

Client Alert

Securities and Exchange Commission Statement on Warrants Issued by Special Purpose Acquisition Companies (SPACs)

Directors' & Officers' Liability (D&O) Insurance and Human Capital Management Ramifications

The Securities and Exchange Commission (SEC) issued a statement on April 12, 2021, in which it “highlighted challenges associated with the accounting for complex financial instruments that may be common in SPACs.”¹ In this statement, the SEC sought to clarify its view of warrants that SPAC sponsors receive at the SPAC’s formation. Among the possible outcomes of the SEC’s commentary, experts anticipate the accounting treatment of these warrants could be reclassified from equity to a liability.

While the accounting treatment is yet to-be-determined, the near-term impact of the SEC’s statement has been the rather abrupt halt to the frenzied SPAC market. Many “in process” SPACs have paused as accounting and law firms digest this announcement and determine next steps with respect to client advice and what confirmations are necessary in order to “sign-off” on the financial statements, SEC filings, and related material.

The Impact on D&O

With respect to the D&O placement process for SPACs, this slow-down has been viewed by some as a welcome break to the breakneck speed of SPAC placements in 2020 and 2021. However, it is expected that, once the SEC provides final guidance with respect to these warrants, SPAC activity may again build momentum. With that as background, Aon is encouraging SPAC clients to gain an understanding of the emerging focus areas of D&O insurers, which will be critically important to successful D&O placements given the SEC’s new-found emphasis on the warrant topic — and expected future additional areas of emphasis when it comes to SPACs. In order to effectively procure D&O cover, clients should be prepared to address underwriters’ questions with respect to:

- **Accounting treatment, particularly for warrants**

Clearly, this area of emphasis for the SEC will be paramount. Underwriters will want to understand how the SPAC applies new guidance from the SEC (once issued), and the who/what/when/where of advisors the SPAC relied upon for its accounting treatment for warrants.

- **Revised financials, particularly with respect to internal controls**

While many SPACs that have already filed financial statements with the SEC are expected to need restating, the SEC also has stated that SPACs should consider their obligation for prudent and effective internal controls for all accounting matters. Given the potential need to restate financials and the heightened sensitivity of auditors, it is possible that some SPACs may need to restate financial statements beyond just the warrant issue. Obviously, such a need would be cause for concern among D&O underwriters.

- **Further SEC Scrutiny**

According to a recent Forbes article, “The SEC’s request for review of SPAC warrant accounting is likely just the tip of the iceberg,” and “In recent weeks, the SEC has been increasingly vocal about the risks of SPAC deals and their complexities. In March, the SEC warned investors, particularly retail investors, about the risks attendant in celebrity-backed SPACs.” With the increased regulatory oversight comes additional risk for D&O insurers, and SPACs increasingly must be prepared to articulate a transparent, concise, and credible business model.

1. Staff Statement on Accounting and Reporting Considerations for Warrants Issued by Special Purpose Acquisition Companies (“SPACs”). [SEC.gov | Staff Statement on Accounting and Reporting Considerations for Warrants Issued by Special Purpose Acquisition Companies \(“SPACs”\).](https://www.sec.gov/staff-statement-on-accounting-and-reporting-considerations-for-warrants-issued-by-special-purpose-acquisition-companies-spacs) Accessed 19 April 2021.

- **Management and the Board's experience and the supporting advisors**

A key distinguisher for a SPAC with D&O underwriters is the breadth and depth of the experience of the management team and Board to execute merger transactions, in particular conducting and effectuating a robust due diligence process void of any conflict and merger pitfalls.

- **Board composition and corporate governance**

Proxy advisory firms, such as ISS and Glass Lewis, are weighing in more frequently on SPAC mergers, as institutional investor interest continues to grow. Their shareholder vote recommendations and evaluations of the deal can pose unexpected challenges for the vote (as well as afterwards) and with potential negative optics if perceived egregious board structure, composition or corporate governance issues are noted in their reports.

- **Impact on Employee Incentive Compensation**

While non-employee equity compensation has undergone several changes over the past approximately four years (moving from mark-to-market accounting to equity accounting), SPAC-issued warrants have generally been classified as equity-treated. The structure of these warrants is generally what is causing scrutiny from the SEC, in that there are specific features that are out of the company's control and arguably could, under the accounting guidance, be treated as liability instruments. If treated as liability instruments, it could, among other things require revaluation, potential restatement of financial statements both historically and prospectively, a reclassification on the Balance Sheet between equity and liabilities, and an impact to the Income Statement as these changes in fair value every reporting period will flow through earnings. Depending on the quantum of these changes and revaluations, the impact to earnings could be significant. Further, if these companies have Short Term Incentive (STI) or Long Term Incentive (LTI) programs that have goals tied to earnings (Net Income, EPS, ROE, ROA, etc.) or balance sheet metrics (Debt to Equity, ROIC, Quick Ratio, etc.), these incentive programs could come into question retrospectively and may need to be re-engineered going forward.

Conclusion

The D&O placement market for SPACs will remain challenging in light of the uncertainties created by the SEC's increased scrutiny of SPACs. Further, in order to assess the retroactive and prospective impacts of potential accounting changes on compensation programs, such programs, and broader Human Capital Management (a key part of any SPAC transaction), will need to be evaluated by each individual company.

Aon's dedicated SPAC Taskforce has deep and sophisticated experience placing D&O coverage for SPACs, as well as, de-SPAC combination placements, and navigating the complexities of Human Capital throughout the lifecycle of the transaction. Our experience in matters involving corporate governance, Human Capital Management, compensation structures and valuation helps companies find best-in-class solutions for their human capital strategies. Aon will continue to keep our clients apprised not only of the challenges inherent to the SPAC D&O and HCM markets, but also the solutions and opportunities they present.

2. Hot SPAC Market Could Freeze After Potential SEC Rule Change. <https://www.forbes.com/sites/stevenbertoni/2021/04/12/hot-spac-market-could-freeze-after-potential-sec-rule-change/?sh=3a74d40444c0>. Accessed 19 April 2021.