A Primer on SPACs: An Explanation of the Purpose, Structure and Current Issues Affecting Special Purpose Acquisition Companies

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Special Purpose Acquisition Companies, commonly known as “SPACs,” have recently surged in popularity as an alternative to traditional acquisition vehicles, due to their ability to raise capital through the public equity markets. Formed for the purpose of acquiring one or more operating companies in a particular sector, nearly 30 SPACs filed initial public offering (“IPO”) registration statements with the Securities and Exchange Commission (“SEC”) between January and June 2005, compared with only 14 such filings during all of 2004. In addition, during that same period, SPACs have raised approximately $481 million in eight IPOs. For example, International Shipping Enterprises, Inc. and Services Acquisition Corp. International, which completed IPOs in December 2004 and July 2005, respectively, each raised well in excess of $100 million.

Despite their recently demonstrated potential to raise significant amounts of public equity, though, SPACs have not yet gained widespread acceptance within the financial and investment communities, due in part to their unique, and often misunderstood structure. The question remains whether SPACs will become an accepted way to access the public markets, or if they will instead remain a novel capital raising vehicle.

**Formation and General Structure**

SPACs typically are organized to acquire, through a business combination, one or more operating companies in a designated market sector. For example, previous SPACs have limited their scope of prospective operating companies to focused market segments such as, among others, the following:

- Technology;
- Shipping;
A SPAC is generally incorporated with the primary objective of raising funds through a public offering of its securities. However, it usually begins as a corporation formed by a small group of sophisticated investors (the “Initial Stockholders”) who will initially hold 100% of the common equity of the SPAC and who also will, at least in part, serve as the management of the SPAC during the period the SPAC is searching for prospective target operating companies. A SPAC will file a registration statement on Form S-1 (the “Registration Statement”) under the Securities Act of 1933, as amended (the “Securities Act”), to register the IPO of its securities.

The Registration Statement sets forth a description of the target sector in which the SPAC intends to acquire operating companies, as well as any objective criteria management intends to employ to screen prospective target operating companies. The Registration Statement also sets forth a description of the offering, the securities to be offered in the IPO, biographies of the management of the SPAC and other related information.

With respect to the Registration Statement, a key factor in the timing and ultimate success of the IPO lies in the length and depth of the review of the Registration Statement undertaken by the staff of the SEC. In this regard, the substantial influx of recent SPAC filings has garnered significant interest from the SEC staff, which has raised concerns regarding certain structural elements and features of SPACs, many of which are described below.

Upon consummation of the IPO, the Initial Stockholders generally will retain an equity position in the SPAC of approximately 20%, which may be reduced in certain circumstances.

**Types of Securities Offered**

Pursuant to the IPO, a SPAC will typically issue units to the public at a set public offering price ranging from approximately $6.00 to $8.00 per unit. Generally, units consist of one or more shares of common stock and one or more warrants exercisable for additional shares of common stock at a set exercise price. Initial Stockholders are permitted to acquire units in connection with the IPO. The units will then trade publicly after the consummation of the IPO for a set period of time (usually one to three months), after which the common stock and warrants underlying the units will begin to trade separately. In most cases, the securities issued by a SPAC during its IPO will trade on the Over-the-Counter Bulletin Board Exchange, commonly referred to as the “OTC-BB,” which is managed by the National Association of Securities Dealers. Recently, however, the American Stock Exchange, or “AMEX,” has begun
accepting applications for listing of SPACs, and at least one SPAC has already begun trading on AMEX subsequent to its initial public offering.

The primary distinction between the OTC-BB and AMEX is that securities traded on the OTC-BB will be required to qualify for offer and/or sale in particular states, some of which prohibit the offer and/or sale of securities issued by SPACs; a listing on AMEX reduces the restrictions on distribution and trading in the secondary market.

Applicability of “Blank Check” Company Restrictions

Rule 419 of the Securities Act imposes certain obligations and restrictions upon issuers that are deemed to be “blank check” companies under applicable rules and regulations. Blank check companies generally lack any revenues, assets, operating history or plan of operations. Among other things, Rule 419 requires that nearly all of a “blank check” issuer’s offering proceeds be placed in escrow until the issuer has completed a business combination. All of a “blank check” company’s securities must also be placed in escrow until after the completion of a business combination, and no trading may occur until the issuer’s securities have been released from escrow. Notably, the definition of a “blank check” company set forth in Rule 419 excludes issuers whose outstanding shares are not deemed to be “penny stock.” In turn, the definition of “penny stock” set forth in Rule 3a51-1 of the Securities Exchange Act of 1934, as amended (the “Exchange Act”), provides an exception for issuers with less than three years of operations who have a minimum of $5 million in net assets.

In this respect, the staff of the SEC has previously determined through interpretive guidance that, to the extent an issuer files a Current Report on Form 8-K promptly upon consummation of an IPO indicating that net assets are in excess of $5 million, the Staff will not deem the issuer to be a “blank check” company subject to the requirements of Rule 419. As a result, SPACs generally file such a Current Report on Form 8-K, once the IPO is consummated, thereby avoiding the restrictions imposed by the requirements of Rule 419.

Notwithstanding the fact that Rule 419 does not apply directly to SPACs, the structure of a SPAC generally tracks most of the requirements of Rule 419. These self-imposed restrictive provisions, which are typically included in a SPAC’s organizational documents or offering-related agreements, seek to provide a certain level of investor protection. The most significant of these self-imposed restrictions are described in more detail below.

It is important to note that recently proposed revisions to the definition of the term “penny stock” leave the SEC staff’s previously guidance open to change, particularly in light of the significant number of SPACs that have filed registration statements during 2005, and on which the SEC staff has focused considerable attention.
Self-Imposed Restrictions

As noted above, while the requirements of Rule 419 are typically not applicable to SPACs, SPACs generally will nonetheless restrict their own activities, as well as those of their respective management teams, subsequent to their IPO to provide protection for their investors. These restrictions generally include, among other things, the following:

- **Escrowing of Offering Proceeds** – A fixed percentage (generally above 90%) of the proceeds from a SPAC’s IPO will usually be placed in an escrow account until the earlier of (i) the consummation of a business combination that has been approved by stockholders, and (ii) liquidation of the SPAC as discussed below.

- **Limitation on Fair Value of Target Businesses** – SPACs are typically required to acquire, in a single business combination, one or more operating businesses that have a fair market value in excess of 80% of the SPAC’s net assets at the time of the acquisition.

- **Limitation on Exercise of Warrants** – The warrants included as part of the units issued by a SPAC will often not become exercisable until the later of (i) the consummation of a business combination, and (ii) some fixed date subsequent to consummation of the SPAC’s IPO (usually one year after the IPO date).

- **Opportunity to Approve a Business Combination** – SPACs are required to seek stockholder approval of a proposed business combination, and any business combination must be approved by at least a majority of the shares of common stock purchased in connection with the IPO.

- **Conversion Right of Disapproving Stockholders** – SPACs typically permit stockholders who vote against a proposed business combination, which business combination is otherwise approved by the stockholders, to convert their shares into a pro rata portion of the SPAC’s then escrowed funds. In the event that greater than 20% of disapproving stockholders elect to convert their shares, a SPAC would also be prevented from completing a proposed business combination.

- **Business Combination Deadline** – A SPAC must typically consummate a business combination within twelve months of its IPO, or within eighteen months of its IPO if it enters into a letter of intent, agreement in principle or definitive agreement with a prospective target operating company within twelve months of its IPO. Some SPACs have also used eighteen and twenty-four month time periods, respectively.

- **Liquidations Requirement** – In the event that a SPAC fails to complete a business combination within the required time period, it typically is required to liquidate and distribute a pro rata share of the then escrowed funds to its stockholders. Initial Stockholders are generally not eligible to receive any distribution of escrowed funds with respect to any shares they acquired prior to the SPAC’s IPO, however.

In earlier SPACs, the foregoing provisions were often included as covenants in the underwriting agreement entered into between the SPAC and the underwriters for the IPO.
Certain of the provisions were also included in “side letter” agreements between the Initial Stockholders and both the underwriters and the SPAC itself. Recently, however, SPACs have begun to incorporate these provisions in their organization documents, and have created corresponding audit committees to enforce such provisions. This revised structure reduces the participation of the underwriters in the business and operations of the SPAC following the IPO, which may be more efficient for, and less burdensome to, the SPAC and the Initial Stockholders.

Use of Net Offering Proceeds Not Held in Escrow

In addition to the offering proceeds typically held in escrow, the remaining proceeds of a SPAC’s IPO generally remain available for use by the SPAC in connection with its search for prospective target operating companies, as well as to satisfy general operating expenses of the company prior to completion of a business combination. The Registration Statement will typically include detailed information regarding its intended use of the net offering proceeds not held in escrow, which excludes any amounts to be paid in connection with offering related expenses. Typically, SPACs will reserve a portion of their net offering proceeds not held in escrow for such items as directors and officers insurance and legal and accounting expenses related to ongoing SEC reporting obligations. A significant portion of the proceeds not held in escrow, however, will generally be reserved for due diligence investigations of prospective target businesses, along with legal and accounting expenses related to the negotiation, structuring and shareholder approval of a business combination.

In addition, SPACs will typically designate the bulk of their net offering proceeds not held in escrow as working capital. Such working capital may generally be used for a variety of purposes, including, among other things, the reimbursement of out-of-pocket expenses incurred by a SPAC’s officers and directors on its behalf, the retention of independent valuation firms and third-party consultants in connection with the evaluation of prospective target operating companies, and other expenses related to the completion of a business combination, including the making of a down payment or the payment of exclusivity or similar fees and expenses.

A SPAC’s officers and directors will generally receive no salary or other compensation from the SPAC, other than amounts the SPAC may pay to reimburse its officers and directors for any out-of-pocket expenses they may incur on its behalf.

Optional Structural Elements

In addition to the self-imposed restrictions generally found among SPACs, certain SPACs also include additional features either to satisfy market expectations or as a result of agreements involving the Initial Stockholders and underwriters. The most common of these additional SPAC features include:
Lock-up Agreements – SPACs will often require Initial Stockholders to agree to lock-up provisions to ensure that the Initial Stockholders retain their respective ownership interests in the SPAC until some period of time after a business combination. In some cases, this period of time has been as short as six-months and, in other cases, this period of time has been as long as three years.

Warrant Purchase Commitment Agreements – In order to better align the interests of the Initial Stockholders with investors purchasing securities of the SPAC’s in the IPO, certain SPACs will require that one or more of the Initial Stockholders agree to purchase a fixed dollar amount of warrants in the public markets, which warrants will also be subject to a lock-up period until the SPAC consummates a business combination.

Underwriters’ Purchase Option – Certain SPACs will sell to their lead underwriter, for a nominal cost, an option to purchase additional units. These units generally will have comparable terms as the units issued in the IPO, except that the unit purchase price and the warrant exercise price will be higher (approximately 125% of the corresponding amounts of the IPO-offered securities). Such a purchase option would be in addition to any over-allotment option granted to the underwriters in connection with the IPO. The SPAC will also commonly grant limited registration rights with respect to the securities underlying such purchase option.

Registration Rights Agreements – SPACs often grant the Initial Stockholders registration rights with respect to the shares of common stock acquired prior to the IPO. The registration rights generally permit a fixed number of demand registrations, as well as “piggy back” registration rights.

Ongoing Reporting and Corporate Governance Requirements

Upon effectiveness of the Registration Statement relating to its IPO, a SPAC will become subject to numerous SEC reporting and corporate governance requirements as a result of its status as a public company. For example, a SPAC must begin to file both Quarterly and Annual Reports with the SEC, on Forms 10-Q and 10-K, respectively. A SPAC must also periodically file Current Reports on Form 8-K to disclose the occurrence of certain material events. For example, a SPAC must file a Form 8-K to announce its entry into a merger or acquisition agreement with respect to a proposed business combination, as well as upon completion of a business combination.

SPACs are also subject to the SEC’s proxy solicitation rules, set forth in Regulation 14A under the Exchange Act, upon becoming a public company. Regulation 14A will generally govern the process by which a SPAC seeks shareholder approval of a proposed business
combination, and will require the filing of both preliminary and definitive proxy materials with the SEC under cover of Schedule 14A.

In addition, a SPAC must comply with the various corporate governance requirements imposed on public companies by the Sarbanes-Oxley Act of 2002. SPACs that opt to list on AMEX must also comply with additional corporate governance requirements included within the listing standards applicable to all AMEX-listed companies, including the establishment and maintenance of an audit committee composed of independent directors.

**Selection and Evaluation of Prospective Target Operating Companies**

Once its IPO is completed, a SPAC will usually begin its search for prospective target operating companies. The officers and directors of a SPAC will often play a significant role in locating and evaluating prospective target operating companies. A SPAC may also designate special advisers, who hold no formal position with the SPAC, to assist management in locating and evaluating prospective target operating companies. Generally, a SPAC’s officers and directors, as well as any special advisers it may designate, receive no compensation from the SPAC for any services they may perform on the SPAC’s behalf, other than the reimbursement of any out-of-pocket expenses they may incur on the SPAC’s behalf.

Once one or more prospective target operating companies have been located, a SPAC’s management will typically begin the process of performing due diligence on the prospective target operating companies. In connection with this due diligence process, the SPAC may seek the assistance of legal counsel, as well as independent valuation firms and third-party consultants. A SPAC may also opt to pay an exclusivity or similar fee to a prospective target operating company to prevent the sale of that company to a third party during the due diligence process.

Once the due diligence process has been completed, a SPAC will generally negotiate merger or acquisition agreements with each of the prospective target operating companies selected by the SPAC. In the event that a SPAC intends to acquire multiple operating companies, it must generally do so in a single business combination. As a result, any agreements relating to the acquisition of separate operating companies must be drafted to ensure that the individual acquisitions occur simultaneously in order to satisfy one of the key elements of the SPAC structure. The board of directors of a SPAC will then be required to approve any formal merger or acquisition agreements relating to a proposed business combination. Once a SPAC has entered into a definitive agreement with respect to a proposed business combination, it must file a Current Report on Form 8-K to publicly disclose the proposed business combination,
and must generally attached a copy of the definitive agreement as an exhibit to that Current Report on Form 8-K.

**Obtaining Shareholder Approval of a Proposed Business Combination**

After the board of directors has approved a proposed business combination, including any merger or acquisition agreements relating to the proposed business combination, the SPAC must then obtain stockholder approval of the proposed business combination. To that end, the board of directors of a SPAC must establish record and meeting dates for a special meeting of the stockholders of the company in order to approve the proposed business combination. In addition, a SPAC must prepare and file preliminary proxy materials with the SEC under cover of Schedule 14A in connection with the solicitation of proxies for approval of the proposed business combination.¹

These proxy materials remain subject to review by the SEC staff, which may provide comments with respect to the disclosure contained in such proxy materials. This review process may take a considerable amount of time to the extent the SEC staff focuses particular scrutiny on the terms of a proposed business combination. Upon completion of any SEC staff review of the proxy materials, the SPAC will then file its proxy materials with the SEC in definitive form, and begin the process of printing and mailing its proxy materials to its stockholders.

After stockholders have approved a proposed business combination by the requisite majority of votes, escrowed funds will be released to the SPAC in order to complete the proposed business combination. In the event, however, that disapproving stockholders holding more than 20% of the SPAC’s outstanding shares opt to convert their outstanding shares into a **pro rata** portion of the IPO proceeds held in escrow, the escrowed funds would not be released to the SPAC, and the SPAC would be prevented from completing the proposed business combination. Once the escrowed funds are released to the SPAC, it will typically complete the proposed business combination shortly thereafter. The SPAC will also be required to file a Current Report on Form 8-K announcing the completion of the business combination.

¹ In the event that a SPAC opts to issue additional securities in connection with a proposed business combination, it would also be required to file a registration statement on Form S-4 to register that issuance of securities, pursuant to Rule 145 of the Securities Act.
Benefits of the SPAC Structure

Despite their seemingly complicated structure, SPACs still hold a unique advantage over traditional acquisition vehicles, due to their ability to raise public capital to fund takeover acquisitions of private operating companies. Although SPACs have yet to gain widespread popularity and acceptance within the financial and investing communities, recent developments such as the decision by AMEX to begin accepting SPACs for listing suggest a growing comfort with the SPAC structure. As the more recently registered SPACs begin to achieve acceptance in the public markets by successfully closing business combinations, the SPAC model may gain increasing acceptance as a viable alternative for sophisticated investors seeking future acquisition vehicles.

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