A New SPAC Structure May Lead to Renewed Interest in SPAC Offerings

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Recent developments relating to SPACs may lead to some renewed interest in SPAC offerings. A SPAC is a special purpose acquisition company formed to acquire one or more operating companies but without an immediate acquisition having been identified. A new SPAC structure has been introduced recently that is designed to facilitate subsequent acquisitions by SPACs. We refer to the new SPAC structure as the Tender Offer Structure.

Traditional SPAC Structure vs. Tender Offer Structure

The traditional SPAC structure generally involves the solicitation of shareholder approval by the SPAC prior to the completion of an acquisition. In the Tender Offer Structure, the SPAC is required to make a tender offer for the shares held by certain shareholders of the SPAC prior to completing an acquisition. The first SPAC to use this structure was 57th Street General Acquisition Corp., which filed a registration statement for its initial public offering (IPO) in December 2009. Since then, a number of new SPACs using the Tender Offer Structure have filed registration statements, several of which have been declared effective.

Until recently, the Nasdaq Stock Market LLC, New York Stock Exchange and NYSE Amex would only list the securities of SPACs that use the traditional structure. Accordingly, to date, those SPACs adopting the Tender Offer Structure in 2010 did not list, or propose to be listed, on a national securities exchange and, instead, have had their shares quoted on the OTC Bulletin Board. However, in December 2010, the Nasdaq effectively endorsed the new structure by amending its listing rules to allow SPACs using the Tender Offer Structure to list on the exchange. Subsequently, on January 21, 2011, NYSE Amex adopted a rule change for the same purpose. Listing on the Nasdaq or NYSE Amex should improve the liquidity of the SPAC securities and, therefore, may make these SPACS more attractive to investors. Since the beginning of 2011, a number of SPACs have filed registration statements, none of which have been declared effective. However, the SPACs using the Tender Offer Structure that have filed registration statements after the Nasdaq and NYSE Amex adopted those changes have still proposed to be listed on the OTC Bulletin Board. The only exceptions are two foreign incorporated SPACs.

On January 9, 2011, 57th Street entered into an agreement in connection with a proposed acquisition and on February 22, 2011, it launched a tender offer for its outstanding shares and warrants. In March and April 2011, 57th Street extended the tender offer period and announced changes to certain terms of the proposed

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acquisition. The experience of this proposed acquisition and the related tender offer, together with the new listing rules of the Nasdaq and NYSE Amex, should shed light on the potential for increased SPAC activity in the coming months. Click here and here to view the agreement and certain related documents.

SPACs Generally

SPACs provide public investors with a means of investing in a leveraged buy-out or other private equity form of transaction. A SPAC starts life as a shell or "blank-check" company and then undertakes an IPO. A substantial majority of the IPO proceeds are deposited in an escrow account and are intended to finance the merger with, or acquisition of, one or more operating companies to be identified some time after completion of the IPO. Some SPACs are formed to focus on particular industries; others are formed without qualification as to the type of target companies to be sought. In SPAC IPOs, the SPAC generally issues units consisting of a number of different securities, including shares of common stock and one or more classes of warrants. Shortly after the closing of the IPO, the SPAC releases audited financial statements that reflect the receipt of the offering proceeds. In addition, at some point shortly after the IPO, the common stock and warrants underlying the units begin to trade separately, as well as collectively in unit form.

SPAC Activity on the Decline since 2007

The year 2007 was a significant year for SPAC offerings. According to IPO Vital Signs, an online IPO research and analysis tool produced by Wolters Kluwer,[1] 65 blank-check companies raised $10.9 billion in public offerings in the United States, accounting for about 25% of the number of IPOs, and 17% of the aggregate IPO proceeds, for that year. The size of SPAC offerings in 2007 was also significant. The year 2007 witnessed a billion dollar SPAC offering, and the average offering size of SPAC IPOs in 2007 was $167.2 million (not counting over-allotments), which was slightly more than twice the size of a typical SPAC IPO in 2006. In 2007, bulge-bracket banks began to participate in SPAC offerings and close to 50 SPACs listed on the American Stock Exchange (now known as NYSE Amex). During 2008 and 2009, the SPAC market cooled down. According to IPO Vital Signs, there were 17 SPAC offerings in 2008 with an average deal size equal to $214.0 million. In 2009, there was one SPAC offering, which raised only $36.0 million. From the beginning of 2010 through April 11, 2011, 25 SPACs filed registration statements. In 2010, seven SPACs completed offerings, raising $491.0 million in the aggregate. In 2011, through April 11, four SPACs completed offerings raising $209.5 million in the aggregate. Although there seems to be renewed SPAC activity, the size of the SPAC offerings has not returned to the levels seen in 2007 and 2008.

Year	No. of Offerings	SPAC Offerings	Average Offering Size
2007	65	$10.9 billion	$167.2 million
2008	17	$3.6 billion	$214.0 million
2009	1	$36.0 million	$36.0 million
2010	7	$491.0 million	$70.1 million
2011	4	$209.5 million	$52.4 million

A Defining SPAC Characteristic: Significant Shareholder Control

A defining characteristic of SPACs is that, in order to attract public investors, they traditionally grant significant control over the ultimate acquisition and the life of the entity to shareholders. A SPAC also adopts individualized criteria to define qualifying acquisitions for the SPAC. Although exact structures vary, a review of SPACs formed between 2005 through 2009 shows that during that time, SPACs generally adopted charter documents that prohibited completion of an acquisition without a shareholder vote on the acquisition, whether or not

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required by applicable law, rule or regulation. Those SPACs generally require the consent of the holders of a majority, or more than a majority, of the outstanding shares to complete an acquisition. Many SPACs formed during that period were prohibited under the terms of their charter documents from completing an acquisition if the holders of more than a designated number of shares voted against the acquisition. For example, the charter documents of many SPACs formed prior to 2010 provide that the SPACs may not complete an acquisition if holders of a fixed number of the outstanding shares of common stock (generally 20% to 30%) vote against the acquisition. This number is important because the charters generally provide that a shareholder voting against an acquisition has the right to exchange its shares for that shareholder's pro rata interest in the escrow account, minus certain deductions. Accordingly, a shareholder may have an incentive to vote against an acquisition, even if the shareholder generally believes the acquisition will be beneficial to the SPAC. In such scenario, the shareholder may determine that it is in its best interest to liquidate its position prior to the acquisition in exchange for its pro rata share of the escrow account, which often is close to, or ever slightly more than, the shareholder's basis in the securities, rather than wait for the value of the acquisition to be reflected in the issuer's market price.

Limitations of SPACs

Regulatory Obstacles

SPACs face a number of obstacles once they become reporting companies. A SPAC is an "ineligible issuer," as that term is defined in Rule 405 under the Securities Act of 1933. The entity will generally continue to be an ineligible issuer for a three-year period after the SPAC completes an acquisition and ceases to be a blank-check company. Ineligible issuers are not entitled to issue free writing prospectuses (FWPs), as that term is defined in Rule 405, in connection with offerings. Given that FWPs are now frequently used in marketing securities offerings, the inability to use an FWP is important to keep in mind. In addition, SPACs may not take advantage of any form of electronic roadshow that is a graphic communication, as that term is defined in Rule 405. Accordingly, SPACs may only use live road shows. Live roadshows need not be in person meetings—there is some flexibility with respect to the means of transmission—but any electronic roadshow that is a graphic communication is not available to SPACs.

Even after a SPAC has been a reporting company for at least 12 months, the SPAC is not eligible to use a registration statement on Form S-3 for a primary offering for cash unless the aggregate market value of the voting and non-voting common equity of the SPAC held by non-affiliates is $75 million or more.[2] This limitation applies for a 12-month period after the entity files with the Securities and Exchange Commission (SEC) the information required to be set forth in a Form 10 registration statement under the Securities Exchange Act of 1934 reflecting its status as an entity that is not a shell company. In addition, shell companies may not file a registration statement on Form S-3 for a secondary offering without disclosing the identities of the selling shareholders and the amount of securities to be registered on their behalf.[3] This limitation applies for a three-year period after the entity ceases to be a shell company. These regulatory limitations result in SPACs not being able to take advantage of many conveniences that the SEC has made available to increase the efficiency of the registration process and to facilitate capital formation.

The limitations are not limited to securities offering issues. The holders of securities issued by a SPAC may not immediately take advantage of the safe harbor provided in Rule 144 under the Securities Act for the resale of the securities. Rule 144 will only be available for the resale of SPAC securities once the SPAC has ceased to be a blank-check company, is subject to the reporting requirements of the Exchange Act and has filed all required reports and other materials required to be filed by Section 13 or 15(d) of the Exchange Act, as

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applicable, during the preceding 12 months (or for such shorter period that the SPAC was required to file such reports and materials), subject to certain exceptions. The entity must also have filed the Form 10 information, as defined in Rule 144, with the SEC. The securities may be sold under Rule 144 after one year has elapsed from the date the Form 10 information has been filed. Based on this limitation, SPACs will likely continue to either register all securities issued by the SPACs in their IPOs, including shares of common stock underlying warrants issued by the SPACs, or agree to use best efforts to register such shares by the time the warrants become exercisable. Absent either of these options, it is unlikely that investors will be willing to participate in the IPO, as the common stock underlying the warrants might not be freely tradable at the time they become exercisable.

Governance Obstacles

In addition to these regulatory limitations, SPACs face other limitations. The management team of a SPAC receives a generous equity stake in the company at the time of the IPO, typically as high as 20% of the total shares outstanding (not giving effect to the warrants). The equity issued to management is generally referred to as the "management carry" and the securities are generally referred to as the initial securities. Management typically purchases additional securities simultaneously with the completion of the IPO. The securities held by management are typically not entitled to a pro rata share of the escrowed IPO proceeds in a liquidation. Many potential investors avoid SPACs because of the high management carry. In addition, the different forms of securities issued by a SPAC attract certain investors that seek to profit from technical investing rather than long-term investing. Technical traders may purchase units in a SPAC IPO only to trade in the underlying securities intending to profit from arbitrage opportunities. The intention of technical investors to cash out their investments prior to an acquisition, or the public perception that they will do so, has had an adverse effect on SPACs.

In recent years, the shareholder consent provisions have proven to be obstacles to the closing of SPAC acquisitions. A SPAC generally includes a provision in its charter that requires that the SPAC liquidate, and distribute the escrowed IPO proceeds to shareholders, if it does not complete an acquisition after a fixed period of time, generally 18 or 24 months. As discussed above, many SPAC shareholders in the past determined that it was in their best interest to vote against a particular acquisition and to recoup their pro rata share of the applicable escrow account. In addition, many SPACs that solicited shareholder consent for acquisitions found that they were able to obtain the necessary vote only by entering into forward purchase agreements with some shareholders. Those transactions serve to buy out certain shareholders and appease other shareholders concerned about the warrant overhang. Many SPACs failed to obtain sufficient consent for acquisitions, even after attempting, or even completing, such transactions. These transactions, even if they achieve the desired results, are expensive, result in significant distractions for the SPACs' management, and prolong the acquisition process considerably. Many SPACs have failed to close acquisitions before the mandatory liquidation date due to the shareholder approval requirement.

A Potential Solution: The SPAC Tender Offer Structure

The Tender Offer Structure, which was tested and accepted by the SEC over the course of 2010, addresses some, but not all, of the limitations associated with the shareholder vote or approval requirement. First, and most important, as discussed above, 57th Street abandoned the mandatory shareholder vote on acquisitions and replaced it with an issuer tender offer. That is, rather than solicit shareholder approval of an acquisition, the SPAC will conduct a tender offer pursuant to which it will offer to redeem all outstanding shares of the SPAC, subject to certain exceptions, upon a proposed acquisition. Unless state law or other rules and/or regulations require a vote, shareholder consent is not required to close

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the acquisition. If, however, shareholders elect to redeem more than a fixed number of shares (88% in the 57th Street structure), the SPAC will not complete the acquisition. SPACs using the Tender Offer Structure generally agree that if they decide to solicit a shareholder vote on an acquisition, for any reason, the vote or consent, as applicable, will be conducted with the same terms and conditions as the traditional SPACs. The Tender Offer Structure is a much easier standard for a SPAC to meet than the traditional structure. The new structure also contains a number of other concessions to make SPACs more attractive, including shorter time periods before liquidation, less warrant coverage, higher warrant strike prices, and smaller management carries.

There are differences among the exact structures adopted by the various entities that have adopted the Tender Offer Structure. Some have opted to set a minimum amount of net tangible assets that must remain in the hands of the SPAC as a condition to completion of the issuer tender offer, rather than fixing a cap on the amount of shares that may be tendered. See, for example, Hicks Acquisition Co. II, Inc. and JWC Acquisition Corp. Some have an express provision that allows the SPAC to use the funds in the escrow account to purchase up to a fixed amount of securities from holders if the SPAC seeks shareholder approval of an acquisition. See, for example, RLJ Acquisition, Inc. and SCG Financial Acquisition Corp. Such a provision makes it easier for the SPAC to buy out shareholders expected to vote against the acquisition if a vote is needed or desired. Last, some SPACs have reserved the right to remain in existence as a shell company if it is required to distribute the escrow proceeds to the shareholders due to the failure to complete an acquisition during the proscribed period. See, for example, Cazador Acquisition Corp. and Lone Oak Acquisition Corp.

Registration of Shares

SPACs have increasingly sought to limit the market overhang created by the registration of the shares of common stock underlying the warrants issued to the public in the IPO. These warrants generally may not be exercised until the closing of the initial business combination. Although many registration statements filed for SPACs register every combination of securities possible, which results in all offered securities being freely tradable by the investors (subject to certain exceptions), some of the recently formed SPACs have excluded from the initial registration statement the shares of common stock underlying the warrants issued to all IPO investors, as well as certain of the securities held by the SPAC management. The SPACs that have so limited the scope of the registration statement have provided the holders of the securities with various registration rights. With respect to the public warrants and the warrants purchased by management at the closing of the IPO, the SPACs generally agree to use best efforts to have an effective registration statement covering the underlying shares of common stock available when the warrants become exercisable (generally shortly after an acquisition is completed). With respect to the initial shares and the shares of common stock underlying the initial warrants issued to the SPAC sponsor and management, the SPACs generally grant the holders demand and "piggy-back" registration rights that can only be exercised one year after completion of an acquisition. As discussed earlier, registration statements on Form S-3 may not be available for many of these registrations, which makes for a cumbersome and expensive process. Further, the holders will not immediately have the opportunity to rely on Rule 144 if the registration statements are not declared effective in a timely manner.

Listing Shares on Exchanges

As discussed above, the Nasdaq and NYSE Amex have adopted changes to their rules that will allow SPACs using the Tender Offer Structure to list on those exchanges. Notwithstanding these developments, the listing of a SPAC on either of those exchanges may subject the SPAC to limitations that outweigh the benefits of listing. For example, both the Nasdaq and NYSE Amex have

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rules requiring a listed company to obtain shareholder approval for the issuance of a number of securities equal to, or convertible into, or exchangeable for, 20% or more of the company's total shares outstanding (TSO) if the purchase price of the securities involves a discount to the greater of the market price or book value of the company's common stock, or involves the acquisition of the stock of another company or assets. Shareholder consent is also required if securities are issued in connection with a transaction that involves a change of control. Accordingly, a SPAC that is listed on the Nasdaq or NYSE Amex will likely need to obtain shareholder approval for any acquisition that involves stock consideration in excess of 20% of the TSO. Thus, a SPAC electing to list on the Nasdaq or NYSE Amex under the new rules must consider that its ability to avoid a shareholder vote in connection with an acquisition is not absolute. In comment letters to the Nasdaq rule change, commenters raised this issue, but the SEC did not address the existing shareholder consent rules (nor did the Nasdaq request that the shareholder consent rules be changed).

A Flexible Approach

Australia Acquisition Corp., a SPAC that completed an IPO in 2010, generally follows the traditional structure and is listed on the Nasdaq. Unlike other SPACs, however, Australia Acquisition agreed that if the Nasdaq rules are amended to allow SPACs to list on the exchange without the shareholder approval requirement before Australia Acquisition solicits shareholder approval in connection with an acquisition, it would follow the Tender Offer Structure unless shareholder approval is otherwise required by law or it chooses to solicit shareholder approval.

Conclusion

The Tender Offer Structure appears to have resulted in at least some renewed interest in SPAC offerings. A review of the SPAC offerings that were completed during 2010 shows that although many SPACs experienced a decrease in the proposed offering price during the registration process, the offerings did close. However, the acquisition process has yet to be tested. Closing an acquisition should be the ultimate factor in determining whether the Tender Offer Structure will result in a stronger market for SPAC offerings. The recent announcement by 57th Street is interesting news for the SPAC market. The market will be following the acquisition process closely to see whether the anticipated advantages of the Tender Offer Structure are realized. However, challenges remain and many of the limitations inherent in SPACs have not changed. Management carries overall have not decreased and, although some SPACs have decreased their warrant coverage compared to others, the warrant overhangs remain. Recent reports in the media indicate that 2011 will be a strong year for corporate M&A activity. Increased competition on the acquirer side will affect the amount of target companies willing to consider an acquisition by a SPAC. What is certain is that the SPAC market should experience a number of changes over the course of 2011.

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[1] See http://www.ipovitalsigns.com/www.ipovitalsigns.com%20(last visited Apr. 11, 2011).

[2] See Form of Registration Statement on Form S-3, instructions I(B)(1) and I(B)(6).

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[3] See Securities Act Rules 430B(a) and (b).

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