Assessing SPAC Risk After SEC Pumps Brakes On Market

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Special purpose acquisition companies (SPACs) have been on fire since 2020. After an average of only 23 SPAC IPOs between 2003 and 2019, 248 SPACs went public in 2020 and 308 have gone public so far in 2021. SPACs represent 76% of all IPOs in 2021.

Part of the purported appeal of SPACs is that they can close more quickly, are less expensive to launch than traditional IPOs and require fewer disclosures.

Against this backdrop, the U.S. Securities and Exchange Commission (SEC) has been signaling its desire to slow down the surge in the SPAC market. Specifically, the SEC recently issued a series of advisories about the SPAC market:

- In December 2020, the Commission's Division of Corporate Finance issued disclosure guidance related to potential conflicts of interest amongst SPAC sponsors, directors, officers, underwriters, and public shareholders.
- In March, SEC acting Chief Accountant Paul Munter issued a public statement on the complexities surrounding the quality and reliability of financial reporting, governance, and the quality of audits for SPACs.
- On April 8, SEC acting Director of the Division of Corporate Finance John Coates made a public statement highlighting the staff's focus on SPAC transactions, filing, and disclosure requirements and emphasized the legal liability that may attach to disclosures when a SPAC acquires a target (the de-SPAC transaction).

- Finally, on April 12, 2021, the SEC made its strongest statement yet when Munter and Coates raised raised concerns about the accounting and financial disclosure for warrants issued by SPACs.

It is important to note that the SEC's public statements are not single-page caveats; they are detailed and lengthy guidance setting forth a wide array of very specific concerns. Further, the SEC is not the only regulator signaling concerns about the flurry of SPAC transactions.

In its 2021 Report on examination and risk monitoring, the Financial Industry Regulatory Authority (FINRA) highlighted several risks of investing in SPACs, including possible misrepresentations and omissions in offering documents and communications with shareholders for SPAC acquisition targets, the transparency of fees associated with SPAC transactions, the control of funds raised in SPAC offerings, and insider trading.

These regulatory warnings doused the SPAC market in mid-April, leaving lawyers and accountants in this market questioning the necessary steps to allow transactions to proceed and withstand regulatory scrutiny. Consider the following accounting review and due diligence steps in response to the regulators' concerns:

Revisit the SPAC's Accounting and Financial Reporting

While some have interpreted the SEC's April 12 staff statement as a shift in the SEC's position for accounting for warrants, this is not the case. Rather, these provisions have existed in the accounting literature for a number of years and are applicable to registrants of all types, regardless of whether or not they are operating companies.

The crux of the issue is whether such warrants can be considered as equity instruments or whether they carry provisions that would cause them to be treated as liabilities under generally accepted accounting principles (GAAP). If the latter classification is found to be the appropriate one, those warrants need to be treated as financial instruments and marked to market through the income statement on a quarterly basis.

Hence, at the inception of a SPAC—long before an acquisition occurs—it is incumbent upon sponsors and managers to apply a number of provisions in Accounting Standards Codification (ASC) 480 on distinguishing liabilities from equity, and ASC 815, addressing derivatives and hedging, to evaluate if warrants are liabilities.

In general, a warrant does not qualify for equity classification if the warrant isn't appropriately indexed to the underlying shares of stock or if the issuer could be required to settle the warrant in cash. These are complex determinations that require a detailed reading of governing agreements. Given this, it is recommended to have an expert evaluate, in concert with management and the sponsors, the warrants' key deal terms.

If this evaluation identifies an error in the classifications of warrants, the next step is to evaluate the materiality of the error using the guidance in Selected Staff Accounting Bulletins (SAB) Topic 1.M. Unfortunately, as SPACs are blank-check companies without operations, many errors will be material and require restatement.

To the extent a restatement is necessary, the SPAC must file a Form 8-K stating the previously

filed financial statement may no longer be relied upon. Next, the SPAC must measure the warrants at fair value for all previous periods and prepare a restatement footnote to the financial statements showing the impact of the restatement.

Determining fair value for all of these periods is another highly complex area and will likely require the assistance of a valuation specialist. A restatement will also trigger a re-evaluation of the SPAC's internal control over financial reporting (ICFR) to determine if management's evaluation of ICFRs and disclosure controls require revision. Lastly, any restatement must be audited by the SPAC's accounting firm.

Perform Thorough and Extensive Due Diligence on SPAC Acquisition Targets

Despite the heightened scrutiny from the SEC and other regulators, SPACs will continue to provide a popular alternative to IPOs and present an appealing opportunity for investors.

Further, many SPAC organizers have publicly announced their intentions to find suitable acquisition targets over the next two years and raised billions of dollars to do so— making it unlikely that SPAC fever will be fully remedied near-term. However, investors wishing to take advantage of SPACs should heed the concerns raised by government watchdogs and conduct their own diligence before signing on as parties to that 'blank check.'

In general, investors face two very important decision points: the decision to invest initially in the SPAC and the decision to stay with the business combination once the acquisition target is announced. At the outset, it is important to independently perform thorough financial and reputational due diligence on the investor team, the purpose and strategy for the SPAC, the financial structure, and the terms with other investors.

Once a target is known, due diligence should include thorough financial and reputational reviews of the target's operations, management, and ability to produce reliable financial reports after the de-SPAC transactions. These efforts should focus on the history and caliber of management, risks in the market, and how the financials of the target company will hold up to public scrutiny.

Considerations should also include how the target will compose a qualified and effective audit committee.

The goal is to avoid or, be prepared to weather, the many types of private litigation that may arise as the result of an ill-conceived or poorly executed SPAC, including: SPAC IPO suits / securities class actions, M&A suits and bankruptcy proceedings. Potential SEC enforcement actions, which seem increasingly likely at this point, are a costly but separate risk category altogether.

The current lull in market activity provides SPACs and their professional advisors an opportunity to perform more focused due diligence procedures on targets and to evaluate the prior accounting of warrants to ensure regulatory compliance.

With dozens of Forms 8-K filed in the last week of April stating SPACs financial statements will be restated, now is the time to assess whether that seemingly high-return SPAC is likely to lead to enforcement actions or a costly dispute further down the line.

About the Authors

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