Published on *The National Law Review* https://natlawreview.com

SEC Statements Regarding SPACs Address Warrants and Projections

Article By:

Brian Hecht

Mark J. Reyes

Mark D. Wood

Following the increase in the number of special purpose acquisition companies (SPACs) and the related business combinations between SPACs and private target businesses (commonly referred to as “de-SPAC” transactions), an increase in regulatory scrutiny, particularly from the Securities and Exchange Commission, is emerging. As discussed below, in the last week the SEC has issued two statements — one related to the accounting treatment of warrants and one related to liability risk — that have attracted considerable attention from SPACs and other stakeholders.

Accounting Treatment of SPAC Warrants

On April 12, the Division of Corporation Finance (Corp Fin) of the SEC issued a Staff Statement from the Acting Director, John Coates, and Acting Chief Accountant, Paul Munter, relating to the accounting treatment of warrants issued by SPACs.

In a typical SPAC initial public offering (IPO), a SPAC will issue and sell to public investors units, comprised of one share of common stock and a fraction of a warrant to purchase additional shares of common stock. In addition, SPAC sponsors also will typically purchase warrants from the SPAC to fund SPAC offering and operating expenses. These privately placed warrants, when held by the sponsor and certain permitted transferees, include certain protective provisions, including a provision that prevents the SPAC from redeeming the privately placed warrants at such as time as the warrants held by public stockholders would otherwise be redeemable. The protective provisions fall away when the private placement warrants are transferred to other third parties.

Historically, the financial statements of SPACs have classified warrants as equity. The Staff Statement challenges this long-applied accounting treatment and suggests that the warrants should instead be classified as a liability in financial statements if they contain certain customary provisions in the agreement governing the terms of these warrants. The two features that the Staff Statement focused on to support their view that the warrants should be treated as a liability apply in the case of a reorganization of the SPAC or tender or exchange offer with respect to the SPAC common stock.

More particularly:

1. The Staff Statement highlights the fact that an equity-linked instrument, such as the warrants, must be considered indexed to the entity's stock in order to qualify for equity classification, as opposed to liability classification, under applicable accounting rules. Nonetheless, certain variables may affect the settlement amount (i.e., the value upon exchange) for the warrants without causing liability accounting treatment. However, "the holder of the instrument" is not an approved variable input that may be considered. Accordingly, the Staff Statement expressed the view that, because in certain situations (including as a result of the protective provisions of the private placement warrants discussed above), the settlement amount of the private placement warrants containing the offending features will differ depending on whether such warrants are held by the SPAC sponsor or an unrelated third party, those warrants should be classified as a liability.

2. **Tender Offer.** The Staff Statement also focused on the fact that the terms of the warrants (public and private) provide that, in the event of a tender offer or exchange offer with respect to the SPAC common stock that is accepted by holders of more than 50 percent of the common stock, all holders of the warrants would be entitled to receive cash for their warrants. In those situations only holders of common stock that received and accepted the relevant cash tender offer would receive cash consideration. The fact that all warrant holders, but not necessarily all common stockholders, would receive cash consideration, would require that those warrants be treated as a liability under applicable accounting rules, the Staff Statement concludes.

As a result, SPACs that have completed an IPO or that are planning for an IPO will likely need to take steps to address the conclusions set forth in the Staff Statement.

SPACs that have already completed their IPO will need to confirm whether their outstanding warrants contain the provisions that have been called into question by the Staff Statement, and if they do, consider along with their auditors, the impact on their financial statements for prior periods, including whether any accounting errors in prior period financial statements are "material" and financial statements need to be restated to account for outstanding warrants as liabilities rather than as equity. The Staff Statement provides that SPACs may correct material errors relating to the warrant accounting treatment by amending their most recent Form 10-K and any subsequently filed Form 10-Qs. In addition, going forward, these companies will need to determine whether quarterly valuations of the warrants and mark-to-market accounting treatment will be required.

SPACs that have not yet completed their IPO have additional options. This may include accounting for their warrants as liabilities on a go forward basis or structuring the warrants to exclude the features that would give rise to a need to classify the warrants as a liability and maintain the ability to classify the warrants as equity.

The impact that the Staff Statement will have on the market for existing and future SPACs, and whether additional SEC guidance on SPAC accounting matters will be issued, is yet to be seen.

The Staff Statement represents staff views of Corp Fin and the Office of the Chief Accountant. It is not a rule, regulation, or statement of the SEC. However, issuers should anticipate the need to address the matters set forth in the Staff Statement in a satisfactory manner in connection with the SEC comment and review process with respect to IPOs and their ongoing periodic reports made

under the Securities Exchange Act of 1934.

SEC Corp Fin Staff Statement

SPAC Liability Risk

On April 8, John Coates, the Acting Director of Corp Fin, issued a statement addressing the rise of SPAC transactions and his views on certain important liability issues, stating that the Corp Fin staff "will continue to be vigilant about SPAC and private target disclosure so that the public can make informed investment and voting decisions about these transactions."

Mr. Coates' statement focused particularly on the use of projections in disclosures in connection with de-SPAC transactions. He noted that the conventional market wisdom on the benefit of SPAC transactions, as compared to traditional IPOs, focuses on the perceived ability of SPACs to rely on the safe harbor for forward-looking statements (such as projections) provided by the Private Securities Litigation Reform Act of 1995 (PSLRA) in connection with a de-SPAC transactions. In general, the PSLRA provides a safe harbor for forward-looking statements (including projections) made by issuers, when properly identified as a forward-looking statement and accompanied by meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those in the forward-looking statement. The PSLRA explicitly excludes statements made "in connection with an initial public offering" from the safe harbor. In recent years, the use of projections has helped fuel the market for de-SPAC transactions, as startups and other growth companies that would not typically pursue a traditional IPO, have merged with SPACs and impressed investors with strong projections for future results.

Certain commentators, Mr. Coates observed, "suggest or assert that the safe harbor applies in the context of de-SPAC transactions but not in conventional IPOs." Mr. Coates expressed his view that this perceived benefit is overstated and potentially misleading, in particular noting his views that:

- Notwithstanding the safe harbor provided by the PSLRA, any material misstatement or omission made by a SPAC in a registration statement or proxy statement is subject to liability under existing federal securities laws, including Section 11 of the Securities Act of 1933 (the Securities Act).
- The safe harbor does not protect against false or misleading statements made with actual knowledge that the statement was false or misleading.
- Statements and disclosures made in connection with a de-SPAC transaction may give rise to liability under state law, including in the case of Delaware corporations, with respect to the duty of candor and fiduciary duties.
- The PSLRA safe harbor applies only in the case of private litigation and does not prevent the SEC from taking action to enforce the federal securities laws.

In addition, while noting that the PSLRA does not apply to statements made in connection with an IPO, Mr. Coates observed that the term "initial public offering" is not defined in the PSLRA or, for these purposes, any relevant SEC rules. Accordingly, he stated, given that a de-SPAC transaction serves as the transaction in which a private operating company goes public, the phrase initial public offering "may include de-SPAC transactions."

Mr. Coates further raised the possibility that, in the future, the SEC could revisit the scope of the PSLRA safe harbor, through new rulemaking or guidance, particularly to better address the realities of a de-SPAC transaction and the extent to which it serves, from an economic and practical perspective, and from the perspective of investors, as the true go public transaction of a private company. He also noted that the SEC could reconsider the concept of “underwriter” in the context of de-SPAC transactions. In conclusion, Mr. Coates stated that, given the practicalities of SPAC transactions, the SEC may need to consider the de-SPAC transaction the “real IPO” and focus the application of the federal securities laws more fully on that aspect of a SPAC life cycle.

As noted in the statement, the statement represents the views of Mr. Coates. It is not a rule, regulation, or statement of the SEC. The extent to which the statement leads to any new rulemaking by the SEC or other change in policy is yet to be seen.

Mr. Coates’ Statement

©2024 Katten Muchin Rosenman LLP

National Law Review, Volumess XI, Number 106

Source URL:https://natlawreview.com/article/sec-statements-regarding-spacs-address-warrants-and-projections