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The Year of Peak SPAC? The SPAC Gold Rush and Implications for D&O Liability and Insurance

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2021 may be known as the year of peak SPAC, given the explosion in Special Purpose Acquisition Company (SPAC) initial public offering (IPO) transactions. SPAC transactions have implications for D&O liabilities as well as the insurance to pay those liabilities. Because SPACs present novel issues, we expect both plaintiff's lawyers and insurance companies to take some creative positions not always helpful to D&O policyholders.

The rate of increase in the number of these still-novel transactions has been astounding. The first SPAC transaction occurred in 2009, and only one was recorded in that year. In 2016, 13 transactions with total proceeds of $3.9 billion took place. 2020 had 248 transactions with total proceeds of $83.3 billion. So far in 2021, 308 SPAC IPO transactions have taken place with total gross proceeds of over $100 billion and an average IPO size of $325.8 million. The total count of SPAC transactions stands at 782—39% of them occurring in the first four months of this year.

Background

To describe the liability and insurance implications of the SPAC gold rush, some background describing SPACs, their popularity and the SEC's approach to SPACs will prove useful.

What is a SPAC? A special purpose acquisition company is a type of shell company—sometimes called a 'blank check' company—set up by a group of investors or sponsors for the specific purpose of raising money through an IPO with the object of purchasing another company. The SPAC itself has no operations, and its assets usually consist of the proceeds of the IPO. The SPAC then seeks within a limited period of time, typically two years, to acquire an operating target company. The

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acquisition by the SPAC of the target company is referred to as the *initial business combination*. If this de-SPAC transaction takes place, it often structured as a reverse merger. The combined company after the initial business combination is publicly traded, often does a public capital raise, and carries on the target operating companies' business.

Generally, the proceeds of the SPAC IPO are held in a trust account and invested in conservative interest-bearing investments, though that is not uniformly required. Once the initial business combination is complete SPAC investors can either receive shares of the merged de-SPAC-ed company or receive back their share of the trust account.

Why are SPACs popular? Sponsors, who are often private investors, private equity funds, or private companies, often receive sponsor shares that receive special treatment. Sponsors often also receive warrants to purchase shares with an execution price modestly above the initial price of the shares in the SPAC. The sponsors thus benefit from rising share prices.

The alternative of going public by merging a private operating company with a SPAC can often be accomplished more quickly, and avoids some of the perceived problems with traditional IPO's such as the traditional IPO registration process with the SEC and the impact of market volatility on traditional IPO share pricing.

Some have suggested that going public via a SPAC merger is "cheaper" than a traditional IPO. Usually, that thought process lists underwriter fees paid by the sponsor, investment banking, legal and accounting fees, but neglects the dilution effect on other shareholders of sponsor shares and warrants. Indeed, some target companies negotiate over those warrants and shares as part of the SPAC transaction for that reason.

Investors in SPACs seek various things. Some investors seek yield, and the ultra-low yield environment has investors looking for higher-yielding alternatives, including SPACS. Some investors prefer to invest in SPAC warrants which provide the right to buy equity shares. Accounting for SPAC warrants is one topic that has led to increased SEC scrutiny of SPAC transactions.

What does the SEC think of SPACs? The attention paid to SPAC-related investment perhaps reaches an apex with the involvement of movie stars, professional athletes, and well-known celebrity investors. In March 2021, the U.S. Securities and Exchange Commission (SEC) published an investor Alert, warning, "It is never a good idea to invest in a SPAC just because someone famous sponsors or invests in it or says it is a good investment." The same Alert noted that "sponsors may have conflicts of interest so their economic interests in the SPAC may differ from shareholders. Investors should carefully consider these risks." Those potential conflicts of interest may form the cornerstone of the SEC concerns regarding the impact on public securities markets of SPACs—also reflected in a SPAC investor bulletin published in December 2020.

The SEC has described the de-SPAC transaction as the "real IPO", explaining, "If we do not treat the de-SPAC transaction as the 'real IPO,' our attention may be focused on the wrong place, and potentially problematic forward-looking information may be disseminated without appropriate safeguards." For example, the accounting treatment of SPAC-related warrants for sponsors is one area of potential disclosure possibly leading to financial restatements and the concomitant possible enforcement and accounting-related securities lawsuit activity.

Liability and D&O Liability Insurance Implications of the SPAC Gold Rush

SPAC-related lawsuits. The SEC's public statements have suggested that enforcement attention will be paid to SPAC transactions. Private plaintiffs have filed and will doubtless continue to file a significant number of SPAC-related lawsuits. One well-known plaintiff's law firm has announced a task force to help investors victimized by fraud and malfeasance related to SPAC investments. The Securities Class Action Clearinghouse tracks 24 SPAC-related securities lawsuits filed between January 2019 and April 2021, becoming an increasing source of significant D&O liability exposure.

D&O liability insurance implications. Policyholders purchasing D&O liability insurance expect that they will be provided an insurance policy suitable for their needs. They are entitled to the broad coverage sold by underwriters and not the creatively narrow interpretations devised by claims departments.

Different Times, Different Entities. Unfortunately, since the SPAC/de-SPAC process involves a complex of multiple entities, multiple boards and differing capacities over time, the temptation to assert unfounded arguments against coverage may be too hard for some insurance claims personnel to resist. Some of the complexities relate to the differing time periods in a SPAC transaction: (1) the time period of initial registration and offering associated with the SPAC entity itself; (2) the post-initial offering, but pre-target acquisition period; (3) the period during for the target company investment decision; (4) the time during which the initial SPAC shareholders are solicited by proxy to approve the de-SPAC merger with the target company; and (5) the time during which post-SPAC operating company operates as a public company.

Multiple Policies Covering Differing Boards. The target company will have private company D&O liability insurance covering it and its directors and officers prior to the SPAC process. It may make sense for the target to purchase a tail policy for post-transaction claims relating to pre-transaction events.

The SPAC entity itself will have D&O Liability insurance, which should cover early investment efforts such as road shows or early private placements. Here too, a 'tail' policy with a reporting period of six-years for the SPAC entity is worth considering at the time the initial policy is purchased. Personal coverage for the directors only—called *Side-A*—is also worth considering.

Wrongful Acts, Change in Control. The post-SPAC public company will require D&O insurance with appropriate *retroactive*, *prior and pending* and similar coverage-impacting dates to avoid inadvertent coverage gaps related to timing of alleged *wrongful acts*.

Likewise, the D&O liability insurance policies should be designed so that the *change in control* provisions or definitions of *management control* in the D&O liability insurance policy do not create potential inadvertent gaps. Similarly, thought should be given to the functioning of the usual D&O liability provisions in the SPAC context, including: Insured v. Insured, the so-called "bad acts" exclusions, and priority of payment clauses. An expert D&O liability insurance broker, risk manager or consultant can help make sure that policies are designed to perform as intended to provide broad coverage.

When a claim arises complexities of the SPAC transaction may require vigorous advocacy to obtain the fair value of the insurance purchased.

Conclusion

Peak SPAC or not, the more than $100 *billion* gold rush in SPAC transactions conducted to date in 2021, and the enormous growth in deal volume in this novel structure, will lead to increased assertions of liability against director and officers for alleged wrongful acts covered by D&O liability insurance policies.