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By Trevor Scott



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Corporate Bulletin

The Toronto Stock Exchange Considers Special Purpose Acquisition Companies (SPACs)

On August 15, 2008, the Toronto Stock Exchange announced that they are considering permitting Special Purpose Acquisition Companies, commonly known as SPACs. A SPAC is a company formed for the purpose of raising money from the public and then using that money to acquire an operating company. Although SPACs have been in the US market since 1993, they have recently re-emerged and gained popularity. In 2007, 65 SPACs conducted IPOs in the US, raising on average well in excess of \$100 million each and representing over a quarter of all successful IPOs in the US. The New York Stock Exchange, NASDAQ and American Stock Exchange all list SPACs. In Europe, SPACs are also listed on London Stock Exchange's AIM market and Euronext. Global financial institutions such as Goldman Sachs, Citi, UBS, Deutsche Bank, Merrill Lynch, JP Morgan and Morgan Stanley have all acted as investment bankers for SPACs.

SPACs on the TSX – The Highlights

- A SPAC raises IPO proceeds of at least \$30 million on the TSX
- At least 90% of the IPO proceeds are held in trust
- The SPAC will have up to three years to acquire one or more businesses worth at least 80% of the amount held in trust
- The business acquisition must be approved by a majority of the SPAC's shareholders, other than founders
- Founders hold at least a 10% equity interest in the SPAC, but generally not more than 20%
- The IPO proceeds held in trust will be returned to those shareholders that vote against the business acquisition or to all shareholders (other than founders) in the event a business acquisition does not occur within three years of the IPO

What is a SPAC?

A SPAC is a corporation formed for the purpose of raising capital through an initial public offering (IPO) of its securities, in order to fund an acquisition of an existing operating company or companies. The SPAC is typically founded by a management team that has private equity experience, management experience or industry experience. Though the SPAC itself has no business operations, investors entrust the management team to seek out and consummate a value-building acquisition of an operating business.

A SPAC typically identifies a particular industry, sector or geographic region in which it intends to acquire operating companies, as well as any objective criteria that the management team intends to consider in evaluating prospective operating companies. This targeted approach is intended to capitalize upon the related experience of the management team. However, SPACs are not required to identify a target area.

After the acquisition of the operating company, the SPAC's management team may choose to run the operating company themselves, keep existing management, or recruit a new management team altogether.

The Toronto Stock Exchange (TSX) will consider the experience and track record of the management team in determining whether it will permit the listing of a SPAC.

How do You Create a SPAC?

Founders' investment – The SPAC's founders make an initial capital investment in the SPAC. This investment is made before the IPO at a price significantly less than the IPO price. The founders' original equity interest must represent at least 10% of the SPAC's outstanding equity post IPO and not exceed the 20% maximum recommended by the TSX. The actual amount of the founders' original equity investment will typically be part of the negotiations with the investment banker for the IPO. Founders can increase their original equity investment above 20% by purchasing the SPAC's shares in the IPO or through the TSX.

The founders' original equity investment cannot be transferred prior to the completion of a business acquisition and, subsequently, may be subject to the TSX's escrow requirements. Equity purchased by the founders in the IPO or through the TSX is not subject to this transfer prohibition.

Initial public offering – A minimum of \$30 million must be raised in the IPO. A SPAC will issue common shares or, more commonly, units in its IPO. Units consist of one share and no more than two share purchase warrants. The warrants allow the holder to purchase a share of the SPAC in the future, generally at a discount to the IPO price, and are typically redeemable for a nominal amount if the SPAC's shares trade above a fixed price for a period. The warrants are not exercisable before the completion of a business acquisition and will expire if no business acquisition is made.

The IPO will involve a listing application to the TSX and the filing of a prospectus with the applicable securities regulatory authorities in Canada. A SPAC may be in the process of reviewing potential acquisitions, but is prohibited from having an agreement to acquire a business in place, at the time of its IPO.

Proceeds held in trust - At least 90% of the gross IPO proceeds must be held in trust. In the US, some larger SPACs have placed 100% of the gross IPO proceeds in trust. The actual percentage of proceeds held in trust will typically be part of the negotiations with the investment bankers for the IPO. These funds may only be invested in certain permitted investments, such as government guaranteed securities or deposits with Schedule I or III banks having an A1+ or better rating. These rules are intended to protect the SPAC's shareholders by ensuring sufficient proceeds are available for the business acquisition or for return to shareholders. Depending on how the SPAC is structured, interest on the IPO proceeds held in trust will be added to the trust or used to fund the SPAC's operating expenses. In recent US SPAC offerings where the percentage of IPO proceeds held in trust has increased, all or a portion of the interest on those funds held in trust has been made available to the SPAC's management to fund expenses prior to a business acquisition.

The investment bankers will also be required to deposit 50% of their commission in trust with the IPO proceeds. If a business acquisition is completed, these funds will be returned to the investment bank, otherwise they will be available for return to the SPAC's shareholders.

Conversion feature – Shareholders, other than founders, who vote against a proposed business acquisition can elect to convert their shares into their pro rata portion of the IPO proceeds held in trust.

Liquidation feature – A SPAC will have up to three years from the date of its IPO to complete a business acquisition. The permitted acquisition period may be shorter - 18 to 24 months is common with US SPACs. The actual period of time the SPAC has to complete an acquisition will typically be part of the negotiations with the investment bankers for the IPO. If a business acquisition is not completed within the permitted period, all shareholders, other than founders in respect of their original equity interest, will receive a pro rata share of the IPO proceeds held in trust. Founders forfeit their original equity investment in the SPAC, but do participate in the liquidation feature in respect of any shares they acquired in the IPO or stock market.

How does a SPAC Operate Prior to a Business Acquisition?

Operating funds - The founders' initial capital investment, the portion of the IPO proceeds not held in trust and, depending on how the SPAC is structured, the interest from the IPO proceeds held in trust, may be used to fund the SPAC's operations and identify a business acquisition.

Management compensation – Prior to completion of the business acquisition, the SPAC's officer and directors are typically not paid a salary or management fee. The SPAC does generally pay a nominal monthly amount for office space and related administrative services. A SPAC is not permitted to have any security based compensation arrangements (e.g. option plans) prior to the completing a business acquisition.

Additional financing - To limit dilution to the SPAC's shareholders, any additional securities issued by the SPAC prior to the business acquisition must be done by a rights offering to existing shareholders. A minimum of 90% of the additional funds raised in the rights offering must be held in trust. Before its business acquisition, a SPAC is not permitted to obtain any debt financing other than ordinary course short term trade or accounts payables.

Ongoing public company obligations - A SPAC will have the same on-going obligations as any other public company prior to completing a business acquisition, including complying with governance requirements, continuous disclosure requirements (e.g. press releases and financial statements) and shareholder meetings.

How Does a SPAC Acquire a Business?

Acceptable acquisitions – A SPAC will have up to three years to complete a business acquisition. If a SPAC does not complete a business acquisition within that period, the liquidation feature will become effective and the IPO proceeds held in trust will be returned to the SPAC's shareholders (other than founders).

The value of the business acquisition or acquisitions must represent at least 80% of the value of the IPO proceeds held in trust. This does not mean that 80% of the funds in trust must be used by the SPAC to pay for the business acquisition. Rather, it is merely a requirement for the minimum value of the target business to be acquired. The SPAC may pay the vendors of the operating business with cash from the IPO proceeds held in trust, with monies raised in equity and/or debt financings or with stock, or any combination of the foregoing. If multiple acquisitions are being made, they must close concurrently.

Shareholder approval – A majority of the SPAC’s shareholders, other than founders, must approve the business acquisition at a meeting of shareholders. The SPAC must deliver an information circular that describes the business or businesses being acquired to shareholders in advance of this meeting. This information circular is reviewed by the TSX prior to mailing but is reviewed by the securities regulators, as is the case in the US for domestic SPACs.

If the business acquisition is approved by shareholders, those shareholders that voted against the business acquisition are entitled to the conversion feature, which allows them to exchange their shares for their pro rata share of the IPO proceeds held in trust. The SPAC may impose a condition that it will not proceed with a business transaction if more than a pre-determined percentage of shareholders vote against the business acquisition and exercise the conversion feature.

Regulatory approval – The SPAC, following the completion of the business acquisition, must satisfy the TSX’s listing requirements. The SPAC will be required to obtain the TSX’s listing approval prior to the completion of the business acquisition.

The SPAC must also prepare and file with the applicable securities regulators in Canada a “non-offering” prospectus describing the SPAC and the proposed business acquisition. This prospectus must be cleared by the securities regulators before the information circular can be mailed to shareholders in connection with seeking shareholder approval for the business acquisition.

Why a SPAC?

Opportunities for investors – In the US, SPACs have typically attracted sophisticated investors, including hedge funds. In Canada, the TSX Venture Exchange’s Capital Pool Company program, which bears some similarity to SPACs, has been operating for many years and, as a result, Canadian retail investors may be more familiar with and comfortable investing in SPACs. Because a private operating business which is acquired by a SPAC immediately becomes a public company, there is generally instant value created as valuation multiples for public companies are on average greater than valuation multiples for private companies. SPACs present an opportunity for retail investors that are typically not able to buy into private equity or hedge funds to participate in the take-overs of private companies.

SPACs also offer advantages over investing in private equity or venture capital funds. While investors in a fund cannot liquidate their investment until the fund has a liquidity event, SPACs are publicly traded and investors can liquidate at any time. Investors in a fund typically have no discretion over the specific investments the fund makes, whereas an investor in a SPAC may vote against a proposed business acquisition and receive its portion of the IPO proceeds held in trust back. Whereas an investor in a fund has unlimited downside, a SPAC has limited downside as the IPO proceeds held in trust will be returned to investors if a business acquisition does not occur within a specified period or if the investor votes against the business acquisition. SPACs also generally provide more transparency than funds, because they are subject to the same requirements as other public companies, including providing financial statements and promptly disclosing any material changes.

Opportunities for private equity – In an environment where credit is scarce and exit opportunities are more limited, a sale to a SPAC becomes an attractive exit opportunity for a private equity sponsor. SPACs also provide private equity sponsors with an opportunity to realize a liquidity event while continuing to maintain equity in a public company. In the US, numerous private equity firms have also acted as founders of SPACs. This has allowed them to pursue opportunities that are not within their traditional investment area, such as where the seller wants to retain a significant equity stake or become a public company.

Opportunities for private companies – In a market where traditional IPOs by private companies are limited, becoming a public company through a SPAC becomes more attractive. SPACs provide certainty of financing, an institutional shareholder base and access to experienced management. The bulk of the expense of going public shifts from the private company to the

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SPAC. Also, the acquisition by the SPAC of the private company can be structured so that the owners of the private company receive both shares of the SPAC and cash, thereby allowing those owners to partially realize cash on their investment. This is in contrast to a traditional IPO where it is uncommon for existing shareholders of a private company to be able to sell any of their shares and significant shareholder are typically required to enter into lock-up or escrow arrangements.

SPACs are also a superior alternative to reverse take-overs (whereby a private company takes over a company with an operating history listed on an exchange) as, in addition to the benefits above, a SPAC has no operating history so there is limited risk of hidden liabilities.

How is a SPAC Different from a Capital Pool Company?

SPACs bear some similarity to the TSX Venture Exchange's Capital Pool Company (CPC) program, in that both involve the creation of a publicly-traded company without any operations other than to acquire an operating business. However, CPCs are only permitted to raise between \$200,000 and \$1.9 million in their IPO, whereas SPACs are required to raise a minimum of \$30 million. SPACs have more stringent investor protections than CPCs, such as the liquidation and conversion features. Also, unlike the CPC program, shareholders of the SPAC must approve the business acquisition.

What are the Next Steps?

The TSX's rules for SPACs are currently in a proposed form. We are optimistic that the TSX's rules for SPACs will be finalized, and that SPACs will begin listing on the TSX, by November of this year.



About Trevor Scott

Trevor Scott is a solicitor at Farris and provides strategic and legal advice in diverse business areas. He has extensive experience in debt and equity financings for public and private companies, representing both issuers and investment banks. He also regularly advises on business acquisitions, divestments and take-over bids, including compliance issues with the Competition Act and assisting foreign investors with Investment Canada Act matters. Trevor also advises on corporate governance matters.

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