Can the SPAC Make It Back? Structural Changes, Including Elimination of the Stockholder Vote to Approve an Initial Acquisition, May Help Renew Interest in SPACS.

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The Rise and Fall of the SPAC Market

Before the financial markets went into free fall at the end of 2007, the initial public offerings (IPOs) of special purpose acquisition companies (SPACs) represented a significant portion of all IPO activity in the U.S.[1] Between 2005 and 2008, 148 SPACs completed IPOs raising more than $21 billion.[2] In 2007 alone, 66 SPACs raised more than $12 billion and SPAC IPOs represented 20 percent of all IPOs that year.[3]

A SPAC is a newly organized corporation formed to acquire or merge with an operating business by a specific date. A SPAC generally is organized by one or more individuals or entities (known as sponsors) experienced in acquiring, investing in, or managing operating companies. Prior to its IPO, a SPAC conducts no operations and has only nominal assets. Following its IPO, a SPAC's activities are limited to identifying acquisition targets and completing its initial acquisition. After completing its initial acquisition, a SPAC "de-SPACs" and becomes an operating business that remains a public company. Following the acquisition, a substantial portion of the proceeds of the SPAC IPO are available for use as acquisition consideration or for working capital. SPAC acquisitions are typically structured as reverse mergers in which the target company is merged with a subsidiary of the SPAC and a majority of the SPAC's shares are issued to the stockholders of the target company.

As the equity markets declined and IPO activity dwindled in 2008, the number of SPAC IPOs dropped to 17 and the amount of funds raised dropped by approximately 70 percent from 2007 to $3.8 billion.[4] Fourteen SPACs that had sought to raise nearly $3 billion withdrew their IPO registration statements in 2008.[5] In 2009, no SPAC IPOs were completed.[6] Moreover, many SPACs that had completed their IPOs could not complete acquisitions. Through May 2010, 64 SPACs that had raised approximately $8.9 billion since 2003 liquidated because they were unable to identify or reach an agreement with suitable acquisition targets or to obtain the stockholder approval required to timely complete their acquisitions.[7]

Although market conditions played a central role in the demise of these SPACs, flaws in the traditional SPAC structure related to the stockholder approval process for SPAC acquisitions also contributed significantly. These flaws, if unaddressed, are likely to inhibit a SPAC market recovery regardless of an improvement in the equity markets. Potential SPAC sponsors may be reluctant to make the financial and time commitments necessary to complete a SPAC IPO as long as the stockholder approval process presents a potentially significant obstacle to

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completing an acquisition. Likewise, an acquisition target may be reluctant to assume the risk that a SPAC with which it enters into an acquisition agreement will be unable to complete a transaction.

As of November 30, 2010, four SPAC IPOs have been completed this year.[8] These recent SPAC IPOs introduced a new structure that seeks to address the concerns with the stockholder approval process in the traditional SPAC structure. Whether these recent offerings mark the beginning of a revival of the SPAC market remains to be seen.

The Traditional SPAC Structure

In a traditionally structured SPAC IPO, units consisting of one share of common stock and one warrant are offered to the public at $10.00 per unit. The warrant exercise price typically is $7.50 per share. SPAC sponsors purchase founder shares for nominal consideration and these shares represent as much as 20 percent of the SPAC's outstanding common stock after completion of its IPO.

A percentage of the proceeds of the IPO—generally in the high 90s—is deposited in a separate, interest-bearing account, referred to as a "trust account."[9] Except for a portion of interest earned and used by the SPAC as working capital, the amount on deposit in the trust account is released only after the SPAC completes its acquisition or, if it is unable to complete its acquisition within the required period (typically, 24 to 30 months after the IPO), liquidated. Under this traditional structure, a SPAC is not able to complete an acquisition unless and until the acquisition is approved by holders of a majority of the SPAC's shares. Public stockholders that vote against the acquisition have the option to convert their shares of common stock (with the ability to retain their warrants) into a pro-rata portion of the amount on deposit in the trust account. If holders of more than a specified percentage of the shares sold in the IPO (typically between 20 percent and 40 percent) vote against the acquisition and opt to convert their shares, the SPAC is unable to complete its acquisition.

Challenges Posed by the Stockholder Vote Requirement

Hedge funds are among the largest investors in SPACs and have used SPACs to pursue different investment strategies. For example, a hedge fund with a buy-and-hold strategy would be likely to continue to own the SPAC's securities until the SPAC announces its acquisition. After the announcement of the acquisition and before the stockholder vote, the hedge fund would decide whether to continue to hold the SPAC's securities following completion of the acquisition or to vote against the transaction and convert its SPAC shares into a proportionate share of the amount on deposit in the trust account. If the hedge fund were to find the acquisition attractive, it would vote in favor of the transaction, retain its shares and/or warrants following the closing of the acquisition, and possibly increase the number of shares and/or warrants it owns. For a hedge fund seeking a predictable cash return, it would be likely to sell the warrants in the open market, vote against the SPAC's acquisition, and convert its SPAC shares into a proportionate share of the amount on deposit in the trust account. A variation of this "yield to trust" strategy would be to purchase the SPAC's common stock in the open market at a per share price below the per share amount on deposit in the trust account, vote against the SPAC's acquisition, and convert the purchased shares into a proportionate share of the amount on deposit in the trust account.

The economic downturn increased the likelihood that hedge funds would vote against SPAC acquisitions. During the economic crisis, newly risk-averse and cash poor investors redeemed their hedge fund interests in droves, causing a cash crunch for these funds. To finance these redemptions, hedge fund managers voted against proposed SPAC acquisitions, sought the return of their pro rata share of the amount on deposit in the trust account, and used the returned amount to fund investor redemptions. The combination of hedge funds starved for cash and hedge funds with a "yield to trust" strategy made obtaining

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stockholder approval of acquisitions extremely difficult for SPACs. Uncertainty regarding the outcome of the stockholder vote discouraged potential acquisition targets from pursuing discussions with SPACs.

The uncertainty of the outcome of the stockholder vote compounded the concern of targets regarding the amount of time required to complete a transaction with a SPAC, including the possibility that a SPAC would be unable to hold a stockholders' meeting to consider an acquisition before the SPAC expired. This concern was not unfounded because, between 2005 and 2008, it was not unusual for six months or more to elapse between the time the SPAC announced an acquisition and the closing of the transaction.[10]

The delay between the announcement of an acquisition by a SPAC and the closing of the transaction resulted principally from the application of Regulation 14A of the Securities Exchange Act of 1934, as amended, which regulates the solicitation of proxies, to the stockholder vote on an acquisition.[11] Under Regulation 14A, an issuer seeking approval from its stockholders for an acquisition must file a proxy statement with the Securities and Exchange Commission (SEC), which proxy statement is subject to review and comment by SEC staff. The proxy statement describes in great detail the acquisition, including the risk factors associated with it, the target company's business, the interest of the sponsors and others in the acquisition, and how stockholders who wish to vote against the acquisition can convert their shares into a pro rata share of the amount on deposit in the trust account. After completing the SEC review process, the proxy statement must be sent to stockholders.[12] The meeting to vote on the acquisition must be held within the time frame prescribed by the certificate of incorporation and bylaws of the SPAC and in accordance with applicable state law.

Certain investors in SPACs used the stockholder vote to achieve a more favorable return from an investment in SPACs than those available to stockholders generally. As noted above, prior to a SPAC's IPO, its sponsors acquired founders' equity for nominal consideration and, contemporaneous with the IPO, purchased warrants comparable to those offered to the public. Both the founders' equity and the sponsors' warrants became worthless if the acquisition was not completed prior to the SPAC's expiration, which made SPAC sponsors highly motivated to complete an acquisition. Recognizing this, certain investors sought to extract additional value from SPACs and their sponsors in exchange for their support of the acquisition. Many SPACs entered into forward contracts with certain investors by which the SPAC, in exchange for a proxy to vote in favor of the acquisition, agreed to purchase the investor's SPAC shares after the acquisition was completed for an amount in excess of the per share amount on deposit in the trust account.[13] Also, certain sponsors of SPACs transferred a portion of their shares or warrants to investors in exchange for the investor's proxy to vote its shares in favor of the transaction.[14] On occasion, owners of target companies, as well as sponsors of SPACs, purchased shares in open market or privately negotiated transactions to increase the likelihood of obtaining the required stockholder vote.[15] The conduct of these activist investors and the response of SPACs, their sponsors, and owners of the targets damaged the integrity of the stockholder vote process.

The New SPAC Structure

The four SPAC IPOs completed in 2010 modify the traditional SPAC structure by, among other things, mitigating the dilutive impact of the founders' equity and the warrants issued to the public and the SPAC's sponsors.[16] This mitigation is accomplished by reducing the number of shares issued to founders for nominal consideration and by increasing the exercise price of the warrants. The key structural modification, however, is the elimination of the stockholder vote requirement for a proposed acquisition. Instead of submitting the transaction to a stockholder vote and complying

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with Regulation 14A, these SPACs offer stockholders the opportunity to redeem their shares upon consummation of an acquisition for their pro rata share of the cash on deposit in the trust account (less taxes).

Under the new structure, redemption offers will be made in compliance with Regulation 14E[17] and Rule 13e-4[18] of the Exchange Act, which regulate issuer tender offers. The SPAC will file tender offer documents with the SEC that contain substantially the same financial and other information about the SPAC's acquisition and the steps to be taken to exercise the redemption rights as would be included in a proxy statement prepared in accordance with Regulation 14A.[19] The redemption offer will preserve the ability of stockholders to "vote with their feet" if, following full disclosure, they find an acquisition proposal insufficiently attractive to justify retention of their shares. The tender offer process should alleviate the concern of potential targets regarding the time required for a SPAC to close an acquisition and the possibility that a SPAC will be unable to do so before its expiration.[20]

Unlike proxy statements, tender offer documents may be disseminated to a SPAC's stockholders at the same time as they are filed with the SEC.[21] Prior to the expiration of the tender offer period, the SEC either will provide comments on the tender offer documents or notify the SPAC that it will not review the tender offer documents. If the SPAC receives comments from the SEC, it must file amended tender offer documents in response to those comments and, if necessary, extend the tender offer period in order to respond. But, unless material changes are made to the information previously disclosed in the tender offer documents, the SPAC will not be required to redistribute the amended tender offer documents to its stockholders.[22] If, as a result of the SEC's comments or otherwise, material changes are made to the information previously disclosed in the tender offer documents, the SPAC may need to consider whether the tender offer period should be extended.

Elimination of the stockholder vote requirement also will eliminate the closing condition described in the SPAC's certificate of incorporation that stockholders of no more than a specified percentage of shares elect to convert them into a right to receive a portion of the amount on deposit in the trust account. Thus, even if a substantial majority of stockholders elect to have their shares redeemed, the acquisition could still close, thereby reducing the target's concern that conversion requests from "yield to trust" investors would prevent the closing.

Some SPAC targets, however, may not wish to close a transaction with a SPAC that has substantially less cash than originally anticipated, even if the ownership percentage of the SPAC's shares by the target's stockholders is increased to reflect the reduced amount of cash in the SPAC. These targets may require a contractual condition that requires the SPAC to have no less than a specified amount of cash at closing after giving effect to all redemptions. If the number of shares tendered for redemption is too high to meet the condition, then the acquisition will not close, absent a waiver from the target.

Rule 14e-5[23] of the Exchange Act provides that no "covered person" (*i.e.*, an issuer and its affiliates, which, for a SPAC, includes its sponsors) may directly or indirectly purchase or arrange to purchase the class of securities subject to the tender offer except as part of the tender offer. This prohibition applies from the time of public announcement of the tender offer until the tender offer expires.[24] Similarly, Rule 13e-4(f)(6)[25] of the Exchange Act prohibits an issuer or any of its affiliates from purchasing a security which is the subject of the tender offer, other than pursuant to the tender offer, until at least ten days after the completion of the tender offer. Therefore, after the announcement of the tender offer, SPACs and their sponsors will be unable to enter into forward contracts with investors or offer to purchase those securities from investors outside of the tender offer. Thus, in addition to reducing the risk that SPACs will be unable to complete an acquisition, the

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substitution of the tender offer for the stockholder vote should reduce the ability of certain investors to extract concessions from the SPAC and its sponsors that are not available generally to all stockholders.[26]

Amendments to Exchanges' Listing Rules to Accommodate New Structure

Prior to 2005, the public securities of SPACs were not listed on any securities exchange, but were quoted on the National Association of Securities Dealers' Over-the-Counter Bulletin Board (OTCBB). OTCBB securities, including SPAC shares, are not "covered securities" under the Securities Act of 1933, as amended, and are thus subject to registration or qualification under state blue sky laws.[27] Beginning in 2005, the American Stock Exchange (AMEX) permitted listings of SPAC shares.[28] By 2007, of the 66 SPAC IPOs listed, 50 were listed on AMEX and only 16 on the OTCBB.[29] A principal attraction of an exchange listing is that securities traded on an exchange are deemed covered securities and thus exempt from registration or qualification under state blue sky laws.

Prior to 2008, however, a SPAC was unable to list on either the New York Stock Exchange (NYSE) or the National Association of Securities Dealers Automated Quotation System (NASDAQ) because those exchanges required a company to have an operating history prior to listing. Ironically, just as the market for SPACs softened in 2008, the SEC approved changes to listing rules that enabled a traditionally structured SPAC to list on the NYSE (after May 6, 2008)[30] or NASDAQ (after July 25, 2008).[31] The NYSE, AMEX, and NASDAQ listing requirements applicable to SPACs, however, require stockholder approval of the initial acquisition by a SPAC.[32] Accordingly, unless the exchange listing requirements are amended, SPACs adopting the new transaction structure will be limited to quotation of their securities on the OTCBB.

On October 22, 2010, filed with the SEC a proposed change to its listing requirements that, if approved, would apply to a SPAC organized with the new structure. If adopted, amended NASDAQ Listing Rule IM-5101-2NASDAQ [33] (the Proposed NASDAQ Rule) would permit a listed SPAC, in lieu of seeking stockholder approval, to conduct a redemption offer after the public announcement, but before the completion of its acquisition.[34] Under the Proposed NASDAQ Rule, the offering documents used in connection with the tender offer must include the same information about the acquisition and redemption rights that would have been included in a proxy statement relating to a vote on the acquisition. This requirement is consistent with the new SPAC structure.

Although the Proposed NASDAQ Rule eliminates the stockholder vote from the listing requirements for SPACs, it leaves unchanged NASDAQ Listing Rule 5635, which requires listed companies to obtain stockholder approval for any issuance in an acquisition transaction of a number of shares of common stock equal to or greater than 20 percent of the issuer's outstanding shares of common stock prior to the acquisition.[35] Since most SPAC acquisitions are reverse mergers in which more than 20 percent of the shares of the SPAC are issued, the Proposed NASDAQ Rule would not benefit most SPACs. Accordingly, unless NASDAQ Listing Rule 5635 is modified, SPACs are unlikely to elect to list on NASDAQ.

AMEX (now part of NYSE Euronext) also has informally stated its intent to file a proposed rule change with the SEC that would seek to accommodate the new SPAC structure.[36] The AMEX rule may, however, suffer from the same infirmity as the Proposed NASDAQ Rule.

Conclusion

By eliminating the stockholder vote requirement, SPACs can enhance their opportunity to complete an acquisition and avoid the distasteful practices that plagued acquisitions by traditional structure SPACs. As the equity and IPO markets improve, this change, combined with other structural changes,

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may facilitate a revival in interest in SPACs. If, however, stock exchanges do not amend their rules requiring stockholder approval of issuances of 20 percent or more of an issuer's common stock in connection with an acquisition, SPACs will continue to trade on the OTCBB, at least until an initial acquisition is completed.

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[1] This article discusses only SPACs organized in the U.S. Some SPACs were foreign private issuers as defined in 17 CFR § 230.405 (2010).

[2] *Summary of Funds Raised*, SPAC Analytics, http://www.spacanalytics.com (last updated June 8, 2010).

[3] Meghan Leerskov, *Year in Review: SPACs Could Revert to Old Structures, Sizes,* The SPAC Report, Jan. 22, 2009 at 1, 20.

[4] Id. at 20.

[5] Id. at 20-21.

[6] Liz Enochs, *Year in Review: Insiders Expect Revival after 2009 SPAC Drought*, The SPAC Report, Jan. 28, 2010 at 1, 12.

[7] *Recent SPAC Activity Summary*, The SPAC Report, May 27, 2010 at 5.

[8] See JWC Acquisition Corp., Current Report (Form 8-K) (Nov. 30, 2010); L&L Acquisition Corp., Current Report (Form 8-K) (Nov. 24, 2010); Hicks Acquisition Company II, Inc., Current Report (Form 8-K) (Oct. 20, 2010); 57th Street General Acquisition Corp., Current Report (Form 8-K) (May 28, 2010).

[9] Although the account is identified as a "trust account," no separate legal trust is formed and thus the account is not a trust account under applicable state law.

[10] E.g., Kennedy-Wilson Holdings, Inc. (formerly Prospect Acquisition Corp.), Current Report (Form 8-K) (Nov. 16, 2009); Current Report (Form 8-K) (Sept. 9, 2009).

[11] 17 CFR § 240.14A (2010).

[12] Prior to 2009, SPACs were often frustrated by the amount of time that SEC staff required to review and comment on the proxy statement. Beginning in 2009, however, the SEC staff demonstrated a commitment to expediting the review and comment process. As a result, the period between the public announcement of an acquisition and its closing has been reduced considerably, particularly for those SPACs approaching their expiration.

[13] Seee.g., , Westway Group Inc. (formerly Shermen WSC Acquisition Corp.), Schedule 13D, as amended, filed by Francis P. Jenkins, Jr. and Shermen WSC Holding LLC (June 4, 2009); Secure America Acquisition Corporation, Schedule 13D, as amended, filed by Victory Park Capital Advisors, LLC, Victory Park Credit Opportunities Master Fund, Ltd., Jacob Capital, L.L.C. and Richard Levy (Nov. 2, 2009); Secure America Acquisition Corporation, Current Report (Form 8-K) (Oct. 27, 2009).

[14] Seee.g., , Prospect Acquisition Corp., Current Report (Form 8-K) (Nov. 13, 2009).

[15] Seee.g., , Secure America Acquisition Corporation, Current Report (Form 8-K) (Oct. 27, 2009).

[16] See suprasuprasupraJWC Acquisition Corp. note 7; L&L Acquisition Corp. note 7; Hicks Acquisition Company II, Inc. note 7; 57th Street General Acquisition Corp., supra note 7.

[17] 17 CFR § 240.14e (2010).

[18] 17 CFR § 240.13e-4 (2010).

[19] Compare Schedule 14A, Information Required in Proxy Statement, 17 CFR § 240.14A (2010) with Schedule TO, Tender Offer Statement, 17 CFR § 240.14d-1 (2010) or 17 CFR § 240.13e-1 (2010).

[20] Although the amount of time required to clear SEC staff comments on tender offer documents filed in connection with an acquisition generally is less than the amount of time necessary to clear comments on a proxy statement filed for the same purpose, whether this also will be the case with respect to tender offers made in connection with the initial acquisition by a SPAC is untested.

[21] See 17 CFR § 240.14d-2 to 14d-6 (2010).

[22] See 17 CFR § 240.14d-6(c) (2010).

[23] 17 CFR § 240.14e-5 (2010).

[24] In this context, a public announcement is any oral or written communication by the SPAC (or any person authorized to act on the SPAC's behalf) that is

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reasonably designed to, or has the effect of, informing the public or security holders in general about the tender offer.

[25] 17 CFR § 240.13e-4(f)(6) (2010).

[26] An ancillary effect of the application of Rule 13e-4(f)(6) and 14e-5 will be to prohibit Rule 10b-18 compliant purchases by the SPAC and its affiliates after the announcement of the acquisition, which purchases had been an element of many earlier SPACs.

[27] See 15 U.S.C. § 77r (2010).

[28] M. Ridgway Barker and Michael L. Pflaum, *Exchanges for Listing SPACs - A Shifting Landscape*, The Metropolitan Corporate Counsel, Jan. 2009, at 5.

[29] Id.

[30] Self-Regulatory Organizations; New York Stock Exchange LLC; Order Approving Proposed Rule Change to Adopt New Initial and Continued Listing Standards to List Securities of Special Purpose Acquisition Companies, Exchange Act Release No. 34-57785 (May 6, 2008).

[31] Self-Regulatory Organizations; The NASDAQ Stock Market LLC; Notice of Filing of Amendment No. 1 and Order Granting Accelerated Approval to Proposed Rule Change, as modified by Amendment No. 1, to Adopt Additional Listing Standards to list Securities of Special Purpose Acquisition Companies, Exchange Act Release 34-58228 (July 25, 2008).

[32] See NYSE Listed Company Manual Section 102.06, NYSE Amex LLC Company Guide Section 119, NASDAQ Listing Rule IM-5101-2.

[33] Self-Regulatory Organizations; the NASDAQ Stock Market LLC; Notice of Filing of Proposed Rule Change to Amend IM-5101-2 to Provide Acquisition Companies the Option to hold a Tender Offer in Lieu of a Shareholder Vote on a Proposed Acquisition, 75 Fed. Reg. 68846 (proposed Oct. 22, 2010).

[34] See id.

[35] See id.

[36] Robert Wotczak, Managing Director and Regional Head at NYSE Euronext, SPAC Seminar (Oct. 12, 2010).

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