of the SPAC for nominal consideration. They may need to be able not only to provide start up expenses, but also to supply 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. Typically, a business combination will not proceed even with majority approval if 20% or more of the public shareholders

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exercise their conversion rights. On top of these risks, once the business combination is complete, investors then face all of the risks of an investment in a typical IPO.

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

Will There Be Calm After The Storm?

While SPACs certainly enjoyed a very prominent year, market activity for SPACs was mixed in the third and fourth quarters of 2005. While the number of SPAC IPOs increased due to SPAC offerings in the second quarter of 2005, the number of filings for new offerings decreased.

Only 20 S-1s were filed by SPACs in the third quarter, a drop of almost 13% from filings made during the second quarter. Even fewer were filed in the fourth quarter of 2005. While SPAC IPOs accounted for almost half of all IPO filings in the second quarter of 2005, that number dropped to approximately 28% of the total IPO filings in the third quarter. The percentage of SPACs comprising the total number of IPO filings also decreased, with only eight SPACs going effective in the fourth quarter of 2005.

Although the number of SPAC filings dropped at the end of 2005, the SPAC structure continues to draw investor interest. The SPAC market will continue to evolve in 2006 according to these investor wants and demands. (MK)

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