

FEATURED ARTICLE

SPECIFIED PURPOSE ACQUISITION COMPANIES

Mitchell C. Littman, Partner and Mark Coldwell, Associate; Littman Krooks LLP

A Specified Purpose Acquisition Company, or 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.

SPACs are a relatively new method, based on the blank check format, to launch small but promising private companies into the public sector via initial public offerings ("IPOs"). Due partly to the protection provided to investors, SPACs are increasingly becoming the structure of choice in making public offerings. For potential private company targets, SPACs offer the opportunity for a reverse merger, access to capital markets to spur future growth and to receive strategic resources and insight of the SPAC founding management team.

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.

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

TYPICAL STRUCTURE

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 or 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 target company, 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, if more than 20% of a SPAC's shareholders exercise their conversion rights, the acquisition will not be consummated.

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 (which does not include the initial insider 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 stockholders are exchanged for shares of the target company.

RECENT STRUCTURAL DEVELOPMENTS

In early SPACs, in the event of a liquidation of the SPAC, amounts held in trust were not sufficient to repay investors the full amount of their investment. In response to this, there have been several developments designed to increase the amount of funds available to investors upon liquidation of the SPAC. For example, underwriters will defer a portion of their compensation, which is added to the trust and will not be paid out unless a business combination is consummated. Insiders may also purchase units in the offerings and waive their liquidation rights.

In a more sophisticated twist on the structure of the SPAC, multiple units are offered in which one series of units does not participate in the liquidation of the company. This more sophisticated structure, coined as a "START," provides investors with a choice between Series A and Series B Units. Class A units promise investors significantly more warrant coverage, while Class B holders have greater voting power and the benefit of the trust. Only Class B holders will receive trust money upon liquidation; Class A holders bear the entire expense of the offering for both units.

TRADING

SPAC securities may be traded in a variety of ways after an offering. SPAC securities that are listed on a national securities exchange, such as the NYSE, AMEX or the NASDAQ national market system, are preempted from state registration requirements. Restrictions on distribution and trading in secondary markets are also eased.

While AMEX had taken a short hiatus from allowing SPACs to trade there, it has recently begun reviewing applications and accepting SPACs for trading. AMEX now accepts SPACs if they pass an enhanced due diligence review. Such review examines the suitability of the investment – the SPAC must have at least \$65 million in gross IPO proceeds. In addition, AMEX reviews the details of the underwriter's sales practice and the regulatory history of the underwriter and the selling syndicate or any affiliates.

More traditionally, SPAC securities were listed on the OTCBB. These securities must register in those states where offers and sales will occur. Jurisdictions that accept SPAC security offerings currently are: Colorado, Delaware, DC, Florida, Illinois, Indiana, Hawaii, New York, Rhode Island and Wyoming.

WORTHY INVESTMENT?

Despite the required 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. Investors may also lose that eight to fifteen percent of their initial investment if their shares are converted into an interest in the trust account. 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.

NEW CONCERNS

Qualified management teams often demonstrate their commitment to the deal by investing money and purchasing warrants of the SPAC. Such commitment by management offers



evidence to potential investors that they are willing to take the risk on their own deal. If a deal is not consummated in the future, the warrants purchased will expire and be worthless.

Recently, however, regulators raised concerns by claiming that such warrant purchase agreements between the SPAC and the management may potentially violate Regulation M, which bans the manipulation of a trading market during an offering period. Regulation M bars underwriters from buying securities after an IPO in ways that could create an inflated impression of demand among public market investors.

In a recent no-action letter, the SEC made clear that these warrant purchase agreements do not necessarily violate Regulations M. In Key Hospitality Acquisition Corp., the SEC provided guidance as to how to avoid potential Regulation M violations. First, the terms of the agreement must be fully disclosed in the prospectus and filed as an exhibit to the stock registration statement. If there is a pre-established agreement, the management must follow SEC rules for buying warrants under that agreement. Secondly, management cannot sell their warrants until after the business combination or acquisition is made and must disclose any warrant purchases in Form 4 filings. Managers must not bid for or buy any warrants during the 60 days after an IPO, other than those covered by the purchase plan. In addition, management must be able to provide the SEC with daily, time-sequenced schedules of the warrant purchases if so requested and representatives must be available at SEC offices to answer any questions regarding the agreements. If all of these can be shown by the SPAC, they should not run the risk of being found in violation of Regulation M.

CONTINUING POPULARITY?

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

In the market, SPACs that began trading in the third quarter had an average market value of \$72 million and a total market cap value of \$936.5 million. An additional eight SPACs completed their offerings during the fourth quarter.

Although the number of initial filings by SPAC IPOs decreased in the third and fourth quarters of 2005, those SPACs that did go effective increased in number and size. In the third quarter, thirteen deals raised over \$816 million, an average of \$62.8 million per IPO. This average was 35% larger than the average amount raised during the second quarter. Fourth quarter numbers grew even larger, with SPAC IPOs raising over \$996 million.

Based on these numbers, the SPAC structure is still drawing interest from investors. Depending on investor demands, the SPAC market will continue to evolve in 2006.

