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ARTICLES

Claims Related to Special Purpose Acquisition Company and D&O Insurance Face Increased Insurer Scrutiny

The recent gold rush in SPAC transactions and the enormous growth in deal volume in this novel structure will lead to increased assertions of liability against directors and officers for alleged wrongful acts covered by D&O liability insurance policies.

By William G. Passannante and Raymond A. Mascia Jr. [1]

Share:

Directors and officers may face both increased scrutiny of claims related to special purpose acquisition company (SPAC) transactions and overly aggressive claims denials from their directors' and officers' (D&O) liability insurance companies. The incorrect assertion of coverage exclusions—the "bump-up" exclusion is but one—increases director and officer uncertainty.

The year 2021 may be known as the year of peak SPAC, given the explosion in SPAC initial public offering (IPO) transactions. SPACs are 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 sole objective of purchasing another company. SPACs differ

from traditional IPOs and companies in that the SPAC itself has no operations, and its assets usually consist of only the proceeds of the IPO.

The rate of increase in the number of these still-novel transactions has been astounding. There have been over 300 SPAC IPO transactions this year. Lawsuits have followed and likely will continue to follow this sort of volume. Faced with these potential liabilities, companies and their directors and officers involved in SPAC transactions should be concerned about potential attempts by their D&O insurance companies to assert the “bump-up” or “inadequate consideration” exclusion.

Insurance companies routinely argue that the bump-up exclusion precludes coverage for any lawsuit following a corporate merger or transaction in which a settlement payment or judgment could be characterized as an increase (a “bump-up”) of the price paid for a target company. Because a SPAC’s sole objective is to purchase a target company, companies and directors and officers involved in these transactions may be particularly exposed to such lawsuits and denials of insurance coverage based on the bump-up exclusion. But in our experience, insurance companies have been interpreting the bump-up exclusion far too broadly, reflexively asserting it in lawsuits following a merger or similar corporate transaction. Policyholders involved in SPAC transactions should be prepared to resist such coverage denials.

Background

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 plaintiffs’ lawyers and insurance companies to take some

creative positions not always helpful to D&O policyholders. To describe the liability and insurance implications of the SPAC gold rush, some background describing SPACs, their popularity, and the approach of the U.S. Securities and Exchange Commission (SEC) 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.[2] The SPAC then seeks within a limited period of time, typically two years, to acquire an operating target company. The acquisition by the SPAC of the target company is referred to as the *initial business combination*. If this de-SPAC transaction takes place, it is often structured as a reverse merger.[3] 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? 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. The year 2020 had 248 transactions with total proceeds of $83.3 billion. So far in 2021 (as of May 1), 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 percent of them occurring in the first four months of this year.

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.

Going public by merging a private operating company with a SPAC can often be accomplished more quickly than a traditional IPO and avoids some of the perceived problems with traditional IPOs 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 traditional IPO expenses such as underwriter fees paid by the sponsor and investment banking, legal, and accounting fees, but neglects the dilution effect on other shareholders of sponsor shares and warrants in a SPAC. 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 current ultra-low yield environment has investors looking for higher-yielding alternatives, including SPACs.[4] 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 SEC published an investor alert that warns, "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."[5] 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.[6]

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."[7] 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.[8]

Will Insurance Companies Try to "Bump" SPAC-Related Insurance Claims?

SPAC-related lawsuits. The SEC's public statements have suggested that enforcement attention will be paid to SPAC transactions.[9] Private plaintiffs

have filed, and will doubtless continue to file, a significant number of SPAC-related lawsuits. One well-known plaintiffs' law firm has announced a task force to help investors victimized by fraud and malfeasance related to SPAC investments.[10] 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.[11]

The SPAC-related lawsuits assert a variety of claims, including under sections 14(a) and 10(b) of the Securities Exchange Act and the federal securities laws' proxy and antifraud provisions. There also has been a growing trend of shareholder plaintiffs relying on state law to assert breach of fiduciary duty claims against the directors and officers of the SPAC or the target company. Either way, because a SPAC transaction involves the purchase of a target company, we expect insurance companies to raise the bump-up exclusion in response to potential D&O insurance claims arising out of such transactions.

Not so fast: Courts have limited the application of the bump-up exclusion. Insurance companies traditionally have argued that the insurance industry intended the bump-up exclusion to exclude insurance payments for additional consideration paid by an acquiring company above the transaction price in lawsuits against the acquiring company. But with the recent explosion of merger objection lawsuits, insurance companies have sought to stretch the application of the bump-up exclusion to a variety of circumstances beyond even the insurance industry's purported intent behind the exclusion. Thankfully, a number of courts have rejected these attempts.

The bump-up exclusion varies from policy to policy but generally is found in a D&O policy's definition of "loss." A common version of the exclusion states:

> In the event of a Claim alleging that the price or consideration paid for the acquisition or completion of the acquisition of all or substantially all the ownership interest or assets in an entity is inadequate, Loss with respect to such Claim shall not include any amount of any judgment or settlement representing the amount by which such price is effectively increased. . . .[12]

Insurance companies have interpreted the bump-up exclusion in a variety of ways unfavorable to policyholders. For example, they have argued that the bump-up exclusion precludes coverage for lawsuits against *target companies* and their directors and officers following a corporate merger. At least one court has considered and rejected this argument.[13] In the *Gardner Denver* case, the U.S. District Court for the Eastern District of Pennsylvania held that the bump-up exclusion, which applied to the "purchase of securities or assets of a Corporation[,]" did not clearly apply to the target company because of the policy's use of the article "a" before the word "Corporation."[14] Even though the policy defined "Corporation" as the insured target company, the court held that a "reasonable person could construe the use of the phrase 'a Corporation' as meaning an entity other than [the insured target company]."[15] Accordingly, the court denied the insurance companies' motion to dismiss and rejected their argument that the bump-up exclusion "unambiguously exclude[d] coverage" in that case.[16]

This interpretation of the bump-up exclusion makes perfect sense, because the exclusion provides that "Loss . . . shall not include any amount of any judgment or settlement representing the amount by which such price"—that is, "the price or consideration *paid*"—"is effectively increased. . . ." By definition, damages in an action against a target company or its directors and

officers cannot reflect an increase in the price of consideration *paid* because target companies have paid no consideration in the first place.

Insurance companies also have argued that the bump-up exclusion is not an exclusion at all, asserting that it is a coverage provision that the policyholder bears the burden of proving. But, thankfully, courts have rejected that argument as well, finding that the bump-up exclusion is indeed an exclusion and that the insurance company must prove that it unambiguously applies to the transaction at issue.[17]

Finally, courts have recognized the extremely limited scope of the bump-up exclusion. For example, in *Northrop Grumman Innovation Systems, Inc. v. Zurich American Insurance Co.*, the Superior Court of Delaware held that the bump-up exclusion applies *only* to "a lawsuit ('Claim') that 'alleg[es]' *only* the 'consideration' exchanged—*nothing else*—as part of only one specific control transaction (an 'acquisition' of 'all or substantially all ownership interest or assets' of an 'entity') was 'inadequate.'"[18] In addition, *Northrop Grumman* held that the "Exclusion pushes out Loss *only* that 'represent[s]' an 'effective[ ] increase[ ]' of the claimant's inadequate consideration; no other Loss will do."[19]

In *Northrop Grumman*, the court therefore held that the bump-up exclusion did not preclude coverage for a claim under section 14(a) of the Securities Exchange Act because the section 14(a) claim was not only about "inadequate consideration"; it also alleged that the dissemination of allegedly false proxy statements "induced [shareholders] to vote their shares" in a merger when they otherwise would not have.

Policyholders also should pay particular attention to the corporate transaction at issue. As the *Northrop Grumman* court explained, the bump-up exclusion there applied *only* to "an *acquisition* of all or substantially all of an entity's assets or ownership." Because the corporate transaction in *Northrop Grumman* was structured as a *merger*, and not an acquisition, the court found that the bump-up exclusion did not apply.[20]

Defense costs and difficult decisions. Under most D&O policy forms, the bump-up exclusion does not apply to the policyholder's defense costs. Although this is very helpful to the company and its directors and officers, it raises difficult decisions about when and how to resolve claims. An insurance company's refusal to settle a claim will continue defense costs expenditure and erode policy limits that otherwise could be used to pay for a settlement or judgment. At a minimum, the insurance company has a duty to settle claims reasonably and fairly, and that duty includes an obligation to act promptly. "By refusing to settle within the policy limits, an insurer risks being charged with bad faith on the premise that it has 'advanced its own interests by compromising those of its insured.'"[21]

Conclusion

Policyholder directors, officers, and corporations should be prepared for a few bumps in the night. 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 directors and officers for alleged wrongful acts covered by D&O liability insurance policies. Because a SPAC transaction involves the purchase of a target company, companies and their directors and officers involved in such transactions should be prepared to resist any coverage

denials based on the bump-up exclusion or other improper coverage-avoidance exclusions popular in D&O insurance company claims departments.

William G. Passannante and Raymond A. Mascia Jr. are with Anderson Kill.

[1] William G. Passannante is cochair of Anderson Kill's Insurance Recovery Group and is a nationally recognized authority on policyholder insurance recovery in D&O, E&O, asbestos, environmental, property, food-borne illness, and other insurance disputes, with an emphasis on insurance recovery for corporate policyholders and educational and governmental institutions. He is a Fellow of the American Bar Foundation, a member of the Association of the Bar of the City of New York, and a member of the National Association of Corporate Directors.

Raymond A. Mascia Jr. is a shareholder in Anderson Kill's New York office and a member of the firm's Insurance Recovery Group. Ray represents corporate and governmental policyholders in all types of insurance recovery matters, including matters involving D&O coverage, professional liability coverage, general liability coverage, environmental and asbestos claims, commercial crime insurance, and first-party property and business interruption losses arising from natural disasters and other perils. He is a member of the Insurance Law Committee of the New York City Bar Association

[2] SEC, What You Need to Know About SPACS—Updated Investor Bulletin (May 25, 2021).

[3] SEC, Reverse Mergers (June 9, 2011).

[4] Kristi Marvin, "SPACs & Falling Interest Rates . . . What to Anticipate Going Forward," *SPACInsider*, Aug. 7, 2019.

[5] SEC, Celebrity Involvement with SPACs—Investor Alert (Mar. 10, 2021).

[6] SEC, What You Need to Know About SPACS—Updated Investor Bulletin (May 25, 2021).

[7] John Coates, Acting Director, Division of Corporation Finance, SEC, SPACs, IPOs and Liability Risk under the Securities Laws (Apr. 8, 2021).

[8] Coates, SPACs, IPOs and Liability Risk under the Securities Laws.

[9] Coates, SPACs, IPOs and Liability Risk under the Securities Laws.

[10] "Robbins Geller Rudman & Dowd LLP Launches SPAC Task Force," *Business Wire*, Apr. 12, 2021.

[11] Securities Class Action Clearinghouse, Current Topics in Securities Class Action Filings.

[12] *Northrop Grumman Innovation Sys., Inc. v. Zurich Am. Ins. Co.*, No. CV N18C-09-210, 2021 Del. Super. LEXIS 92, at *19 (Del. Super. Ct. Feb. 2, 2021).

[13] *See Gardner Denver, Inc. v. Arch Ins. Co.*, No. CIV.A. 16-0159, 2016 U.S. Dist. LEXIS 174026 (E.D. Pa. Dec. 16, 2016).

[14] *Gardner Denver*, 2016 U.S. Dist. LEXIS 174026, at *5–7.

[15] *Gardner Denver*, 2016 U.S. Dist. LEXIS 174026, at *7.

[16] *Gardner Denver*, 2016 U.S. Dist. LEXIS 174026, at *7.

[17] *See, e.g.*, *Northrop Grumman Innovation Systems*, 2021 Del. Super. LEXIS 92, at *19 ("[T]he provision says an otherwise-covered Loss—*e.g.*, a settlement—suddenly loses coverage if the Insurers conclude it falls into this carve-out [the bump-up exclusion]. As a result, a reasonable insured—and really any reasonable person—would think 'bump up' Loss is excluded from coverage.").

[18] *Northrop Grumman Innovation Systems*, 2021 Del. Super. LEXIS 92, at *20 (emphasis added).

[19] *Northrop Grumman Innovation Systems*, 2021 Del. Super. LEXIS 92, at *20 (emphasis added).

[20] *Northrop Grumman Innovation Systems*, 2021 Del. Super. LEXIS 92, at *21 (emphasis added).

[21] *Pavia v. State Farm Mut. Auto. Ins. Co.*, 82 N.Y.2d 445, 452 (1993).

Endnotes

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