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SPAC Warrants Requiring Liability Classification

On April 12, 2021, the SEC issued Staff Statement on Accounting and Reporting Considerations for Warrants Issued by Special Purpose Acquisition Companies ("SPAC"). The statement highlights potential accounting implications of terms included within many SPAC warrant agreements and provides guidance on what to consider when making the determination between classifying the warrants as equity versus classifying them as a liability. The statement can be found here.

Based on the SEC's statement, warrants that are commonly issued in connection with a SPAC's IPO should be classified as liabilities under US GAAP. This will require the warrants to be remeasured at fair value through earnings each period. To the extent such warrants have been previously classified within equity, an entity will need to assess the materiality of this error and consider its Form 8-K filing obligations.

Background

SPACs are companies with no commercial operations that are formed to raise capital through an initial public offering (IPO) for the sole purpose of acquiring one or more target businesses. In its IPO, a SPAC typically issues units consisting of a common share and one public warrant (or fraction of a warrant) to purchase common stock to investors ("Public Warrants"), while contemporaneously issuing private placement warrants to its sponsor ("Private Warrants"). The classification of these warrants as liabilities or as equity must be determined when they are first issued.

Recent Developments

Public and Private warrants both commonly contain a provision allowing the warrant holder to redeem the warrant for cash in the event of a tender offer initiated by a third party. While a majority of the common stockholders may sell their shares for cash, it is possible not all common shareholders will be able to. That is, a potential exists for the warrant holders to receive cash consideration from the SPAC when less than 100% of the common stockholders also receive cash when the tender offer is settled. The possibility of this scenario means equity classification is precluded; the likelihood of this situation actually occurring is not relevant to the accounting assessment.

In addition, the settlement amount for the sponsor vs. a third party may differ in a reorganization or change of control transaction. The Private Warrants often state their fair value will be determined based upon a capped American call option to determine a strike price adjustment. However, the contract also states other provisions in the agreement that are specific to the sponsor "shall be taken into account." We understand some entities and their advisors have concluded this proviso means the fair value would be determined based on an uncapped call option, which would be greater than a valuation based upon a capped call option. This creates a scenario where the settlement terms of the warrant contract differ based on the identity of the warrant holder, which is not consistent with the terms of a standard option-pricing model. If other provisions of a warrant contract differ based on the identity of the holder, they would also likely preclude equity classification. As such, equity classification is precluded.

Entities will also need to update their earnings per share assessments, which will be impacted by a change in the classification of a warrant.

If a registrant has previously reported its Public and/or Private Warrants within equity, the entity should evaluate:

- Whether the effects of the error are material to its previously issued financial statements and, if so, whether a notice of non-reliance must be filed under Form 8-K. In that case, previously issued financial statements should be restated.
- The impact on the entity's internal control over financial reporting.

Lastly, entities are encouraged to remain abreast of any further developments on this topic through discussion with their advisors and/or the SEC staff.