EY Forensic & Integrity Services

SPACs: Litigation risk considerations from an underwriting perspective

August 2022

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Role of SPAC underwriters[1]

There are various roles that underwriters may assume through the special purpose acquisition company (SPAC) process. Under these processes for which services are provided, underwriters are eligible to receive a percentage of the offering price for equity or a percentage of the principal amount of debt, formally known as the "underwriting discount."[2] This discount should be disclosed to the SPAC's Board of Directors for conflict of interest concerns arising out of any of the underwriter's continued roles.

As of late 2020, the SEC has largely focused on the economic interests of SPAC sponsors and associated directors, officers, and affiliates of a SPAC, often differing from those of public shareholders. As a result, the SEC has increased its emphasis on performing conflict of interest due diligence and disclosure of potential conflicts of interests related to the compensation and role of underwriters, including deferred compensation.[3] In addition to increased scrutiny, the SEC has previously charged the parties involved, an example of which occurred in 2019 related to the merger of a SPAC and a communications company under which sponsors convinced shareholders to vote in favor of the merger by fabricating the Target's business prospects and ownership of "game-changing" products.[4]

The role an underwriter may play in the issuance of a SPAC and de-SPAC process are described below.

Role	Responsibilities	Risks	Mitigation
Capital Markets Advisor	1. Assist with wall-crossing process in order to discuss views on a potential transaction 2. Arrange meetings with investors before and during proxy solicitation process 3. Assist SPAC with preparation of various materials	1. Communication with investors may cause issues under proxy solicitation rules if the underwriter has not complied with regulations applicable to soliciting a proxy 2. Incomplete information, inaccurate disclosures and aggressive forward projections relied on to produce materials	1. Limit activities in ministerial functions and include language disclosing the fact that underwriter could receive deferred compensation if the SPAC completes the merger 2. Utilize independent third party to perform select fact checking and analysis procedures
Private Placement Agent	1. Control public investment in private equity (PIPE) process, including conducting business and financial due diligence 2. Underwrite and arrange debt financing	1. Potential for conflict of interest arising from roles and responsibilities associated with acting as placement agent 2. Inaccurate information produced in underwriting process	1. Include language in letter of engagement and communications with investors indicating that underwriter could receive deferred compensation if the SPAC completes the merger 2. Utilize independent third party to perform select underwriting procedures
M&A Financial Advisor	1. Bring potential acquisition opportunities to the SPAC and provide relevant sector expertise, due diligence	1. Potential for conflict of interest to arise in the rendering of a fairness opinion with respect to the merger 2. Investors learn of the true operating and financial performance of the target company after the merger is executed, inclusive of poor culture of compliance 3. Fail to identify material information during due diligence process	1. Include language in letter of engagement indicating that underwriter could receive deferred compensation if the SPAC completes the merger 2. Perform adequate due diligence on the finances, internal controls and policies and procedures, and management prior to the merger 3. Utilize independent third party to perform select diligence, underwriting and analysis procedures

[1] *Frequently Asked Questions About PIPEs*, Morrison & Foerster LLP, 2018; *Special Purpose Acquisition Companies ("SPACs")*, Mayer Brown, 2020.

[2] "Glossary: Underwriting Discount," Thomson Reuters website, https://content.next.westlaw.com/3-382-3890?__lrTS=20210208071954213&transitionType=Default&contextData=(sc.Default)&firstPage=true#:~:text=Also%20known%20as%20underwriting%20commission,marketing%20and%20selling%20the%20offering, accessed 26 July 2021.

[3] "Along Came SPACs, and Then SPAC Litigation, " *law.com*, 2 March 2021.

Benefits to underwriters

The way in which a company is taken public through a SPAC versus the traditional initial public offering (IPO) process varies in a multitude of ways. A SPAC, often referred to as a "blank-check company," allows for increased IPO efficiency given that the entity has no operations, assets or financial history.[5]

As such, the SPAC IPO process benefits underwriters and sponsors in the following ways:

1. The process may not require an underwriting syndicate or multiple investment banks and/or broker-dealers operating together to perform traditional underwriting procedures. Underwriting syndicates are routinely used when an IPO is too large for one firm to handle, this may indicate higher risk for underwriters working alone on a SPAC IPO.
2. A SPAC IPO has fewer Securities and Exchange Commission (SEC) hurdles regarding the IPO prospectus, which in turn allows for faster issuance by the underwriter and sponsor in comparison with a traditional IPO process.[6]
3. SPACs have the benefit of avoiding the need to attract investors through a road show but rather maintain a long-term investor pool through the use of a PIPE. From an underwriting and sponsor perspective, there is a responsibility to control the PIPE process and conduct associated business and financial due diligence.
4. SPACs can provide forward-looking financial projections in the de-SPAC process, which are not allowed in the traditional IPO process under SEC regulations. The use of projections reduces the risk that an underwriter or sponsor omitted material information or made inaccurate disclosures, however, the risk that the underwriter or sponsor remains responsible for inflated projections is not to be discounted.[7]
5. Though underwriting fees in a SPAC process may fall slightly below those of a traditional IPO, there tend to be lower direct expenses and indirect costs (bulky due diligence and transaction costs) reducing the gross proceeds in which the underwriting fee is derived.
6. The issuance of a SPAC itself requires less documentation surrounding disclosures and due diligence that is traditionally produced by underwriters and sponsors than that of a traditional IPO as investors are buying into the reputation of the SPAC sponsor(s) and mission statement rather than the Target in which it will merge.
7. In a traditional IPO process, it may be difficult to address doubts about a company and its business model or other operating functions to mutual funds, pension managers and other institutional investors as a result of the required road show process.[8]
8. Compared with the de-SPAC process, a company may circumvent addressing existing operating issues that would have been discussed in depth during the road show. It is important to note, however, that a de-SPAC process still requires many of the same disclosures and documentation produced by underwriters and sponsors of a traditional IPO process, inclusive of audited financial statements and disclosure items of the Target.[9]

[4] *SEC Charges Intelligence Communications Company and Top Executives With Defrauding Merger Investors*, U.S. Securities and Exchange Commission press release, 20 June 2019.

[5] "Along Came SPACs, and Then SPAC Litigation, " *law.com*, 2 March 2021.

[6] "SPAC vs Traditional IPO: Investors See Benefits of Blank-check Companies," *crunchbase* news, 3 December 2020; *SPAC vs Traditional IPO & Reverse Takeover*, Bridge Point Capital, 2021.

[7] *The Special Purpose Acquisition Company (SPAC) or Private Public Equity (PPE)™ Initiative*, GigCapital, 2021.

[8] "After Failed I.P.O., WeWork Will Go Public Through a Merger," *The New York Times*, 26 March 2021.

[9] *SPAC vs Traditional IPO & Reverse Takeover*, Bridge Point Capital, 2021.

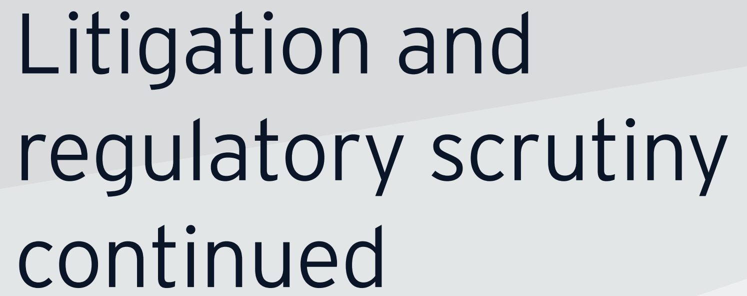
Litigation and regulatory scrutiny

Given the acceleration in issuance of SPACs, civil lawsuits and regulatory scrutiny have increased significantly. Proxy disclosures have been challenged at both the federal and state levels with a focus on disclosures related to the acquisition process, financial analyses, projections and potential conflicts of interest.[10] If shareholders believe a proxy statement lacks adequate disclosures which impacts their ability to make an informed decision, they may challenge the disclosures under Section 14(a) of the Securities Exchange Act of 1934. The Department of Justice (DOJ) will also play a role in scrutinizing whether a SPAC has adequately disclosed potential conflicts of interest.[11]

Going forward and taking into consideration the two-year time frame to find a Target upon completion of the SPAC IPO, the DOJ and SEC may enhance their regulatory focus on whether completing the de-SPAC process within the allotted time frame pressured sponsors and underwriters to complete a process not in the best interest of shareholders in order to avoid liquidation. Already, Jay Clayton, former Chairman of the SEC, has stated the Commission's intention to focus on "the incentives and compensation to the SPAC sponsors. How much of the equity do they have now? How much of the equity do they have at the time of the IPO-like transaction? What are their incentives?"[12] in order to do so, the SEC will scrutinize the "the initial (equity) distribution of the SPAC to the market and … when the transaction takes place with the operating company. We want to make sure [investors are] getting the same rigorous disclosure that you get in bringing an IPO to market."[13] Gary Gensler, current Chairman of the SEC, further stated that "the agency was taking a closer look at some of the hottest trends in investing – SPACS and retail trading apps – out of concern that smaller investors are getting a raw deal."[14] The heightened monitoring by the SEC on the SPAC process comes with increased issuance to bring Targets public.[15]

[10] "Along Came SPACs, and Then SPAC Litigation," *law.com*, 2 March 2021.
[11] *How SPACs Can Manage the Risks of White Collar Scrutiny*, White & Case LLP, 23 March 2021.
[12] "What are SPACs and Should You Invest in Them?," *Money For The Rest Of Us,* 15 June 2021.
[13] *Blank check stocks tumble as SEC plans greater scrutiny*, Seeking Alpha, 24 September 2020.
[14] Gary Gensler Says SEC Is Focusing on SPACs and Retail Trading Apps | Barron's (barrons.com).
[15] Clayton, Jay, SEC Chairman, interviewed on CNBC, 24 September 2020.

Litigation and regulatory scrutiny continued



During the SPAC-IPO process, underwriters and sponsors are responsible for the accuracy and completeness of due diligence and the evaluation of disclosures. Though this responsibility falls heavily on the SPAC itself in the de-SPAC process, it does not remove the negative reputational impact on a SPAC-IPO underwriter or sponsor in the instance that inaccurate or incomplete information is uncovered. Additionally, safe harbor from the Private Securities Litigation Reform Act (PSLRA) protects the SPAC and underwriters in the de-SPAC process if the financial projections are deemed to be accurate and forward-looking. However this does not entirely reduce the risk that litigation may present itself on these grounds. Conversely, traditional IPOs do not typically include financial projections due to this liability. John Coates, Acting Director of the Division of Corporate Finance of the SEC, made it clear that "SPAC sponsors and Targets should already be hearing from their legal, accounting, and financial advisors that a de-SPAC transaction gives no one a free pass for material misstatements or omissions."

Within the past year, there has been significant litigation surrounding material misstatements or omissions under Section 10(b) of the Securities Exchange Act and false and misleading statements in connection with proxy solicitations under Section 14(a) as detailed above. One such example is that of a food ordering and delivery business that pursued a merger with a blank-check firm. The largest investors backing the blank-check company were taken to court in a class-action lawsuit claiming they had misled shareholders on the risks of the target business. Another class-action lawsuit was brought against a SPAC process in which shareholders claimed there were conflicts of interest among members of the Board who were incentivized to make the deal regardless of shareholders best interests.

Reputational harm for underwriters

Needless to say, SPACs and their underwriters and sponsors will begin to see an uptick in litigation related to adequacy of registration statements and IPO and de-SPAC disclosures involving potential conflicts of interest with sponsor affiliates and terms of SPAC insider investments and financing transactions, specifically PIPEs. Additionally, SPAC directors can face litigation on the basis of breach of fiduciary duty with regard to business combination transactions and stock price declines following the de-SPAC process.[16] However, given that shareholders are able to redeem their investment in the SPAC upon announcement of the proposed de-SPAC transaction, it would make awarding damages difficult in court. Nevertheless, underwriters and sponsors must consider the above SPAC litigation and the indirect impact on the financial institution's reputation given its involvement in the transaction.

How we can help

Our EY Forensic & Integrity Services team includes more than 4,500 practitioners in over 70 countries who can mobilize quickly to meet the urgent needs of our global clients. Our team includes former federal prosecutors, former SEC Division of Enforcement investigators, former corporate compliance officers, forensic accountants and forensic technology resources who have extensive experience in handling regulatory inquiries, responding to state or federal requirements and assisting in complex litigation. We bring all these disciplines along with industry experience to assist underwriters in any SPAC-related roles they pursue.

Transaction forensics

a. Pre-acquisition anti-corruption due diligence
b. Contractual language assessment
c. Post-acquisition analysis and integration and/or forensic look-back
d. Post-closing assistance with preparation of accounting mechanisms

Disputes services

e. Contract disputes
f. Class action disputes
g. Expert reports and witness testimony

Discovery services

h. Preservation and collection of electronically stored information
i. Computer forensics, data mining and analysis
j. eDiscovery data and advisory services
k. Managed document review

[16] "Along Came SPACs, and Then SPAC Litigation," *law.com*, 2 March 2021.

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US SCORE no. 13329-211US

2206-406454. ED None.

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