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FEATURED ARTICLE:

GENERATION III—THE NEW MECHANICS OF SPACS

by Douglas S. Ellenoff, Esq. – Ellenoff Grossman & Schole LLP

A SPAC (a Special Purpose Acquisition Corporation) is a newly-formed corporation by a prominent and qualified sponsor/management team for the purpose of raising capital in an underwritten initial public offering ("IPO") in anticipation of identifying and consummating a business combination. Oftentimes, the SPAC is focused on a particular industry due to the expertise of the sponsor/management team. Pending the approval and closing of the business acquisition candidate, the IPO funds remain in a trust account for the benefit of the shareholders. The amount held in trust is 100% or more in most cases. For potential private company targets, SPACs offer the opportunity for a reverse merger, access to capital markets to spur future growth, and strategic resources and insight of the SPAC founding management team. Typically, the IPO consists of the sale of units, consisting of both a share of common stock and a warrant. Shareholders who do not want to participate in the future business opportunity may request a return of their capital and keep the accompanying warrant.

Due partly to the protection provided to investors, SPACs have seen a dramatic increase in popularity over the last decade. Since 2003, 161 SPAC IPOs have been underwritten in the U.S., raising over $20 billion in the process. Of those SPACs, approximately 45% closed an acquisition, 30% returned capital to their shareholders, and the remaining 25% are still outstanding. Some of the issues plaguing the early SPACs were a lengthy SEC review/approval process and the involvement of hedge funds that bought shares in secondary trades below the net asset value of the SPAC and then voted against a pending deal, effectively forcing the SPAC to return its capital.

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As with any new financing vehicle, SPACs have evolved based on market feedback. Generation I SPACs (through 2000) were replaced by Generation II SPACs (through 2008), which in turn now have been replaced with Generation III SPACs. While the 2010 SPACs are conceptually similar to older versions, the 2010 SPACs have been restructured to respond to many of the issues that presented themselves in the nearly 50 SPAC acquisitions consummated during 2008/2009. The third generation structure is worth reviewing on its own merits. This isn't to say that everyone will necessarily be a convert, but we believe that it deserves attention. Whether for a potential sponsor of a SPAC IPO, an investor in a SPAC, or a seller of a business to a SPAC, many features of the old program have been modified to make the vehicle more attractive to each of those constituent parties.

Generation III SPACs originated with 57th Street General Acquisition Corp., which was sponsored by Mark Klein, who had been the sponsor of an earlier Generation II SPAC— Alternative Asset Management Acquisition Corp., which successfully completed its SPACquisition in 2009. 57th Street raised approximately $55 million. The objective in structuring 57th Street was to balance the varied and disparate interests of the three primary constituents (sponsors, investors, and targets). This article summarizes certain of the primary modifications first introduced to the SPAC program in 57th Street and why we believe that these changes are beneficial.

Central to the success of the SPAC program has been and continues to be the commitment to maintain nearly all of the raised capital in a trust account and to permit investors a return of most, if not all, of their capital if they so choose. Generation III maintains the same procedural safeguard for investors, but rather than achieving this result via a shareholder approval process, the SEC has agreed to permit the use of a tender offer process—which ought to be a faster process with the SEC (20 days by statute, although we believe it may go longer) and, therefore, a faster pathway to closing any proposed business transaction than having to file a proxy with the SEC and obtain and respond to comments. Avoiding the shareholder approval process eliminates the need to obtain a majority vote and, therefore, provides a clearer path to closing a deal from structural and regulatory perspectives.

One of the issues that caused significant procedural problems in the consummation of the 2008/2009 proposed business combinations was a provision that was commonly referred to as the redemption threshold. The redemption threshold, which was unique to SPACs, mandated that a business combination could not proceed if more than 30% (which varied deal by deal) of the shareholders voted against a transaction and requested their capital be returned. In 2008/2009, most SPACs shareholder bases shifted to "yield investors," who were purchasing SPAC shares in the open market at nearly a 10% discount to the SPAC's NAV and seeking an arbitrage opportunity. These investors were only really interested in voting against a transaction and asking for the redemption of their common stock at 100% of NAV, as the SPAC trusts were invested in U.S. Treasury securities. So even though there might have been new investors (fundamental investors) prepared to purchase those shares, certain transactions did not have the opportunity to close due solely to the procedural aspects of the old SPAC structure.

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While the new tender offer feature provides investors with the same practical opportunity to have a return of their capital, it eliminates the redemption threshold entirely. Additionally, the tender offer process is mandated to be a quicker process for the return of the capital. The tender offer process, however, doesn't address the commercial reality that none of the constituent parties will know whether the investors will support the proposed transaction by not tendering and how much of the trust funds will remain—this is a commercial issue to be resolved by the SPAC, the target, and the investors. Nonetheless, the investors can maintain their investment or have their funds returned. In addition, they retain a warrant in an entity that ought to be able to consummate a transaction more easily, and thereby have increased value rather than have a failed business combination and liquidation—so the Generation III structure is a positive for investors.

One of the other main issues present in the Generation II SPACs that needed attention was that many targets were not inclined to entertain a transaction with a SPAC given the dilutive nature of the then sponsor promote, consisting of common stock and warrants (20+%), as well as the below market exercise price of the one-to-one warrant coverage included in the SPAC IPO. The substantial dilution resulted in many quality targets' unwillingness to contemplate a transaction with a SPAC or, for those that would, a complicated and sensitive restructuring of the economics of both the sponsor and the investor. In most of the Generation III SPACs, the sponsor's promote has been halved (although there may be an additional promote earned over time if the subsequent stock price increases), and the investor's warrants are structured to be exercisable at above-market prices. As a result of these changes, which are actually consistent with where many of the 2008/9 SPACquisitions ended up after restructuring, many targets perceive that the Generation III SPACs to be worthy of consideration as an alternative to a traditional underwritten IPO.

For sponsors, a benefit of the Generation III SPAC is that they have far greater certainty of closing a transaction, since the new structure permits the elimination of the shareholder approval process and the redemption threshold. Although the new Generation III SPAC has the flexibility of eliminating the shareholder vote from a securities law perspective, the structure of the transaction and the laws relating to the state of incorporation may nonetheless require the shareholder approval process. The re-pricing of the warrants at above-IPO levels, as opposed to the old structure, where the exercise price was at a 20% to 25% discount, means a transaction is also more likely to be accepted by the markets. Given that the sponsors of a SPAC have capital at risk in the range of 3% to 5% of the capital raised in the IPO, having the ability to close a transaction in less time, with greater certainty and fewer structural issues to modify at the time of the tender, is a meaningful benefit. The at risk capital of the sponsors is contributed at the time of the IPO in a contemporaneous financing, and that capital pays for the expenses of the offering (i.e., underwriters' discount, legal and accounting fees, printing costs, filing fees, etc.) and is the mechanism that permits the trust account to be nearly equal to all of the IPO proceeds. In return for the sponsors' investment, they receive the promote package mentioned above (consisting of both common stock and warrants), which only has value if they

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consummate a business transaction, so removing both procedural and commercial obstacles is critical to improving the SPAC program.

Since the success of 57th Street, there have been two additional SPAC IPOs in 2010—Hicks II, which raised $150 million, and Cazador, which raised $40 million. As of the writing of this article, there are three additional SPAC sponsors on the road marketing their offerings. Interest in the Generation III SPAC program has meaningfully increased since the summer, with several other filings submitted to the SEC, as well as other new SPAC structures with interesting variations of certain of the terms. What is clearly apparent is that there is an interest by both sponsors to raise blind pool capital and investors to support those managers—the issue from here is how attractive the new structure is to potential targets. For now though, the Generation III SPAC has recaptured the capital markets' attention.

Ellenoff Grossman & Schole LLP is a mid-sized New York City-based law firm, offering its clients legal services in a broad range of business and litigation related matters. Douglas S. Ellenoff, a member of the firm since its founding in 1992, is a corporate and securities attorney with a specialty in business transactions and corporate financings.

In the last several years, he has been involved at various stages in numerous registered public offerings, including 30 financings and, with other members of his firm, over 100 private placements into public companies, representing either the issuers of those securities or the registered broker-dealers acting as placement agents. Along with other members of his firm, Mr. Ellenoff has been involved at various stages with over 50 SPACs, 17 of which have consummated their IPOs, raising over $1.5 billion. He also provides counsel with regard to their respective ongoing (SEC, AMEX, and NASD) regulatory compliance.

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