

**AS FEATURED IN BLOOMBERG CORPORATE LAW JOURNAL
FEBRUARY 2006****Specified Purpose Acquisition Companies**

By Sarah Hewitt

Background

The past two and one-half years have seen the reemergence of blank check companies, popular in the 1990s but tainted due to abuses, which have been given the names “Specified Purpose Acquisition Company” (SPAC) and “Target Acquisition Company” (TAC) by the investment banks that have popularized them since mid-2003.¹ Blank check companies, in their 2000s incarnation (most commonly referred to as SPACs), are a structured investment product with principal protection and upside potential. They are a cross between an initial public offering (IPO) and a reverse merger, also popular the past few years. SPACs, like reverse mergers, were initially a reaction to the soft IPO market and lack of investment banks willing or able to underwrite small public offerings. Unlike a reverse merger, a SPAC provides the target company with cash raised through the IPO. SPACs also offer pristine shells (as they are newly-formed companies), US listings and the leadership and involvement of highly qualified management teams rather than promoters whose interests are closely aligned with those of the public shareholders of the company.

SPACs are shell companies formed by individuals with M&A, capital markets and industry expertise who engage an investment firm to underwrite an IPO of the SPAC. The SPAC is marketed and sold to investors on the basis of the management team’s credibility and the appeal of the industry or geography specific to the team’s acquisition strategy. Following the IPO, the management team of the SPAC seeks, typically for up to eighteen months, one or more merger candidates in a specified industry with a value of at least eighty percent of the SPAC proceeds that wants a public listing. The two entities will do what essentially amounts to a reverse merger using the cash raised in the IPO as all or part of the consideration for the combination. An acquisition target must have a business large enough to sustain a public company but small enough not to either interest private equity investors or be a viable IPO candidate. Investors in SPACs are typically hedge funds, equity funds and other institutional investors with expertise in the securities market which are comfortable with structured finance products and are enthusiastic about launching small but promising private concerns into the public sector.

At least thirty-eight SPACs have raised over \$2,000,000,000 through IPOs since May 2003 while approximately forty-three SPACs seeking to raise over \$3,350,000,000 have their securities in registration with the U.S. Securities and Exchange Commission (SEC) waiting to go public in the coming weeks or months. Three of the funded companies have closed an acquisition and seven have announced acquisitions and are in the proxy solicitation process. The rest of the funded companies are seeking investment targets.

Mechanics of the SPAC Offering

A small group of individuals with M&A and industry expertise and more importantly who have created value for public shareholders in the past get together to form a management team. That team typically invests \$25,000 in the SPAC, paying \$.015 to \$.03 per share for their founders’ shares. The founders’ shares typically will be held in escrow and locked up until two to three years after the IPO but will have registration rights after the expiration of the lock-up period. The management team’s ownership stake is intended to ensure that their interests are firmly aligned with those of the investing public.

The management team works with investment bankers and together they put together a registration statement describing the specified purpose for which the SPAC has been formed, the

industry opportunity, the securities being offered, the risks associated with the venture, the mechanics related to the future business combination and the management team and its experience. The process typically takes about three to six months including time for preparing and filing the Form S-1 registration statement and time for the SEC review process and commentary and subsequent amendments to the registration statement. The underwriters present the team and the SPAC to potential investors, typically hedge funds and equity funds and other institutional investors, in the traditional road show format from the time the preliminary prospectus is filed. Although there may be a small retail component to offerings by SPACs, the Blue Sky laws of the various states are such that most offerings can only be done in about ten jurisdictions at the retail level.

The SPAC typically will offer units consisting of one share of common stock and two warrants, each of which can be converted into one share of common stock at an exercise price which is typically a discount of fifteen to twenty percent from the issue price of the units for a period of four years. The warrants are not exercisable until the later of the completion of a business combination and one year from the date of the prospectus. The warrants typically are redeemable in whole by the SPAC at a price of \$.01 if the trading price of the common stock is at or above an eighty percent premium to the original issue price for a period of twenty out of thirty trading days. The units are generally priced at \$6 each in the IPO. SPACs have raised anywhere from a low of \$7.88 million to a high of approximately \$200 million to date, with median offer pricing in the \$70 million range and growing, not inclusive of proceeds from the exercise of warrants. The \$6 per unit pricing with a minimum raise of approximately \$8 million (giving the SPAC more than \$5 million of tangible net assets) allows the offerings to be treated outside of Rule 419 promulgated under the Securities Act of 1933, as amended, governing offerings by blank check companies and the SEC's penny stock rules.

Upon the closing of the IPO, the SPAC will place anywhere from approximately eighty-five to ninety-three percent of what was raised (after expenses) into a trust fund with a money center bank to be invested in government securities with specified maturities (typically treasury bills with maturities of 180 days or less so the company does not get treated as an investment company) and that is where the cash remains until the earlier of the completion of a business combination and the company's liquidation upon failure to effect a business combination within the allocated time. The balance of the funds raised in the IPO is used by the management team as operating capital to find and effect the proposed business combination, for offering expenses and for working capital. Any proceeds generated from the exercise of warrants will go directly to the SPAC and will not be placed in the trust. The trust structure assures investors of recovering a large percentage of their investment with the potential to make up the balance through the resale of the warrants.

After the IPO, the members of the management team typically will control about twenty percent of the outstanding common stock and public investors typically will control the balance of the SPAC. Each member of the management team will have director and officer positions with the SPAC but will get no salary (although their expenses will be fully reimbursed by the SPAC). The management team is generally required by the underwriters to buy approximately ten percent of the outstanding warrants after the IPO after the warrants are detached from the units and trade separately at a specified maximum price although the SEC and NASD have recently raised concerns under Regulation M about this requirement. The members of the management team will not commit a specific amount of time to the SPAC but will continue their activities with other, often related, ventures while they search for acquisition candidates for the SPAC. Upon the business combination, members of the management team will resign their officerships, if not their directorships, with the SPAC. Shortly after the business combination, the lockup on their founders' shares will expire and their registration rights will be exercisable.

SPACs must typically complete a business combination within eighteen months after the consummation of their IPOs or twenty-four months after the consummation of their IPOs if a letter of intent or definitive agreement relating to a prospective business combination was entered into prior to the end of the eighteen-month period. If the SPAC fails to complete a deal within the time allotted, the proceeds in the trust plus any remaining net assets after payment of the costs of

liquidation and dissolution are returned to the public shareholders, while the management team and founding shareholders receive nothing. The management team may, in fact, pay expenses in excess of amounts in the escrow in the event of the liquidation of the SPAC. The warrants, of course, would be worthless.

By custom and SEC preference, each SPAC must identify an initial target business for acquisition that has a fair market value equal to at least eighty percent of the SPAC's net assets at the time of such acquisition. The Board of Directors of the SPAC can make that determination as to value relative to its net assets or an opinion can be sought from an investment banker. SPACs may issue debt or equity securities in addition to using some or all of the cash raised in the IPO to fund the acquisition.

Once the merger target is identified, the SPAC will give its stockholders the opportunity to vote on the business combination, whether or not required by state corporate law. In connection with seeking stockholder approval, the SPAC will prepare and distribute a proxy statement containing the information required by the SEC. This distinguishes the SPAC from the blank check companies of the 1990s where the investor didn't have a seat at the table when the investment decision was being made. Shareholders can vote to approve or disapprove the business combination or can sell their securities. The vote of the majority controls. The management team and founding shareholders typically agree to vote with the majority of the public shareholders for or against the transaction. Not more than twenty percent of the shareholders may vote against the business combination if the transaction is to succeed. If the majority of the shareholders approves the transaction but some vote no, each of the dissenting stockholders following the procedures described in the proxy statement is given the right to convert his or her stock into a pro rata share of the trust account plus interest and be paid such share in cash once the transaction closes. The dissenting stockholders can continue to exercise any warrants they hold. However, a stockholder who does not follow these procedures or a stockholder who does not take any action would not be entitled to the return of any funds.

The SPAC units may commence trading on or promptly after the date of the prospectus typically on the OTC Bulletin Board. The common stock and warrants comprising the units typically will begin to trade separately on the ninetieth day after the date of the prospectus unless the underwriter informs the SPAC of its decision to allow earlier separate trading, provided the SPAC has filed with the SEC its Current Report on Form 8-K which includes an audited balance sheet reflecting the SPAC's receipt of the proceeds of the IPO. Although SPACs have typically listed their securities on the OTC Bulletin Board, the AMEX has shown some interest in listing the securities of some of the larger SPACs with approved underwriters and management teams and listed its first two SPACs recently. SPACs will routinely file Exchange Act reports such as Annual Reports on Form 10-K, Quarterly Reports on Form 10-Q and Current Reports on Form 8-K as well as Section 16 reports following the effectiveness of their prospectuses and the closing of their IPOs.

Status

SPACs are a relatively new incarnation of an old vehicle. SPAC investors can potentially achieve returns in a private equity-style transaction with public liquidity and warrant upside with risk mitigated by the trust structure and the shareholder vote requirement. However, SPACs are relatively untested in the sense that, to date, there have been only three completed acquisitions and seven proposed acquisitions from some thirty-eight potential deals. A large number of SPACs, especially the larger SPACs coming down the pike, could potentially fail to complete a business combination within the time allotted, returning funds to investors upon liquidation, without the anticipated gains. Improvements in the IPO market could do away with the need for this alternative offering structure. New structures could come into vogue. SEC regulation or actions by the NASD or Blue Sky regulators could impact the usefulness of the SPAC structure. Time will tell.

Sarah Hewitt is a partner in the New York office of Brown Raysman Millstein Felder & Steiner LLP. She concentrates on corporate and securities law, mergers and acquisitions and venture

capital financing. She has extensive experience in private placements, public offerings, mergers, acquisitions, joint ventures, reorganizations and related financing. She has represented issuers, as well as buyers and sellers in a wide variety of industries including cable television, cellular telephone, cement, defense contracting, direct marketing, discount brokerage, health care, life sciences, new media, petrochemical, restaurant, software, steel and technology. Ms. Hewitt was Co-Editor-in-Chief of the newsletter, eSecurities: Trading and Regulation on the Internet, published by American Lawyer Media and co-authored a column on corporate finance for the New York Law Journal.

ⁱ“Specified Purpose Acquisition Company” and “SPAC” are service marks of EarlyBird Capital, Inc. and “Target Acquisition Company” and “TAC” are service marks of I-Bankers Securities.