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Kirkland Alert

A SPAC Curveball

15 April 2021

Overview

On April 12, 2021, the Staff of the U.S. Securities and Exchange Commission (SEC), under the signature of Acting Director of the Division of Corporate Finance John Coates and Acting Chief Accountant Paul Munter, released the Staff Statement on Accounting and Reporting Considerations for Warrants Issued by Special Purpose Acquisition Companies ("SPACs") (the Statement). The Staff's observations will have ramifications for almost every SPAC with warrants in its structure — whether in formation/registration, newly public, approaching a business combination, or post-initial business combination (even years ago). SPACs, their sponsors and deal professionals (particularly the accounting and auditing firms) are rushing to assess the impact of the Statement and evaluate an appropriate response. This Alert is intended to help our clients understand the Staff's position, assess implications and formulate next steps.

SEC Statement

Most SPACs have both private placement warrants and public warrants as part of their structure. SPACs have almost universally accounted for both types of warrants as equity instruments, an approach that had been allowed by the Staff, all "Big-4" audit firms and the principal SPAC-focused audit firms.

The Statement challenges long-held views about equity treatment for SPAC-issued warrants, suggesting that certain nearly ubiquitous features in SPAC warrants require the warrants to be recorded as "liabilities" on the SPAC's balance sheet rather than as "equity." It also highlights financial reporting considerations if a SPAC determines it has misclassified its warrants.

The Statement will require each SPAC with warrants in its structure to evaluate the terms of those warrants, whether those terms in fact should result in liability treatment instead of equity treatment given the Statement, and whether the impact of such change in accounting treatment is "material" so as to require a restatement of previously issued financial statements.

Private Placement Warrants

SPACs typically fund their start-up costs (offering costs and monies outside of the trust account) through the sale of warrants to their sponsors. These "private placement warrants" usually provide for both (1) cash and cashless exercise (as opposed to the public warrants, which can only be exercised for cash other than in the case of certain redemptions) and (2) the absence of redemption (forced exercise) provisions as long as the warrants are held by the SPAC sponsor or its permitted transferees (as opposed to the public warrants, which can be redeemed by the SPAC at various price thresholds). In the Statement, the Staff points to accounting guidance that an entity must consider in determining whether to classify contracts that may be settled in the entity's stock as equity of the entity or as an asset or liability of the entity. The Staff noted that the particular warrant that it reviewed was drafted such that it would not fall within the accounting guidance for equity treatment because the warrant included provisions that provided for potential changes to the settlement amounts dependent upon the characteristics of the holder of the private placement warrant. The Staff concluded that, in this fact pattern, such a provision would preclude the warrants from being classified as equity, and thus the warrants should be classified as a liability measured at fair value, with changes in fair value each period reported in earnings. Almost all SPAC private placement warrants have terms similar to those reviewed by the Staff in its example.

Public Warrants

Most SPACs also typically issue warrants together with shares at IPO as a way of enhancing the overall potential financial return of the SPAC security (typically in fractions of 1/2, 1/3, 1/4 or 1/5). These so-called "public warrants" are held by the public and have substantially similar terms to the private placement warrants (except as described above). These warrants typically provide that if a tender or exchange offer is made to and accepted by holders of more than 50% of the outstanding shares of a single class of common stock, then all holders of the warrants would be entitled to receive cash for their warrants. In other words, if a qualifying cash tender offer (which could be outside the control of the entity) occurs, in the SEC's view of the agreement 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 concluded

that, in this fact pattern, the tender offer provision would require the warrants to be classified as a liability measured at fair value, with changes in fair value reported each period in earnings. Many legal practitioners do not interpret the tender offer provision in this way and, instead, believe the provision is intended to provide for similar consideration on a pro rata basis regardless of the type of security.

Implications of the Statement

We note that the Staff made observations regarding two specific fact patterns where the accounting guidance and the language in the warrant agreements is very technical. Thus, a careful reading of each SPAC's contractual warrant provisions will be required to determine whether in fact liability treatment is applicable rather than equity treatment. If a SPAC and its advisors determine that any of its warrants should be accounted for as liabilities rather than equity, the SPAC must then assess whether the error in its previously filed financial statements is material such that it should restate such financials. In the Statement, the Staff cited to its well-known Staff Accounting Bulletin No. 99 — Materiality, which is codified in SAB Topic 1, Section M - Materiality (SAB 99), which states that the formulation of materiality in the accounting literature is the same as that used by courts in interpreting the federal securities laws:

> a substantial likelihood that the… fact would have been viewed by the reasonable investor as having significantly altered the "total mix" of information made available.

In the context of a misstatement of a financial statement item, while the "total mix" includes the size in numerical or percentage terms of the misstatement, it also includes the factual context in which the user of financial statements would view the financial statement item. The shorthand in the accounting and auditing literature for this analysis is that financial management and the auditor must consider both "quantitative" and "qualitative" factors in assessing an item's materiality.

Arguably, the significance of the accounting treatment, and resulting financial statement impact, of SPAC-issued warrants is immaterial. That is, SPAC investors are well aware of the existence and terms of both the private placement warrants and the public warrants, and the accounting treatment is arguably not material to an investment decision to buy into a SPAC (given, among other things, the presence of the trust account and related stockholder redemption features) or a de-SPAC'd company (given, among other things, its much larger size and scope). Nonetheless, we believe that SPACs and their accountants may choose to engage a third party

valuation firm to determine the amount of the liability represented by the warrants. While this valuation may enable the SPAC to assess materiality on a quantitative basis, the SPAC should also consider qualitative factors bearing on materiality.

Practically speaking, we believe that SPACs with warrants in their structure will:

- review the terms of their warrants for the provisions highlighted in the Statement,
- determine whether, given the Statement, the warrants should be accounted for as liabilities rather than as equity,
- confirm such determination with their auditors,
- if liability treatment is deemed appropriate, and the SPAC does not wish to pursue an amendment of the warrant terms to change such treatment, engage a valuation firm to value the liability represented by the warrants,
- based on the quantitative valuation of the liability, together with the other qualitative factors, decide whether the accounting impact is “material” to the SPAC’s financial statements, and
- if material, determine whether to restate previously issued financial statements.

According to the Statement, SPACs that determine that the error is not material may provide the Staff with a written representation to that effect in correspondence on Edgar.

Below, we address in turn the specific considerations that are relevant if a restatement may be required, as well as specific decisions that may be faced by SPACs based on where they are in their life cycle.

Restatement Considerations

8-K Filing

If and when a SPAC (specifically its Board, a committee thereof or an officer authorized to take such action) concludes that a restatement of previously issued financial statements is required, the SPAC must file a Current Report on Form 8-K under Item 4.02 (Non-Reliance on Previously Issued Financial Statements or a Related Audit Report or Completed Interim Review). This Form 8-K is due within four business days after such conclusion. Item 4.02 disclosure must be contained in a Form 8-K and cannot be initially reported in a Form 10-Q or Form 10-K.

The Item 4.02 disclosure must include the following information:

- the date of the conclusion of the non-reliance and identify the financial statements and years or periods covered that should no longer be relied upon,
- a brief description of the facts underlying the conclusion to the extent known to the SPAC at the time of filing, and
- a statement of whether the audit committee, or the board of directors in the absence of an audit committee, or authorized officer or officers, discussed with the SPAC's independent accountant the matters disclosed in the filing.

In addition, once the decision to restate is made but before the public announcement, the SPAC should contact its securities exchange.

Periodic Reports

The need to restate previously issued financial statements often leads to an inability to file timely periodic reports. However, if the SPAC fully complies with Rule 12b-25 of the Securities Exchange Act of 1934, the periodic report deadline can be extended so that the SEC will treat the late periodic report as if had been timely filed. To comply with the rule:

- the SPAC must file a Form 12b-25 (Notification of Late Filing) with the SEC within one business day after the due date of the late report,
- the SPAC must represent in the Form 12b-25 that it could not file the periodic report on time without unreasonable effort or expense, and
- the delayed report must then be filed by the end of the applicable extension period (five calendar days for Form 10-Q and 15 calendar days for Forms 10-K and 20-F).

When the restated financial statements are available, amended quarterly and annual reports will need to be filed to correct the past filings that relied on the restated financial statements (dating all the way back to the IPO of the SPAC in many cases). The amended periodic filings should include an explanatory note following the cover page to briefly describe the restatement. Only items that are modified by the restatement need to be included.

Specific Fact Patterns

SPACs with Pending IPO Registration Statements

SPACs with warrants in their structure that are currently in registration (that is, in the process of filing an initial IPO registration statement and any amendments thereto and prior to that registration statement being declared effective by the SEC) should consider revising their warrant agreements and related disclosure as follows:

- First, based on the Statement, we believe issuers should ensure that the private placement warrants typically held by the sponsor do not have different settlement amounts dependent upon who holds the private placement warrants as is often the case today. In other words, SPACs should consider (a) making the private placement warrants non-transferable or (b) providing that the terms do not change depending on who holds the warrants.
- Second, based on the Statement, SPACs should clarify that in a tender offer, the warrant holders should receive the same consideration, if any, as the underlying common stock.

In the absence of such revisions, SPACs will need to undertake actions described above under "Implications of the Statement," which may result in the warrants being classified as a liability measured at fair value, with changes in fair value reported each period in earnings.

To state the obvious, any modifications to the terms of the warrants for purposes of achieving an accounting result should be reviewed by the SPAC's accountants and verified with its auditors as they may have different or additional views on the actions required to be taken to maintain equity treatment.

Existing SPACs and companies that have completed a business combination with a SPAC should consult with their advisors about amending their warrant agreements to make the changes suggested above to avoid future liability accounting.

Newly Public SPACS

Public SPACs that are not on the verge of signing a business combination agreement will have time to evaluate the appropriate response to the Statement, which may include:

- working together with its advisors, accountants and auditors in order to evaluate the materiality of any errors to their financial statements (if any), and
- if necessary, considering its Form 8-K filing obligations under item 4.02 *(Non-Reliance on Previously Issued Financial Statements or a Related Audit Report or Completed Interim Review)*,

- engaging, if necessary, a third party valuation firm in order to determine the liability represented by their SPAC's warrants, and
- reassessing the internal control of financial reporting of their SPAC should its evaluation conclude that there have been material errors in the SPAC's financial statements.

The SPAC should consult with its audit committee as part of the process described above and, once the above evaluation is complete, convene a meeting of the audit committee and its auditors to evaluate any errors to the financial statements and the results of management's materiality analysis.

Generally, a SPAC will be able to correct material errors related to accounting issues by amending its most recent Form 10-K and any subsequently filed Form 10-Qs. Such amended Form 10-Ks and Form 10-Qs should, among others, include:

- restated financial statements and applicable footnote disclosures; and
- revised Management's Discussion and Analysis of Financial Condition and Results of Operations (MD&A) disclosure, based on the restated financial information.

Depending on the outcome of the materiality analysis prepared by management, a SPAC will need to consider different types of amendments to its publicly reported financial information.

A newly public SPAC that has not filed a Form 10-K this year — for instance, because the SPAC was formed in 2021, because the SPAC's Form S-1 that was declared effective by the SEC included year-end audited financials, or because the SPAC will be filing a so called look-back 10-K after the closing of its IPO — will be able to correct any material errors in its publicly reported financial statements by taking the following steps:

1. If management's materiality analysis concludes that a "Big R restatement" of a SPAC's financial information is necessary (i.e., when the error is deemed material to prior financial statements), a SPAC should file:
    - an amendment to the Form 8-K with which it filed its IPO closing balance sheet in order to disclose the new liability represented by the warrants going forward and how past financial statements should have accounted for the warrants;
    - its look-back Form 10-K with appropriate disclosures about the accounting treatment warrants will be subjected to in future financial statements and how the warrants should have been accounted for in financials in the past (a SPAC will only be required to file such a look-back Form 10-K if its Form S-1 was

declared effective within 90 days of the SPAC's December 31, 2020 fiscal year-end and the effective Form S-1 did not include year-end audited financials); and/or

- a first quarter Form 10-Q that reflects the newly adopted accounting standards and that discloses how the warrants should have been accounted for in financials in the past.

2. If management's materiality analysis concludes that only a "Little r restatement" of a SPAC's financial information is necessary (i.e., when the error is deemed immaterial to prior financial statements), a SPAC will only need to reflect the new accounting treatment of the warrants in its upcoming Form 10-Q filing. This Form 10-Q would incorporate the new liability represented by the warrants as of March 31, 2021, update any December 31, 2020 financials and disclose in a footnote the accounting change and its impact on past and future reporting periods.

If management's materiality analysis concludes that a "Big R restatement" of a SPAC's financial information should be made, a newly public SPAC that already filed a Form 10-K and is preparing to file its first Form 10-Q with the revised accounting treatment for its warrants should amend its year-end financial statements by filing an amendment to its previously filed Form 10-K. However, if management's materiality analysis concludes that only a "Little r restatement" should be made, a newly public SPAC that already filed a Form 10-K will not need to amend its previously filed Form 10-K and will be able to correct the accounting treatment of its warrants in its upcoming Form 10-Q filing.

SPACs Poised to Enter into a Business Combination Agreement

In connection with the signing of a business combination agreement, SPACs should determine whether the business combination agreement or other ancillary signing documents, including the PIPE subscription agreements, require the SPAC to represent that all reports filed by the SPAC with the SEC (including the financial statements within such reports), comply in all material respects with the rules and regulations of the SEC (including applicable accounting requirements). Within such agreements, SPACs should consider including an acknowledgment by the target and each of the PIPE investors, of the issuance of the Statement and the SPAC's ongoing review of the implications of the Statement.

A restatement of previously issued financials may also create a delay for a SPAC's first proxy/prospectus filing on Form S-4 following the signing of the business combination agreement. SPACs should adjust transaction timelines in order to properly account for any updates to the Form S-4 in response to the Statement as detailed below.

SPACs That Have Entered into a BCA, but for Which Their Form S-4 is Not Yet Effective/Proxy Statement Not Yet Cleared

SPACs that have signed a business combination agreement with a target but do not yet have an effective Form S-4 or cleared proxy statement on file may be unable to obtain effectiveness or clearance until they address the proper accounting for warrants due to Staff scrutiny of this topic. Assuming a restatement is determined to be necessary, the SPAC would proceed as discussed above under "Newly Public SPACs."

Once the SPAC has made these filings, it could then file an amendment to the Form S-4 or proxy statement related to the business combination with with updates to the SPAC's historical financial information, pro forma financial statements and disclosures under Capitalization, Dilution and MD&A.

According to the Statement, SPACs that determine that the error is not material to the financial statements and disclosures may provide the Staff with a written representation to that effect in correspondence on Edgar.

SPACs with an Effective Form S-4 or Cleared Proxy Statement with a Pending Shareholder Meeting

SPACs with an effective Form S-4 or a proxy statement that has been cleared by the Staff prior to the release of the Statement should consider the materiality of the revisions that would need to be made to the SPAC's financial statements and the combined company pro forma financial statements. If a SPAC reasonably determines that the revised warrant treatment, in light of all relevant qualitative and quantitative factors, would not be material to a reasonable investor, it is recommended that the SPAC make a supplemental filing (either under Rule 425 or as additional definitive proxy materials, as applicable) describing the SEC's guidance in the Statement and the likelihood that the SPAC's financials will need to be restated. With this supplemental filing, it is possible that a SPAC could continue with its previously scheduled shareholder meeting.

If a SPAC determines that the revised warrant treatment and restated financials would be material, the SPAC would proceed as discussed above under "Newly Public SPACs" and would make a supplemental filing (either under Rule 425 or as additional definitive proxy materials, as applicable) and include the restated financial information, M&DA and pro formas. Depending on the timing of the meeting, the SPAC would need to consider whether or not it needs to change the timing of its stockholder meeting.

Note that restated financial statements of the SPAC and revised combined company pro forma financial statements reflecting the restated financial statements will need to be included in a Current Report on Form 8-K that will need to be filed within four business days of closing the business combination (the "super 8-K"). While SPACs and their counterparties in this situation may be able to work through the necessary revisions with their financial consultants and auditors during the shareholder solicitation period and close the transaction immediately after the shareholder meeting, the parties may also delay closing the business combination after the shareholder meeting in order to prepare the revisions and ensure that the super 8-K will be ready to be filed on time. Note that the super 8-K will generally require auditor consents.

De-SPAC'd Companies

SPACs that have closed an initial business combination are not immune from the impact of the Statement. These companies — commonly referred to as "de-SPAC'd companies" — must perform the same analysis of their warrant structure and consider the implications of "equity" versus "liability" treatment on each fiscal period reflected in their financial statements. The materiality analysis under SAB 99 and other relevant guidance may be somewhat easier in the case of a de-SPAC'd company given its much larger size as compared to the original SPAC. Even if a de-SPAC'd company can avoid a restatement for periods after its initial business combination, the Statement also has implications for each fiscal period reflected in the financial statements. Therefore, even if the difference in warrant treatment is not material for one or more periods post-business combination, the de-SPAC'd company may still be required to restate its financial statements for earlier periods (i.e., pre-deSPAC). The consequence is that de-SPAC'd companies may have to (1) pause the use of resale registration statements, (2) postpone the filing, or pause the use of, other registration statements and (3) notify investors of non-reliance on previously issued financial statements under Item 4.02 of Form 8-K.

Conclusion

While the Staff has been broadcasting for months that it is looking closely at SPACs, in particular their structure and disclosures, this position on the appropriate accounting treatment for SPAC-issued warrants was unexpected. The consequence of the Statement will be that all SPACs with warrants in their structure, and their existing advisors, as well as newly engaged valuation firms, will likely be busy sorting out the accounting and disclosure ramifications for months. On the other hand, it is likely that

SPAC warrant accounting treatment is fundamentally not material to the investment decision of SPAC investors and other than the unfortunate delay that this interpretation causes and the subsequent revisions we expect to see in warrant agreement forms, we do not expect this development to otherwise affect the SPAC market.

Authors

Philippa Bond, P.C.

Partner / Los Angeles – Century City

Jonathan L. Davis, P.C.

Partner / New York

Sophia Hudson, P.C.

Partner / New York

Mathieu Kohmann

Associate / New York

Peter Martelli, P.C.

Partner / New York

Christian O. Nagler

Partner / New York

Peter Seligson

Partner / New York

Sean T. Wheeler, P.C.

Partner / Houston / New York

Debbie P. Yee, P.C.

Partner / Houston

Anthony Zangrillo

Associate / New York

Related Services

Practices

- Capital Markets

Suggested Reading

- 14 April 2021 Press Release Kirkland Advises The Jordan Company and Sabre Industries on Sale of Sabre Industries to Blackstone
- 13 April 2021 Press Release Kirkland Advises Spring Valley Acquisition Corp. on $1.2 Billion AeroFarms Combination
- 12 April 2021 Press Release Kirkland Advises on Convertible Senior Notes Offering of Li Auto

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