Publications & Events

01 JUN 2021 | Alert |

Joel L. Rubinstein | Jonathan P. Rochwarger | Elliott M. Smith | Daniel Nussen

Clarity Emerges in the Aftermath of the SEC Statement on SPAC Warrant Accounting: A Roadmap for the Changes to Permit Equity Classification

Following the release in April of the statement by the staff (the "Staff") of the U.S. Securities and Exchange Commission ("SEC") requiring most warrants issued by special purpose acquisition companies ("SPACs") to be accounted for as liabilities, SPACs scrambled to determine whether they needed to revise or restate their previously issued financial statements. At the same time, SPACs have been seeking accounting guidance to determine whether and how to revise the agreements governing their warrants so that their warrants qualify for equity classification. There now is clarity on the path forward. This Client Alert explains the current state of affairs and provides practical guidance to pre- and post-IPO SPACs seeking to implement changes to permit equity classification for their warrants.

Background

On April 12, 2021, the Acting Director of the SEC's Division of Corporation Finance, John Coates, and Acting Chief Accountant of the SEC, Paul Munter, released a statement on accounting and reporting considerations for warrants issued by SPACs (the "Statement").[1] The Statement was issued to "highlight the potential accounting implications of certain terms that may be common in warrants included in SPAC transactions and to discuss the financial reporting considerations that apply if a registrant and its auditors determine there is an error in any previously-filed financial statements.

Many SPACs issue warrants to investors as part of units sold in their IPOs ("public warrants") and also issue warrants to their sponsors in a private placement at the time of their IPOs ("private placement warrants" and, collectively, with the public warrants, "SPAC warrants"). The SPAC warrants have generally been classified as equity instruments – both prior to de-SPAC transactions, where the audits have principally been conducted by two auditing firms, and following de-SPAC transactions, where the audits have been conducted by a wide variety of auditing firms, including the "Big 4." The Statement challenges this accounting treatment by concluding that certain common features in SPAC warrants require the warrants to be classified as liabilities for financial statement purposes rather than as equity. The Statement also highlights financial reporting considerations if an issuer determines it has misclassified its SPAC warrants, and effectively requires every issuer that has or had SPAC warrants to evaluate the terms of those warrants, whether their accounting treatment was appropriate in light of the Statement and whether the impact of any misclassification constituted a "material" deviation from U.S. generally accepted accounting principles ("US GAAP") so as to require a restatement of previously issued financial statements.

Longtime SPAC market participants will recall that, on at least two prior occasions, SPACs and post-business combination companies faced the need to reclassify their SPAC warrants from equity instruments to contingent liabilities for different reasons.[2] In those cases, even for post-business combination companies, the market shrugged it off, because the liabilities and non-cash charges do not affect the company's revenue, operating expenses, operating income, taxes, cash flows or cash and cash equivalents, or any adjusted EBITDA results the company might report. Further, following those cases, new SPACs simply revised the then-standard SPAC warrant agreement to eliminate the provisions that were resulting in liability classification. Not surprisingly, the market appears to be having the same reaction this time, and investors do not seem fazed by the countless restatements and Item 4.02 Form 8-Ks that have been filed by SPACs and post-business combination companies.

Accounting Issues

In the Statement, the Staff described two accounting issues, one of which relates to the private placement warrants, and the other of which relates to both the public warrants and private placement warrants.

Indexation

Section 815-40-15 of Accounting Standards Codification ("ASC") Subtopic 815-40, **Contracts in Entity's Own Equity**, addresses equity versus liability treatment and classification of equity-linked financial instruments, including common stock purchase warrants, and states that a warrant may be classified as a component of equity only if, among other things, the warrant is indexed to the issuer's common stock. In the Statement, the Staff said that an example of such indexation is a warrant that is settled with a fixed number of shares or at a fixed strike price. However, the Staff noted, some warrants may include variables that could affect the settlement amount, which could potentially preclude a determination that the warrant is indexed to the company's own stock.[3] For example, in the Statement, the Staff indicates that it recently reviewed a warrant agreement that "included provisions that provided for potential changes to the settlement amounts dependent upon the characteristics of the holder of the warrant." Because the holder of the warrant is not an input to the fair

value of an option on equity shares, the Staff concluded that such provisions would "preclude the warrants from being indexed to the entity's stock, and thus the warrants should be classified as a liability measured at fair value, with changes in fair value each period reported in earnings."

The typical SPAC warrant agreement provides for different settlement amounts for the private placement warrants and the public warrants under certain circumstances. For example, one provision requires an adjustment to the exercise price of the SPAC warrants in connection with certain fundamental transactions occurring following a de-SPAC transaction (the "Fundamental Transaction Adjustment Provision"). Under the Staff's reading, the private placement warrants may be entitled to a greater adjustment pursuant to this provision than the public warrants. Further, the public warrants, but not the private placement warrants, are subject to redemption when the trading price of the company's stock following a business combination reaches a specified threshold, typically $18.00. The private placement warrants also may be exercised at any time, at the option of the holder, on a cashless basis. The warrant agreement provides that once the private placement warrants are transferred to persons other than certain permitted transferees, they become public warrants. Because the settlement amount of a private placement warrant may change if the warrant is transferred to a non-permitted transferee thereby becoming a public warrant, the Staff believes that the private placement warrants containing any of the above provisions must be classified as liabilities.

Tender Offer Provisions

Another problematic SPAC warrant provision identified in the Statement relates to tender offers. For a warrant to qualify for equity classification under ASC Subtopic 815-40, it is not sufficient that it is considered indexed to the entity's common stock. The warrant must require or permit the issuer to share settle the contract (either physically or net in shares). Any provision that could require the issuer to net cash settle the contract precludes equity classification with limited exceptions. The Staff explained that one exception to this is that the warrant may be classified as equity if net cash settlement can be triggered only in circumstances in which the holders of the shares underlying the contract also would receive cash, including "events that fundamentally change the ownership or capitalization of an entity, such as a change in control of the entity or a nationalization of the entity." In the Statement, the Staff notes a fact pattern it recently evaluated in which the SPAC warrants provided that, "in the event of a tender or exchange offer made to and accepted by holders of more than 50% of the outstanding shares of a single class [emphasis added] of common stock, all holders of the warrants would be entitled to receive cash for their warrants. In other words, in the event of a qualifying cash tender offer (which could be outside the control of the entity), all warrant holders would be entitled to cash, while only certain of the holders of the underlying shares of common stock would be entitled to cash." The Staff determined that, since the language referred to a single class of stock and did not relate to an event that would necessarily cause a change in control, the warrants should be classified "as a liability measured at fair value, with changes in fair value reported each period in earnings."

The Path Forward

Since the release of the Statement, accounting firms involved in SPAC transactions, including the "Big 4" as well as other firms that have dominated the SPAC auditing market, have engaged in discussions with each other and the SEC Staff to address the concerns raised by the Statement, and to otherwise review the standard form of SPAC warrant agreement to determine what revisions are necessary in order for SPAC warrants to be classified as equity instruments.

Based on our discussions with these firms, we understand there is general consensus that the changes to the standard SPAC warrant agreement discussed below will allow the warrants to be classified as equity instruments.

Public Warrants and Private Placement Warrants

Tender Offer Provision

The specific tender offer provision identified by the Staff as requiring liability classification provided that if a tender, exchange or redemption offer is made to and accepted by the holders of common stock under circumstances in which, upon completion of such offer, the maker thereof beneficially owns more than 50% of the outstanding shares of "Common Stock," the holder of a warrant is entitled to receive, upon exercise of a warrant, the highest amount of cash, securities or other property to which it would actually have been entitled as a stockholder if it had exercised the warrant prior to the expiration of such offer, accepted such offer and all of the Common Stock held by such holder had been purchased pursuant to such offer. As indicated above, the definition of "Common Stock" was limited to shares of the issuer's Class A common stock.

Most SPACs (and some post-business combination companies) have dual class structures consisting of two classes of shares of voting common stock — Class A shares and Class B shares — with the Class B shares comprising 20% of the total number of outstanding shares of common stock; as a result, in many cases, as drafted, the event triggering the cash settlement of the SPAC warrants would not constitute a change in control of the company, and, therefore, the SPAC warrants would not meet the equity classification conditions in the applicable accounting guidance and would have to be classified as liabilities.

If this provision is revised so that the tender offer triggering cash settlement of the SPAC warrants results in the maker of the tender offer holding more than 50% of the voting power of the issuer's securities, thereby constituting a change in control of the issuer, this provision will not preclude equity classification of the SPAC warrants.

The Warrant Table

Certain SPAC warrant agreements contain a provision which effectively permits the issuer to force the exercise of the public warrants, and in many cases the private placement warrants, on a net share basis if the stock price of the issuer equals or exceeds $10.00 for a specified period. The number of shares of common stock issuable by the issuer to the warrantholders pursuant to this provision is determined by reference to a table included in the warrant agreement, commonly referred to as the "warrant table," and varies based on the then-current stock price and the period of time remaining prior to the expiration of the warrants. The various net share settlement amounts set forth in the warrant table are intended as make-whole payments to compensate warrantholders for the potential lost value of the warrants due to the early forced exercise of the warrants, and have been calculated based on a Black-Scholes methodology with a volatility input that is

considered higher than would be used to calculate fair value at the time the warrant agreement is executed creating a premium for the warrantholders. Accordingly, warrant tables with settlement amounts calculated in accordance with the foregoing may preclude the applicable SPAC warrants from being indexed to the company's stock and, therefore, may be required to be classified as liabilities.

In order to address this issue, there are two alternatives: remove or modify the table. If the table is removed, the post-business combination company will still have the ability to make a tender/exchange offer for the warrants for cash and/or stock (as many post-business combination companies have successfully done in the past), but there is no certainty that a sufficient number of warrantholders will accept the offer. If the warrant table is modified, it is likely that the various net share settlement amounts will be lower than the current standard, so it remains to be seen whether IPO investors will find such a provision acceptable.

Private Placement Warrants

As described above under "Indexation," pursuant to most current warrant agreements, the terms of the private placement warrants are typically substantially identical to the terms of the public warrants, except that, so long as they are held by the sponsor or its permitted transferees, the private placement warrants: (i) can be exercised on a cashless basis and (ii) are not subject to mandatory redemption like the public warrants if the issuer's stock trades at or above $18 for the requisite period (the "$18 redemption provision") (and sometimes are not subject to the "warrant table" provision). In addition, under the Staff's reading of the Fundamental Transaction Adjustment Provision, the private placement warrants may be entitled to a greater adjustment thereunder than the public warrants. However, if the private placement warrants are transferred from their initial purchaser(s) to a non-permitted transferee, they become redeemable by the issuer and exercisable by the transferee holders on the same basis as the public warrants and become public warrants. Because the settlement amount of any private placement warrant containing any of the provisions described above would change if the warrant is transferred to a non-permitted transferee, such private placement warrant would be precluded from being indexed to the SPAC's stock and would have to be classified as a liability.[4]

There are two alternatives to permit equity classification for the private placement warrants, each of which has commercial and other implications.

The first is to keep private placement warrants separate and distinct from public warrants with no possibility of changes to their terms. The private placement warrants would retain cashless exercise optionality and would not be subject to the $18 redemption provision (and potentially also would not be subject to the "warrant table" provision if such a provision is retained for the public warrants). However, this lack of fungibility with the public warrants means that the holders of the private placement warrants would not have the ability to sell the warrants publicly if liquidity is needed (although they could potentially sell them privately subject to applicable securities law registration or exemption and/or lockup requirements), and would be required to exercise the warrants and sell the shares if liquidity is needed. If a sponsor chooses to go this route, it may also consider adding the ability to net exercise the warrant using a warrant table. This would create potential liquidity even if the warrant was out-of-the-money.

The other alternative is to make the private placement warrants the same as the public warrants, i.e., they would be subject to the $18 redemption provision and would not be exercisable on a cashless basis. This would allow the private placement warrants to be sold publicly, and would also be perceived as aligning the sponsor with the public investors, but would come at a significant economic cost to the sponsor and/or other initial purchasers of the warrants.

Implementing the Changes in Warrant Agreements for Post-IPO SPACs

SPACs that have completed their IPOs need to consider, in connection with their initial business combinations, whether to amend their warrant agreements to implement the changes to classify their warrants as equity instruments after the consummation of the business combination.

If the post-business combination company will only have a single class of common stock, the tender offer provision described above will not preclude equity classification because it would only be triggered when there is a change in control. In that case, only the private placement warrants would need to be addressed. If the post-business combination company will have a dual class structure (e.g., where certain former owners of the target company receive super-voting stock in the business combination), then the public warrants also will need to be addressed.

There are three approaches to be considered:

1. Accept liability treatment for the warrants on a going forward basis;
2. Seek the approval of warrantholders to amend the warrant agreement concurrently with the solicitation of approval of the SPAC's stockholders for the business combination; or
3. Rely on the "warrant table," if applicable, or a tender/exchange offer after the consummation of the business combination, to "redeem" or repurchase some or all of the then-outstanding SPAC warrants.

If an amendment to the warrant agreement is desired, the amendment provision of the applicable warrant agreement will need to be reviewed to determine whether some or all of the changes require approval of the holders of the public warrants and/or the private placement warrants, or if some or all of the changes can be implemented without their approval.

The Last Word

Now that there is clarity about the changes to SPAC warrant agreements necessary to permit equity classification, we expect that sponsors of new SPACs that intend to offer units containing warrants in their IPOs will structure the warrants so they are classified as equity instruments. As described above, sponsors will need to decide among different alternatives to reach this result, which will require them to balance the commercial interests of SPAC investors and, with respect to the private placement warrants, sponsor economics. In the case of the private placement warrants, some SPAC sponsors place a significant premium on the cashless exercise/uncapped value features of

private placement warrants while others are more focused on aligning terms with the public warrantholders. For SPACs addressing these issues at the time of their initial business combinations, the same considerations will need to be taken into account. Time will tell whether the market adopts any one particular alternative in the various contexts.

1 The Statement is available here.

2 First, in 2006, financial statements were restated in response to Staff comments that under EITF Issue No. 00-19 there was a presumption that a holder of a warrant was entitled to net cash settlement if the issuer could not deliver registered shares upon the exercise of the warrants (a position the Staff later reversed). Second, in 2013, financial statements were restated because a make-whole adjustment provision in a number of SPAC warrant agreements provided for a reduction in the exercise price of the warrants under certain circumstances that that were determined to not be inputs to the fair value of the warrants and, accordingly, the warrants were determined not to be indexed to the company's common stock (see the discussion under "Indexation" in this Client Alert below).

3 The Statement notes that "[s]uch variables do not preclude a conclusion that the instrument is indexed to an entity's own stock if the variables would be inputs to the fair value of a fixed-for-fixed forward or option on equity shares. To assist in an entity's evaluation, GAAP includes a list of such inputs."

4 As indicated in the Statement and discussed above, the holder of the warrant is not an input into the fair market of an option on equity shares.

This publication is provided for your convenience and does not constitute legal advice. This publication is protected by copyright.
© 2021 White & Case LLP