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Locke Lord QuickStudy: SPACs and the Implications for D&O ?Insurance

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Special Purpose Acquisition Companies or "SPACs" have emerged as a significant part of the ?financial and transactional markets. A SPAC is a company with no commercial operations, formed ?strictly for the purpose of publicly raising capital to acquire an unidentified private company (called ?the target company), through a process that has similarities to an IPO and results in a publicly-held ?operating company. The SEC defines a SPAC as a "blank check company" that "is created ?specifically to pool funds in order to finance a merger or acquisition opportunity within a set ?timeframe" [Blank Check Company | Investor.gov]. The merger or acquisition opportunity is called a de-SPAC transaction (or in the recent ?words of SEC Chair Gary Gensler, a "SPAC target IPO"), and it typically must take place within two ?years after the initial public offering or the SPAC is required to liquidate. The growth in popularity of ?SPACs suggests that this is an important alternate way to go public. SPACs, though, present unique ?risks with potential increased exposure to liability at each stage of the SPAC/de-SPAC process. This ?in turn has implications for directors and officers ("D&O") insurance, including the prospect of ?increased demand, tightening markets and rising costs for this insurance. This article examines the ?effect of the rise in SPAC popularity on the D&O insurance market.?

The 2020 SPAC boom

The year 2020 was dubbed "the year of the SPAC," with exponential growth in the number of SPAC ?IPOs from previous years. From July through December 2020, there was more than one new SPAC ?IPO per day [2020 Has Been the Year of SPAC IPOs: Here Are the Prominent 4 | Nasdaq]. In total, there were 238 SPAC IPOs that raised a total of $86 billion, accounting for 46% ?of total IPO proceeds and 55% of all IPOs in 2020.[1]

SPAC popularity continued into 2021 with 954 SPAC IPOs in the U.S., surpassing the number of ?SPACs in 2020 [SPAC Analytics]. The growth of SPAC IPOs was somewhat suppressed by new SEC scrutiny and the ?Acting Director of the Division of Corporation Finance's April 8, 2021 statement regarding the liability ?that can attach to the disclosures required for a de-SPAC transaction, but SPAC IPOs have ?continued and there are numerous SPACs out there in search of de-SPAC transactions.?

Risks associated with SPACs

As the SEC highlighted in recent enforcement actions, there are several events associated with the ?formation of a

SPAC and with a subsequent de-SPAC transaction that can lead to unwanted ?litigation and potential liability for SPACs, their sponsors, target companies, and the directors and ?officers of each. This has been underscored by the number of private securities antifraud and ?corporate breach of fiduciary duty cases that have been filed against the parties involved in SPAC ?and de-SPAC transactions. SPAC litigation also could involve aiding and abetting claims against a ?number of the parties involved in the challenged transaction.?

The risks of liability associated with SPACs can arise from the adequacy of disclosure in the original ?SPAC offering, breakdowns in negotiations between the SPAC and its target company, shareholder ?attempts to prevent or undermine the transaction, failure to comply with the SEC disclosure ?requirements in seeking approval of the de-SPAC transaction, and subsequent disclosure failures of ?the newly created public company. SPACs, by their nature, can be replete with conflicts of interest ?and the SEC requires all conflicts to be adequately disclosed to potential investors and current ?shareholders [SPAC IPOs plunged 87% during Q2 amid tougher SEC scrutiny | CFO Dive]. In addition, these conflicts of interest and judgments made during the transaction ?process can lead to breach of fiduciary duty claims.?

Recent Enforcement Actions and Litigation

There have been a number of enforcement actions and private securities and derivative actions ?involving SPACS and de-SPAC transactions. The following are some recent examples, with an ?emphasis on the potential liability associated with de-SPAC transactions.?

On July 13, 2021, the SEC brought regulatory charges against the SPAC Stable Road Acquisition ?Company, its sponsor, its CEO, the proposed merger target Momentus, Inc., and the target's founder ?and former CEO for misleading claims about Momentus' water-based propulsion technology and for ?the failure of the SPAC to conduct adequate diligence [SEC Charges SPAC, Sponsor, Merger, Target and CEOs for Misleading Disclosures Ahead of Proposed Business Combination | SEC.gov]. In its disclosures, Momentus claimed that it ?had successfully tested its technology in space when, in actuality, the space test failed its primary ?objectives? [SPAC Action Met With Litigation and Regulatory Reaction | Law.com].

On July 29, 2021, the DOJ brought criminal charges against Trevor Milton, the founder and former ?CEO of Nikola, a SPAC target, for allegedly defrauding investors by making false statements about ?the early success of Nikola's semi-truck prototype, primarily through traditional and social media ?platforms [SPAC Action Met With Litigation and Regulatory Reaction | Law.com]. On December 21, 2021, Nikola settled the fraud charges brought against it by the SEC for ??$125 million [Nikola Corporation to Pay $125 Million to Resolve Fraud Charges | SEC.gov].

In addition to regulatory actions, SPAC-related litigation has increased since 2020. The Stanford ?Law School Securities Class Action Clearinghouse keeps an updated record of all SPAC-related ?securities claims.[2] For example, Hyzon Motors and two of its former officers were the subject of a ?securities class action lawsuit filed on September 30, 2021, arising out of Hyzon's July 2021 de-?SPAC transaction.[3] The complaint alleges that Hyzon issued materially false and misleading ?statements in connection with its de-SPAC transaction by misrepresenting its customer contracts, ?deals and partnerships, and falsely claiming it could deliver certain vehicles to the market in 2021. ?The Hyzon litigation is just one of forty-two ongoing class actions arising out of SPAC transactions. [Securities Class Action Clearinghouse | Stanford Law School].

Other SPAC-related lawsuits have sought high-stakes, precedential rulings that “could alter the legal ?landscape in which SPACs operate” [SPAC Action Met With Litigation and Regulatory Reaction | Law.com]. In March 2021, after the publicly traded corporation Multiplan ?Corp. was attacked by a short seller, shareholders of the SPAC Churchill Capital Corp III that ?acquired MultiPlan brought a lawsuit in the Delaware Court of Chancery alleging breach of fiduciary ?duty against the board and sponsor, arguing that the de-SPAC transaction was both rife with ?conflicts of interest and “grossly mispriced.[4] Plaintiffs and commentators alike are currently awaiting ?a highly-anticipated ruling on the defendants’ motion to dismiss, in which they argue that the ?plaintiffs’ claims are derivative and should be dismissed for failure to properly make a demand, and ?that the entire fairness standard should not apply [SPAC Action Met With Litigation and Regulatory Reaction | Law.com]. A ruling in this case could have a substantial ?effect on de-SPAC transactions and related litigation.?

Most recently, on December 10, 2021, shareholders of Paysafe Limited, a digital payments company, ?filed a securities class action lawsuit on behalf of investors who purchased shares of Paysafe or the ?SPAC Foley Trasimene Acquisition Corp II that merged with Paysafe. They allege that Paysafe and ?the SPAC failed to make numerous disclosures surrounding their de-SPAC transaction. More ?specifically, the complaint alleges that, in violation of the antifraud provisions of the federal securities ?law, there were significant adverse developments in Paysafe’s business that were not disclosed to ?shareholders and investors as required by the antifraud provisions of the federal securities laws [Post-SPAC-Merger Fintech Company Hit with Securities Suit | The D&O Diary]. This ?recent lawsuit demonstrates that de-SPAC related litigation is alive and thriving, and can be ?anticipated to increase in 2022.?

Implications for D&O insurance

The explosion of SPAC IPOs and de-SPAC transactions and resulting litigation has increased the ?demand for D&O insurance. The exponential increase in the number of SPACs in 2020 and beyond ?created a backlog of SPACs ?waiting in line for insurance from insurers who faced pressure to meet ?the demand. This left some SPACs exposed to being uninsured or underinsured until a policy was ?obtained? [Top D&O Insurance Considerations for SPACs and SPAC Targets | JD Supra].

Increased litigation involving SPACs has also played a role in the coverage and cost of D&O ?insurance. ?Because the litigation risks associated with SPACs have proven to be higher than ?previously expected, D&O insurers may no longer be willing to insure the same risks at the same ?price as before. ?Also, there are not that many insurers currently in the market who are willing to write ??D&O coverage for SPACs. Because of this, the price of D&O ?insurance has nearly doubled since ??2020. D&O insurers have typically reduced their maximum exposure ?limits from $10 million to $5 ?million, while continuing to charge similar premiums. In the first ?quarter of 2021, SPACs found the ?premium for a $5 million primary D&O policy to be at ?least $1 million. This reduced coverage and ?increased cost, as noted above, leads to the problem of uninsured or underinsured SPACs, which ?ultimately leaves ?management of the SPAC and post-transaction entity at risk of being inadequately ?protected from exposure to liability. ?

The complexity of SPAC transactions also has created a need to better understand the intricacies of ?D&O insurance coverage. These include adequate insurance for the SPAC itself, particularly in ?connection with its capital-raising and acquisition activities, for the target company in de-SPAC ?transaction, and for the ongoing public entity. Also important is a need for a heightened ?understanding of tail coverage and limitations on typical exclusions. As a result, advice from ?competent experts, including experienced counsel and insurance professionals, is more important ?than ever.?

For more information on the matters discussed in this Locke Lord QuickStudy, please contact the ?authors or your regular Locke Lord contact.?

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[1] https://blog.auditanalytics.com/spac-popularity-continues-to-grow; https://caia.org/blog/2021/06/02/will-the-2020-spac-ipos-boom-?continue. ?

[2] *See* https://securities.stanford.edu/current-trends.html. ?

[3] *See* https://www.dandodiary.com/2021/10/articles/securities-litigation/fuel-cell-vehicle-company-hit-with-spac-related-securities-suit-?following-short-seller-report/. ?

[4] *See In re MultiPlan S'holders Litigation Consol.,* C.A. No. 2021-0300-LWW (Del. Ch. 2021).?

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