

EVERYMAN A VENTURE CAPITALIST

Taking Private Equity Public

By Steven B. Boehm and Hannah L. Friedberg

Investment in private businesses, with the potential for high returns coupled with substantial risk, has historically been the province of wealthy individuals and institutional investors like corporations, pension plans, and endowments. Exposure to the potential rewards and risks of backing new and growing companies—commonly referred to as “private equity” investing—frequently is achieved by investing in pooled vehicles sponsored by asset managers who are compensated based on the amount of assets under management and a percentage of the fund’s capital gains. The barriers to entry into these “private equity funds,” chiefly high net worth and access to the right financial intermediaries, makes these funds inaccessible to most investors. This inaccessibility, in turn, restricts the capital pool available to the thousands of private U.S. issuers that cannot access traditional sources of finances.

Recently, a wave of democratization has begun to sweep through the private equity world, and several alterna-

tive investment vehicles have emerged as viable means through which private equity exposure has been made available to the public. Chief among these vehicles are business development companies (BDCs), special purpose acquisition companies (SPACs), and structured trust acquisition companies (STACs). This article provides an overview of the BDC, SPAC, and STAC business models and the legal issues that potential private equity managers and investors should consider before attempting to develop or invest in one of those models.

Business Development Companies

BDCs are the most established of the public structures for private equity. A type of “closed-end” company that is subject to many, but not all, of the provisions of the Investment Company Act of 1940 (the 1940 Act), BDCs became part of the Securities and Exchange Commission’s (SEC) regulatory framework in 1980 as part of a congressional initiative to funnel public dollars into private and smaller public companies.

In general, the 1940 Act defines an investment company as an issuer more than 40 percent of whose assets are securities of companies in which it owns less than a majority of the outstanding voting securities and doesn’t

otherwise qualify for an exclusion from the definition. Assuming an entity meets the investment company definition and the promoters want to raise capital in a public, rather than private, offering, the BDC model is appropriate when the company intends to focus its investment activities on private and smaller public companies.

BDCs fall into one of two general categories: those that are internally managed and those that rely on an external manager. Internally managed BDCs employ and compensate officers and employees like operating companies, relying on cash and stock option or restricted stock plans or profit-sharing arrangements to incentivize its management personnel. Externally managed BDCs, on the other hand, do not have employees; rather, like mutual funds and traditional closed-end funds, they are operated by third-party investment advisers and administrators, which house and compensate most of the BDCs management personnel.

The regulatory requirements associated with the BDC model are somewhat less cumbersome than those to which traditional SEC-registered closed-end funds are subject under the 1940 Act. For example, BDCs are given more leeway to compensate officers and directors (if they are internally managed) and investment advisers (if

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they are externally managed), and also have greater flexibility to borrow money for investment. In return for these advantages over traditional registered funds, BDCs generally are required to invest at least 70 percent of their assets in certain types of investments, most notably “eligible portfolio companies,” as defined in section 2(a)(46) of the 1940 Act. While a clarification of the meaning of this term is currently subject to an SEC rule-making effort, it generally covers all private U.S. companies, as well as U.S. public companies whose shares are not traded on a national securities exchange.

The dissimilarities between traditional closed-end investment companies and BDCs don't end with their regulatory treatment under the 1940 Act. Unlike other closed-end funds, BDCs are required to register a class of securities under the Securities Exchange Act of 1934 (the Exchange Act) just like public operating companies. BDCs must file periodic reports and comply with other requirements of the type ordinarily associated with public operating companies. In addition, the requirements imposed on public operating companies under the Sarbanes-Oxley Act of 2002 and the corporate governance listing rules of the New York Stock Exchange, the NASDAQ Stock Market, Inc., and the American Stock Exchange generally apply to BDCs. Thus, from a securities regulatory perspective, BDCs are effectively a hybrid between an investment company and an operating company.

Despite the overlap in the regulatory regime between BDCs and traditional operating companies from a securities law standpoint, BDCs provide a significant regulatory advantage over operating companies from a taxation perspective. Like registered mutual funds and closed-end funds, BDCs are eligible to elect to be taxed as “regulated investment companies” under subchapter M of the Internal Revenue Code. Thus, to the extent they distribute at least 90 percent of their ordinary income annually and meet certain asset diversification

and other requirements, BDCs generally can avoid having to pay corporate-level income tax on the income or gains they distribute to their shareholders.

When it added the BDC model in 1980, Congress believed that BDCs would have an immediate impact on the capital markets. However, the anticipated deluge of filings by BDCs following their introduction did not

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occur as Congress envisioned. Although there were some highly successful entrants, such as Allied Capital Corporation, into the BDC field in the early years of the structure's existence, until recently, BDCs operated in relative anonymity, barely visible on the capital markets' landscape. In fact, as recently as 1997 there were only a handful of active BDCs with combined assets of only \$1 billion. See Steven B. Boehm et al., “Shedding New Light on Business Development Companies,” *Investment Lawyer*, Oct. 2004 (detailing the history of BDCs and recounting the emergence of externally managed BDCs).

Then, in 2004, BDCs were thrust into the limelight seemingly overnight when a spate of IPO filings sponsored by high-profile private equity managers thrust BDCs into the financial mainstream. Perhaps the most significant BDC IPO completed that year was the \$930 million IPO by an affiliate of powerhouse Apollo Management, L.P. Apollo Investment Corporation's suc-

cessful IPO spearheaded a steady stream of BDC IPOs. Today, there are approximately two dozen actively traded BDCs with combined assets totaling over \$23 billion.

Although early BDCs tended to follow the internally managed model, the majority of BDCs that have recently IPOed are externally managed. The structure of choice of most BDCs today finds its provenance in TICC Capital Corp. (formerly Technology Investment Capital Corp.), which completed its \$130 million IPO in late 2003. TICC compensates its external investment adviser with a fee structure consisting of a base management fee of 2 percent and a two-part incentive fee of 20 percent on TICC's capital gains, and 20 percent of TICC's pre-incentive fee net investment income. The success of TICC's IPO indicated that externally managed BDCs were viable. Since then, at least a dozen externally managed BDCs with fee structures substantially similar to TICC's have completed IPOs.

BDCs provide private equity with access to public markets by raising money from the public and investing it in building a portfolio of private (or smaller public) companies, thus effectively giving private companies access to public dollars. Unlike traditional private equity funds, there are no minimum income, net worth, or sophistication requirements for investors in a BDC. Also in contrast to traditional private equity funds, BDCs provide investors with the liquidity found in any other publicly traded investment, while simultaneously giving BDC managers access to a permanent source of capital in the public capital markets.

The vast majority of publicly traded BDCs today invest primarily in debt securities, reflecting the market's greater comfort with yield-based BDCs rather than those that invest primarily in equity securities. This is because, historically, shares of equity-based closed-end funds have tended to trade at a discount to their net asset values. On the other hand, many BDCs that

invest primarily in debt securities tend to trade off their yield and, thus, historically have tended to trade above their net asset values.

In light of the steadily increasing interest in BDCs since 2004, capital markets permitting, it is reasonable to conclude that we will continue to see more BDC IPOs in the coming years.

Special Purpose Acquisition Companies

SPACs are formed for the purpose of raising capital solely to acquire one or more operating companies. SPACs use the net proceeds they receive in connection with their IPOs to accomplish this acquisition goal. In connection with its IPO, a SPAC will typically issue units to the public at a set public offering price ranging from approximately \$6 to \$10 per unit. Units generally consist of one or more shares of common stock and one or more warrants exercisable for additional shares of common stock at a set exercise price. After the consummation of the IPO, the units will trade publicly for a set period of time, up to three months, after which the common stock and warrants underlying the units will begin to trade separately. At the time of their IPO, SPACs cannot have identified their future acquisition target. If they had, they would have to disclose that information. This would, of course, undermine the very nature of the SPAC model.

Subsequent to their IPOs, SPACs generally will restrict their own activities to provide protection for their investors. These restrictions, which typically are market driven, generally include, among other things, the following:

- *Business Combination Deadline.*

Typically, a SPAC must consummate a business combination within 18–24 months of its IPO. In some cases, this deadline may be extended an additional 6–12 months if a SPAC enters into a letter of intent, agreement in principle, or definitive agreement with a prospective target operating company prior to the applicable deadline, or

if it receives shareholder approval for such an extension.

- *Escrowing of Offering Proceeds.* A fixed percentage, usually of at least 95 percent, of the proceeds from a SPAC's IPO will be placed in an escrow account until either the completion of a business combination that has been approved by its stockholders or the liquidation of the SPAC, as discussed below.

- *Limitation on Fair Value of Target Businesses.* SPACs are typically required to acquire, in a single business combination, one or more operating businesses that have a fair market value in excess of 80 percent of the SPAC's net assets or the balance of the escrowed offering proceeds at the time of the acquisition.

- *Stockholders' Opportunity to Approve a Business Combination.* SPACs are required to seek stockholder approval of a proposed business combination prior to commencing a combination. Any business combination must be approved by at least a majority of the SPAC's shares of common stock purchased in connection with its IPO.

- *Conversion Right of Disapproving Stockholders.* Even if a business combination is otherwise approved by stockholders, SPACs typically permit stockholders who vote against a proposed combination to convert their shares into a pro rata portion of the balance of the SPAC's escrowed offering proceeds. If more than 20 percent of disapproving stockholders elect to convert their shares, a SPAC would be prevented from completing the proposed business combination. This percentage has been increased to 30 percent to 40 percent in some more recent SPAC IPOs, thus lowering the shareholder approval level necessary to complete a business combination.

- *Liquidation Requirement.* As referenced above, in the event that a SPAC fails to complete a business combination within the required time period, it typically is required to liquidate and distribute a pro rata share of the

then-escrowed funds, along with any remaining assets, to its stockholders.

The SPAC model can provide an attractive platform for creating the equivalent of a private equity "buyout" fund using publicly raised capital. Also, because a SPAC is a public company, it can be attractive to potential target businesses as an alternative means of "going public" in lieu of a traditional IPO. However, like any other public operating company, the use of public capital subjects a SPAC to ongoing compliance with reporting and other requirements of the Exchange Act after the completion of its IPO. In addition, SPACs are required to comply with the Sarbanes-Oxley Act and any corporate governance listing requirements of the national exchange on which its securities are traded.

SPACs have become a popular alternative to traditional acquisition vehicles due to their ability to raise funds through the capital markets, particularly of late. From 2003 through the third quarter of 2007, of the 118 SPACs that priced, more than 59 have announced or closed on acquisitions. In 2007 alone, 66 SPACs IPOed, raising approximately \$12 billion. Additionally, 19 SPACs announced transactions in 2007. One notable IPO of 2007 was that of Aldabra Acquisition Corp., which raised \$414 million with its IPO. Aldabra was one of the first companies to adopt a 60 percent shareholder approval threshold.

Until recently, SPACs tended to be sponsored by management teams that targeted acquisitions in specific industries in which they had experience and expertise. Recently, the SPAC market has seen the introduction of private equity-sponsored SPACs; that is, SPACs whose management teams' value derives from their ability to identify attractive acquisition targets across industry sectors. The private equity-sponsored model is attractive to both SPAC managers and SPAC investors alike; for private equity managers, it provides access to an alternative pool

of capital to engage in the type of acquisition transactions they have traditionally targeted with institutional-based private equity funds. Likewise, the model effectively offers investors the opportunity to benefit from a pre-IPO stage investment in a private company while affording them liquidity and principal protection that would not otherwise be available.

The recent increased interest by the private equity community in SPACs has led in turn to the involvement of the so-called bulge bracket investment banks, including Citigroup Global Markets, Inc., Deutsche Bank Securities, Inc., Lazard Capital Markets, and Merrill Lynch, among others, in SPAC IPOs, both as sponsors and as underwriters. Sapphire Industrials Corp., a SPAC that IPOed late in 2007—and was able to increase its offering size from \$500 million to \$800 million in January 2008—is one recent example of a private equity-sponsored SPAC. Lazard Funding, Ltd., a subsidiary of the well-known investment bank, founded Sapphire and, prior to its IPO, owned approximately 78 percent of the company. Following the offering, Lazard is expected to own a 20.1 percent stake in the company. Consistent with the current trend discussed below, Sapphire plans to list its units on the American Stock Exchange (AMEX).

Traditionally, securities issued by SPACs in their IPOs would trade on the Over-the-Counter Bulletin Board Exchange (OTCBB), which is managed by the Financial Industry Regulatory Authority (FINRA). However, beginning in 2005, AMEX began accepting applications for SPAC listings. As SPACs have increased in size, more and more have begun trading on the AMEX, and there have been indications that AMEX is moving toward a more standardized review of process of SPACs. The benefit of trading on the AMEX is that, unlike securities traded on the OTCBB, AMEX-traded securities are not subject to

state blue sky regulation. Therefore, the securities of AMEX-traded SPACs have significantly fewer restrictions on distribution and trading in the market than do the securities of OTCBB-traded SPACs.

Despite the restrictions and requirements placed by the securities laws and the securities markets on SPACs, they nonetheless can provide a very useful structural alternative to traditional acquisition vehicles due to their ability to raise public capital to fund takeover acquisitions of private operating companies. As SPACs have gained greater popularity and acceptance within the financial and investing communities, recent developments

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such as the decision by AMEX to accept SPACs for listing suggest a growing comfort with the SPAC structure. As more SPACs begin to achieve acceptance in the public markets by successfully closing business combinations, the SPAC model may gain even greater acceptance as a viable alternative for sophisticated investors seeking future alternative acquisition vehicles.

Structured Trust Acquisition Companies

STACs represent the most recent development among efforts to manage and grow private equity investments through a public vehicle, and the structure is decidedly still in its nascent stage. To date, two STACs—Macquarie Infrastructure Company Trust and Compass Diversified Trust—have completed IPOs, raising more than \$700 million in equity capital. In each

case, the capital raised by these companies was immediately used to acquire previously earmarked private businesses.

STACs borrow heavily from the concepts and principles present in existing investment structures, but also implement innovative organizational and structural features to achieve specific business, operational, and financial objectives. As a result, STACs may be best understood through their distinguishing characteristics, such as the following:

- Unlike other public operating companies, which ordinarily are corporations, the STACs to date have been structured with two tiers: a Delaware statutory trust and a Delaware limited liability company.
- Unlike other public operating companies, the day-to-day business and affairs of STACs are externally managed.
- STACs are not subject to the 1940 Act. Unlike BDCs, they own more than a majority of the outstanding voting securities of the business they acquire, thus avoiding the investment company definition. Therefore, STACs are necessarily only appropriate for making control investments.
- Unlike SPACs, STACs have specific target acquisitions that are consummated in conjunction with the completion of their IPOs.

STACs are structured using a newly formed Delaware statutory trust and Delaware limited liability company, and have four basic elements. First, the trust, the shares of which are issued to the public, will own interests in the limited liability company. The LLC interests will comprise the trust's property underlying the publicly issued shares. Second, the limited liability company will have one or more classes of interests, one of which will be held by the trust. A second class of interests may be issued to the external manager as a profit-sharing arrangement. Third, the limited liability company will be externally managed. And fourth, the limited liability company

will own controlling interests in one or more operating businesses.

The use of the STAC model offers several unique advantages over traditional investment vehicles. For example, similar to BDCs, the unique structure of STACs affords them a unique tax efficiency. Through their use of the limited liability company, STACs realize the benefits of partnership taxation. Therefore, STACs are able to avoid significant entity-level taxation with respect to dividends and interest income that they receive from the businesses they own. This benefit increases the potential return on investments for public stockholders of STACs.

Another unique feature of STACs is their use of an external manager. Having an external manager allows a STAC to effectively outsource its management pursuant to a management services agreement that provides for the calculation and payment of a single management fee. This structure provides greater transparency to public stockholders over traditionally complicated compensation packages for corporate executives. At the same time, external managers have the flexibility to engage in other business activities that are unrelated to those of the SPAC. In addition, because the limited liability company is governed by an operating agreement, profit-sharing

arrangements can be customized and implemented to align management's interests with those of the public stockholders.

Without much operating and market history to draw upon, the extent to which the STAC structure will gain widespread acceptance in the capital markets is unclear. More clear, however, is the fact that the STAC structure may offer distinct benefits as a vehicle through which to access the public markets to finance multiple control investments. As a result, the STAC structure can offer an attractive portal to taking private equity public.