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SEC Upends Classification of SPAC-Issued Stock Warrants

By **Robert J. Anello, Brian A. Jacobs & Anthony Sampson**

As explained elsewhere, the Special-Purpose Acquisition Company ("SPAC") has been the subject of significant market activity, with the use of SPACs skyrocketing for several months before recently falling back to Earth. Despite the recent dip in SPAC use, according to data from Dealogic, U.S. SPACs had raised over $100 billion in 2021 alone, with the value of SPAC mergers surpassing $260 billion. In recent months, however, the number of SPACs going public has dropped precipitously, dropping from 116 listings in March down to just 18 in April and 19 in May. Nevertheless, with the increasing prevalence of this once-derided investment vehicle, regulators such as the United States Securities and Exchange Commission ("SEC") were sure to scrutinize the structure and conduct of SPACs in both their initial public offerings and the subsequent merger with private companies hoping to go public through a business combination with the SPAC. Indeed, as the SPAC market became white-hot in early-2021, SEC officials had signaled that restrictions on the SPACs were in the offing. In one of the Agency's first concrete measures towards reining in the use of SPACs, it has taken aim at SPACs' accounting practices. While it is an open question whether the decrease in SPAC use is attributable to the SEC's increased regulatory attention, one certainty is that the Agency's commencement of formal regulatory measures is noteworthy.

On April 12, 2021, the Staff of the SEC issued a *Staff Statement on Accounting and Reporting Considerations for Warrants Issued by Special Purpose Acquisition Companies ("SPACs")* (the Staff Statement). The Staff Statement reflects the views of the Division of Corporation Finance and the Office of the Chief Accountant and is thus not a rule or guidance document. Nevertheless, it portends an important shift in the Agency's regulatory posture that SPACs would be remiss to ignore. The Staff Statement takes aim at a near universal accounting structure in the SPAC market. Almost every SPAC issues both public stock warrants as part of its initial IPO and private warrants to the SPAC's sponsors. SPACs typically issue public warrants to

SPACS IN THE NEWS

Buffet Decries SPACs' Impact on Legacy Investors

Berkshire Hathaway CEO Warren Buffet did not mince words when addressing SPACs at the Company's annual shareholders' meeting on May 1, 2021. "It's a killer," Buffet said, referring to the pressure that SPACs were placing on longstanding institutional equity firms like Berkshire that traditionally filled the role of seeking out companies to acquire. Because of stimulative monetary and fiscal policies, investors are flush, but the pool of attractive target companies is limited. With the surge in SPACs, even household firms like Berkshire are facing intense competition for promising acquisitions. This means that the Berkshire is left in the position of having a near-record stockpile of case—more than $145 billion—but limited ways to spend it. Buffet, however, seemed bearish on the long-term prospects for SPACs: "That won't go on forever, but it's where the money is now and Wall Street goes where the money is."

Buffet's prediction may portend a shift in how Wall Street's major players view SPACs. Until recently, big-name institutional investors had warmed to the idea of using SPACs as an acquisition device. Other big names may be following suit. David Solomon, CEO of Goldman Sachs—which itself formed two SPACs worth more than $1 billon—recently referenced SPACs on an earnings call, cautioning that even established banks like Goldman must "be thoughtful regarding the transactions we underwrite, with a particular focus on the quality of sponsors, sponsor economics, investor protections, and disclosure." Solomon's statement came on the heels of research from Goldman Sachs strategist David Kostin on the declining second quarter SPAC market. Kostin noted that because of the increasing scrutiny of the SEC, the market's skepticism of SPACs' long-term prospects is "warranted." While it is impossible to predict whether brand-name investment firms will continue to work through SPACs, their reluctance will only grow as regulatory pressure increases.

sweeten the pot for early investors. Private warrants, meanwhile, are given to the SPAC's management team as an incentive to find a profitable target company to take public. The terms of these warrants are similar, with the principal difference being that the public warrants can only be exercised for cash and are subject to redemption at the discretion of the SPAC. Typically, these warrants show up on a SPAC's books as equity, not liabilities. The Staff Statement suggest, however, that in many cases, this classification is inaccurate.

The Agency first analyzes the conditions under which SPACs should categorize these warrants as corporate liabilities. The Staff Statement cautions that that classification of warrants as equity or as a liability would depend upon two provisions of the warrant contracts: indexation and tender offer provisions.

First, the Staff Statement instructs companies to examine the formula used to determine the value of the stock warrants: to properly qualify as equity, redemption of the SPAC's stock must be indexed to the Company's own stock. That is, the settlement amount of the warrant must correspond to a fixed strike price or a fixed number of shares. Warrants whose settlement amount is calculated by inputs other than the fair value of the Company's stock are properly categorized as liabilities, rather than equity. If, for example, the settlement amount of the warrant is in part determined by who holds the warrant (e.g., a sponsor of the SPAC, a permitted transferee, or a non-permitted transferee), that instrument is no longer indexed to the fair value of the Company's stock and would properly be classified as a liability, not equity.

The Staff Statement's second criterion of warrant accounting is how the warrant contracts structure tender offers. Once again following GAAP, the Staff Statement provides that "if an event that is not within the entity's control could require net cash settlement, then the contract should be classified as an asset or a liability rather than as equity." If, however, a net cash settlement can only be triggered where all holders of the shares underlying the instrument would also receive cash, such as a change of control of the entity. In a common arrangement for SPAC public warrants, warrantholders would be entitled to receive cash buyouts if a tender offer is made and accepted by holders of more than fifty percent of the outstanding shares of common stock. The Staff Statement provides that in this case, all warrantholders would be entitled to a cash payout, while only some of the holders of underlying common stock would be eligible for cash. Thus, SPACs that structure tender offers in this fashion would properly characterize their warrants as liabilities, not equity.

SPAC IN THE NEWS

SEC Chief Gensler Addresses SPACs Before Congress

SEC Chief Gary Gensler went before the Subcommittee on Financial Services and General Government of the House Appropriations Committee on May 26, 2021 and began his remarks with a series of comments on the SPAC trend. While Commissioner Gensler did not tip his hand as to any concrete guidance or enforcement priorities that the Agency was considering, he noted some of the tensions that might lead SPACs to disserve investors. "First and foremost," Commissioner Gensler stated, "are SPAC investors being appropriately protected? Are retail investors getting the appropriate and accurate information they need at each stage—the first blank-check IPO stage and the second target IPO stage?" Commissioner Gensler went on to question "how . . . SPACs fit in to our mission to maintain fair, orderly, and efficient markets?" Commissioner Gensler broached the idea that despite SPACs' popularity among certain investors and purported efficiency gains over traditional IPOs, they may carry significant costs. For example, Commissioner Gensler cited one study showing that SPACs' structure—in particular, the benefits afforded early investors and sponsors in the SPAC—results in significant dilution of later investors' capital. Similarly, Commissioner Gensler noted that financial advisors often reap handsome profits throughout the course of the SPACs' lifecycle. Many of these costs, Commissioner Gensler testified, are borne by retail investors who invest later. Commissioner Gensler stopped short of previewing forthcoming guidance from the Agency but suggested that the Agency "will . . . be closely looking at each stage to ensure that investors are being protected."

As a practical matter, the Staff Statement means that prospective SPACs and those that have already completed a merger with a private company will have to scrutinize their warrant contracts to determine if their accounting practices are accurate. Because virtually all SPACs have traditionally accounted for their warrants as equity, those entities will have to revise or restate their financial statements. The consequences are most pronounced for SPACs that have already fulfilled their mission of locating and merging with a private company.

- Post-de-SPAC entities may, for instance, be required to make a disclosure under Item 4.02 in their next Form 8-K, which requires an entity to note when previous financial statements should not be relied upon.
- An entity may be required to amend its previously periodic reports, such as its prior Form 10-K or 10-Qs.
- Because of the need to revisit prior accounting of warrants, entities may not meet deadlines to file future periodic reports, which means that entities will need to seek the relevant extensions with the SEC.
- With warrants newly classified as liabilities, post-de-SPAC entities would have to obtain third-party valuations of those liabilities, as well an analyses of whether the reclassification alters their legal obligations under any agreements, including with respect to registration rights or any debt facilities.
- Post-de-SPAC entities may also face private securities litigation claims associated with the restatements or with the failure to timely file periodic reports.
- The SEC may delay approval of registration statements relating to SPAC transactions until the SPAC resolves the warrant accounting issue.

While not a direct crackdown on the burgeoning SPAC market, the Staff Statement reflects an important shift in the SEC's posture. Early returns suggest that the Staff Statement has stalled the previously exploding SPAC market. Companies are already filing Form 8-Ks to announce that they are analyzing their past accounting practices or preparing restated financial statements. It is ultimately unclear whether this shift portends a market reaction away from SPACs, or whether SPACs will skyrocket again once companies align their accounting practices with the Staff Statement. Whatever the discrete impact of this regulatory move, however, it is perhaps more indicative of the SEC's opening salvo in a bid to curb what the Agency views as the dangers of this vehicle to the investing public.

SPACS IN THE COURTS

- *Velodyne Lidar, Inc.*, 21 Civ. 1486 (N.D. Cal.), 21 Civ. 1736 (N.D. Cal.): Velodyne became a public entity when it merged with the SPAC Graf Industrial Corp. on Sept. 29, 2020. On November 9, 2020, when Velodyne filed its quarterly report on a Form 10-Q with the U.S. Securities and Exchange Commission, it stated that its "disclosure controls and procedures were effective at the reasonable assurance level." In February 2021, the Board of Directors removed Velodyne's chairmen and fired the Chief Marketing Officer of the Company after an internal investigation revealed that those managers failed to operate with respect, honesty, integrity, and candor in their dealings with [Velodyne] officers and directors." This resulted in the company's common stock falling $3.14 (~15%) and their warrants falling $1.47 (~20%). In two complaints filed in March 2021 in the Northern District of California plaintiffs allege, *inter alia*, that Velodyne's positive statements about its business, operations, and prospects were materially misleading and that the Company failed to disclose to investors that members of senior management were under investigation.

- *Canoo Holdings Ltd.*, 21 Civ. 3080 (C.D. Cal.): On December 21, 2020, the SPAC Hennessy Capital acquired Canoo Holdings, making the latter a public entity. On March 29, 2021, after the market closed, Canoo Holdings revealed that the Company would no longer focus on its engineering services line, which had been touted in the SPAC merger documents just three months earlier and formed the basis of Canoo Holdings' growth story. This about-face resulted in the company's stock price falling $2.50 (21.19%). The Class Complaint filed in the Central District of California on April 9, 2021, alleges that the documents related to the SPAC merger failed to disclose the following facts and were thus materially misleading: (1) that Canoo Holdings had decreased its focus on its plan to sell vehicles to consumers through a subscription model; (2) that Canoo Holdings would de-emphasize its engineering services business; (3) that, contrary to prior statements, Canoo Holdings did not have partnerships with original equipment manufacturers and no longer engaged in the previously announced partnership with Hyundai. Separately, on May 17, Canoo announced that the Company was under investigation by the SEC. The Company stated that the investigation covered the acquisition by Hennessy Capital and Canoo's "operations, business model, revenues, revenue strategy, customer agreements, earnings and other related topics, along with the recent departures of certain of the Company's officers."

- *Romeo Power, Inc.*, 21 Civ. 3362 (S.D.N.Y.), 21 Civ. 4058 (S.D.N.Y.): Romeo Power, a manufacturing company focused on the production of lithium-ion batteries, became a public company when it merged with the SPAC RMG in later-2020. On March 30th, 2021, Romeo Power disclosed to investors that production of its batteries had been disrupted by "a shortage in supply of battery cells and that its estimated 2021 revenue would be therefore reduced by approximately 71-87%." As a result, Romeo's shares declined by $2.04 (~20%). Two class complaints filed on April 16 and May 6, 2021, allege that during the time the merger was being negotiated and finalized, the defendants concealed that: (1) Romeo Power had only two battery cell suppliers, not four; (2) the future potential risks that the defendants warned of concerning supply disruption or shortage had already occurred and were already negatively affecting Romeo's business, operations and prospects; (3) Romeo Power did not have the battery cell inventory to accommodate end-user demand and ramp up production in 2021; (4) Romeo Power's supply constraint was a material hindrance to its revenue growth; and (5) Romeo Power's supply chain for battery cells was not hedged, but in fact, was totally at risk and beholden to just two battery cell suppliers and the spot market for their 2021 inventory.

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