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PAINT IT SPAC

ARE SPECIAL PURPOSE ACQUISITION COMPANIES A NEW MODEL FOR CAPITAL INFORMATION?

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As initial public offerings have waned as an exit strategies, special purpose acquisition companies, or Spacs, have become a popular alternative for private equity transactions. A Spac turns the typical private equity investment cycle on its head by putting the exit strategy first. A Spac first raises equity capital via an IPO, then locates and acquires a target company and has an immediate exit via the existing public market for its shares.

Blank-check companies have a checkered past. In response to abusive transactions in the "penny stock" market during the 1980s, regulators adopted stringent rules to discourage them. However, in the mid-1990s, a new model, featuring significant investor-protection features, began to develop. Spacs have recently come into their own, accounting for as much as 22% of annual IPO volume.

Spacs now feature significant investor protections. A Spac will have a high-quality management team experienced in making acquisitions. Nearly all of the IPO proceeds are escrowed and invested in Treasury securities until the company completes an acquisition approved by its public stockholders. Public stockholders who disapprove of a proposed acquisition may convert up to 20% of outstanding shares into a pro-rata share of the trust account. If the company fails to make an acquisition within 18 to 24 months, the trust account is liquidated and proceeds distributed to the public shareholders.

The company management, and frequently the underwriters, will have "skin in the game" via the purchase by management of stock or warrants and the deferral by underwriters of substantial fees and expenses, which provide additional funds in escrow. Management also does not receive large salaries or management fees and may not dispose of its investment until after it creates value for investors by consummating a business combination.

Spacs are usually sold in $6 to $8 "units," consisting of one share of common stock and one or two warrants to purchase shares of common stock. Warrants typically have an exercise price one or two dollars below the unit purchase price, a four- or five-year life and are redeemable at the option of the company (thus forcing an exercise) if the stock price trades at a 25% to 40% premium over the unit purchase price. A relatively small portion of the public offering proceeds (or the income on the trust account) is used to provide working capital necessary to consummate an acquisition.

Some practical considerations when contemplating a Spac include:

Stock exchange listing. Registration of a Spac IPO under state blue-sky laws is particularly challenging, due to the many restrictions on blank-check offerings adopted in the 1980s. However, a federal exception from blue-sky registration requirements is available to "covered securities" listed on a national securities exchange or on the Nasdaq National Market System. The American Stock Exchange has proved hospitable to Spacs, so an Amex listing is a typical feature.

Tax issues. Most expenses of locating, investigating and consummating a business acquisition must be capitalized rather than expensed. Investment income, however, is fully taxable. Thus a Spac can find cash severely reduced by taxes on investment income computed without the deduction of current cash expenditures. The investment management agreement should be drafted to prevent this result.

Inadvertent investment company problems. Spacs must be designed to avoid the burdensome registration and compliance requirements of the Investment Company Act of 1940 pending a business acquisition. For this reason, investments should be limited to U.S. government securities or money market funds complying with SEC rules.

Securities law compliance. Federal securities laws will affect not only the Spac, but also the selection of a target, which must comply with SEC accounting and internal controls requirements.

Private placements. Many Spacs feature a private placement of stock or warrants to the management team at the time of the IPO. Great care must be taken to avoid integration of the private placement with the IPO, which could violate securities laws.

No pre-IPO acquisition discussions. As a general rule, Spacs may not engage in acquisition talks prior to the IPO because their disclosure in the prospectus would compromise their confidentiality.

Shareholder approval of acquisition. Spacs commit to obtain stockholder approval for any business combination, whether or not required by state law. This involves preparing a detailed SEC proxy statement, which can take several months.

Accounting issues. In recent months, the SEC has questioned whether warrants issued in the IPO must be treated as debt rather than equity and "marked to market" to reflect changes in the market price of the underlying stock. This serious problem can be resolved by careful drafting of the warrant agreement.

Delays in the registration process. Virtually all Spacs are subject to full SEC staff review, resulting in delays in the registration process. Patience is a prerequisite, and persistence is nearly always rewarded in this endeavor.

Spacs provide a new opportunity for private equity managers to shorten the investment cycle by creating a built-in exit strategy. The advantages offered to private equity managers and investors may cause Spac offerings to be an increasingly popular investment vehicle for years to come. ■

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